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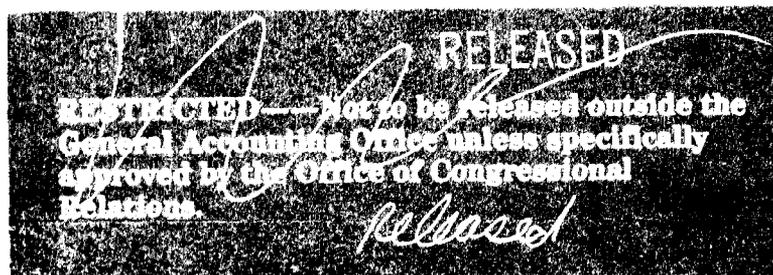
United States General Accounting Office

Report to the Chairman, Committee on  
Governmental Affairs, U.S. Senate

March 1991

# CONTRACT PRICING

## Competitive Subcontract Price Estimates Often Overstated



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United States  
General Accounting Office  
Washington, D.C. 20548

National Security and  
International Affairs Division

B-242507

March 20, 1991

The Honorable John Glenn  
Chairman, Committee on Governmental Affairs  
United States Senate

Dear Mr. Chairman:

This is one in a series of reports being issued in response to your request that we evaluate the adequacy of controls for preventing fraud, waste, and mismanagement in Department of Defense (DOD) subcontracts. This report discusses our review of subcontract costs negotiated in four DOD contracts awarded to the Marine Division of Westinghouse Electric Corporation. Our objective was to determine whether competitive subcontract estimates proposed by Westinghouse and negotiated in the contracts were fair and reasonable. We also reviewed prior GAO audits and those of other audit agencies to determine the extent to which competitive subcontract problems had been identified.

## Results in Brief

The four DOD contracts we reviewed were overpriced by about \$8.9 million because the estimates Westinghouse proposed for 66 subcontracts were not accurate or reliable. According to the contractor, the subcontract estimates included in its proposals were based on competitive vendor quotations. However, we found Westinghouse had not used the quotations to award the subcontracts. Rather, the contractor had solicited and obtained significantly lower prices in awarding its subcontracts.

Contracting officers, unaware of the contractor's practice of soliciting and obtaining lower prices in awarding the subcontracts, accepted the estimates included in the contractor's proposals.

Our work, and that of the Air Force Audit Agency and the DOD Inspector General, has shown that in many cases the government is not realizing the benefits to be gained through competition because prices actually obtained by prime contractors are lower than the competitive subcontractor prices included in contractor proposals. One set of competitive prices are used to support prime contractors' proposals to the government. Subsequently, prime contractors solicit prices from the original or new vendors and often obtain prices lower than those submitted to the government and used to negotiate prime contract prices. As a result, the prime contracts are excessively priced by millions of dollars. The

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remedy for this practice is knowledge—knowledge of what the prime contractor actually pays, not what is quoted.

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## Background

Subcontract costs are significant elements to be considered during the negotiation of DOD prime contracts—comprising over 50 percent of some prime contracts' values. Often, DOD and its prime contractors agree to contract prices before prime contractors and their subcontractors agree to subcontract prices. Accordingly, negotiated prime contract prices often contain estimates of what the subcontract prices may likely be—not the prices of the actual subcontracts.

Prime contractors are responsible for negotiating subcontract prices. DOD contracting officers, however, must be satisfied that the subcontract estimates proposed and negotiated in prime contract prices are fair and reasonable. The extent to which such estimates exceed a reasonable approximation of the ultimate cost of contract performance may give rise to unjustified gains or enrichments at the expense of the government.

There are several statutory and regulatory requirements, such as the Truth in Negotiations Act (P.L. 87-653) and the Defense Federal Acquisition Regulation Supplement, that govern the pricing of subcontracts. Prime contractors are required to obtain, in certain circumstances, cost or pricing data supporting subcontractor proposals, to evaluate the data, and to provide the evaluation results as part of their contract proposals. Such requirements, however, do not apply to subcontracts awarded on the basis of adequate price competition because competition is presumed to produce fair and reasonable prices. The expectation inherent in competition is that market forces will provide a fair and reasonable price for the buyer.

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## Competitive Subcontract Prices Overstated on Four DOD Contracts

The proposed prices of 66 subcontract estimates in the four prime contracts we reviewed were listed in the contractor's proposals as having been based on competitive bidding. Because the subcontracts were identified in the proposals as competitive, DOD contracting officers accepted the proposed prices as fair and reasonable and negotiated the proposed amounts in three of the four prime contracts. On the fourth contract, the DOD contracting officer reduced the proposed subcontract estimates by 5 percent as part of an overall reduction in total material prices.

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According to the contracting officers' price negotiation memorandums, about \$44 million was included in the four prime contracts for the 66 subcontracts. However, we found that Westinghouse, after soliciting subcontract prices to support its proposals to the government, had resolicited prices to award the subcontracts. Westinghouse's practice allowed the company to obtain subcontract prices that were substantially lower than what it had proposed to the government and included in the prime contracts.

Specifically, we found that Westinghouse had obtained prices on 55 subcontracts that were \$10.4 million lower than what was proposed and included in the prime contracts. Westinghouse awarded 10 subcontracts at prices that were about \$1.5 million more than what was proposed and negotiated in the prime contracts. One subcontract was awarded at the price proposed by Westinghouse.

The following examples show the differences between the subcontract prices Westinghouse proposed on the four contracts we reviewed and the prices Westinghouse paid its subcontractors. The identity of the subcontractors and the items being purchased are not disclosed because of the proprietary nature of this information. However, we have disclosed the actual proposed and negotiated prices.

On one contract, Westinghouse proposed \$417,792 for a part based on a subcontractor's proposal of \$68 a unit for 6,144 units. According to the DOD contracting officer's negotiation records, the proposed amount had been included in the contract without reduction because it was identified in Westinghouse's proposal as based on competitive bidding.

After soliciting subcontract prices to support its proposal to DOD, Westinghouse solicited prices for the part from five subcontractors, including the subcontractor that had proposed \$68 a unit. After receiving unit price quotations from all five subcontractors, Westinghouse purchased the part from the low bidder for \$40,366 (6,144 units at \$6.57 a unit), or \$377,426 less than the price that had been proposed. Including its overhead and profit, the company realized a windfall of \$494,286.

On another contract, Westinghouse proposed \$120,384 for a part based on a subcontractor's proposal of \$1,368 a unit for 88 units. The DOD contracting officer's negotiation record shows that the proposed price had been included in the contract without reduction because it was identified in Westinghouse's proposal as having been based on competitive bidding.

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After soliciting subcontract prices to support its proposal to DOD, Westinghouse solicited prices from five subcontractors and purchased the part from the low bidder for \$84,128 (88 units at \$956), or \$36,256 less than the price that had been proposed and included in the contract. Including its overhead and profit, the company realized a windfall of \$44,733.

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## Comments From Contracting Officers and Westinghouse Officials

DOD contracting officers told us they had accepted Westinghouse's proposed prices in these cases as fair and reasonable because Westinghouse said that these prices were based on competitive bidding. Contracting officers said they were not aware that Westinghouse had solicited different prices in awarding its subcontracts.

Westinghouse officials told us they had not informed the contracting officers of their intention to obtain additional subcontract prices because they assumed the contracting officers realized the proposed prices were subject to change. Westinghouse officials also said that, because the contracts included incentives for cost reductions, the government would share in any cost savings. Finally, Westinghouse officials said they planned to continue this method of estimating subcontract costs.

We believe Westinghouse's argument that DOD will share in the lower subcontract prices is flawed. Had the DOD contracting officers been aware that the estimates included in the company's proposals did not represent the likely cost of buying the materials, they could have taken action during the negotiations to protect the government from inflated subcontract estimates. Had the system worked and the contracting officers taken protective actions, DOD should have realized virtually all the savings—not just a share. Furthermore, although the contracts we reviewed were incentive-type contracts, DOD will not necessarily share in the lower subcontract prices if the company incurs higher costs for other contract cost elements, such as labor and overhead.

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## Other Audits Identified Similar Problems

Other defense contractors also have a practice of proposing competitive subcontract prices and subsequently obtaining substantial price reductions. Our work and audits performed by the DOD Office of the Inspector General and the Air Force Audit Agency show that this practice has resulted in the overpricing of DOD contracts.

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## Our Reviews

In October 1985, we testified before the Legislation and National Security Subcommittee, House Committee on Government Operations, that two contractors had purchased subcontracted items at prices substantially below the estimates proposed and negotiated in DOD prime contracts. The contractors' proposals indicated that the subcontract estimates had been based on competitive bidding. For example, one contractor included six subcontract estimates totaling \$23.6 million in its contract proposal and identified the estimates as based on competitive bidding. However, the contractor had received only one price quotation for each subcontract estimate. After negotiations with DOD, the contractor purchased the six subcontracted items for about \$19.9 million, or about \$3.7 million less than the amount negotiated in the prime contract.

More recently, we found that contractors had proposed prices for 13 subcontracts that they presented as based on competitive bidding but subsequently negotiated prices that were about \$3 million less.<sup>1</sup> About \$2 million pertained to a dual-source subcontract procurement in which the contractor had obtained pricing concessions from both the high and low bidders after agreeing to a price with DOD.

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## Air Force Audit Agency Report

In September 1986, the Air Force Audit Agency reported that, among other things, "contractors are able to realize additional profit on competitive subcontracts."<sup>2</sup> The Air Force Audit Agency found that two contractors had a policy of negotiating with subcontractors after the subcontractors' competitive prices had been used to develop the prime contractor proposals and to negotiate Air Force contracts. According to the audit report:

"Current procurement policy does not require the Air Force to use pricing techniques to review competitive [subcontract] procurements because competition is expected to produce a fair and reasonable price. However, this policy does not prevent the contractor from negotiating with the lowest competitive bidder after negotiation with the Air Force. Consequently, the procurement is not based on strict competition (accepting the lowest bidder's price as the price of the purchase order). Air Force pricing guidance does not address this competitive procurement method used by the contractors and AFPRO [Air Force Plant Representative Office] pricing personnel at the two locations were not aware of the contractor practices."

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<sup>1</sup>Contract Pricing: Inadequate Subcontract Evaluations Often Lead to Higher Government Costs (GAO/NSIAD-91-161).

<sup>2</sup>Administration of Subcontract Material Decrement Factors and Subcontract Change Orders Within the Air Force Systems Command (Air Force Audit Agency, Project 5036411, Sept. 5, 1986).

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Air Force Headquarters, in commenting on that audit report, stated:

"It is not reasonable for the government to base the price of the prime contract in part on a competitive subcontract quote when it is known that the prime contractor routinely negotiates reductions from vendors' competitive quotes."

Subsequently, Air Force Headquarters issued policy guidance noting that contractors were responsible for maintaining and furnishing decrement information as support for material prices.<sup>3</sup>

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## DOD Inspector General Report

In April 1990, the DOD Inspector General reported that 15 prime contractors had a practice of reducing competitively proposed subcontract prices after negotiating DOD contracts.<sup>4</sup> According to the Inspector General, prime contractors obtained lower subcontract prices by (1) asking subcontractors for best and final offers; (2) negotiating with them; (3) selecting new, lower-priced vendors; or (4) increasing quantities to achieve lower unit prices.

According to the Inspector General, DOD contracting officers were unaware of the contractors' practices and had accepted proposed subcontract estimates when negotiating contracts with 10 of the 15 contractors the Inspector General reviewed. DOD contracting officers had reduced proposed competitive subcontract estimates when negotiating contracts with the other five contractors.

The Inspector General recommended that DOD emphasize to contracting officers the need to reduce competitive subcontract proposed prices when the contractor had a history of negotiating reduced prices with its subcontractors. DOD did not agree with the Inspector General's recommendations because the contracts reviewed by the Inspector General preceded regulatory changes and policy memorandums issued to deal with the subcontracting problems identified in the Inspector General report.

The Inspector General also recommended that Defense Contract Audit Agency (DCAA) audit reports address contractors' practices of negotiating with competitive subcontractors. DCAA agreed to implement the

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<sup>3</sup>A "decrement" is an estimated percentage price reduction that reflects the historical difference between vendors' proposed prices and the actual prices negotiated by the contractor.

<sup>4</sup>Evaluation of Subcontract Price Proposals (DOD Office of the Inspector General, No. 90-057, Apr. 9, 1990).

recommendation and issued guidance in September 1990 requiring its auditors to explain in audit reports whether decrement information was related to “competitive and/or noncompetitive (subcontract) quotes.”

## Recommendation

We recommend that the Secretary of Defense ensure that contracting officers determine whether contractors have a practice of providing competitive subcontractor prices for the purpose of negotiating the prime contract and subsequently obtaining lower prices for the purpose of buying the material. Where this practice exists, contracting officers should be required to obtain historical data on purchases from vendors. When that information shows substantially lower subcontract prices than what were proposed, contracting officers should take appropriate actions to negotiate reductions to proposed prices.

## Scope and Methodology

On the basis of the results of prior work at Westinghouse Marine Division,<sup>5</sup> we reviewed 66 subcontract estimates included in four Westinghouse Marine Division proposals. The proposals were used in negotiating four contracts for Peacekeeper missile canisters and tactical hardware for Trident missile launchers. Table 1 contains information on the four contracts.

**Table 1: Information on the Four Westinghouse Contracts GAO Reviewed**

Dollars in millions			
Contract number	Award date	Amount	DOD contracting activity
F04704-85-C-0067	11/22/85	\$120.5	Air Force Ballistic Missile Office
F04704-85-C-0067 (Modification P00014)	01/07/87	76.0	Air Force Ballistic Missile Office
N00030-86-C-0040	09/12/86	89.0	Navy Strategic Systems Program Office
N00030-87-C-0083	07/21/87	72.1	Navy Strategic Systems Program Office

The samples of material items included in our prior work included 116 subcontracts designated by Westinghouse Marine Division as competitive and proposed to the government for about \$58 million. For this review, we selected 66 of these subcontracts, accounting for about

<sup>5</sup>Contract Pricing: Material Prices Overstated on Peacekeeper Missile Canister Contracts (GAO/NSIAD-89-37, Jan. 19, 1989) and Contract Pricing: Material Prices Overstated on Trident II Missile Launcher (GAO/NSIAD-90-35, Jan. 19, 1990).

\$44 million of the \$58 million, because the quantities proposed and purchased were comparable.

We analyzed contract file documents, negotiation records, purchase order files, and related pricing data and compared proposed subcontract prices to actual prices. We also interviewed contractor representatives and government officials responsible for procurement, contract administration, and contract auditing.

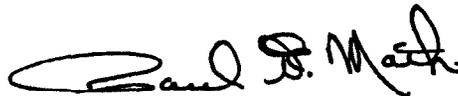
We also reviewed the results of prior GAO reviews and audits performed by the Air Force Audit Agency and the DOD Inspector General.

We performed our review from June 1990 to February 1991 in accordance with generally accepted government auditing standards. As agreed, we did not obtain agency comments on this report. However, we discussed our findings with DOD officials and contractor representatives and have incorporated their comments where appropriate.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time we will send copies to the Secretary of Defense; the Directors of the Defense Logistics Agency and DCAA; the Director, Office of Management and Budget; and other interested congressional committees. Copies will also be made available to others upon request.

Please contact me at (202) 275-8400 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix I.

Sincerely yours,



Paul F. Math  
Director, Research, Development, Acquisition,  
and Procurement Issues



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# Major Contributors to This Report

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