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DECISION | **THE COMPTROLLER GENERAL OF THE UNITED STATES**
WASHINGTON, D.C. 20548

FILE: B-209658 **DATE:** June 15, 1983

MATTER OF: Varian Associates, Inc.

DIGEST:

1. When contracting agency changes request for proposals from one for fixed-price contract to one for cost-type contract, it also should amend evaluation factors to notify offerors that it will assess cost realism and may adjust proposed costs accordingly.

2. When, during discussions, contracting agency encourages offeror to reduce proposed costs in certain areas, but offeror makes greater reductions than anticipated by agency, as well as others that were not discussed, GAO cannot conclude that discussions were inadequate.

3. When offeror changes best and final offer in areas that have not been discussed, contracting agency may--but is not required to--reopen discussions and provide offeror with opportunity to explain changes. When request for best and finals specifically states that any technical or price revisions must be fully documented, decision not to reopen is reasonable.

4. GAO review of cost realism assessments is limited to determination of whether agency's evaluation is reasonably based and not arbitrary, capricious, or in violation of procurement regulations. Extent to which agency examines proposed costs is generally a matter of discretion.

5. Even when offeror has previously been rated as superior in technical approach and organization, unsupported cost reductions in best and final may lead contracting agency reasonably to conclude that risk has increased that offeror will not be able to perform at proposed cost.

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Varian Associates, Inc. protests the award of two contracts for engineering development of third generation image intensifier tubes for use in a night vision system. The Army awarded cost-plus-fixed-fee contracts to International Telephone and Telegraph (ITT) and Litton Industries after determining that Varian, the highest technically-rated offeror, had proposed costs that were unrealistically low. We deny the protest.

Background:

The Army's Mobility Equipment Research and Development Command, Fort Belvoir, Virginia, issued request for proposals No. DAAK 70-81-R-1197 on September 8, 1981. It contained five line items covering a total of 175 units (tubes and assemblies meeting different specifications and with different delivery dates) and associated data.

The solicitation stated that while the Army anticipated awarding a firm fixed-price contract, proposals for other contractual arrangements would be considered. Of the offerors submitting proposals on November 9, 1981, three including Varian proposed firm fixed prices; a fourth, however, submitted a cost-plus-fixed-fee proposal. After reassessing the risks associated with performance, the Army on July 30, 1982, issued an amendment requesting all offerors to submit revised proposals for cost-plus-fixed-fee contracts.

Evaluation factors set forth in the original solicitation included (A) Technical Approach; (B) Organization, Personnel, and Facilities; and (C) Lowest Evaluated Cost to the Government. Technical approach was said to be as important as the other two factors combined, and cost was nearly twice as important as organization, personnel, and facilities. While three pages of extremely detailed subfactors followed (A) and (B), no subfactors were listed for (C). When the Army requested proposals for cost-type contracts, it did not change either the evaluation factors or their weights.

After submission of revised proposals on August 18, 1982, the Army held discussions with all offerors and requested best and finals by September 19, 1982. A three-member technical evaluation committee from the Night Vision and Electro Optics Laboratory evaluated these, using a scoring system in which technical approach was accorded a maximum of 52 points; organization, personnel, and facilities, 18 points; and cost, 30 points.

The record reveals that for technical approach, Varian scored 50.85, the highest of the four offerors; in addition, Varian received 13.75 points for the organization factor. However, Varian received only 7.5 points on its cost proposal. The technical evaluation committee compared the firm's initial fixed price proposal ($2,425,553), its revised cost-plus-fixed-fee proposal ($1,773,287), and its best and final ($1,470,143), and found the last unrealistically low. The committee independently estimated what Varian's costs were likely to be and, for evaluation purposes, increased Varian's proposed costs plus fixed fee to $2,100,000. As a result, although Varian had proposed the lowest costs of any offeror, its evaluated total was higher than that of either ITT ($1,897,166) or Litton ($1,918,900). Since Varian's overall point score also was lower than either of these firms, the Army awarded contracts to Varian's competitors in late October 1982.

Varian's Protest:

The major thrust of Varian's protest is that discussions were not adequate because the Army failed to advise Varian that its revised proposal for a cost-type contract was lower than the Government estimate and was considered only "marginally" acceptable. Varian asserts that during negotiations the Army "directly encouraged" it to reduce certain costs still further. Citing GTE-Sylvania, Inc., 57 Comp. Gen. 715 (1977), 77-2 CPD 422, Varian points out that in decisions approving undisclosed cost realism adjustments, our Office has assumed that "adequate cost and technical discussions have been previously conducted." Discussions in which the agency directly encourages an offeror to reduce its proposed costs to a level that the agency then assesses as unrealistically low, Varian contends, cannot be classified as "adequate." Consequently, Varian concludes that the Army's upward adjustment of its proposed costs was improper.

Varian supports its allegations with an internal handwritten memorandum, dated August 31, 1982, summarizing telephone conversations in which the Army contract specialist allegedly recommended that Varian reduce costs in three areas: its assumed labor escalation rate; its proposed fee; and its proposed engineering manhours for software. The last reduction, Varian states, was suggested because it had developed software in connection with another Army contract for night vision tubes that could be adapted for use on this contract.

These adjustments, Varian advised the Army in a letter submitted with its best and final offer, accounted for $136,658 of the amount by which its proposed costs had been reduced. An additional reduction of $156,737, Varian stated, was due to the fact that it had projected a yield rate[1] more than 30 percent higher than previously estimated for one line item, covering 60 "subspec" tubes, for which the Army had relaxed specifications in an amendment dated August 31, 1982.

The Army's Response:

The Army denies that it encouraged Varian to make any except minor reductions in proposed rates that were required by the Defense Contract Audit Agency; these, the contracting officer states, amounted to only $11,290. In addition, the Army states that Varian's projected increased yield rate for the subspec tubes was inconsistent with the level pricing scheme[2] that Varian previously had proposed. The Army argues that the change in Varian's best and final prevented identification or tracking of costs for any tubes.

Evaluators concluded that Varian's proposed labor hours, particularly for software, were unrealistically low and that its projected yield rate for subspec tubes

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[1]Yield rate reflects the number of tubes fully meeting specifications in relation to the number started. Thus, if only 40 full specification tubes are obtained from 100 starts, the yield rate is 40 percent.

[2]Varian calculated the total cost of labor and materials required to produce 175 tubes, then apportioned this amount among line items according to quantity, rather than quality. Thus, an item covering 20 tubes was priced at approximately twice as much as an item covering 10 tubes, regardless of differences in specifications and delivery dates. This method of pricing assumed an average yield for all line items, Varian advised the Army during discussions.

was unrealistically high. They estimated an overrun of approximately 50 percent and changed Varian's rating in the cost category to "poor." It also was argued that Varian's technical rating should be changed, since Varian had not addressed the production techniques that it planned to use to increase yield rates, and award to it therefore would involve an element of risk; this change, however, was not actually made.

GAO Analysis:

Anticipating a challenge to its use of cost realism as an undisclosed evaluation factor, the Army has argued at length that it actually was a subfactor "reasonably related to or encompassed by 'Lowest Evaluated Cost to the Government.'" We believe it would have been preferable for the Army to have amended the solicitation to state specifically that it would evaluate the reasonableness and realism of proposed costs and might adjust them accordingly. See, e.g., Bell Aerospace Company et al., 54 Comp. Gen. 352 (1974), 74-2 CPD 248; Pioneer Contract Services, Inc., B-197245, February 19, 1981, 81-1 CPD 107 at 35. As Varian concedes, however, once the Army sought proposals for a cost reimbursement contract, it was obliged to make a cost realism assessment, rather than simply accept proposed costs at face value. See generally Analytics Incorporated, 61 Comp. Gen. 560 (1982), 82-2 CPD 147 (setting forth an agency's duty to examine proposed costs); see also Defense Acquisition Regulation § 3-803(c) (Defense Acquisition Circular 76-40, November 26, 1982).

With regard to whether the Army's discussions with Varian were meaningful, the record is far from satisfactory, since the Army apparently posed all questions to offerors by telephone, and we therefore cannot tell how strongly it encouraged Varian to reduce costs. The record, however, confirms that evaluators believed Varian could reduce its costs by adapting existing software, and the Army acknowledges that it informed Varian that a 7.91 percent fee would be more appropriate than the 10.2 percent that it first proposed.

Nevertheless, we cannot conclude that Varian was induced during discussions to reduce its proposed costs to a level that the Army subsequently found unrealistic, or that the discussions were therefore inadequate. Rather, the amount of Varian's reductions in the areas discussed, combined with additional reductions due to the change in yield rate--which was not discussed--appear to have led to the Army's determination that Varian's proposed costs were unrealistically low. Compare Technology, Inc., 54 Comp. Gen. 681 (1975), 75-1 CPD 107, and Jerry Fairbanks Productions, B-181811, March 14, 1975, 75-1 CPD 154 (in which protesters alleged that agencies had encouraged them to increase proposed costs, then made award to lower offerors).

In software hours, for example, the Army states that it did not anticipate reductions of more than 100 hours. Varian, however, eliminated so many hours that its proposed costs were reduced by more than 50 percent, leading evaluators to conclude that it would be unable to complete even the three most essential of 15 contract data requirements.

As for Varian's reductions on the basis of an increase in yield rate for the subspec tubes, the record shows that although the rate Varian initially proposed was 10 percent higher than the Government estimate, evaluators believed it was supported by proposed labor and material costs. For this reason, the Army did not question Varian directly about its yield rate.

Once Varian changed the yield rate for subspec tubes and departed from its level pricing scheme, the Army could have--but was not required to--reopen discussions and provide Varian with an opportunity to explain the changes. See Electronic Communications, Inc., 55 Comp. Gen. 636 (1976), 76-1 CPD 15; Burns and Roe Tennessee, Inc.--Reconsideration, B-189462, August 3, 1979, 79-2 CPD 77. Varian's best and final, pointing out where the reductions had occurred and giving its bottom line prices, did not meet the requirement in the request for best and finals that any technical or price revisions be fully documented, and in our opinion the decision not to reopen was reasonable.

The remaining question is whether the Army's upward revision of Varian's proposed costs was proper. Our review of cost realism assessments is limited to a determination of whether an agency's evaluation was reasonably based and was not arbitrary, capricious, or in violation of the procurement regulations. Vinnell Corporation, B-203806, August 3, 1982, 82-2 CPD 101. Moreover, the extent to which an agency examines proposed costs is generally a matter of discretion. Support Systems Associates, Inc., B-200332, February 9, 1982, 82-1 CPD 112.

In this case, the Army could not have compared its own estimate for each line item with Varian's, since the former included different amounts for labor, materials, and other costs, reflecting varying specifications, while Varian's was based on level pricing. The Army did, however, compare total proposed costs, and found that while Varian's revised proposal for a cost-type contract had been only 4 percent lower than the Government estimate, its best and final was nearly 20 percent lower. On the other hand, ITT's and Litton's best and finals were 2.5 and 4.7 percent higher, respectively.

In addition, the Army compared Varian's three proposals with each other. Varian objects to this on grounds that a firm fixed-price contract involves different risks than a cost-type contract, and because more than 10 months elapsed between submission of the first and final proposals. We have held, however, that proposals for different types of contracts may be evaluated by comparison when they have been submitted by different offerors, Marine Management Systems, Inc., B-185860, September 14, 1976, 76-2 CPD 241 at 9, and we see no reason why proposals from the same offeror may not similarly be compared.

As for the impact of Varian's cost reductions on its rating in the categories covering technical approach and organization, even though these previously had been superior, we believe the Army reasonably could conclude that the changes in Varian's best and final increased the risk that Varian would not be able to perform at its proposed cost. See 50 Comp. Gen. 391 at 407 (1970).

We therefore find that the Army's cost realism analysis of Varian's best and final was reasonably based, and was neither arbitrary and capricious nor in violation of the procurement regulations. In addition, although large parts of the record have been deleted from the report provided to Varian, we have reviewed the Army's cost realism analysis of ITT's and Litton's proposals in terms of software hours, yield rates, and in relation to the Government estimate, and we conclude that it also was reasonable.

The protest is denied.

Milton J. Socolar

Acting Comptroller General
of the United States