



UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

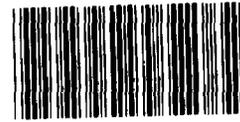
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PROCUREMENT AND SYSTEMS
ACQUISITION DIVISION

NOVEMBER 16, 1979

B-195254

The Honorable Harold Brown
The Secretary of Defense



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Attention: Assistant for Audit Reports
Room 3A336
ASD (Comptroller)

Dear Mr. Secretary:

Subject: Delays in Definitizing Letter
Contracts Can Be Costly to the
Government (PSAD-80-10)

In a review of the Army's and Navy's use of letter contracts, our objective was to determine whether such contracts were being definitized ^{1/} in a timely manner and the impact of any untimely definitizations. In definitizing letter contracts, the Army and Navy often exceeded the time limits set forth in Defense regulations. This sometimes compromised the Government's negotiating position and thus increased costs, particularly in the case of the Navy. Also, neither the Army nor the Navy exercised the unilateral de-termination clause.

SCOPE AND DEFINITION

We analyzed selected letter contract data at the Army Tank-Automotive Materiel Readiness Command, the Army Armament Materiel Readiness Command, the Naval Air Command, the Naval Sea Systems Command, and the Naval Material Command. We examined, in detail, procurement records for 87 of the 389 letter contracts awarded between July 1, 1973, and March 30, 1979, that had not been definitized within the time period set out in Defense regulations. We selected the Army and Navy for review because of the large increase in the number and dollar value of letter contracts awarded during fiscal years 1973 through 1977.

^{1/}To formalize a letter contract by setting forth all the terms and conditions of the agreement.

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Letter Report

We discussed our findings with procurement personnel of the five commands included in our review, and they agreed with them.

Letter contracts are the least desirable method of contracting for supplies and services and can be costly to the Government. Under a letter contract, the contractor has little incentive to control costs. Usually, the contractor has incurred some costs by the time negotiations begin, and delays in definitization allow the contractor to accumulate more actual costs. Since this gives the advantage in the negotiations to the contractor, timely definitization is necessary to assure that the Government obtains a fair and reasonable price.

FINDINGS

In many instances, the time the Army and Navy took to definitize letter contracts greatly exceeded that set forth in Defense regulations. When it takes an unduly long period to definitize such a contract, the cost risk tends to shift from the contractor to the Government, thus putting the Government in a poor negotiating position. For example, although the bulk of the costs had been incurred on certain Navy letter contracts prior to definitization, the Navy did not reflect this situation by negotiating lower profit rates commensurate with the decrease in cost risk. In other instances, the delays caused the Government to incur costs that the contractor would normally bear.

Since December 1968, the Naval Audit Service has periodically reported on delays in definitizing letter contracts. Navy management has concurred with the auditors' findings and promised corrective action, but the situation has not improved.

Although delays in definitizing letter contracts have been a continuing problem, neither the Army nor the Navy exercised the unilateral determination clause. This clause provides authority for the contracting officer to unilaterally set the price when agreement cannot be reached in the definitization negotiations. Judicious use of this clause can lessen the time period for definitizing letter contracts.

Procurement officials indicated several reasons for their reluctance to use the unilateral determination clause to establish contract prices when negotiations become stalemated. Some believe this might cause contractors to become much more difficult to negotiate with in the future,

especially in sole-source situations. In addition, Army Tank-Automotive Command officials believe that it was not feasible to make price determinations based on estimates or judgments. They also questioned (1) the feasibility, time, and cost of making and successfully litigating such actions and (2) the timeliness of a decision under the contract disputes procedures.

In our view, these arguments are presently based on conjecture. The arguments may be valid, but they need to be tested in some actual cases to determine if the benefits of taking such action outweigh the costs. For example, the possible long-term benefits of demonstrating the Government's willingness to use its unilateral determination authority when contractors continually delay negotiations may easily justify any cost and delay involved in litigating a few cases. Further, there is no assurance that such cases will automatically result in litigation or administrative appeal under the contract disputes clause.

Thus, we believe that this alternative should be used when a contractor continually delays the negotiation process. If used, contractors would be given to understand that delays in definitization will result in lower profits. This could result in improving the negotiation process and will lessen the time taken to definitize letter contracts.

RECOMMENDATIONS

We recommend that your office establish specific guidelines for contracting officers to use in determining when to unilaterally definitize letter contracts. As the regulations are now written, unilateral determination is left to the discretion of the contracting officer. We believe that the regulations should trigger such unilateral action when the contractor has incurred some specified percentage of the total estimated cost of the procurement.

In addition, whenever a significant amount has been incurred under cost reimbursement letter contract arrangements, the military departments should be required to recognize this in negotiating profit. We believe this would provide an incentive to definitize as soon as possible.

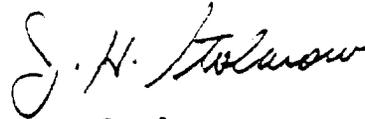
Further details on our review are included in the enclosure to this letter.

We would appreciate receiving your comments on these matters and would be pleased to discuss them with you or your representatives.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of this report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this letter to the Director, Office of Management and Budget, and the Secretaries of the Army and the Navy. We are also sending copies to the chairmen of the Senate Committees on Appropriations, Armed Services, and Governmental Affairs and the House Committees on Appropriations, Armed Services, and Government Operations.

Sincerely yours,



J. H. Stolarow
Director

Enclosure

DELAYS IN DEFINITIZING LETTER CONTRACTSDEFENSE REGULATIONS ON
USE OF LETTER CONTRACTS

A letter contract is a preliminary agreement authorizing the contractor to immediately begin manufacturing supplies or performing services. Department of Defense regulations provide two instances permitting a letter contract: (1) when the interests of national defense demand that the contractor be given a binding commitment so that work can be started immediately, and (2) when negotiation of a definitive contract in sufficient time to meet the procurement need is not possible.

Defense regulations also provide that letter contracts shall include an agreement as to the expected definitization date. This date shall be prior to (1) the expiration of 180 days from the date of the letter contract or (2) the completion of 40 percent of the production of the supplies or the performance of the work, whichever occurs first. These regulations state that a letter contract should be superseded by a definitive contract at the earliest practical date and not later than the scheduled definitization date. In extreme cases, an additional period may be authorized. If agreement cannot be reached in negotiations on a definitive contract, under letter contract provisions the contracting officer has authority to unilaterally determine a reasonable price or fee.

LETTER CONTRACT USAGE

In many instances, the Navy and Army have not definitized letter contracts on a timely basis. The Navy has frequently exceeded both the time and financial limits prior to definitizing letter contracts; the Army generally has exceeded only the time limitations.

Although failure to definitize letter contracts on a timely basis has been a continuing problem, we found no instances in which Navy or Army contracting officers made use of the unilateral determination clause to definitize contract prices.

Navy use of letter contracts

The Naval Air and Sea Systems Commands are the two largest purchasing organizations within the Naval Material Command, accounting for almost two-thirds of all Navy contract dollars for fiscal year 1978. Additionally, the Air and Sea Systems Commands awarded over 85 percent of the \$848 million in outstanding fiscal year 1978 Navy letter contracts. From fiscal years 1974 through 1978, they awarded 383 letter contracts.

In general, we found the Navy was not complying with Defense regulations requiring definitization of letter contracts within 180 days or 40 percent of completion. The extended period required to definitize letter contracts caused the following problems.

- The Navy paid for some costs which would normally have been the contractor's responsibility if the contract had been definitized initially as a fixed-price type contract instead of being issued as a letter contract.
- The Navy assumed much of the cost risk under cost reimbursement type letter contracts, while the contractor was allowed profit at a rate normally associated with fixed-price type contracts in which the risk is much greater.
- The Navy was often placed in a poor negotiating position because the contractor had substantially completed the contract in many cases. In addition, the Navy had not used alternative means to strengthen its position, such as setting a unilateral price or reducing the contractor's profit.

Of the 383 letter contracts issued by the Air and Sea Systems Commands from fiscal years 1974 to 1978, 291 (or 76 percent) were not definitized within the 180-day period specified in Defense regulations. The Air Command failed to definitize 81 percent of its 217 letter contracts during this period, and the Sea Command failed to definitize 69 percent of its 166 letter contracts. In 48 instances, contracts issued by the Air Command were not definitized until 360 or more days had elapsed, twice as long as specified by Defense regulations. Four of these contracts were not definitized for 667 to 884 days. The Sea Command was unable to definitize 33 letter contracts within 360 days, including five contracts which ran from 629 to 914 days. In both the Air and Sea Commands, the average length of time to definitize letter contracts during fiscal year 1978 was well in excess of the 180-day requirement--286 days in the Air Command and 242 in the Sea Command.

In addition to failing to definitize most contracts within the 180-day requirement, the Air and Sea Commands often did not definitize letter contracts within the 40-percent completion of work criteria. We obtained percentage of completion data for 18 letter contracts and found that the Air Command did not definitize 5 of 9 and the Sea Command 6 of 9 letter contracts within the 40-percent completion criteria. Performance of the work under one of the Air Command letter contracts was approximately 90-percent complete and another

was 74-percent complete at the time of definitization. In the Sea Command, one contract was nearly 90-percent complete and two others were 80-percent complete.

The Navy offered a variety of reasons for the long delays encountered in definitizing letter contracts. We found that frequently the delays resulted from contractors submitting new or revised proposals requiring additional audit work. The new proposals were sometimes caused by (1) changes in or lack of funding availability which changed the requirement or (2) unsupported or incomplete proposals initially submitted by the contractor. In some cases, the delays resulted from the contractor's and Navy's negotiators being too busy trying to definitize prior letter contracts.

Delays can increase costs
to the Government

Letter contracts, until definitized, operate like cost reimbursement type contracts under which the Government is responsible for essentially all costs the contractor incurs in performing the contract. This cost reimbursement aspect prevails even if a fixed-price type contract is contemplated upon definitization. In some cases this can result in additional cost to the Government, especially if definitization of the letter contract is delayed.

For example, on letter contract N00024-78-C-5156, such delay cost the Navy over \$60,000. This letter contract, awarded by the Sea Systems Command on March 20, 1978, was intended to be definitized as a firm fixed-price contract within 180 days but actually took 428 days. By this time, the contract was 80-percent complete and the contractor had already incurred approximately 75 percent of the contract cost, including over \$60,000 for increased testing that was not contemplated at the time the letter contract was awarded.

According to contract specifications, the contractor was required to X-ray a sample of rocket motors to detect voids in the propellant. The specification also required that if the sample from any batch of motors failed the X-ray test, all motors in the batch would be tested. The contractor proposed to test a sample of 18 motors to satisfy this requirement. According to the contract negotiator, the Navy paid for the testing because it was required for quality control. It was expected, however, that the contractor would bear the cost of any additional testing which resulted from failures found under sample testing.

Prior to definitization of the letter contract, but after the 180-day time limit had expired, the Navy Command determined that all 96 motors already produced would have to undergo

X-ray testing because of problems found in the test sample. The negotiator said the Navy was forced to pay over \$60,000 to complete the testing of the motors because the contractor was still operating under the letter contract. The negotiator said the contractor, not the Navy, would have borne these costs if the letter contract had been definitized before the test sample failed.

Cost risk shifted to Government

Another problem is the negotiation of high profit rates when the contractor has little cost risk. This can occur when a letter contract is not definitized for a lengthy period of time and the contractor incurs substantial amounts of cost for which the Government is liable.

Department of Defense policy is that contractors should bear an equitable share of contract cost risk and receive compensation for the assumption of that risk. The amount of compensation paid is calculated by determining the degree of risk assumed by the contractor--from a minimum under a cost-plus-fixed-fee contract to a maximum under a firm fixed-price contract. According to the Defense Manual for Contract Pricing, costs that have already been incurred on an unpriced action, such as a letter contract, have virtually no cost risk associated with them. Therefore, these incurred costs should be assigned a 0-percent weighting for cost risk.

The Naval Air and Sea Systems Commands did not always negotiate lower profit rates commensurate with the decrease in cost risk under letter contracts with substantial costs incurred prior to definitization. For example, the Sea Command negotiated an 11.3-percent profit on a letter contract which was over 90-percent complete when definitized 701 days after award. Although both the contractor and the Navy contributed to the long delay on this contract, we do not believe that the contractor deserved \$11.4 million in profit, including \$3.62 million based on cost risk, for a contract over 90-percent complete when definitized. According to the Defense guidelines, the Navy should have allowed the contractor substantially less for cost risk.

As shown below, the difference between what the Navy negotiated and the minimum which could have been negotiated is \$3.15 million (\$3.62 million - \$.468).

Cost Risk Calculation

<u>Allowed by Navy</u>	<u>Computed using Defense Manual guidelines</u>	
	<u>Cost incurred</u>	<u>Cost remaining</u>
\$100.60 million x <u>3.60%</u> weight	\$94.75 million x <u>0%</u> weight	\$5.85 million x <u>8.00%</u> (note a)
\$ <u>3.62</u> million	\$ <u>0</u>	\$ <u>.468</u> million

a/Assuming the maximum cost risk allowable on the remaining costs under a firm fixed-price contract.

Generally, the Government's negotiating position deteriorates the longer a contract remains undefinitized and the greater the cost incurred. For example, we found three cases in which the contractor refused to accept a reduced profit for assuming risk even though most of the contract cost had been incurred and reimbursed by the Government. In another case, the Navy claims it was unable to negotiate a fixed-price incentive contract because the contractor insisted on a firm fixed-price contract. In yet another case, the contractor refused to accept a downward-only cost sharing arrangement.

Navy officials agreed that their negotiating position is weak when letter contracts are not promptly definitized. These officials, however, have not taken action to strengthen their position. For example, even though the Sea Command responded to previous criticism by the Naval Audit Service in this area by agreeing to make unilateral price determinations when agreement could not be reached on a price or fee, we did not find any instance in which the Sea Command took such action. In fact, a Naval Material Command official stated he knew of no occasion in the last 20 years in which the Navy used its authority to unilaterally set the price on a letter contract when the contractor and Government could not agree. Air Command officials could only recall one instance in which they had used this provision.

Army use of letter contracts

For fiscal years 1973 through 1977, the Army Tank-Automotive Materiel Readiness Command (Tarcom) and Armament Materiel Readiness Command (Arrcom) awarded about 40 percent of the total fixed-price type letter contracts awarded by the Army, representing about 75 percent of the total dollar value of such contracts.

Generally, the two Army Commands did not comply with Defense regulations requiring definitization of letter contracts within 180 days. Yet, neither Tarcom nor Arrcom

contracting officials used the unilateral determination clause to expedite letter contract definitization. Although the Army Commands did not comply with the time criterion, only moderate amounts of costs were incurred at definitization and contract completion was well below 40 percent.

For the period of fiscal year 1974 through the third quarter of fiscal year 1979, Arrcom awarded 261 letter contracts. Over 65 percent of the letter contracts were definitized within 180 days, while 26 percent took longer than 180 days and 8 percent were open at June 30, 1979. The average number of days to definitize letter contracts was 160 days.

Over one-half of the letter contracts awarded by Tarcom during the 4-year period ended March 1979 were not definitized within 180 days. Delays in definitization were attributed to both the contractors and the Government. In reviewing larger dollar value letter contracts, however, we found that only a moderate amount of costs had been incurred at the time of definitization.

Tarcom awarded 60 letter contracts during the 4-year period. Of this total, 42 percent were definitized within 180 days. Fifty percent took over 180 days, and the remaining 8 percent were open at March 1979 (most of which were over 180 days old). The average number of days Tarcom took to definitize letter contracts was 235 days. For those over 180 days old, the average was 321 days. Ten letter contracts took over 400 days to definitize--from 401 to 489 days. The Government caused some delays by revising quantities, and contractors caused delays by such actions as submitting inadequate or late proposals. The primary reason for using letter contracts was to maintain continuity of production.

Although some letter contracts were in use for over 400 days, Tarcom did not exercise the unilateral determination clause to shorten the definitization process. Contracting officials indicated a reluctance to do so for fear of creating unworkable relationships with contractors. Tarcom officials said that even though the unilateral determination clause has not been used to definitize letter contracts, Tarcom has used the threat of unilateral action on several occasions to expedite negotiations.

In one instance, Tarcom threatened to unilaterally establish the price for a letter contract, and this threat may have expedited the definitization process. The letter contract was awarded April 8, 1974, and included a 90-day limitation for definitization. The contractor was scheduled to submit his price proposal in May 1974 but did not meet this date. Proposal submission was rescheduled for June 1974, and again the contractor failed to submit a price

proposal. This procedure was repeated each month until a proposal was finally received October 15, 1974. However, the proposal was incomplete because the contractor had not submitted backup data supporting costs or subcontractor evaluations. Subsequent requests for additional data resulted in the contractor's final proposal being received December 23, 1974.

Because the Army had to audit the proposal, negotiations were delayed until April 17, 1975. As reported by Tarcom contracting officials, the contractor remained adamant on many questionable cost areas, thus requiring extensive negotiation conferences. In an effort to definitize by June 30, daily negotiations were scheduled for the last 3 weeks. Only when Tarcom contracting officials threatened to unilaterally set the contract price did the contractor consent to an agreement which could be accepted by the Government. The letter contract was finally definitized July 8, 1975, 456 days after its award.

In a letter dated October 5, 1979, Tarcom officials said they believe that it was not feasible to make price determinations based on estimates or judgments. They also questioned (1) the feasibility, time, and cost of making and successfully litigating such actions and (2) the timeliness of a decision under the contract disputes procedures.

ARMY AND NAVY AUDITORS FIND
UNTIMELY DEFINITIZATION
A CONTINUING PROBLEM

Not definitizing letter contracts within 180 days has been an ongoing concern for the Army and Navy. Both Army and Navy internal auditors have reported that delays in definitizing letter contracts are a recurring problem. According to the auditors, since the contractor's risk is lessened when long delays occur, the profit rate should be lower. However, they found that contractors were receiving similar profit rates to those negotiated for definitive fixed-price contracts.

Although management promised corrective action on the Army and Navy auditors' findings, the long delays in definitizing letter contracts continue to be a problem and profit rates are not being lowered. (See discussion on pages 4 and 5.)

Since December 1968, the Naval Audit Service has periodically reported on delays in definitizing letter contracts. Although Navy management has concurred in the auditors' findings and has promised corrective action, the situation has not improved. As reported on page 2, for the 5-year period of

fiscal years 1974 through 1978, over 76 percent of the letter contracts awarded by the Naval Air and Sea Systems Commands were not definitized within the 180-day period.

In a July 1977 report, the Navy Audit Service recommended that the Sea Command take action to ensure that letter contracts are definitized in the 180-day period set out in Defense regulations. Further, it recommended that in cases when the Government and the contractor cannot definitize a letter contract after prolonged negotiations because of failure to reach a price or fee agreement, the Sea Command should exercise the unilateral determination clause.

Navy management promised to take action to ensure that letter contracts were definitized within the 180-day period and, when appropriate, to make a unilateral determination.

As shown on pages 1 to 5, the Navy has not corrected the problems. Letter contracts are still taking over 180 days to be definitized, and profits are not being lowered even though the contractors' risks are reduced. Also, the Sea Command has not made use of unilateral determinations although letter contracts have been delayed for as long as 914 days.

In its May 1979 report on contracting practices of the Army Troop Support and Aviation Materiel Readiness Command, the Army Audit Agency reported that once letter contracts were awarded, obtaining timely definitizations was a recurrent problem. On letter contracts with substantial costs incurred prior to definitization, the Army Audit Agency questioned whether the command was giving adequate consideration to the contractor's reduced risk when determining profit factors. Profit percentages allowed for letter contracts were usually similar to those negotiated for contracts priced before award.