

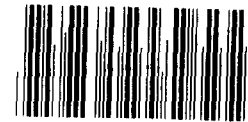
GAO

Report to the Honorable  
William V. Roth, Jr., Ranking Minority  
Member, Committee on Governmental  
Affairs, U.S. Senate

April 1987

# CONTRACT PRICING

## DOD's Use of Unpriced Contracts



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National Security and  
International Affairs Division

B-222888

April 30, 1987

The Honorable William V. Roth, Jr.  
Ranking Minority Member  
Committee on Governmental  
Affairs  
United States Senate

Dear Senator Roth:

On September 12, 1985, you asked us to review the Department of Defense's (DOD's) use of unpriced contracts. Accordingly, we initiated work at five contractor locations<sup>1</sup> with the primary objective of determining if contracting officers were properly using unpriced contracts and pricing them on time.

Unpriced contracts authorize contractors to start work and incur costs before final agreement on terms and conditions, including price. Properly used, unpriced contracts can be a useful tool to support urgent operational needs. However, because they are awarded without firm or final prices, such contracts are not a desirable form of contracting. They do not provide incentives to achieve cost controls since the contractor bears minimum cost risk and operates in a cost-plus mode until negotiations are complete.

This report summarizes the results of our work, including earlier recommendations to the Secretary of Defense, presents the value of unpriced contracts<sup>2</sup> as of September 30, 1986, and discusses actions to control unpriced contracts. Because of the numerous actions underway to control unpriced contracts and the large reduction in such contracts, we are not making further recommendations at this time.

## Information Previously Reported

On September 30, 1985, DOD's use of unpriced contracts was at its highest value ever—about \$28 billion. Many of those contracts remained undefinitized for long periods of time, and a substantial dollar

<sup>1</sup>The contractor locations are. General Electric Corporation, Aircraft Engine Business Group, Evendale, Ohio, McDonnell Douglas Corporation, St. Louis, Missouri; FMC Corporation, Ordnance Division Operations, San Jose, California; Texas Instruments, Defense Systems and Electronics Group, Dallas, Texas, and Westinghouse Electric Corporation, Defense Group, Defense and Electronics Systems Center, Baltimore, Maryland.

<sup>2</sup>The value of unpriced contracts generally refers to the not-to-exceed or ceiling prices on such contracts that are not firm or final prices

amount of unpriced contracts had not been definitized within the usual 180-day limit prescribed by DOD procurement regulations. At the five contractor locations, 45 percent of the value of unpriced contracts—about \$1.7 billion—had not been definitized a year or more after the contract had been placed. We provided this information to you in a letter dated December 20, 1985. We also pointed out that delays in pricing contracts (1) place the government in an unfavorable negotiating position, (2) shift cost risk from the contractor to the government, and (3) reduce contractor incentive to control cost.

On May 2, 1986, we reported<sup>3</sup> that DOD obligated 18 percent more than was subsequently needed to cover the definitized prices on 716 unpriced contracts we reviewed at the 5 contractor locations. Excess obligations on these contracts totaled \$136 million. The excess obligations resulted because DOD contracting officers used contractors' estimates as the basis for obligating funds to cover not-to-exceed and ceiling prices. The contracts were initially obligated at \$763 million and finally priced at \$627 million, resulting in the \$136 million in excess obligations. The period of time between initial obligation and final pricing was over 1 year in most cases.

This was a serious problem in view of the magnitude of unpriced contracts DOD-wide, and we recommended the Secretary of Defense (1) review existing unpriced contracts to deobligate excess funds and (2) implement controls on a DOD-wide basis to prevent excess obligations on future unpriced contracts. DOD concurred with our recommendations and initiated actions to address the problems.

## DOD and Congressional Actions to Control Unpriced Contracts

DOD has taken several actions to control the use of unpriced contracts. On November 7, 1985, for example, the Defense Council on Integrity and Management Improvement, which is chaired by the Deputy Secretary of Defense, directed reductions in the backlog of unpriced contracts by the end of fiscal year 1986. The Council directed that the Navy, Air Force, and Defense Logistics Agency (DLA) reduce their backlogs by 32 percent and that the Army reduce its backlog by 10 percent. The Navy, Air Force, and DLA achieved their directed reductions. The Army did not reduce its backlog. As of September 30, 1986, DOD's unpriced contracts totaled \$16.4 billion—an \$11.5 billion reduction from the end of the previous year as indicated in table 1.

<sup>3</sup>Obligations Exceed Definitized Prices on Unpriced Contracts (GAO/NSIAD-86-128, May 2, 1986)

**Table 1: DOD Unpriced Contracts**

Dollars in billions			
Service	September 30,		
	1984	1985	1986
Army	\$5.2	\$3.2	\$3.2
Navy	7.8	11.5	5.8
Air Force	10.9	12.9	7.3
DLA	0.4	0.3	0.1
<b>Total</b>	<b>\$24.3</b>	<b>\$27.9<sup>a</sup></b>	<b>\$16.4</b>

<sup>a</sup>This figure is about \$1 billion higher than the corresponding number reported in our May 1986 report (NSIAD-86-128) because it includes more current information obtained from DOD on DLA and Navy figures.

The Assistant Secretary of Defense (Acquisition and Logistics) also issued policy guidance to deal with problems regarding how contracting officers obligated funds on unpriced contracts. On January 9, 1986, policy guidance was issued requiring contracting officers to fund only an amount necessary to cover the estimated or target prices of unpriced contracts, rather than funding the contracts to the level of ceiling prices. On May 7, 1986, further guidance was issued requiring that existing unpriced contracts be reviewed for the purpose of deobligating excess funds.

Each of the military services has also initiated numerous actions to deal with unpriced contracts such as

- requiring negotiable proposals from contractors before they are authorized to proceed with work,
- limiting the amount of profit that may be awarded on unpriced contracts that are substantially complete, and
- increasing management attention to the use of unpriced contracts and negotiating them on time.

The Congress has also acted to limit DOD's use of unpriced contracts. Section 908 of the National Defense Authorization Act for Fiscal Year 1987, 10 U.S.C. 2326, placed a number of restrictions on DOD's use of unpriced contracts. The act

- requires that a request to use an unpriced contract be submitted to the head of an agency with an explanation of the effect on requirements if a delay is incurred for contract definitization,
- places limitations on the amount of funds that can be obligated and spent on unpriced contracts,

- precludes the use of unpriced contracts for non-urgent requirements unless the head of the agency approves their use as being good business practice and in the best interests of the United States,
- precludes scope modifications on existing unpriced contracts unless the head of the agency approves the modification as being good business practice and in the best interests of the United States, and
- restricts the amount of profit allowed on unpriced contracts.<sup>4</sup>

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## Objective, Scope, and Methodology

As requested, our primary objective at the five contractor locations was to determine if contracting officers were properly using unpriced contracts and pricing them on time. During our review, we

- examined data, files and records related to unpriced contracts at contractor locations, and major buying activities authorizing work at the contractors;
- interviewed responsible government officials at the contractor plants and the buying activities; and
- reviewed appropriate rules and regulations at the federal procurement, DOD, service, and local plant level.

We limited our detailed examination to contracts awarded in fiscal year 1985, the latest complete operating period available during our review. Where available, we obtained data related to unpriced contract activity in fiscal year 1986. However, we did not determine the effect of the numerous DOD and service initiatives which were taken during 1986. Also, because of its recency, we did not evaluate the effect of the 1987 defense authorization legislation restricting the use of unpriced actions. We discussed the results of our work with DOD officials and considered their views in preparing information and analyses provided to you. Generally, they concurred with our findings and took corrective action. Our review was performed in accordance with generally accepted government auditing standards.

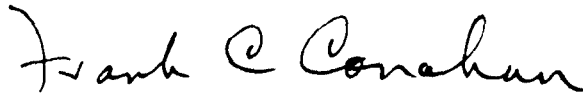
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<sup>4</sup>On November 14, 1986, DOD issued an interim rule on profit policy. The rule eliminated the portion of profit associated with contract risk for cost incurred by contractors before definitization of unpriced contracts.

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We are sending copies of this report to the Secretary of Defense and the Chairmen, Senate Committee on Governmental Affairs and House Committee on Government Operations and the Senate and House Committees on Armed Services and Appropriations. Copies will also be made available to others upon request.

Sincerely yours,



Frank C. Conahan  
Assistant Comptroller General

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