Audit Report

OFFICE OF THE INSPECTOR GENERAL

COMMERCIAL AND NONCOMMERCIAL SOLE-SOURCE ITEMS PROCURED ON CONTRACT N000383-93-G-M111

Report No. 98-064

June 24, 1998

This special version of the report has been revised to omit data that Sundstrand Corporation considered confidential business information.

Department of Defense

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To obtain additional copies of this audit report, contact Mr. Terry L. McKinney, Audit Program Director, at (703) 604-9288 (DSN 664-9288) or Mr. Henry F. Kleinknecht, Audit Project Manager at (704) 604-9324 (DSN 664-9324).

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Acronyms

BOA	Basic Ordering Agreement
CY	Calendar Year
DCMC	Defense Contract Management Command
DLA	Defense Logistics Agency
DISC	Defense Industrial Supply Center
DSCC	Defense Supply Center Columbus
DSCR	Defense Supply Center Richmond
FARA	Federal Acquisition Reform Act
FASA	Federal Acquisition Streamlining Act
FAR	Federal Acquisition Regulation
NSN	National Stock Number
TINA	Truth In Negotiations Act

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

June 24, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION AND TECHNOLOGY
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Redacted Audit Report on Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111 (Report No. 98-064)

We are providing this redacted report for public release. We performed this audit in response to a complaint to the Defense Hotline. The complaint was substantiated. Although the audit indicated serious flaws in DoD procurement practices, it did not indicate violations of applicable laws and regulations by the contractor, the Sundstrand Corporation. DoD management comments on a draft of the report were considered in preparing the final report which was issued on a For Official Use Only basis on February 6, 1998.

We provided the For Official Use Only version of the report to the Sundstrand Corporation for its comments on information that could be company confidential or proprietary. Sundstrand's response contained an extensive discussion of its concerns about the potential public release of confidential commercial or financial information contained in the report.

We recognize that there are competing arguments in this area, and considerable litigation over the nature of the materials that should be considered confidential commercial or financial information, and the extent of which that information is entitled to protection. In the interest of an early public release of the report, and without conceding the validity of each of the numerous arguments advanced by Sundstrand, we have decided to use for public release the redacted version of the report provided in the Sundstrand response.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Terry L. McKinney, Audit Program Director, at (703) 604-9288 (DSN 664-9288) or Mr. Henry F. Kleinknecht, Audit Project Manager, at (703) 604-9324 (DSN 664-9324). See Appendix H for the report distribution. The audit team members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 98-064 **February 6, 1998**
(Project No. 6CF-0068)

Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111

Executive Summary

Introduction. This is the first of two reports in response to complaints to the Defense Hotline This report discusses a complaint that the Defense Logistics Agency (DLA) was paying excessive prices to Sundstrand Aerospace (Sundstrand) for sole-source commercial items (spare parts) The second report will discuss a similar complaint involving another company. We focused our review on 278 orders to Sundstrand - each valued at $25,000 or more - issued by DLA during calendar years (CYs) 1994 through 1996 on contract N000383-93-G-M111. The 278 orders totaled $24 4 million Fifty-seven of the 278 orders reviewed, totaling about $5.9 million, were purchased from Sundstrand's commercial catalog. The commercial items DLA procured from Sundstrand included pistons, gearshafts, gears, bearings, bolts, springs and other items. Of the 278 orders we reviewed, 162 were placed during CY 1996 totaling $13.6 million. These orders represent 17.3 percent of the DoD after-market purchases (replenishment spare parts) from Sundstrand in that year.

Audit Objectives. The primary audit objective was to determine whether there was merit to the Defense Hotline complaint. Specifically, the complainant alleged that for commercial items DLA paid Sundstrand catalog prices that were several hundred percent higher than the cost-based prices DLA previously paid for the items. We also addressed the adequacy of the DLA management control program, which we will discuss in our second report.

Audit Results. The complaint was substantiated. DLA paid (for sole-source commercial items) modestly discounted catalog prices that were significantly higher prices than the cost-based prices DoD previously paid for the items As a result, DoD was not reaping the benefits anticipated when procuring commercial items For CYs 1994 through 1996, DLA paid about [redacted] (in 1997 constant dollars) or an average of about [redacted] percent more than fair and reasonable prices for the $6 1 million of commercial items procured from Sundstrand (Finding A)

DLA contracting officers also did not effectively negotiate prices for other (noncommercial) sole-source items procured from Sundstrand Through cost analysis, we determined that DLA paid about [redacted] (or more than [redacted] percent) above the fair and reasonable price (Finding B)

Summary of Recommendations. We recommend that the Under Secretary of Defense for Acquisition and Technology provide additional guidance and training to the DoD acquisition community on purchasing commercial items at fair and reasonable prices. We also recommend that, for noncommercial items, the Director, DLA require contracting officers to procure economic order quantities, determine the reliability of data used for price analysis, obtain certified cost or pricing data when required, and perform cost analysis of proposed labor and material costs.

Darkened areas (blank spaces) of this report represent data that Sundstrand Corporation considered confidential business Information which has been deleted.

Management Actions and Comments. In response to the audit, DLA took aggressive action and on December 8, 1997, awarded an indefinite-delivery corporate contract to Sundstrand for 216 sole-source commercial items (Phase I) at prices DLA considered fair and reasonable. Estimated savings over a 6-year period are $83.8 million. DLA is seeking a similar pricing arrangement for 1,567 other sole-source noncommercial items (Phase II). The Under Secretary of Defense for Acquisition and Technology concurred with the recommendations, stating that additional guidance and training were the keys to resolving the problems identified. However, the Under Secretary did not believe that the distinctions between cost-based and commercial catalog pricing had any relevance to the problems and stated market research and price analysis were sufficient to ensure fair and reasonable prices for commercial items. Cost data should not be needed. Also, the Under Secretary cited a DLA survey of over 6,000 commercial items procured under FAR Part 12 procedures where prices had decreased by 12 percent and asserted that the pricing problems with Sundstrand were an anomaly. The DLA management comments also presented a general theme that obtaining uncertified cost or pricing data to determine the reasonableness of contractor prices was an option, but one that should seldom be used. DLA generally agreed with the recommendations except those dealing with economic order quantities and the performance of cost analysis. The comments addressed the success of the negotiating team obtaining fair and reasonable prices, intent of acquisition reform, value of commercial practices, procurement administrative and lead time cost avoidances, and difficulties procuring economic order quantities. DLA also stated that the experience with Sundstrand was markedly different from experiences with other suppliers. See Part I for a summary of the comments on the findings, recommendations, and monetary benefits and Part III for the full text of the comments.

Audit Response. We agree that DoD's experience with Sundstrand could be atypical. More data are needed and some will be provided by ongoing audits. Unfortunately, our review of the DLA study cited by the Under Secretary found that it is seriously flawed and cannot be used to show savings relating to commercial items. Also, we do not agree that cost-based pricing is irrelevant. The distinction between cost-based and commercial catalog pricing was the issue that highlighted the pricing problems with Sundstrand. Although the Phase I negotiating team obtained prices significantly less than catalog prices for the sole-source commercial items during its price-based negotiations, those negotiations were hardly less laborious than had cost-based pricing been used and, in this instance, more of the subjectivity in the final prices could have been eliminated had uncertified cost or pricing data been obtained. We believe it is premature to assume that the situation described in this report was so unique that it would be prudent for the DoD to limit its contracting officers ability to evaluate price reasonableness by discouraging use of all tools available, including obtaining uncertified cost or pricing data for sole-source commercial and noncommercial items when clearly needed to determine price reasonableness. As for procuring economic order quantities of noncommercial items, we believe that item managers and contracting officers must consider economic order quantities when it makes good business sense. The disjointed purchasing approach indicated by the audit shows how much still needs to be done to make the DoD a smart buyer. We requested and received comments from the Under Secretary of Defense for Acquisition and Technology and the Director, DLA on the For Official Use Only final report.

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Part I - Audit Results

Introduction

This report resulted from a review of a complaint to the Defense Hotline, and is one of two reports on Hotline cases involving commercial pricing of spare parts. This report discusses an allegation that the Defense Logistics Agency (DLA) paid Sundstrand Aerospace (Sundstrand) "market-based" catalog prices for sole-source commercial items. The catalog prices were significantly higher than the cost-based prices DLA previously paid for the items. The second report will address a complaint that DLA paid significantly higher prices for commercial items from another contractor than the prices paid when the items were purchased competitively. A third audit is underway to evaluate similar issues but is not Hotline related.

We focused our review on 278 orders to Sundstrand - each valued at $25,000 or more - issued by DLA during calendar years (CYs) 1994 through 1996 on contract N000383-93-G-M111. The 278 orders totaled $24.4 million. Fifty-seven of the 278 orders reviewed, totaling about $5.9 million were purchased from Sundstrand's commercial catalog. The commercial items DLA procured from Sundstrand included pistons, gearshafts, gears, bearings, bolts, springs and other items. Overall, about 100,000 spare parts were procured on the 278 orders reviewed. Of the 278 orders we reviewed, 162 were placed during CY 1996 totaling $13.6 million. These orders represent 17.3 percent of the DoD after-market purchases (not part of the original equipment manufacturer purchases) from Sundstrand in that year.

Audit Background

DLA Mission. DLA is the central combat support agency that manages supplies in various commodity areas such as, clothing, construction material, electronic supplies, fuel, food, general supplies, and medical supplies. DLA uses five supply centers to procure supplies:

- Defense Supply Center, Columbus, Ohio (DSCC),
- Defense Fuel Supply Center, Fort Belvoir, Virginia,
- Defense Supply Center Richmond, Virginia, (DSCR),
- Defense Industrial Supply Center, Philadelphia, Pennsylvania, (DISC),
- Defense Personnel Support Center, Philadelphia, Pennsylvania

DLA supply centers consolidate the Services' requirements and procure the supplies in sufficient quantities to meet the Services' needs. Supplies are stored and distributed through a complex of depots or by direct vendor delivery. Consolidation of the distribution functions of the military Services and DLA depots was begun in 1990 and completed in March 1992, creating a single, unified supply distribution system managed by DLA. The DLA also provides contract administration services through its Defense Contract Management Command (DCMC). DCMC has offices throughout the world located primarily at or near contractor plants. DCMC professionals provide pre-award, post-award, and contract close-out services. DLA civilian end strength has declined from 60,649 employees in FY 1993 to 44,307 in FY 1998 as part of overall DoD downsizing.

Truth In Negotiations Act and Cost or Pricing Data. Congress historically has expressed concern with the use of other-than-competitive contracts, which were typically negotiated between the parties. These noncompetitive contracts provide additional risks for the Government to pay unreasonable prices and for contractors to earn excessive profits. Based on these concerns Congress passed the Truth in Negotiations Act (TINA), Public Law 87-653, September 10, 1962, that required contractors to submit cost or pricing data before the award of a negotiated contract; and to certify that the data were accurate, complete, and current. The purpose of TINA was to provide the Government with all the facts on cost and pricing that the contractor used to prepare the proposal, in order for the Government to avoid paying excess prices and profits. Throughout the years, amendments have modified TINA requirements and the appropriate statutory authority is now United States Code, title 10, section 2306a (10 U.S.C. 2306a).

Previous Price Issues. In the 1980's, various audits, congressional investigations and media disclosures indicated that DoD paid excessive prices for many spare parts and supplies, often sole-source procurements from contractors who did not manufacture the items. The disclosures caused both DoD and the Congress to take action to improve procurement prices on DoD spare parts.

Procurement Initiatives. In 1983, the Secretary of Defense directed the Military Departments and the DLA to implement 35 procurement initiatives to reduce overpricing. The initiatives focused on correcting problems related to overspecification, overengineering, small-quantity purchases, inappropriate allocation of corporate overhead in the pricing of individual contract line items, purchasing from other than the actual manufacturer, noncompetitive procurements, and excessive profits. Implementation of the Competition in Contracting Act, enacted in 1984, and the 35 spare parts procurement initiatives resulted in dramatic increases in reported competitive procurements and savings from 1985 to 1988. Competition advocates were also established in 1984 to help ensure that the Government sought full and open competition in all procurements. The Act also required the preparation of justifications for procurements using other than full and open competition and established approval requirements for noncompetitive procurements. Additional staffing was authorized to identify items for competitive procurements or procurement from the manufacturer rather than from the prime weapons systems contractor (breakout) and to perform more thorough cost and price analyses of items being procured.

After FY 1986, the DoD budget for spare parts began to decline and intensive management of spare parts procurements also began to decline. Competition advocate organizations at the buying centers eventually became targets for reductions or reorganization, and breakout screening became more selective.

Acquisition Reform Legislation. By the early 1990's, Congress and the Executive Branch reached a consensus that it was difficult to make sense out of the complex procurement system because of the proliferation of often contradictory requirements governing almost every aspect of the acquisition process. Congress commissioned an Advisory Panel on Streamlining and

Codifying Acquisition Laws pursuant to Section 800 of the National Defense Authorization Act for FY 1991. In January 1993, the panel completed its report and recommended a comprehensive overhaul of the federal procurement laws to:

> Improve Government access to commercial technologies,
>
> Reduce administrative overhead, especially in light of anticipated reductions in the federal acquisition workforce, and
>
> Reverse a perceived trend toward the incremental enactment of procurement statutes without a clear analysis of their impact on the overall acquisition system [Senate Report 103-258, May 11, 1994]

In 1993, the Government-wide National Performance Review, headed by the Vice President, reinforced the recommendations made by the Section 800 panel. The National Performance Review report "From Red Tape to Results: Creating a Government that Works Better and Costs Less," also made recommendations to increase reliance on acquisitions of commercial items, increase the simplified acquisition threshold, and implement other streamlining measures.

In May 1994, Secretary of Defense William Perry described fundamental acquisition reform as his number one priority. The Secretary identified three primary defects in the current system:

> (1) DoD is unable to acquire state of the art commercial technology
>
> (2) DoD is often unable to buy from commercial companies - even when their costs are cheaper . .
>
> (3) DoD's costs of doing business are too great

The Secretary of Defense also commented that:

> Because the world in which DoD must operate has changed beyond the limits of the existing acquisition system's ability to adjust or evolve - the system must be totally re-engineered If DoD is going to be capable of responding to the demands of the next decade, there must be carefully planned, fundamental re-engineering or re-invention of each segment of the acquisition process

On October 13, 1994, Congress enacted Public Law 103-355, the "Federal Acquisition Streamlining Act of 1994," (FASA). The purpose of FASA was to:

> S. 1587 would revise and streamline the acquisition laws of the Federal Government in order to reduce paperwork burdens, facilitate the acquisition of commercial products, enhance the use of simplified procedures for small purchases, clarify protest procedures, eliminate unnecessary statutory impediments to efficient and expeditious acquisition, achieve uniformity in the acquisition practices of Federal agencies, and increase the efficiency and effectiveness of the laws governing the manner in which the Government obtains goods and services. [Senate Report 103-258]

On February 10, 1996, Congress enacted Public Law 104-106, the "National Defense Authorization Act For Fiscal Year 1996." Division D of the Act was titled the "Federal Acquisition Reform Act of 1996," (FARA). The FARA contained various provisions, many of them suggested by DoD, on competition, commercial items, and other acquisition reform measures.

Industry Study on Cost Premium for Cost or Pricing Data. A study prepared for the Secretary of Defense, "The DoD Regulatory Cost Premium: A Quantitative Assessment," December 1994, attempted to estimate the cost to industry of DoD regulation and oversight. The study, based on a review of 10 companies, concluded that compliance with the TINA requirement for certified cost or pricing data was especially burdensome for some companies and was the second largest cost driver, with an average cost impact of 1.3 percent of the acquisition cost. Overall, the study calculated that DoD was paying an average cost premium of 18 percent for goods and services because of Government-unique practices compared to best commercial practices. The study, prepared by Coopers & Lybrand and The Analytic Sciences Corporation, noted that acquisition reform legislation represented an important step towards a more balanced regulatory environment. The study also conceded that the defense industry was highly complex with thousands of contractors, and it was unlikely that 10 companies represented the entire industry. Therefore, those seeking to project the results to the entire defense industry should proceed with caution.

Audit Objectives

The primary audit objective was to determine whether there was merit to a complaint made to the Defense Hotline. Specifically, the complainant alleged that, for commercial items, DLA paid Sundstrand "market-based" catalog

prices, which were several hundred percent higher than the cost-based prices DLA previously paid for the items. We are not addressing DLA's management control program in this report. It will be addressed in our second report. See Appendix A for a discussion of the audit scope and methodology. Appendix B summarizes prior coverage related to the audit objectives.

Management Actions During the Audit

The Office of the Under Secretary of Defense for Acquisition and Technology and DLA have been very responsive to the audit results. DLA established a DCMC negotiating team that negotiated a pricing arrangement with Sundstrand to allow DoD to quickly acquire commercial items at fair and reasonable prices. The team's goals were to attain prices that were reasonable and establish individual corporate contracts with Sundstrand that would cover commercial and noncommercial items, thereby eliminating the need to either purchase commercial items at catalog prices or negotiate separate prices for each individual order. The team addressed the intent of FASA, costs for logistic support, and price reductions for large quantity purchases. The results of this effort are discussed under Finding A. DLA also plans on requesting a voluntary refund for the CY 1996 overpricing identified by the DCMC review team.

Meanwhile, the Office of the Under Secretary of Defense for Acquisition and Technology opened a dialogue with Government and industry procurement experts to discuss the wider ramifications of the audit and to consider issues such as appropriate training initiatives to make the Government a better informed and more efficient buyer.

Finding A. Catalog Prices for Sole-Source Commercial Items

The Defense Logistics Agency (DLA) paid excessive prices for sole-source commercial items from Sundstrand Aerospace (Sundstrand) Those prices were significantly higher than the cost-based prices DoD previously paid for the items. Higher prices were paid for commercial items because:

- as a sole-source supplier with technical data rights, Sundstrand set "market-based" catalog prices for commercial items at "what the market would bear," and there was no competitive commercial market to ensure the reasonableness of the prices;

- Sundstrand refused to negotiate catalog prices for commercial items based on price analysis of previous cost-based prices, refused to provide DLA contracting officers with "uncertified" cost or pricing data for commercial catalog items, and terminated Government access to the Sundstrand cost history system; and

- guidance on commercial items qualified any item "offered for sale, lease, or license to the general public" as a commercial item without clearly addressing commercial pricing concerns, particularly when DoD was the primary customer procuring significantly larger quantities than other commercial customers

As a result, DLA paid about [redacted] (in 1997 constant dollars), or an average of about [redacted] percent, more than the fair and reasonable prices for the $6.1 million of commercial items purchased from Sundstrand during CYs 1994 through 1996 In response to the audit, DLA negotiated a pricing arrangement with Sundstrand for commercial items that generally addressed our concerns About $83.8 million in savings will be realized as a result of this new pricing arrangement over a 6-year period

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Laws and Regulations Relating to Commercial Items

FARA resulted in substantial changes to the FAR, particularly in part 15.8. Our original draft report discussed those changes. Since that draft was issued, FAR part 15 has been substantially rewritten, and FAR 15.8 was revised and moved within the Chapter. We have revised our citations to reflect where the provisions are currently found, as we believe that the substance of the provisions remained relatively the same. See Appendix C, "Laws and Regulations Relating to Commercial Items," for guidance relating to commercial items.

Catalog Prices For Commercial Items

Catalog Versus Cost-Based Pricing. DLA paid modestly discounted catalog prices for sole-source parts labeled commercial by Sundstrand. The prices paid were significantly higher than the cost-based prices DoD previously paid for the items. Catalog (market-based) prices are usually established based on the forces of supply and demand in a competitive marketplace. Cost-based prices are established based on cost or pricing data supplied by contractors when there is no competitive marketplace to ensure reasonable prices. Even though there was no competitive marketplace to ensure reasonable prices because Sundstrand owned the technical data rights and there were no other producers of the parts, DLA paid Sundstrand its catalog prices, less [redacted] percent, for 57 orders costing about $5.9 million ($6.1 million in 1997 constant dollars). In a meeting at Sundstrand on May 20, 1997, Sundstrand stated to us that DLA received the [redacted] percent discount because DLA did not require the commercial items to be stocked but could wait for the items to be manufactured. DCMC representatives were also at the meeting, but had a different opinion and stated that DLA received the [redacted] percent discount because the catalog prices were known to be too high.

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Catalog Prices for Sole-Source Commercial Items

Prices Set at What the Market Would Bear. As a sole-source supplier, Sundstrand set catalog prices for commercial items at what the market would bear and there was no competitive commercial market to ensure the integrity of the prices. Consequently, Sundstrand was naming its "market-based" price for sole-source commercial items. This kind of scenario was addressed by the Director, Defense Procurement in the response to industry's assessment of the TINA cost driver in June 1995.

> The requirements of TINA are necessary to ensure the integrity of DoD spending for military goods and services that are not subject to marketplace pricing When there is a market that establishes prices by the forces of supply and demand, the market provides the oversight. DoD procures many highly complex military systems in the absence of supply/demand situation for these relatively low volume, unique military goods The requirements of TINA address legitimate and necessary differences between DoD and commercial procurement environments
>
> While DoD recognizes the need for TINA, it also is moving to increase competition and decrease the number of pricing actions that would require cost or pricing data. The implementation of FASA, with its emphasis on encouraging the acquisition of commercial end items and increased competition, will bring the requisite market forces to bear on prices, and thus exempt contractors from the requirement to submit cost or pricing data. Absent this competition, the quantitative benefit to the Government of TINA compliance far exceeds the cost of Government oversight These benefits are best illustrated by the fact that during FY94, oversight work related to TINA resulted in net savings of $2 billion on DoD contracts. When compared to the cost of $761 million for TINA compliance the benefits represent a 267% return on investment."

The Under Secretary of Defense for Acquisition and Technology needs to provide additional guidance and training to the DoD acquisition community on how contracting officers should obtain fair and reasonable prices for commercial items from sole-source suppliers when there is no commercial market to ensure the integrity of prices and the commercial items are exempt from certified cost or pricing data.

Rights to Technical Data. Sundstrand recognizes the value of technical data rights and appears to have the rights to the technical data for the commercial and noncommercial items reviewed. As reported in the Sundstrand Corporation Securities and Exchange Commission Form 10-K, March 5, 1997:

> On a selective basis, the Registrant may enter into a contract to research and develop or manufacture a product with a loss anticipated at the date the contract is signed These contracts are entered into in anticipation that profits will be obtained from future contracts for the same or similar products These loss contracts often provide the Registrant with intellectual property rights which, in effect, establish it as the sole producer of certain products Such losses are recognized at the date the Registrant becomes contractually obligated, with revisions made as changes occur in the related estimates to complete.

The Defense Federal Acquisition Regulation Supplement, Appendix E, "DoD Spare Parts Breakout Program," provides guidance on reverse engineering, the process by which parts are examined and analyzed to determine how they were manufactured for the purpose of developing a complete technical data package. The normal, expected result of reverse engineering is the creation of a technical data package suitable for manufacture of an item by new sources. The current Sundstrand pricing policy for commercial items compels DLA to review its options. Alternatives available include performing a full screening of the sole-source Sundstrand commercial items to determine whether reverse engineering is possible and cost-effective, negotiating fair and reasonable prices with Sundstrand, or purchasing the items from Sundstrand at excessive prices. The DCMC negotiating team believes that they were able to obtain fair and reasonable prices for the sole-source Sundstrand commercial items prices during the Phase I negotiations. DLA also plans on initiating action, for instances where it appears cost-effective, to pursue approval from the cognizant Military design control activities of alternative items (reverse engineered parts) to enable future competitive buys of the sole-source Sundstrand commercial items. See Appendix G, "Sundstrand Commercial Items," for a list of the Sundstrand commercial items procured by DLA.

Negotiating Catalog Prices for Commercial Items

Price Analysis of Previous Cost-Based Prices For Commercial Items. Sundstrand refused to negotiate catalog prices for commercial items based on price analysis of previous cost-based prices. Sundstrand normally would not negotiate more than a [redacted] percent discount from the catalog price with individual DLA contracting officers, although Sundstrand did negotiate a [redacted] percent discount from the catalog price for some commercial items when DLA executive personnel participated in the negotiations. However, even with the 50 percent discount, the catalog prices were significantly higher than the cost-based prices. For example, DLA negotiated a [redacted] percent discount from the catalog price for one part and paid a unit price of $965 for it, but the previous cost-based unit price was only $428.

Table 1 shows catalog prices DLA paid Sundstrand for 57 commercial item orders were significantly higher than previous DoD cost-based prices. To determine the cost impact in 1997 constant dollars, we compared the delivery order price based on the Sundstrand catalog to the previous cost-based price and found prices had increased about [redacted] or about [redacted] percent. We used the DoD deflators from the "National Defense Budget Estimates for FY 1997," April 1996, to calculate Sundstrand catalog prices and previous cost-based prices in constant 1997 dollars. Also, the number of DoD orders of products labeled commercial by Sundstrand more than doubled each year from 1994 through 1996.

Table 1. Sundstrand Catalog Prices for Commercial Items Were Significantly Higher Than Previous DoD Cost-Based Prices

CY	Number of Orders	Market-Based Total Sundstrand Catalog Price Delivery Orders	1997 Dollars*	[redacted]
1994	6	$ 485,045	$ 513,469	[redacted]
1995	16	1,823,309	1,897,518	[redacted]
1996	35	3,641,302	3,719,590	[redacted]
Total	**57**	**$5,949,656**	**$6,130,577**	[redacted]

*1997 dollars were calculated using the DoD deflators from the "National Defense Budget Estimates for FY 1997," April 1996.

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Table 2 shows that the 1997 Sundstrand catalog prices (less [redacted] percent) for the 57 commercial item orders are about [redacted] percent higher than the previous DoD cost-based prices. Price increases for individual catalog items range even higher. For example, the 1997 cost-based unit price for one item was [redacted] while the 1997 commercial catalog unit price is $2,327.21 (catalog price less [redacted] percent), or a [redacted] percent increase. In addition, for over half of the commercial items reviewed, the quantity of commercial items procured was larger than the previous DoD cost-based quantity used for our comparison.

Table 2. 1997 Sundstrand Catalog Prices for Commercial Items Are Significantly Higher Than Previous DoD Cost-Based Prices

		Market-Based Total Sundstrand Catalog Price		[redacted]
CY	Number of Orders	Delivery Orders	1997 Catalog*	[redacted]
1994	6	$ 485,045	$ 673,721	[redacted]
1995	16	1,823,309	2,020,628	[redacted]
1996	35	3,641,302	4,528,330	[redacted]
Total	57	**$5,949,656**	**$7,222,679**	[redacted]

*Includes the standard DoD [redacted] percent catalog price discount.

Obtaining Uncertified Cost or Pricing Data. The cost-based prices that DLA negotiated with Sundstrand in previous years included various profit margins that ranged from [redacted] ercent for pass through items (purchased items with virtually no value added by Sundstrand) to about [redacted] percent for manufactured items. DLA contracting officers sometimes negotiated prices for pass through items that included up to a [redacted] percent profit. When negotiating commercial prices for the items, however, the Government did not obtain even uncertified cost or pricing data from Sundstrand.

Acquisition reform legislation and the FAR still provide that contracting officers shall require information other than cost or pricing data which includes uncertified cost or pricing data when necessary to determine price reasonableness for commercial items, but there is a strong DoD preference not to use that mechanism and the Government has not asserted its right to have the data. This issue is discussed in detail in Appendix C. We believe that, in this instance, uncertified cost or pricing data would have been useful to help

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determine price reasonableness for the sole-source Sundstrand commercial items because there is no competitive market-place to insure the integrity of the commercial prices.

Access to Sundstrand Cost History System. Sundstrand terminated DCMC, Rockford access to the Sundstrand cost history system because of a cost analysis of a commercial item performed by DCMC for DSCR. For the commercial item, Sundstrand proposed a unit price of $14,010 (catalog price less [redacted] percent) for 108 units or a total price of $1,513,044 (National Stock Number (NSN) 2835-01-191-8231). From 1992 through 1996, Sundstrand sold 56 of the items with a highest single sale quantity of 8 to non-DoD commercial customers. DCMC, Rockford performed a cost analysis for the item using the Sundstrand cost history system and determined that the maximum fair and reasonable unit price for the item should be [redacted] for a total price of [redacted], a difference of [redacted]. Sundstrand would not negotiate with the DSCR contracting officer based on this data, and terminated DCMC access to the Sundstrand cost history. After the Commander, Defense Contract Management Command called the President of Sundstrand, the DSCR contracting officer finally negotiated a unit price for the item of [redacted] based on a worst case scenario of the cost to manufacture the item. Sundstrand still provides DCMC data from its cost history systems for items not considered commercial with proposals valued over $500,000. For proposals under the $500,000 threshold, DCMC must request cost history information.

Guidance on Commercial Items

Clarification of Guidance and Training on Commercial Items and Commercial Pricing. The definition of commercial item in FAR 2.101 qualifies any item "offered for sale, lease, or license to the general public" as a commercial item. FAR 15.403 [formerly FAR 15.804] exempts commercial items from the requirement to submit certified cost or pricing data. Although this guidance may improve DoD access to commercial technologies, it also qualifies most items that DoD procures as commercial items and qualifies those items for the exception from certified cost or pricing data without comprehensively and clearly addressing possible commercial pricing concerns. This opens up a major loophole for sole-source vendors to charge prices that

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cannot readily be evaluated for reasonableness. This concern will continue to grow as more companies merge and the aerospace industry becomes more of a sole-source environment. FAR 15.403 provides no guidance on whether contracting officers have to grant the exception to certified cost or pricing data for all commercial items meeting the definition; or whether, once an item qualifies as a commercial item, the price should be considered fair and reasonable. FAR 15.408, "Solicitation Provisions and Contract Clauses," does state that the contracting officer may insert the clause at FAR 52.215-21 [formerly FAR 52.215-41] when it is reasonably certain that either certified cost or pricing data or information other than certified cost or pricing data will be required. FAR 52.215-21, a solicitation clause relating to commercial items, mentions granting a commercial items exception; stating the offeror should explain how the proposed prices relate to prices of recent sales in quantities similar to the proposed quantities. Information on recent sales in quantities similar to the proposed quantities is vital for sole-source commercial item pricing, however, this guidance is not clearly addressed in FARA and FAR 15.403 provisions.

Similar Quantities and Substantial Non-Government Sales. Commercial sales information was obtained from Sundstrand for the part numbers procured on the 57 DLA catalog orders. The sales data from 1992 through 1996 was used to determine whether DoD or non-Government commercial customers purchased the largest quantities and highest percentage of each item. For each of the 57 DLA commercial item orders, we plotted the point on the Y axis "DLA Order Quantity to Largest Commercial Order Quantity Ratio" based on the quantity of items purchased on each individual DLA order compared to the highest non-Government commercial quantity buy for the item. We then developed a multiple factor based on how many times the DLA order quantity was greater than the highest non-Government order quantity during the period and vice versa. For example, if DLA purchased 100 parts on an order and the highest quantity sold to a non-Government commercial customer for the same part was 5, then DoD purchased 20 times more than any commercial customer. We then plotted the point on the X axis "DoD Sales as a Percent of Total Sales" based on the percent of DoD sales compared to total Sundstrand commercial sales for the item. For example, if Sundstrand had total sales of 500 for a specific commercial item during the period and DoD purchased 250 of the items then the point would be plotted on the X axis at 50 percent.

Figure 1 shows that for over half the items, DoD purchased significantly larger quantities of individual commercial items measured in multiples of the highest quantity purchased by a non-Government commercial customer and a higher percentage of the overall sales of the commercial items. For example, for [redacted] of the orders, DoD purchased [redacted] percent of all commercial items sold by Sundstrand. For [redacted] of those orders, DoD purchased quantities at least [redacted] times greater than non-Government commercial customers.

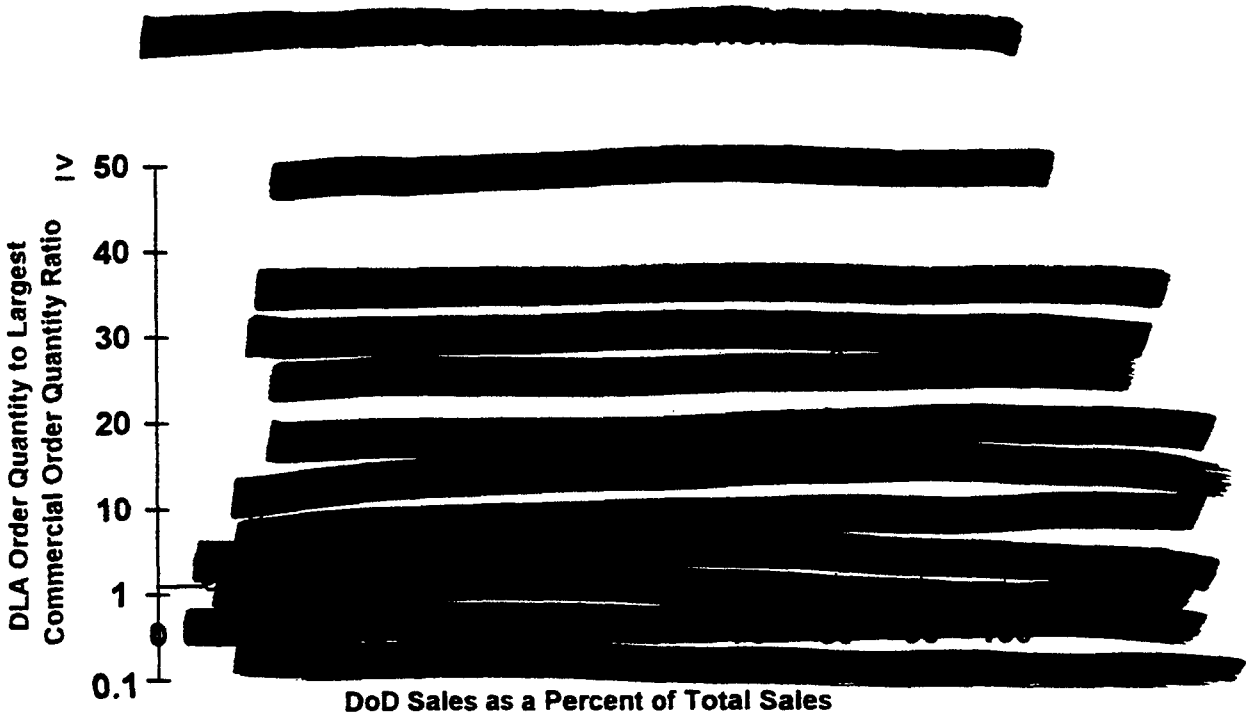

Figure 1. DoD Purchased Larger Quantities (multiples) of Commercial Items Than the Highest Non-Government Purchase Quantity and a Higher Percent of the Total Sales of Commercial Items.

Although FASA did not change the substantial sales requirement, FASA did change how it was to be measured. Under pre-FASA guidance (old FAR section 15.804-3(e), "Claiming and granting exception") which provided an exception to cost or pricing data for established catalog or market prices of commercial items that are sold in substantial quantities to the general public,

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items would normally qualify for the exception if Government sales represented less than 45 percent of the totals sales for the item and would normally not qualify for the exception if Government sales represented more than 65 percent of the total sales. However, the percentage-of-sales test was inconsistent and did not account for the current buy. For example, if Sundstrand had two non-Government commercial sales for an item each year in 1992, 1993, and 1994 and DoD had no purchases, then 100 percent of the sales would be to non-Government commercial customers and the item would qualify for commercial catalog pricing. Then if DoD procured 500 of the items in 1995, the item would technically qualify for commercial catalog pricing based on past sales, but the price would not be fair and reasonable because Sundstrand neither had recent sales of similar quantities nor substantial sales for the item. Once DoD procured the 500 items, the item would no longer qualify as a commercial item based on a new percentage-of-sales test. Based on the percentage-of-sales test for the 57 commercial item orders, 18 of the items currently would qualify for the exception, 14 items were questionable, and 25 of the items would not qualify for the exception.

During the audit, Sundstrand objected to Figure 1, stating that it did not represent commercial sales at the time the DLA orders were placed. Sundstrand stated that at the time orders were placed all items qualified as commercial catalog items under the percentage-of-sales test. However, the commercial sales data were open for interpretation. For example, for NSN 3110-01-009-8144, Sundstrand sold 1 part at the catalog price to a non-Government customer in May 1993 and there were no sales of the part in 1994. DLA then purchased 334 of the parts at the catalog price (less [redacted] percent) on order TZP5 in November 1995. Looking at 1993 and 1994 Sundstrand sales data, 1 part ([redacted] percent) was sold to a non-Government commercial customer and the part qualifies as a commercial catalog item. However, DLA also purchased 400 of the parts in 1992 and there were no non-Government commercial sales in that year. Consequently, if the 1992 sales data are included with 1993 and 1994 sales data, [redacted] percent of the sales were to DoD and the item would not qualify for the commercial catalog item exception.

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Importance of Recent Sales of Similar Quantities and Substantial Sales. Projected sales quantities is a significant factor in determining the catalog price. For example, if a contractor was selling only 2 commercial items per year and the contractor's cost to manufacture the 2 items was $400, the contractor's catalog unit price may be about $250, assuming a 25 percent profit. However, suppose $200 of the costs to manufacture the items were nonrecurring or setup costs, and recurring costs to manufacture the items were $100 per item. If a customer procured 100 of the items the $250 catalog price would not be fair and reasonable. The contractor's costs to manufacture 100 items would be $200 for nonrecurring costs plus $100 times 100 items (assuming no learning curve on recurring costs) for a total cost of $10,200 or $102 per item. Add a 25 percent profit and the fair and reasonable price would now be $127.50, or about half of the catalog price.

Conversely, if a contractor was selling a large quantity of a commercial item to other customers and DoD wanted to procure a smaller quantity of the item, the contractor's catalog price would most likely be based on the cost to manufacture the larger quantity. The catalog price for the smaller quantity procured by DoD would most likely be fair and reasonable. Consequently, although current guidance qualifies most items as commercial items, the commercial prices for those items may not be fair and reasonable. For commercial items to qualify for the exception from certified cost or pricing data and to qualify for commercial pricing, recent non-Government sales of similar quantities to the proposed quantities or substantial non-Government sales at least greater than the proposed quantities is important for fair and reasonable prices. The Under Secretary of Defense for Acquisition and Technology needs to provide additional guidance and training to the DoD acquisition community on the importance of ensuring non-Government commercial item sales of similar quantities or substantial non-Government sales at least greater than the current procurement quantity before contracting officers accept commercial item prices as fair and reasonable.

Commercial Item Delivery. One of the advantages of procuring commercial items is that normally the items are stocked by the contractors, thus reducing lead-times for customers to obtain the items. Reduced lead-times mean commercial customers can stock fewer items, thus reducing inventory costs. Because these costs are borne by the vendor, the price would be expected to be higher. However, DLA did not receive reduced lead-times for Sundstrand commercial items.

Figure 2 shows that [redacted] percent of the commercial items procured from Sundstrand required greater than [redacted] to be shipped. The items shipped in less than 30 days represented one partial order of [redacted] items where DLA paid the full catalog price. The remainder of the order was shipped within [redacted] and DLA paid the catalog price less [redacted] percent.

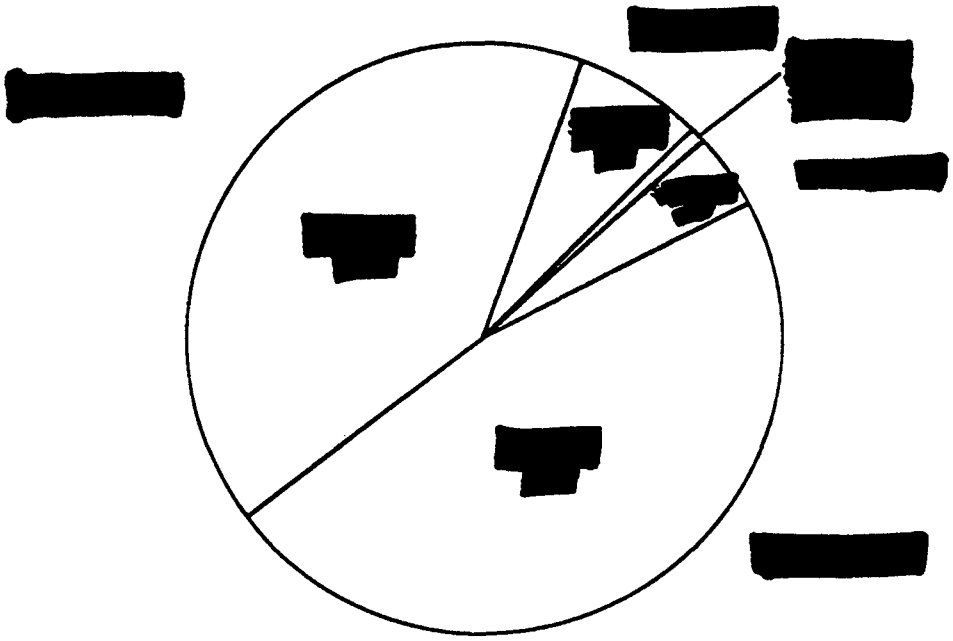

Figure 2. Days for Sundstrand to Ship Commercial Catalog Items

Potential Cost Avoidance

To calculate the potential cost avoidance, we compared total 1997 catalog prices (less [redacted] percent) for the commercial items purchased in CY 1996 ($4,528,330) to the cost-based prices for the same items and quantities inflated to 1997 dollars ([redacted]) for a cost increase of [redacted] ([redacted]). Using the 1996 cost increase, we originally calculated that DLA

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could reduce costs by at least [redacted] during CYs 1998 through 2003 if fair and reasonable prices are paid for commercial items ([redacted]) Our calculation did not consider the fact that commercial item orders were steadily increasing (doubled each year from 1994 through 1996) Also, our calculation was based upon only 17.3 percent of the DoD after-market purchases from Sundstrand in CY 1996. According to DLA, substantially more savings will be realized as a result of the Phase I corporate contract for commercial items, about $83.8 million for the 6-year period. The difference between our calculations and DLA's figures is attributable primarily to the inclusion of more commercial spare parts in the corporate contract than we reviewed and the use of higher annual demand quantities to be purchased over the next 6 years.

Summary

The audit indicated that the DoD was not reaping the anticipated benefits of commercial item procurements in the case of the DLA procurements from Sundstrand under contract N00383-93-G-M111. The DoD needs to learn how to deal more effectively with the nuances of commercial pricing. For example, a major customer can often negotiate huge discounts off catalog prices. The issue of price-based versus cost-based negotiations will need to be closely monitored and more data will be required on DoD experience in buying commercial items. Ongoing work by the GAO, this office, and other DoD components should be helpful in that regard.

Progress and Results of Negotiations with Sundstrand

Summary of Negotiations. After an intensive multiround negotiating effort between the DCMC team and Sundstrand, Phase I of a two phase effort was completed with award of a DoD corporate (fixed-price) contract for commercial catalog items. The DCMC negotiating team and Sundstrand began negotiations on October 15, 1997. Final agreement on prices for 216 of the items was reached on November 10, 1997, when Sundstrand accepted the Government's fourth offer. The resulting contract SPO700-98-D-9701, an indefinite delivery

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type contract (1 year with 2 option years), was awarded on December 8, 1997. The total not-to-exceed value of the contract for the 3 years is about $46.6 million and the negotiated prices represented a [redacted] percent discount from the list catalog prices. Phase II of the negotiations will seek a similar pricing arrangement for 1,567 noncommercial sole-source Sundstrand parts.

Market Research. For Phase I, the negotiating team conducted market research to better understand the customary practices of the commercial marketplace. Interest letters were mailed to a cross section of aerospace industry consumers and their agents and site visits were conducted. In summary, the market research found that few long term supplier agreements existed in the commercial marketplace. Most companies interviewed made their purchase decisions based on forecasted demand and production lead time, similar to the Government. These companies attempt to purchase in economic order quantities because "Storage costs are considered, but the company's experience has been that the value of the inventory increases at a much higher rate than the cost of storage; namely, the value of the parts increases frequently at up to 10 percent annually, while the cost of stocking the parts is much lower. (Stockage policy - Provisions of a 3-5 year basis)."

The market research also showed that most companies tried to avoid dealing with sole-source original equipment manufacturers because the companies had little or no success negotiating more favorable prices. The companies did use parts that were reverse engineered from the original equipment manufacturer and certified by the Federal Aviation Administration.

Sundstrand's Proposal. Sundstrand's proposed prices represented various proposed decrements from their commercial catalog price. Prices offered ranged from a [redacted] percent discount off the list catalog price for direct vendor delivery support to [redacted] percent off list for stock purchases. When quantity breaks were offered, they were approximately [redacted] percent additional discount from the catalog list price.

Government Price Objective. A price analysis report was prepared with participation by DISC, DSCR, DCMC Rockford, and Air Force pricing personnel. This price analysis was performed to develop discrete pricing targets for each of the National Stock Numbers (NSNs). The targets were developed using historical pricing prior to Sundstrand's implementation of its commercial pricing strategy. Additionally, items with no previous price history were

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referred to DCMC for pricing support. The DCMC price analyst reviewed prior production information in deriving recommended targets. The analyst also considered recommended prices in this audit report. These cost- based estimates were also incorporated in arriving at the overall targets. The targets for each NSN were selected from various methods of price and cost analysis. The lowest reasonable price was used as the Government minimum and the highest reasonable price as the Government maximum. Price negotiations were expected to be difficult given the depth of price cuts needed to arrive at fair and reasonable prices.

Measuring Success Of The Negotiating Team. We believe the DCMC negotiating team obtained adequate prices in the FASA/FARA (price-based) pricing environment where cost analysis and reliance on obtaining cost or pricing data are strongly discouraged. The price-based negotiations for the 216 NSNs were difficult, required significant resources, and resulted in none of the administrative burden reductions normally associated with procuring commercial items. The DoD needs to internalize the lessons learned from this experience and develop a more efficient and systematic approach to replace the ad hoc approach necessitated by the need to react to this audit's findings.

One of the main benefits of procuring commercial items is the ability to reduce DoD inventory levels and associated infrastructure by using direct vendor delivery. However, Sundstrand basically does not provide direct vendor delivery; the commercial prices negotiated with Sundstrand are prices associated with DoD stocking and procuring items giving consideration to production lead time. Sundstrand offered only a [redacted] percent reduction from its catalog list price for direct vendor delivery (about a [redacted] percent increase from the actual negotiated prices) so direct vendor delivery was not an option. Further, although DoD is procuring items for stock, negotiations resulted in only a [redacted] percent economic order quantity discount (only [redacted] items).

Even though the items being procured from Sundstrand were spare parts that had been developed and procured many times before (end items include B-52, E-3A, F-15, and F-16 aircraft), Sundstrand's initial offer for the base year was [redacted] or [redacted] percent higher than the Government's first offer. Further, the final negotiated price was [redacted] percent higher than the initial Government offer and [redacted] percent higher than the Government prenegotiation maximum position.

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Request for Cost or Pricing Data. On November 5, 1997, we sent a memorandum to the Director, DLA, expressing concern that the team negotiating prices with Sundstrand for sole-source commercial items had not requested uncertified cost or pricing data. On November 7, 1997, the contracting officer for the negotiating team sent a letter to Sundstrand requesting uncertified cost or pricing data for 73 items where the negotiating team had been unable to support the prices as fair and reasonable. On November 10, 1997, Sundstrand accepted the Government's last offer (fourth offer) instead of providing the cost data. Prior to this correspondence Sundstrand's last offer (fifth offer) was [redacted] percent higher than the Government's last offer. We cannot prove a causal relationship between the team's letter and the changed Sundstrand position. We do not fault the team for accepting Sundstrand's agreement to settle at the Government's forth offer level, but it should be recognized that the Government's understanding of the basis for Sundstrand's commercial pricing remains incomplete and any analysis of the reasonableness of the agreement can only be subjective.

Summary of Negotiations for DLA Contract SP0700-98-D-9701

Negotiation Positions	Base Year Amount[2]	Maximum Amount[3]
[redacted]	[redacted]	[redacted]

[1]Offer accepted by Sundstrand (actual value of contract is [redacted] due to rounding differences).

[2]Base amount represents the annual demand value for 216 NSNs covered under the contract.

[3]Maximum amount represents the not-to-exceed contract amount for the base and two option years (base year amount was also multiplied by [redacted] percent to accommodate first year pent up demand and surge requirements).

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Management Comments on the Finding and Audit Response

Management Comments on Award of the Corporate Contract. The Under Secretary of Defense for Acquisition and Technology commented that it was unlikely that Sundstrand would have entered into the negotiations for the recently awarded corporate contract for commercial items if FASA and Clinger-Cohen had not been in place. The contractor may well have preferred to continue selling to DoD through many small purchases, rather than accept a single, corporate contract requiring certified cost or pricing data.

Audit Response. During the audit, we discussed multiyear contracts with Sundstrand representatives and they stated that although they were interested in such an arrangement, previously the Government was not. The 1997 DSCC price list was basically such an arrangement where (with the assistance of DCMC, Rockford) the Government obtained uncertified cost or pricing data for a sample of items and negotiated fixed prices for a large number of NSNs. Negotiating each individual small purchase was neither in the Government's nor Sundstrand's best interest. In fact, DoD had a pricing agreement with Sundstrand to simplify negotiations for these small purchases. The pricing agreement provided that selling prices would be based on historical costs with profits ranging from [redacted] percent for pass through items to [redacted] percent for labor. Consequently, locking in prices on a multiyear contract would have allowed Sundstrand to earn higher profit margins through increased efficiencies.

Management Comments on Cost-Based Pricing and Commercial Pricing. The Under Secretary of Defense for Acquisition and Technology commented that nothing in the report demonstrates that the prices DoD paid would have been any different had cost-based pricing been used and that all distinctions between cost-based and commercial catalog pricing should be deleted from the report.

Audit Response. During the audit, Sundstrand stated that prices for individual items increased because the items were now priced commercially instead of cost based, but that in the big picture this would save DoD money. In a memorandum dated September 11, 1996, Sundstrand also cited the policy shift of FAR Part 15 (as a result of FASA) with respect to determining price reasonableness. Sundstrand stated that the policy shift made obtaining cost or pricing data an undesirable last choice. Accordingly, Sundstrand withdrew

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from the pricing agreement and significantly reduced the amount of information submitted to the Government on all proposals below $500,000. An example of the difference between cost-based and commercial catalog pricing can be shown for a part that was just negotiated on the Phase I corporate contract and also included on the 1997 DSCC price list. The corporate contract commercial unit price for the part is $354.10, the price for the part on the DSCC 1997 price list (where uncertified cost or pricing data was obtained) was [redacted]

Management Comments on the Need for Cost Data. The Under Secretary of Defense for Acquisition and Technology commented that uncertified cost or pricing data were not needed to establish price reasonableness. The contracting officer's tools should primarily be market research and price analysis, and that cost data should not be needed.

Audit Response. We agree that market research and price analysis are sufficient for determining price reasonableness in a competitive commercial market. However, as shown by the audit, DLA contracting officers were using market research and price analysis but were unsuccessful in obtaining fair and reasonable prices for sole-source commercial items from Sundstrand. We believe that contracting officers should use all the tools available, including obtaining uncertified cost or pricing data, when necessary to determine price reasonableness for sole-source commercial items.

Management Comments on Prices DLA is Paying for Commercial Items. The Under Secretary of Defense for Acquisition and Technology commented that DLA conducted a survey of the prices paid for commercial items on contracts over $25,000 awarded under FAR Part 12. DLA found that in these contracts prices have decreased approximately 12 percent after adjusting for inflation.

Audit Response. We reviewed the computer-processed data that DLA used to calculate the decrease in prices for commercial items. Our initial conclusion is that the data are seriously flawed and cannot be used to show savings relating to commercial items. We have discussed the data problems with DLA and will work closely with them to verify the reliability of future data provided to the Under Secretary.

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Although DLA has subsequently determined that the database used for the survey was flawed, the main problem we identified with the data related to individual orders with multiple line items for different NSNs. On those orders, the total number of NSNs on the order and the total order amount were averaged, causing the quantities of commercial items to be overstated and the unit prices to be understated. Consequently, when those quantities and prices were compared to previous quantities and prices the results showed large savings relating to commercial items, when in fact, prices had increased.

Management Comments on Calculation of Unreasonable Prices and Potential Monetary Benefits. DLA concurred that the prices paid for commercial items were more than the fair and reasonable prices, but nonconcurred with the methodology used in the audit (cost-based) to calculate the extent to which the previous Sundstrand prices were unreasonable. DLA believes that the "less costly to implement" FASA/FARA pricing methodology (price-based) should be used to calculate fair and reasonable prices. In essence, DLA believes that the prices negotiated by the DLA negotiating team with Sundstrand for commercial items using the price-based methodology are fair and reasonable, and that these recently negotiated prices should be used to calculate previous overcharges. DLA stated that it now has a valid basis for calculating the extent of excessive price growth for most of the items in question ($2.6 million) and will initiate appropriate recoupment action with Sundstrand.

DLA management also concurred that prices for commercial items could be reduced during CYs 1998 through 2003.

Audit Response. We commend DLA for its effort in negotiating a fixed-price corporate contract for 216 sole-source commercial items from Sundstrand (Phase I). After an intensive multiround negotiating effort between the DCMC team and Sundstrand, we believe that the negotiating team obtained generally acceptable prices. Measuring the actual success of the team and classifying the negotiated price as fair and reasonable in a sole-source environment without historical cost data is somewhat subjective. The price-based negotiations for only 216 NSNs were difficult and required significant resources, and we see no basis for DLA stating that these price-based negotiations were less costly than cost-based negotiations would have been.

One of the factors that made negotiations difficult was the large difference between Sundstrand's initial offer for the base year ( ) and the Government's first offer ( ). Under a price-based negotiation, Sundstrand provided no factual cost data to support its initial offer. Review of the different negotiation positions shows that although the final negotiated price ( ) was percent less than the Sundstrand initial offer, the final negotiated price was percent higher than the initial Government offer, and percent higher than the Government prenegotiation maximum position ( ).

We take no exception to DLA using the newly negotiated commercial prices to calculate the proposed refund of $2.6 million. Likewise, we agree with the DLA adjustment to our estimate of future cost avoidance as a result of the new pricing agreement. Comparing the Sundstrand catalog price (less percent) to the negotiated prices for the base-year annual demand quantity (216 NSNs) shows an annual potential cost avoidance of about $11.2 million. With the 250 percent contract maximum surge, the annual cost avoidance is about $27.9 million. When the annual potential cost avoidance is calculated over the 3-year contract period, the total cost avoidance ranges between about $33.5 million (base-year annual demand quantity) and $83.8 million (maximum contract amount). Should DLA negotiate a similar pricing arrangement for an additional 3 years, the total potential cost avoidance for a 6-year period would be between $67.1 million (minimum) and $167.7 million (maximum). After discussions with DLA, we agreed that a reasonable calculation of the 6-year potential cost avoidance would be $83.8 million (first year at maximum contract amount and subsequent years at annual demand quantities).

Management Assertion of Misstated Audit Results. DLA commented that Appendix G of the draft report disclosed a $5,949,656 total for Market-Based Catalog Delivery Order Prices. This is the total amount escalated to 1997 dollars, not $6.1 million as reported in Finding A. As a result, the markup for catalog-priced items over previous cost-based items is percent not percent.

Audit Response. The $5,949,656 total for Market-Based Catalog Delivery Order Prices was not escalated to 1997 dollars. The figure escalated to 1997 dollars was $6.1 million as reported, resulting in the percent price increase stated in the audit. Appendix G was omitted from the final report to decrease the complexity of the report.

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Management Comments on Commercial Item Breakout. DLA also commented that follow-on action was being initiated, for instances where it appears cost-effective, to pursue approval from the cognizant military design control offices of alternative items (reverse engineered parts) to enable future competitive buys of sole-source Sundstrand commercial items.

Audit Response. We commend DLA for its follow-on action and believe this may be the best means to determine fair and reasonable prices for the parts.

Management Comments on Savings From Commercial Buying Practices and Streamlining of Government Rules and Policies. DLA commented that "the audit failed to address, much less monetize, the substantial improvements that have been achieved over the last several years through the Government's adoption of commercial buying practices and the streamlining of Government rules and policies; and failed to quantify the savings the Government has made as a result of the enabling legislation and regulation changes." DLA then cited various in-house studies that supported an annual procurement administrative cost and administrative lead-time cost avoidance of $0.992 million. The cost avoidance was for 180 of the DLA managed items covered by the corporate contract because: "(i) future orders under the corporate contract will be automatically processed and placed using DLA's automated ordering systems, and (ii) having these items under contract enables a significantly reduced investment in the stockage levels otherwise needed to cover the normal procurement lead time."

Audit Response. We agree that the Navy BOA previously used to procure commercial items from Sundstrand (where each individual order was negotiated separately) was ineffective, and that the new fixed-price corporate contract (indefinite-delivery-type contract) is measurably better. Indefinite-delivery-type contracts are not new and this more effective contracting vehicle is responsible for the annual procurement administrative cost and administrative lead-time cost avoidances.

Management Comments On Overall Price Increases and Savings From Commercial Contracts. DLA provided figures on overall yearly price increases for approximately 100,000 NSNs out of a total universe of 950,000 different NSNs purchased from FY 1992 through FY 1997. The data showed various annual price increases that ranged from a low of 2.0 percent (FYs 1992 to 1993) to a high of 6.0 percent (FYs 1995 to 1996).

DLA also provided figures that showed price comparisons for items purchased during FYs 1994 through 1995 with prices paid for the same items on FAR Part 12 Commercial Contracts in the subsequent 2-year period (FYs 1996 through 1997). The comparison showed price decreases using absolute dollars of about 6.5 percent (nearly 10 percent when adjusted for inflation). The value of the items included in the study was about $150 million of the $900 million (400 contracts) identified where FAR Part 12 procedures were used for FYs 1996 and 1997.

Audit Response. As previously stated, we have reviewed the computer-processed data used by DLA to calculate the decrease in prices for commercial items and have determined that the data are unreliable and unusable.

Recommendations, Management Comments, and Audit Response

A.1. We recommend that the Under Secretary of Defense for Acquisition and Technology:

a. Provide additional guidance and training to the DoD acquisition community on how contracting officers should obtain fair and reasonable prices for commercial items from a sole-source supplier when there is no commercial market to ensure the integrity of prices and the commercial items are exempt from certified cost or pricing data.

b. Provide guidance and training to the DoD acquisition community on the importance of ensuring non-Government commercial item sales of similar quantities or substantial non-Government sales at least greater than the current procurement quantity before contracting officers accept commercial item prices as fair and reasonable.

Management Comments. The Under Secretary of Defense for Acquisition and Technology concurred with the recommendations, stating additional training and guidance in commercial pricing were needed as the keys to resolving the problems identified in the audit.

Audit Response. We hope to have the opportunity to ensure that the training package being prepared by the Office of the Under Secretary of Defense (Acquisition Reform) and industry will be adequate to resolve the commercial pricing problems identified by this audit. We ask that the Under Secretary of Defense for Acquisition and Technology provide additional comments in response to the final report on what specific guidance and training are contemplated, especially regarding acquisition of sole-source commercial items.

A.2. We recommend that the Director, Defense Logistics Agency require that contracting officers insist that contractors provide uncertified cost or pricing data for future commercial item procurements when needed to determine the reasonableness of prices.

Management Comments. The Defense Logistics Agency concurred, stating that guidance was issued which specifically underscored that the Federal Acquisition Regulation provides that contracting officers must obtain pricing, sales, cost information, or other information excluding [certified] cost or pricing data, as necessary to determine price reasonableness when it cannot be based on adequate price competition.

The Defense Logistics Agency contracting officer for the Sundstrand corporate contract deferred from requesting information other than cost or pricing data (uncertified cost or pricing data) until exhausting all other information sources. Finally, on November 10, 1997, the contracting officer requested uncertified cost or pricing data, but an agreement on substantially reduced prices was achieved shortly thereafter, which the contracting officer concluded obviated the need for such information.

Audit Response. The Defense Logistics Agency comments are responsive. Although we believe a determination of price reasonableness for the sole-source commercial items on the Sundstrand corporate contract is too subjective without cost data, we do believe that the Defense Logistics Agency contracting officer obtained acceptable prices in a price-based pricing environment. We should also note that substantially reduced prices for the commercial items may have been achieved just by requesting cost data from Sundstrand and believe that it may not be possible to negotiate fair and reasonable prices for sole-source commercial items without historical cost data in many instances.

Finding B. Negotiated Prices for Sole-Source Noncommercial Items

DLA contracting officers did not effectively negotiate prices on orders for (noncommercial) sole-source items procured from Sundstrand Sole-source prices were not effectively negotiated because DLA

- did not adequately consider economic order quantities when placing individual orders,

- used price analyses of questionable prior prices to determine price reasonableness and performed inadequate cost analyses because DCMC, Rockford was not used to verify labor and material costs on data that was submitted by Sundstrand; and

- procured items from Sundstrand using a Navy basic ordering agreement (BOA) that utilized over 75 different contracting officers to negotiate and award about 1,800 individual orders totaling over $36 million, without the benefit of certified cost or pricing data

We determined that DLA paid about [redacted] or over [redacted] percent more than the fair and reasonable price on 59 orders on which we performed cost analysis We were unable to calculate a savings associated with using economic order quantities or reducing the resources needed to manage the Sundstrand contract The goals of the DCMC negotiating team to negotiate the Phase II corporate contract for noncommercial items should help address our concerns

Laws and Regulations

10 U.S.C. 2384a. "Supplies: economic order quantities," provides guidance on procuring items in economic order quantities.

> (a)(1) An agency referred to in section 2303(a) of this title shall procure supplies in such quantity as (A) will result in the total cost and unit cost most advantageous to the United States, where practicable,

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> and (B) does not exceed the quantity reasonably expected to be required by the agency.
>
> (2) The Secretary of Defense shall take paragraph (1) into account in approving rates of obligations of appropriations under section 2204 of this title
>
> (b) Each solicitation for contract for supplies shall, if practicable, include a provision inviting each offeror responding to the solicitation to state an opinion on whether the quantity of supplies proposed to be procured is economically advantageous to the United States and, if applicable, to recommend a quantity or quantities which would be more economically advantageous to the United States Each such recommendation shall include a quotation of the total price and the unit price for supplies procured in each recommended quantity

FAR 15.402, "Pricing policy," provides guidance and an order of preference for contracting officers in determining the type of information required when negotiating prices for supplies and services.

> Contracting officers shall--
>
> (a) Purchase supplies and services from responsible sources at fair and reasonable prices In establishing the reasonableness of the offered prices, the contracting officer shall not obtain more information than is necessary To the extent that cost or pricing data are not required by 15 403-4, the contracting officer shall generally use the following order of preference in determining the type of information required
>
> (1) No additional information from the offeror, if the price is based on adequate price competition, except as provided by 15 403-3(b)
>
> (2) Information other than cost or pricing data
>
> (i) Information related to prices (e.g., established catalog or market prices or previous contract prices), relying first on information available within the Government, second, on information obtained from sources other than the offeror, and, if necessary, on information obtained from the offeror When obtaining information from the offeror is necessary, unless an exception under 15 403-1(b)(1) or (2) applies, such information submitted by the offeror shall include, at a minimum, appropriate information on the prices at which the same or similar items have been sold previously, adequate for evaluating the reasonableness of the price

(ii) Cost information, that does not meet the definition of cost or pricing data at 15 401

(3) *Cost or pricing data* The contracting officer should use every means available to ascertain whether a fair and reasonable price can be determined before requesting cost or pricing data Contracting officers shall not require unnecessarily the submission of cost or pricing data, because it leads to increased proposal preparation costs, generally extends acquisition lead time, and consumes additional contractor and Government resources

(b) Price each contract separately and independently and not--

(1) Use proposed price reductions under other contracts as an evaluation factor, or

(2) Consider losses or profits realized or anticipated under other contracts

(c) Not include in a contract price any amount for a specified contingency to the extent that the contract provides for a price adjustment based upon the occurrence of that contingency

FAR 15.404-1, "Proposal analysis techniques," provides guidance for contracting officers reviewing contractor proposals.

(a) General The objective of proposal analysis is to ensure that the final agreed-to-price is fair and reasonable

(1) The contracting officer is responsible for evaluating the reasonableness of the offered prices The analytical techniques and procedures described in this subsection may be used, singly or in combination with others, to ensure that the final price is fair and reasonable The complexity and circumstances of each acquisition should determine the level of detail of the analysis required.

(2) Price analysis shall be used when cost or pricing data are not required (see paragraph (b) of this subsection and 15.404-3)

(3) Cost analysis shall be used to evaluate the reasonableness of individual cost elements when cost or pricing data are required Price analysis should be used to verify that the overall price offered is fair and reasonable

(4) Cost analysis may be used to evaluate information other than cost or pricing data to determine cost reasonableness or cost realism

> (5) The contracting officer may request the advice and assistance of other experts to ensure that an appropriate analysis is performed

FAR 15.404-1(b), "Price analysis," defines price analysis as the process of examining and evaluating a proposed price without evaluating its separate cost elements and proposed profit. The Government may use various price analysis techniques and procedures to ensure a fair and reasonable price, given the circumstances surrounding the acquisition. Examples of such techniques include, but are not limited to the following:

> (i) Comparison of proposed prices received in response to the solicitation
>
> (ii) Comparison of previously proposed prices and contract prices with current proposed prices for the same or similar end items, if both the validity of the comparison and the reasonableness of the previous price(s) can be established
>
> (iii) Use of parametric estimating methods/application of rough yardsticks (such as dollars per pound or per horsepower, or other units) to highlight significant inconsistencies that warrant additional pricing inquiry
>
> (iv) Comparison with competitive published price lists, published market prices of commodities, similar indexes, and discount or rebate arrangements
>
> (v) Comparison of proposed prices with independent Government cost estimates
>
> (vi) Comparison of proposed prices with prices obtained through market research for the same or similar items

Negotiating Prices for Sole-Source Items

DLA contracting officers did not effectively negotiate prices for sole-source items procured from Sundstrand. Prices were not effectively negotiated because DLA contracting officers did not always consider economic order quantities, did not use price analysis of reliable data or perform adequate cost analysis, and used over 75 different contracting officers to negotiate and award about 1,800 individual orders during CYs 1994 through 1996.

Economic Order Quantities

Requesting Economic Order Quantities. DLA contracting officers did not adequately consider economic order quantities when placing individual orders. During CYs 1994 through 1996, DLA requested that Sundstrand provide proposals for economic order quantities on 44 of 248 orders (totaling more than $25,000 each) reviewed (or about 18 percent). We could not determine whether economic order quantities were requested for the remaining 30 orders reviewed (278 total orders reviewed). DISC contracting officers requested economic order quantities for the highest percentage of orders 31 of 62 (50 percent). DSCR requested economic orders quantities for 10 of 34 orders (29 percent), and DSCC requested economic order quantities on only 3 of 152 orders (2 percent). Although the BOA provided for Sundstrand to recommend economic order quantities, we found no cases where this occurred.

Price Difference for Economic Order Quantities. DSCC contracting officers negotiated two different price lists with Sundstrand for 1996 and 1997. Each price list allowed DSCC to negotiate prices for various high usage items for a given period during one negotiation. Although the 1996 price list did not consider price differences associated with different quantities, the 1997 price list showed significant price differences for economic order quantities.

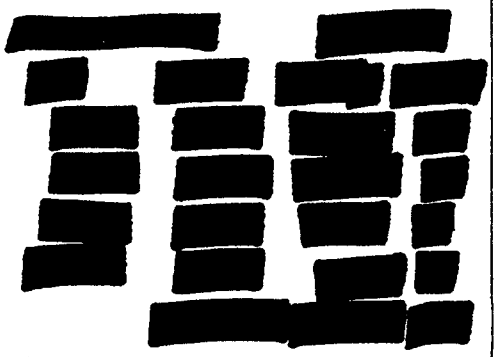
The 1996 price list negotiated with Sundstrand was based on a single order quantity of 10 items. Consequently, when DSCC contracting officers used the price list to procure large quantities of items the prices were not reasonable. Also, DCMC Rockford (responsible for providing pricing services to DSCC) was not requested to review the proposed prices. DSCC was reluctant to use the 1996 price list because the proposed prices were much higher than previous prices. In fact, DSCC continued to issue quotations to Sundstrand after receipt of the proposed price list in lieu of using the price list; however, Sundstrand responded to the quotations referring DSCC to the price list. Negotiations were conducted with Sundstrand for some of the parts on the price list based on cost data and quantity with assistance from DCMC.

Table 3 shows several examples where DSCC purchased items from the 1996 price list without negotiations where prices paid were not fair and reasonable. We determined the reasonable price for the items using actual Sundstrand cost data for the items and the negotiated indirect rates and profits factors on the individual orders.

Table 3. Prices For 1996 Sundstrand Price List Items Were Higher Than Reasonable Prices*

		1996 Sundstrand Price List	
NSN	Quantity	Unit	Total
1650-00-463-7658	101	252.87	$ 25,540
1650-00-978-1569	29	1,008.87	29,257
3020-00-798-7165	49	1,193.64	58,488
3040-00-073-2815	18	1,573.58	28,324
Total			**$141,610**

*Totals reflect rounding of values to the nearest whole dollar



The 1997 price list negotiated with Sundstrand did provide prices for various quantities of items and identified significant savings associated with economic order quantities. DCMC Rockford was also involved in the negotiations and performed a cost analysis of a sample of items from the price list.

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Table 4 shows 10 of the items with significant savings associated with economic order quantities. In fact, for the three of the bolded items Sundstrand part numbers 684588GA, 706261, and 713806, the total price for 25 of the items is less than the total price for 9 of the items. For part number 46494-1, the total price for 75 of the items is less than the total price for 9 of the items. Accordingly, it would never make sense for DLA to purchase less then 25 or 75 items, even if only 9 of the items were needed.

Table 4. 1997 Sundstrand Price List Shows Substantial Savings for Higher Quantity Purchases

Sundstrand Part No.	Description	
02-15574	Cover	
101920-0	Valve	
46494-1	**Valve**	
5008439	Liner	
5902524	Clutch	
684588GA	**Liner**	
694215	Piston	
695516	Seal	
706261	**Piston**	
713806	**Gear**	

The DoD needs to organize its purchasing plans and activities better so that DLA contracting officers procure economic orders quantities on all Sundstrand orders where practicable. The DCMC negotiating team should address economic order quantities in its corporate contract with Sundstrand.

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Price Analysis and Cost Analysis

Price Analysis and Reasonableness of Prior Price. DLA contracting officers used price analysis of questionable prior prices that were not reliable to determine price reasonableness. When using price analysis any comparison is invalid unless the reasonableness of the prior price was established as provided in FAR 15.404-1(b)(2)(ii) [formerly FAR 15.805-2(b)]. Normally, if the prior price was based on competition and the quantities of items being procured were similar, price analysis would be very effective. However, when items are procured from sole-source manufacturers, many factors such as quantity differences, insufficient procurement history, and a manufacturing switch from make to buy can significantly influence the price for an item. For example, for NSN 2520-00-149-9254, order UBGS, the contracting officer determined the proposed unit price of [redacted] to be fair and reasonable based on price analysis of a previous buy of 9 items with a unit price of [redacted] However, the current buy was for 612 items. Based on cost analysis, we determined that the reasonable unit price for the larger quantity was [redacted] therefore, DLA paid about [redacted] than the fair and reasonable price for the item. Further, once an unreasonable price is established for an item, that price becomes the basis for future prices. DLA contracting officers need to determine the reliability of previous prices before using price analysis to determine prices are fair and reasonable on future procurements not covered by the DCMC negotiating team.

Cost Analysis by DCMC Rockford. DCMC Rockford was used to verify labor and material costs on only 16 of the 278 orders reviewed. On 12 of the 16 orders DLA contracting officers negotiated prices lower than the prices proposed by Sundstrand. DLA contracting officers can only verify indirect rates and profit factors. DCMC Rockford has access to Sundstrand cost and pricing information and is needed to verify labor and material costs on uncertified cost or pricing data submitted by Sundstrand. For example, for NSN 1650-00-463-7677, order UBHT, the contracting officer determined that the unit price of [redacted] was fair and reasonable based on the forward pricing rate agreement using the direct labor and material costs proposed from Sundstrand. Based on cost analysis, we determined that the reasonable unit price should have been [redacted] therefore, DLA paid [redacted] than the fair and reasonable price for the item.

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We judgmentally selected 80 orders for which Sundstrand had provided uncertified cost or pricing data and obtained cost information from Sundstrand on the actual labor and material costs. Using actual cost data and the negotiated indirect cost rates and profit factors on the individual orders, we determined that the reasonable prices for the items reviewed were about [redacted] than the negotiated prices. Appendix H. "Cost Analysis of Sundstrand Prices," of the draft report (deleted from the final report) showed the negotiated and reasonable price for 59 orders; actual cost information was not yet available for 20 of the orders. The appendix also shows the major reasons that the actual costs were less than the negotiated costs. These reasons included no procurement history, item quantity sensitive, manufacturing switched to Singapore, and manufacturing changed from make to buy or buy to make.

Interpretation of Cost or Pricing Data. During a meeting with Sundstrand on May 20, 1997, we provided Sundstrand officials documentation for 6 of the orders in Appendix H (bold items) and requested an explanation for significant differences between the negotiated prices based on uncertified Sundstrand cost or pricing data, and the reasonable prices based on our cost analysis of actual labor and material costs. Again, Appendix H was deleted from the final report Our interpretation of the cost data available at the time the orders were proposed showed that the proposed and negotiated prices should have been lower for five of the six items. Sundstrand stated that it would review the data and on June 9, 1997, provided the following explanation.

> Sundstrand conducted a review of the pricing data utilized in the preparation of the six proposals identified on the schedule and found no estimating system deficiencies All of the six proposals were under the $500K TINA threshold and were developed utilizing our standard estimating practices Each proposal was submitted with price breakdowns and priced Bill of Material. For the above reasons, Sundstrand would disagree with an assessment which concluded that the proposal data was inaccurate

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Table 5 shows a comparison of the negotiated prices and the reasonable prices based on our cost analysis of actual Sundstrand labor and material costs for the items.

Table 5. Comparison of Negotiated and Reasonable Prices for Sundstrand Items*

		Negotiated Price	
NSN	Quantity	Unit	Total
1650-00-463-7677	133	422.59	$ 56,204
2520-00-149-9254	612	215.58	131,935
3010-01-054-3970	259	99.12	25,672
3010-01-054-3970	420	93.11	39,106
3020-00-463-7723	59	662.58	39,092
3040-01-083-3886	118	409.10	48,274
Total			**$340,284**

*Totals reflect rounding of values to the nearest whole dollar.

Although Sundstrand believes there were no problems with its estimating system and its interpretation of the data, the [redacted] between the negotiated price and the reasonable price shows the importance of DCMC Rockford performing cost analysis of proposed labor and material costs from Sundstrand and providing its interpretation of the Sundstrand cost data. The DCMC negotiating team needs to obtain certified cost or pricing data for its proposed corporate contract with Sundstrand and use DCMC Rockford personnel to perform cost analysis of proposed Sundstrand labor and material costs. The value of the corporate contract with Sundstrand should be significantly higher than the $500,000 threshold for certified cost or pricing data. DLA contracting officers need to use DCMC Rockford to perform cost analysis of proposed Sundstrand labor and material costs for items not covered by the DCMC negotiating team.

Sundstrand Internal Restructuring Costs and Single Process Initiative. DCMC has approved both internal restructuring costs and single process initiatives for Sundstrand that are designed to provide savings for DoD. Both programs are designed to reduce contractor costs to manufacture items which in

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turn, should provide savings to DoD. However, price analysis alone will not identify the potential monetary benefits associated with these initiatives, only through cost analysis will DoD realize these monetary benefits.

On May 8, 1995, Sundstrand submitted a proposal to amortize [redacted] of internal restructuring costs over a three year period starting in 1997. These costs were for the closure of a plant site in [redacted] and for severance costs for approximately [redacted] and [redacted] During negotiations, the severance costs for the engineers and marketing and administrative personnel were removed for various reasons. DCMC negotiated [redacted] spread over four years starting in 1996. The costs are to be recovered through the Sundstrand general and administrative pool. Since DoD accounts for about [redacted] percent of Sundstrand sales, the DoD share of the restructuring costs should be about [redacted]

On December 8, 1995, the Secretary of Defense and the Under Secretary of Defense for Acquisition and Technology announced implementation of the Single Process Initiative.

> SPI [Single Process Initiative] transitions contractor facilities from multiple government-unique management and manufacturing systems to the use of common, facility-wide processes
>
> SPI is the key to DoD Acquisition Reform efforts, it provides a method to implement acquisition reform goals in contracts It is intended to reduce contractor operating costs and achieve cost, schedule, and performance benefits for the government The benefits of SPI are more efficient, consistent, stable processes, with greater ease of contract administration for both contractor and government, and savings for the taxpayer

As of May 1997, DCMC had approved two single process initiatives for Sundstrand.

Disjointed Purchasing Practices

Contracting Officers. For CYs 1994 through 1996, DLA used over 75 different contracting officers to negotiate and award about 1,800 individual orders totaling over $36 million with Sundstrand. Because the orders

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individually did not exceed the threshold for requiring certified cost or pricing data, this acquisition strategy precluded the contracting officers from obtaining the valuable data. A Navy BOA was the primary vehicle used by DLA to obtain parts from Sundstrand. Since a BOA is not a contract but an instrument for placing orders which basically become contracts, DLA had to negotiate 1,800 individual orders which basically became contracts. The Navy BOA was issued to allow for ease of ordering spare parts.

Requirement or Indefinite-Quantity Contract. A better contract vehicle may be a requirements contract or an indefinite-quantity contract. Fixed prices for various quantities similar to the DSCC 1997 price list could be negotiated in the contract with only one negotiation. This would enable contracting officers to select economic order quantities and greatly reduce order time since prices were already negotiated. Negotiating one contract instead of 1,800 different contracts should also significantly reduce the DLA and Sundstrand resources needed for negotiations. In addition, the contractor would be required to submit certified cost or pricing data with its proposal and the data could be review by DCMC Rockford. This would enable DLA to determine the fair and reasonable prices for sole-source Sundstrand items. If the contract also provided fixed prices for options years Sundstrand would also have greater incentive to improve manufacturing processes to increase profits while DLA would receive these cost benefits on future contracts. The DCMC negotiating team should negotiate some type of requirements or indefinite-quantity contract with Sundstrand.

Summary

DoD wants contracting officers to rely more on priced-based pricing instead of cost-based pricing. Priced-based pricing works well when the previous buys were based on competition of similar quantities. However, for sole-source items, with limited or nonexistent competitive markets, cost analysis needs to be performed periodically because of quantity changes, manufacturing changes, internal restructuring, single process initiatives, and other changes that affect contractor costs to ensure the reasonableness of the prices paid by DoD. The goals of the DCMC negotiating team (Phase II) to negotiate a corporate contract for noncommercial items should help address our concerns.

Management Comments on the Finding and Audit Response

Management Comments on Price Negotiations for Sole-Source Noncommercial Items. DLA nonconcurred that contracting officers did not effectively negotiate prices on orders for noncommercial sole-source items procured from Sundstrand. DLA then addressed the problems negotiating prices for commercial items cited in Finding A and stated that contracting officers negotiated in good faith and in accordance with the laws and regulations in effect at the time.

Audit Response. Finding B relates only to noncommercial items and has nothing to do with the problems associated with commercial items addressed in Finding A. The remainder of the DLA comments indicated at least partial agreement with Finding B.

Management Comments on Economic Order Quantities. DLA nonconcurred that contracting officers did not adequately consider economic order quantities when placing orders. DLA then states that the comments from the inventory control points indicate that greater attention could have been given to the potential for a price break on some buys. DLA states that the negotiating team was able to achieve volume price breaks on only 28 percent of the commercial items negotiated in the Phase I corporate contract and that unless the efforts to negotiate volume price breaks on the Phase II corporate contract for noncommercial items is more successful, the significance of this issue is substantially lessened.

Audit Response. From the text of the comments, it appears that DLA management has agreed that contracting officers did not adequately consider economic order quantities. We agree that obtaining volume price breaks on the Phase I corporate contract for commercial items using a price-based negotiation was not fully successful. However, as shown on the 1997 price list for noncommercial items previously negotiated by DSCC (using cost-based pricing), there should be significant price breaks for economic order quantities in the Phase II negotiations.

Management Comments of Price Analysis. DLA comments that the type of cost analysis performed by the audit team ("exhaustive level of in-depth review") is not contemplated by procurement rules, practical, or even possible

in the current operational environment. DLA also states that cost information will not be available for validation in connection with future buys and that the Government no longer has access to this information (except for the few buys exceeding $500,000).

Audit Response. We agree that our audit entailed an in-depth review of the costs associated with noncommercial items to determine fair and reasonable prices, but the effort was not exhaustive. In fact, we had no problem obtaining cost history information from Sundstrand (in contractor format) and performing the cost analysis to determine fair and reasonable prices was not difficult. DCMC Rockford performed similar cost analysis for a sample of parts negotiated on the 1997 price list. We believe that the procurement rules do contemplate the Government assuring itself of price reasonableness by creating provisions to obtain certified (exceeding $500,000) or uncertified cost or pricing data for sole-source procurements. Furthermore, we see no means for DLA to negotiate fair and reasonable prices in the Phase II negotiations of noncommercial sole-source parts from Sundstrand without performing cost analysis of at least a sample of items. Furthermore, the Phase II contract will be significantly greater than $500,000, and is subject to certified cost or pricing data.

Management Comments on the Number of Contracting Officers. DLA nonconcurred that the number of different contracting officers and the number of individual negotiations had any impact on excessive prices being paid. DLA also commented that cost and pricing data would not have been provided by Sundstrand for any commercial items.

Audit Response. The DLA comments appear to contradict previous comments that praise the Phase I negotiations as a success because total requirements were combined and negotiated in a single negotiation. Also, once again the parts discussed in Finding B are noncommercial only, so uncertified cost or pricing data was available to contracting officers and would have been of value.

Management Comments on Fair and Reasonable Prices. DLA commented that actual cost information for yet to be awarded and performed contracts does not exist at the time prices are negotiated. Very rarely does a cost estimate materialize as an exact projection of the costs. The only valid way to determine whether overpricing occurred is to perform a review of available data and the data that was provided by the conclusion of price negotiations.

DLA also comments that the audit shows Sundstrand generally was able to underrun the contract price but that the audit does not indicate why this occurred.

Audit Response. Price analysis alone in a sole-source noncommercial market may not result in fair and reasonable prices. Many factors affect prices, and periodic cost analysis is necessary to ensure that the contractor's interpretation of cost information used to calculate prices is in agreement with the Government's interpretation of the data. However, on those orders where our interpretation of the cost information available at the time the orders were placed does not support the prices as fair and reasonable, they should be reviewed further by DLA.

The audit clearly explained why Sundstrand was able to underrun the contract prices. The main reason that contract prices were underrun was that negotiated prices were based on Sundstrand's interpretation of the cost data without review by the Government.

Management Comments on Price Variance. DLA commented that when cost or pricing data is submitted, [redacted] percent variance between forecast and actual cost should be expected. When lower contract amounts are involved, less effort is spent by the offeror in estimating, and by the Government in evaluating, the procurement. Typically, in such cases, which included the buys in question, greater variability of as much as [redacted] or [redacted] percent should be expected. DLA commented that 27 of the awards in question fell within the [redacted] percent bounds and another 11 could be added using a [redacted] percent range. Based on this data, DLA concluded that the variance was insufficient to suggest that Sundstrand provided misleading cost data for negotiations of these awards. Apart from these 38 buys, DLA believes that there are 21 remaining buys that warrant further review.

Audit Response. We agree that DLA does not need to review all the questioned buys, especially those with minor variances. However, we have provided DLA with the cost data for all the items and agree that those items with significant variances should be reviewed further.

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Recommendations, Management Comments, and Audit Response

Added Recommendation. As a result of management comments, we added Recommendation B.3. to provide that the Defense Logistics Agency address economic order quantities, obtain certified cost or pricing data, and perform cost analysis for at least a sample of items negotiated on the Phase II corporate contract for sole-source noncommercial items with Sundstrand

B.1. We recommend that the Director, Defense Logistics Agency require contracting officers for future procurements to procure economic order quantities on all orders placed with Sundstrand when practicable .

Management Comments. The Defense Logistics Agency nonconcurred, stating that contracting officer should not be required to procure economic order quantities for commercial items because this area was not addressed in Finding A. Various factors must be considered by the item manger and contracting officer on stock replenishment procurements.

The Defense Logistics Agency then stated that reorder points are automatically calculated and updated by an inventory management program within the Requirement Subsystem of the Standard Automated Material Management System. The system issues purchase requests for stock replenishment buys in time to result in award and receipt of stock, based on the procurement administrative and production lead time of record for each individual stock-managed item. "Any decision to manually override the system-determined stockage and safety levels to increase order quantities must be based on a supply control study by the item manger, which includes consideration of design stability and a determination of the extent to which a stable demand pattern has existed and whether there is any reason to expect demand quantities will increase (or decrease) in the future."

The Defense Logistics Agency also stated that the Government incurs additional expense in determining whether price breaks are sufficiently economically advantageous and economic order quantities could result in holding years of inventory that would exceed total future demands.

Audit Response. The Defense Logistics Agency comments are not responsive Finding B relates only to noncommercial items and as previously discussed, the Government negotiating team for the (price-based) Phase I corporate contract (commercial items) with Sundstrand was less than successful in negotiating economic order quantities. However, as shown in Finding B, the quantity price breaks for noncommercial sole-source items from Sundstrand when using cost-based negotiations have been significant and must be considered by the Defense Logistics Agency. The Defense Logistics Agency needs to determine which parts have economic order quantities and manually override the system determined stockage levels to procure economic order quantities when it makes good business sense. Finally, we do not consider procuring large quantities of items that will exceed future demands the same as procuring economic order quantities. Clearly, it is not economic to procure items that will never be used under normal circumstances. However, as shown in the finding, there may be instances where the total cost to procure a larger quantity of items is less than the cost to procure a smaller quantity. In these instances, we see no reason to procure the smaller quantity because there is always a possibility the items may be used. We request that the Defense Logistics Agency reconsider its position, and provide additional comments in response to the final report.

B.2. We recommend that the Director, Defense Logistics Agency require contracting officers for any future procurements with Sundstrand not covered by the Defense Contract Management Command negotiating team to:

a. Determine the reliability of previous prices before using price analysis to establish prices are fair and reasonable.

Management Comments. The Defense Logistics Agency partially concurred, stating that it would be inappropriate to establish the recommended review requirements for purchases of any residual items not covered by the Phase I and II corporate contracts. The residual and unanticipated requirements would likely all be below the simplified purchases threshold, and many below the $2,500 micro-purchase threshold. The Defense Logistics Agency then states that the validation of the reliability of previous prices is not a prerequisite except when the analysis is based on comparison to prior contract prices (or proposed prices) (FAR 15.805.2(b)) [currently FAR 15.404-1(b)(2)(ii)].

Audit Response. The Defense Logistics Agency comments are responsive. We agree that determining the reliability of previous prices used in price analysis for micro-purchases may be insignificant and that the Phase I and II corporate contract should cover most DLA requirements.

b. Use Defense Contract Management Command Rockford to perform cost analysis of proposed Sundstrand labor and material costs.

Management Comments. The Defense Logistics Agency nonconcurred, stating that data for buys is stored in its automated procurement system. This buy history data includes coding to identify the nature of the price or cost analysis accomplished in arriving at the price reasonableness determination. Contracting officers review purchase history data to identify the nature and basis of the price reasonableness determination.

The Defense Logistics Agency also states that contracting officers are accorded substantial discretion on requesting data reflecting current or prior actual cost experiences or estimates and that this flexibility should not be abridged.

Audit Response. The Defense Logistics Agency comments are not responsive. The finding showed that the prices paid for noncommercial Sundstrand items were not adequate (sole-source environment) to make a determination that future prices were fair and reasonable based on a price analysis. Periodic cost analysis is necessary in a sole-source environment to establish and re-establish a fair and reasonable price baseline. The comments raise concerns about the extent of cost analysis that the Defense Logistics Agency plans to perform for its Phase II negotiations with Sundstrand or whether price analysis will be primarily used to establish fair and reasonable prices. We fail to understand why DLA wants to limit the tools available in a sole-source market to ensure prices are fair and reasonable. We request that the Defense Logistics Agency reconsider its position, address the extent that cost analysis will be used for the Phase II negotiations with Sundstrand of the noncommercial sole-source items, and provide additional comments in response to the final report.

B.3. We recommend that the Director, Defense Logistics Agency require that the contracting officer for the negotiating team on the Phase II corporate contract for sole-source noncommercial items with Sundstrand:

a. Address economic order quantities.

b. Obtain certified cost or pricing data and perform cost analysis for at least a sample of items negotiated.

Part II - Additional Information

Appendix A. Audit Process

Scope

Work Performed. We reviewed DLA procedures and support contract documentation for delivery orders issued by DSCC, DSCR, and DISC to Sundstrand under contract N00383-93-G-M111. During CYs 1994 through 1996, DLA issued 300 delivery orders over $25,000 to Sundstrand totaling $24,372,583. We reviewed 278 of the orders totaling $22,639.215 (22 orders could not be located for various reasons). We also reviewed comparison buys of the same parts on other contracts with Sundstrand. We reviewed Sundstrand sales information for commercial items for CYs 1992 through 1996 and reviewed Sundstrand cost information on a judgmental basis for selected items

Limitations to Audit Scope. We did not review orders under $25,000. For CY 1996, we reviewed 162 orders totaling $13,561,139, or only 17.3 percent of the total Sundstrand military after-market sales of about $78.5 million.

Methodology

Use of Computer-Processed Data. To achieve the audit objectives we relied on computer-processed data from the DoD DD 350 data base for contract actions over $25,000. The computer-processed data were determined reliable based upon the significant number of contract actions we reviewed and compared to the DD 350 output. Although we did not perform a formal reliability assessment of the computer-processed data, we determined that the contract delivery order numbers, award dates, and amounts generally agreed with the information in the computer-processed data. We did not find errors that would preclude use of the computer-processed data to meet the audit objectives or that would change the conclusions in the report.

Universe and Delivery Orders Reviewed. Table 5 summarizes the DLA delivery orders reviewed on Sundstrand Contract N00383-93-G-M111.

Table 5. DLA Delivery Orders Reviewed on Sundstrand Contract N00383-93-G-M111

Over $25,000

	Total Delivery Orders		Delivery Orders Reviewed	
CY	Number	Amount	Number	Amount
1994	36	[redacted]	29	[redacted]
1995	100	[redacted]	87	[redacted]
1996	164	[redacted]	162	[redacted]
Total	**300**	[redacted]	**278**	[redacted]

Under $25,000

	Total Delivery Orders		Delivery Orders Reviewed	
CY	Number	Amount	Number	Amount
1994	378	[redacted]	0	0
1995	505	[redacted]	0	0
1996	655	[redacted]	0	0
Total	**1,538**	[redacted]	**0**	**0**

Audit Type, Dates, and Standards. We performed this program audit from October 1996 through June 1997 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included tests of management controls considered necessary.

Contacts During the Audit. We visited or contacted individuals within the DoD and Sundstrand Aerospace. Further details are available on request.

Darkened areas (blank spaces) of this report represent data that Sundstrand Corporation considered confidential business Information which has been deleted.

Appendix B. Summary of Prior Coverage

General Accounting Office

General Accounting Office Report No. GAO/NSIAD-93-1 (OSD Case No. 9034-B), "Contract Pricing: A Low Percentage of Contractors are Responsible for Most Reported Defective Pricing," November 24, 1992, states that because there was only one supplier for many of DoD's needs, those needs were contracted for noncompetitively. Prices for noncompetitive contracts are generally determined through extensive negotiations. For competitively awarded contracts, it is assumed that market forces result in fair and reasonable contract prices. Recognizing the government's vulnerability in noncompetitive contracting situations, the Congress passed the Truth in Negotiations Act in 1962 to protect the government against overstated contract prices.

The report also states that audits conducted by the Defense Contract Audit Agency identified $3 billion in defective pricing in fiscal years 1987-90. GAO reported that relatively few contractors (including Sundstrand) were responsible for most of the defective pricing. GAO made no recommendations in this audit.

Inspector General, DoD

Report No. 97-145. Inspector General, DoD, Report No. 97-145, "Purchasing Commercial Products," May 23, 1997, indicates that DoD buying commands were purchasing commercial products when practicable. The report contained no findings or recommendations.

Report No. 94-004. Inspector General, DoD, Report No. 94-004, "Contracting Officer Price Analysis," October 15, 1993, indicates that DoD contracting officers did not always perform and adequately document the use of price analysis on contractor proposal prices, resulting in inadequate assurance that fair and reasonable prices were obtained in negotiated contracts.

Contracting officers and negotiators lacked knowledge of price analysis techniques as well. The report recommended that the Military Departments and DLA issue written management control objectives and techniques to verify performance and documentation of price analyses by contracting officers. The report also recommended that the Deputy Under Secretary of Defense (Acquisition Reform) restructure training requirements to emphasize the performance and documentation of price analysis techniques.

The Navy, the Air Force and DLA had all complied with the recommendations as of March 1994. The Army believed that existing guidance was adequate The Deputy Under Secretary of Defense (Acquisition Reform) restructured acquisition courses as recommended by August 1994.

Report No. 90-062. Inspector General, DoD, Report No. 90-062, "Spare Parts Pricing Agreements," May 3, 1990, indicates that spare parts pricing agreements were misused and often resulted in overpricing. Spare parts pricing agreements were used to place nonrecurring, high dollar value orders without satisfying the FAR requirement for the submission of certified cost or pricing data. As a result, four buying commands could have saved $15.3 million by consolidating and pricing orders with certified cost or pricing data. The audit also projects that DoD could avoid costs of at least $4.8 million and as much as $39 million over two years by requiring the submission of certified cost or pricing data at the time of agreement on contract price. The report recommended that the military departments consolidate the same or similar purchase requirements into a single procurement action and establish adequate internal controls to ensure implementation and compliance with that policy. Management generally agreed with the recommendations.

Appendix C. Laws and Regulations Relating to Commercial Items

Federal Acquisition Streamlining Act. FASA section 1202 describes a catalog or market price exception from the requirement to submit certified cost or pricing data for commercial items sold in substantial quantities to the general public. In section 1204, an additional exception was provided for commercial items procured on a competitive basis with adequate price competition. Another exception was described where, lacking a competitive procurement or catalog/market prices the contracting officer was nonetheless able to obtain sufficient price information to assess the reasonableness of the price. Failure to obtain the information needed to assess price reasonableness was a basis to direct certified cost or pricing data. Although FASA provided exceptions from the requirement to submit certified cost or pricing data, the head of a procuring activity could require other than certified cost or pricing data (to include uncertified cost or pricing data) to the extent necessary to determine the reasonableness of the price. See Appendix D, "FASA Excerpts, FARA Changes, and Legislative History," for the complete text on commercial items

FASA section 8001, "Definitions," also provided the definition for commercial items The same FASA definition for commercial items was also included in FAR 2.101, "Definitions."

> (a) DEFINITIONS --Section 4 of the Office of Federal Procurement Policy Act (41 U.S C 403) is amended by adding at the end the following new paragraphs
>
> "(12) The term 'commercial item' means any of the following
>
> "(A) Any item, other than real property, that is of a type customarily used by the general public or by nongovernmental entities for purposes other than governmental purposes, and that--
>
> "(i) has been sold, leased, or licensed to the general public, or
>
> "(ii) has been offered for sale, lease, or license to the general public

FASA also required the use of fixed-price contracts for commercial items and prohibited the use of cost-type contracts, eliminated the requirement for

contractors to identity the actual manufacturers or suppliers of commercial items, and provided for a presumption by DoD that technical data under contracts for commercial items was developed exclusively at private expense and was the property of the contractor. Although data rights could be challenged and the challenge upheld in certain circumstances.

Federal Acquisition Reform Act. FARA significantly changed the FASA exception to cost or pricing data requirements for commercial items. The FARA changes eliminated the requirements that commercial item prices be based on established catalog or market prices and that commercial items be sold in substantial quantities to the general public. FARA did specifically include the word "certified" whenever cost or pricing data was used. FARA provided that when certified cost or pricing data were not required because of an exception, the contracting officer shall require submission of data other than certified cost or pricing data to the extent necessary to determine price reasonableness. See Appendix D for the complete text.

FARA Changes to the Federal Acquisition Regulation. Implementation of FARA resulted in corresponding changes to FAR 15.403, "Obtaining Cost or Pricing Data," [formerly FAR 15.804, "Cost or Pricing Data and Information Other Than Cost or Pricing Data."] FARA resulted in changes to FAR 15.403-1(c)(3), "Commercial Items," which now provides that "any acquisition for an item that meets the commercial item definition in 2.101, or any modification, as defined in paragraph (c)(1) or (2) of that definition, that does not change the item from a commercial item to a noncommercial item, is exempt from the requirement for cost or pricing data." FAR 15.403-1(b), "Exceptions to Cost or Pricing Data Requirements," provides that for a commercial item "the contracting officer shall not require submission of cost or pricing data to support any action (contracts, subcontracts, or modification) (but may require information other than cost or pricing data to support a determination of price reasonableness or cost realism)." FAR 15.403-3, "Requiring Information Other Than Cost or Pricing Data," provides that "to the extent necessary to determine the reasonableness of the price, the contracting officer shall require submission of information from the offeror." The section also provides that requests for sales data relating to commercial items shall be limited to data for the same or similar items sold during a relevant time period; and to the maximum extent practicable, limits the scope of the requests for information relating to commercial items to include only information that is in the form regularly maintained by the contractor in commercial operations.

Appendix E, "Changes to FAR 15.804, 'Cost or Pricing Data and Information Other Than Cost or Pricing' Data Made as a Result of FARA," shows the complete text of the FARA changes relating to commercial items. Effective October 10, 1997, FAR Part 15, Contracting By Negotiation, was rewritten. FAR 15.804 was incorporated into FAR 15.403, with no significant changes relating to commercial items.

As provided by Congress, FAR 15.403 exempts commercial items from the requirement to submit certified cost or pricing data. Contracting officers are still permitted to obtain information other than cost or pricing data, which includes uncertified cost or pricing data. FAR 15.401, "Definitions," defines cost or pricing data as certified cost or pricing data and information other than cost or pricing data to include uncertified cost or pricing data

> "Cost or pricing data" (10 U.S.C. 2306a(h)(1) and 41 U.S.C. 254b) means all facts that, as of the date of price agreement or, if applicable, an earlier date agreed upon between the parties that is as close as practicable to the date of agreement on price, prudent buyers and sellers would reasonably expect to affect price negotiations significantly. **Cost or pricing data are data requiring certification in accordance with 15.406-2. [emphasis added]** Cost or pricing data are factual, not judgmental, and are verifiable While they do not indicate the accuracy of the prospective contractor's judgment about estimated future costs or projections, they do include the data forming the basis for that judgment Cost or pricing data are more than historical accounting data; they are all facts that can be reasonably expected to contribute to the soundness of estimates of future costs and to the validity of determinations of costs already incurred They also include such factors as vendor quotations; nonrecurring costs; information on changes in production methods and in production or purchasing volume; data supporting projections of business prospects and objectives and related operations costs; unit-cost trends such as those associated with labor efficiency; make-or-buy decisions; (g) estimated resources to attain business goals; and information on management decisions that could have a significant bearing on costs.
>
> "Information other than cost or pricing data" means any type of information that is not required to be certified in accordance with 15.406-2 and is necessary to determine price reasonableness or cost realism. For example, such information may include pricing, sales, or **cost information, and includes cost or pricing data for which certification is determined inapplicable after submission. [emphasis added]**

Former FAR section 15.804-1(b)(4), provided that cost or pricing data may be obtained for commercial items only if the contracting officer made a written determination that the pricing information was inadequate for performing a price analysis and determining price reasonableness. Former FAR section 15.804-1(d), "Requesting an exception" provided that the offeror must submit a written request for an exception from the requirement to submit cost or pricing data and that the contracting officer was required to determine whether an exception applied. The FAR section also provided that the solicitation provision 52.215-41, "Requirements for Cost or Pricing Data or Information Other Than Cost or Pricing Data," may be used, however both sections were eliminated as part of the FARA changes to the FAR.

Because of FARA changes, the contract clause FAR 52.215-20, "Requirements for Cost or Pricing Data or Information Other Than Cost or Pricing Data," [formerly FAR 52.215-41] was modified to incorporate new guidance for requesting an exception to the requirement to submit cost or pricing data. However, the new guidance appears to be inconsistent with the provisions of FAR 15.403. The changes added guidance for requesting an exception, and states that for a commercial item exception, the offeror shall submit, at a minimum, information, on prices at which the same item or similar items have previously been sold, that is adequate for evaluating the reasonableness of the price. In addition, the new guidance also requires an explanation on how the proposed price relates to the price of recent sales in quantities similar to the proposed quantities. The part on recent sales in quantities similar to the proposed quantities appears to be inconsistent with the FARA change that eliminated the requirement for commercial items to be sold in substantial quantities. If the offeror is not granted an exception, the offeror shall submit cost or pricing data.

See Appendix F, "Changes to FAR 52.215-41, 'Requirements for Cost or Pricing Data or Information Other Than Cost or Pricing Data,' Made as a Result of FARA" for the complete text. The FAR Part 15 rewrite changed FAR 52.215-41 to FAR 52.215-21 but did not significantly change the text

Appendix D. FASA Excerpts, FARA Changes, and Legislative History

This text in this appendix had been edited to show the FARA changes to FASA. Words with a line through were deleted and bold text with a vertical line in the margin was added based on the legislative changes.

SUBTITLE B--TRUTH IN NEGOTIATIONS

Part I--Armed Services Acquisitions

SEC. 1202 EXCEPTIONS TO COST OR PRICING DATA REQUIREMENTS.

(a) EXCEPTIONS STATED. Subsection (b) of section 2306a of title 10, United States Code, is amended to read as follows:

"(b) EXCEPTIONS.--

"(1) IN GENERAL.--Submission of **certified** cost or pricing data shall not be required under subsection (a) in the case of a contract, a subcontract, or modification of a contract or subcontract--

"(A) for which the price agreed upon is based on--

"(i) adequate price competition; **or**

"(ii) **prices set by law or regulation;** ~~established catalog or market prices of commercial items that are sold in substantial quantities to the general public; or~~

~~"(iii) prices set by law or regulation; or~~

"(B) **for the acquisition of a commercial item; or** ~~in an exceptional case when the head of the procuring activity, without delegation, determines that the requirements of this section may be waived and justifies in writing the reasons for such determination.~~

"(C) in an exceptional case when the head of the procurement activity, without delegation, determines that the requirements of this section may be waived and justifies in writing the reasons for such determination.

"(2) MODIFICATIONS OF CONTRACTS AND SUBCONTRACTS FOR COMMERCIAL ITEMS.--In the case of a modification of a contract or subcontract for a commercial item that is not covered by the **exception** ~~prohibition~~ to ~~of~~ the submission of **certified** cost or pricing data in paragraph

(1)(A) **or (1)(B)**, submission of **certified** cost or pricing data shall not be required under subsection (a) if--

"(A) the contract or subcontract being modified is a contract or subcontract for which submission of **certified** cost or pricing data may not be required by reason of paragraph (1)(A) **or (1)(B)**; and

"(B) the modification would not change the contract or subcontract, as the case may be, from a contract or subcontract for the acquisition of a commercial item to a contract or subcontract for the acquisition of an item other than a commercial item.".

~~"(3) FAR STANDARDS.--The Federal Acquisition Regulation shall provide clear standards for determining whether the exceptions provided in paragraph (1)(A) apply. In the case of the exception provided in paragraph (1)(A)(i), the regulations shall specify the criteria to be used to determine whether adequate price competition exists. In the case of the exception provided in paragraph (1)(A)(ii), the regulations shall provide that the exception applies to items that are sold in substantial quantities to the general public, without regard to the quantity of items that may be sold to the Federal Government.".~~

(b) CONFORMING AMENDMENT TO REFERENCE.--Subsection (a)(5) of such section is amended by striking out "subsection (b)(2)" and inserting in lieu thereof "subsection (b)(1)(B)".

FASA Legislative History. Exceptions to cost or pricing data requirements (sec. 1202) [H R Conf Rep No 103-712, 103d Cong. 2d Sess 186, *reprinted in* 1994 U.S. Code Cong & Admin. News 2616]

(4)Regulations.--The house amendment contained a provision that would require the issuance, in the Federal Acquisition Regulation, of clear standards for determining whether the exceptions to the cost or pricing data requirements apply. In the case of the "adequate price competition" exception the regulations would specify the criteria to be used to determine whether adequate price competition exists. In the case of the "catalog or market pricing" exception, the regulations would preclude consideration of sales to federal agencies in determining whether an item has been sold in substantial quantities to the general public.

The conference agreement would adopt the House provision. The existing regulations apply a "percentage of sales test", which compares a company's sales to the general public to the company's sales to the federal government, for the purposes of determining whether a product is sold in substantial quantities to the general public. Under this approach, two companies that sell precisely the same number of an identical item to the general public are treated differently, depending on the quantity of items they sell to the federal government. The conferees intend that the "percentage of sales" test no longer be used.

The provision recommended by the conferees would require equal treatment of the two companies. Under the new approach, the determination whether sales to the general public are "substantial" could be made by comparison to the size of the market for the item as a whole (including small businesses), but could not be made by comparison to sales of a particular company to the federal government. Standards regarding the percentage of sales made on the basis of catalog prices would still be permissible.

SEC. 1203. RESTRICTIONS ON ADDITIONAL AUTHORITY TO REQUIRE COST OR PRICING DATA OR OTHER INFORMATION.

Subsection (c) of section 2306a of title 10, United States Code, is amended to read as follows:

"(c) **Cost or Pricing Data on Below-Threshold Contracts.--** ~~RESTRICTIONS ON ADDITIONAL AUTHORITY TO REQUIRE COST OR PRICING DATA OR OTHER INFORMATION.—~~

"(1) AUTHORITY TO REQUIRE **Submission.--** ~~COST OR PRICING DATA ON BELOW THRESHOLD CONTRACTS.—(A)~~ Subject to ~~sub~~paragraph **(2)**~~(B)~~, when certified cost or pricing data are not required to be submitted by subsection (a) for a contract, subcontract, or modification of a contract or subcontract, such data may nevertheless be required to be submitted by the head of the procuring activity, but only if the head of the procuring activity determines that such data are necessary for the evaluation by the agency of the reasonableness of the price of the contract, subcontract, or modification

of a contract or subcontract. In any case in which the head of the procuring activity requires such data to be submitted under this subsection, the head of the procuring activity shall justify in writing the reason for such requirement.

"(2) ~~(B)~~ **EXCEPTION.**-- The head of the procuring activity may not require certified cost or pricing data to be submitted under this paragraph for any contract or subcontract, or modification of a contract or subcontract, covered by the exceptions in **subparagraph (A) or (B) of** subsection (b)(1)~~(A)~~.

"(3) ~~(C)~~ **DELEGATION OF AUTHORITY PROHIBITED.**--The head of a procuring activity may not delegate functions under this paragraph.

"**(d)** ~~(2)~~ **SUBMISSION OF OTHER INFORMATION.**--

"(1) AUTHORITY TO REQUIRE **SUBMISSION.**--~~INFORMATION OTHER THAN CERTIFIED COST OR PRICING DATA.--~~When **certified** cost or pricing data are not required to be submitted under this section for a contract, subcontract, or modification of a contract or subcontract, the **contracting officer** ~~head of the procuring activity~~ **shall** ~~may~~ require submission of data other than certified cost or pricing data to the extent necessary to determine the reasonableness of the price of the contract, subcontract, or modification of the contract or subcontract.~~"~~ **Except in the case of a contract or subcontract covered by the exceptions in subsection (b)(1)(A), the data submitted shall include, at a minimum, appropriate information on the prices at which the same item or similar items have previously been sold that is adequate for evaluating the reasonableness of the price for the procurement.**

"(2) LIMITATIONS ON AUTHORITY.--The Federal Acquisition Regulation shall include the following provisions regarding the types of information that contracting officers may require under paragraph (1):

(A) Reasonable limitations on requests for sales data relating to commercial items.

(B) A requirement that a contracting officer limit, to the maximum extent practicable, the scope of any request for information relating to commercial items from an offeror to only that information that is in the form regularly maintained by the offeror in commercial operations.

(C) A statement that any information received relating to commercial items that is exempt from disclosure under section 552(b) of title 5 shall not be disclosed by the Federal Government.".

FASA Legislative History. Restrictions on additional authority to require cost or pricing data or other information (sec. 1203) [H R Conf Rep No 103-712, 103d

Cong. 2d Sess 186, *reprinted in* 1994 U.S Code Cong & Admin News 2617.]

The Senate recedes with an amendment. Under the conference agreement, an agency would be prohibited from requiring the submission of full, certified cost or pricing data where one of the statutory exemptions applies. However, a contracting officer would be authorized to require the submission of information (less than full, certified cost or pricing data), if such information would be necessary to determine the reasonableness of price. Such information need not be certified by the offeror as current, accurate, and complete, and would be limited to the minimum of information that would be necessary to determine price reasonableness.

FARA Legislative History. Title XLII--Commercial item exception to requirement for cost or pricing data (sec. 4201) [H.R. Conf. Rep. No. 104-450, 104th Cong. 2d Sess. 966, *reprinted in* 1996 U.S. Code Cong. & Admin. News 452.]

The conference agreement includes a provision that would amend section 2306a of title 10 and section 254b of title 41, United States Code, to exempt suppliers of commercial items under contracts and subcontracts with federal agencies from the requirement to submit certified cost and pricing data. The provision would include the requirement that, in the cases of such contracts or subcontracts, contracting officers shall require the submission of data other than certified cost or pricing data to the extent necessary to determine price reasonableness. In recognition of the authority of the General Accounting office to audit contractor records, the conferees have removed the specific audit authorities in the Federal Acquisition Streamlining Act of 1994 (Public Law 103-355) that relate to information supplied by commercial suppliers in lieu of certified cost and pricing data.

SEC. 1204. ADDITIONAL SPECIAL RULES FOR COMMERCIAL ITEMS.

Section 2306a of title 10, United States Code, is amended--

(1) by redesignating subsections (d), (e), (f), and (g) as subsections (e), (f). (g), and (i), respectively; and

(2) by inserting after subsection (c) the following new subsection (d):

~~"(d) ADDITIONAL EXCEPTION PROVISIONS REGARDING COMMERCIAL ITEMS.--~~

~~"(1) PROCUREMENTS BASED ON ADEQUATE PRICE COMPETITION. --To the maximum extent practicable, the head of an agency shall conduct procurements of commercial items on a competitive basis. In any procurement of a commercial item conducted on a competitive basis and based upon adequate price competition, the head of the agency conducting the procurement shall not require cost or pricing data to be submitted under subsection (a) for the contract, subcontract, or modification of the contract or subcontract under the procurement. If additional information is necessary to determine the reasonableness of the price of the contract, subcontract, or modification, the head of the agency shall, to the maximum extent practicable, obtain the additional information from sources other than the offeror.~~

~~"(2) PROCUREMENTS NOT BASED ON ADEQUATE PRICE COMPETITION. A(i) In any case in which it is not practicable to conduct a procurement of a commercial item covered by subsection (a) on a competitive basis, and the procurement is not covered by an exception in subsection (b), the contracting officer shall seek to obtain from the offeror or contractor information described in clause (ii). When such information is not available from that source, the contracting office shall seek to obtain such information from another source or sources.~~

~~"(ii) The information referred in clause (i) is information on prices at which the same item or similar items have been sold in the commercial market that is adequate for evaluation through price analysis, the reasonableness of the price of the contract, subcontract, or modification of the contract or subcontract under the procurement.~~

~~"(B) The contracting officer shall exempt a contract, subcontract, or modification of a contract or subcontract under the procurement from the requirements of subsection (a) if the contracting officer obtains the information described in subparagraph (A)(ii) in accordance with standards and procedures set forth in the Federal Acquisition Regulation.~~

~~"(C) A contracting officer may require submission of cost or pricing data under subsection (a) only if the contracting officer makes a written determination that the agency is unable to obtain the information described in subparagraph (A)(ii).~~

~~"(3) AUTHORITY TO AUDIT.—(A) In accordance with procedures prescribed in the Federal Acquisition Regulation, the head of an agency is authorized to examine all information provided by an offeror, contractor, or subcontractor pursuant to paragraph (2)(A) and all books and records of such offeror, contractor, or subcontractor that directly relate to such information in order to determine whether the agency is receiving accurate information required under this subsection.~~

~~"(B) The right under subparagraph (A) shall expire 2 years after the date of award of the contract, or 2 years after the date of the modification of the contract, with respect to which the information was provided.~~

~~"(4) LIMITATIONS ON REQUESTS FOR DATA.—The Federal Acquisition Regulation shall include reasonable limitations on requests under this section for sales data relating to commercial items.~~

~~"(5) FORM OF INFORMATION.—In requesting information from an offeror under this subsection, a contracting officer shall, to the maximum extent practicable, limit the scope of the request to include only information that is in the form regularly maintained by the offeror in commercial operations.~~

~~"(6) CONFIDENTIALITY.—Any information received under this subsection that is exempt from disclosure under section 552(b) of title 5 shall not be disclosed by the Federal Government.".~~

FASA Legislative History. Additional special rules for commercial items (sec. 1204) [H.R. Conf. Rep. No. 103-712, 103d Cong. 2d Sess 187-188, *reprinted in* 1994 U.S. Code Cong. & Admin. News 2617-2618.]

The senate bill contained a provision (sec. 1204) that would create a new exception to cost or pricing data requirements in 10 U.S.C. 2306a for commercial items.

The House amendment contained a similar provision (sec.7104).

The Senate recedes with an amendment, which would address the differences between the two provisions as follows:

(1) *Competition.*--The Senate bill would require that, to the maximum extent practicable, agencies shall conduct procurements of commercial items on a competitive basis. The House amendment would provide that if a commercial item is purchased on the basis of adequate price competition or established catalog or market prices, the procurement shall be exempt from cost or pricing data requirements and, to the maximum extent practicable, the agency may not require any additional information from the offeror to determine price reasonableness.

The conference agreement would combine the language of the Senate and the House bills. Under the conference agreement, agencies would be required to conduct procurements of commercial items on a competitive basis to the maximum extent practicable. It is the intent of the conferees that requirements for commercial items should be structured, wherever possible, so that multiple commercial items can compete for the same requirement. Where a commercial item is purchased on the basis of adequate price competition, the purchase would be exempt from cost or pricing data requirements. If data not obtained through the competition is needed to determine the reasonableness of price, it must be obtained, to the maximum extent practicable, from sources other than the offeror.

(2) *Authority to require cost or pricing data.*--The Senate bill would authorize contracting officers to waive cost or pricing data requirements when they are able to obtain adequate information on commercial pricing to determine that the price is fair and reasonable. The House amendment would permit the waiver of cost or pricing data requirements where price analysis is sufficient to determine whether the price of a contract for a commercial item is fair and reasonable.

Under the conference agreement, the contracting officer would be required (in any case in which it is not practicable to purchase a commercial item on a competitive basis) to seek information on prices at which the same or similar items have been sold in the

commercial market. Such information must be sought from the offeror or contractor, or when such information is not available from that source, from another source of sources. If the contracting officer is able to obtain information of this type that is adequate to evaluate, the reasonableness of contract price through price analysis, the contracting office must exempt the procurement from cost or pricing data requirements. If the contracting officer makes a written determination that the agency is unable to obtain adequate information for this purpose, the contracting officer must require the submission of cost or pricing data.

(3) *Right to audit.*--The Senate bill would authorize audits to determine whether the agency was receiving accurate information under this section. The House amendment would authorize audits for any purpose other than determining the completeness of the data supplied In addition, the Senate bill would provide for audit authority up to three years after the date of award, while the House amendment would limit the authority to one year after the commencement of performance (or any other date agreed upon in the contract). The conference agreement would adopt the Senate language, with a modification to limit the audit authority to a period of two years after the date of award.

(4) Requests for data and forms of information.--The House amendment contained three provisions addressing the information that may be requested under this section. The first provision would require the Federal Acquisition Regulation to establish reasonable limitations on requests for sales data on commercial items. The second would provide that a contracting officer may request information from an offeror of a commercial item only in the form regularly maintained by the offeror in commercial operations, adequate to demonstrate the market price of an item, or otherwise needed to establish a fair and reasonable price. The third would provide that all documentation received from an offeror under this section and marked as proprietary shall be treated by the

Government as confidential. The Senate bill contained no similar provisions.

The conference agreement would adopt the House language with a modification to clarify that: (a) any information received under this section that would be exempt from disclosure under the Freedom of Information Act may not be disclosed by the agency; and (b) contracting officers should, to the maximum extent practicable, request information from offerors in a form that is regularly maintained by the offeror in its commercial operations.

SEC. 1205. RIGHT OF UNITED STATES TO EXAMINE CONTRACTOR RECORDS.

Section 2306a of title 10, United States Code, is amended by striking out subsection (g), as redesignated by section 1204(1), and inserting in lieu thereof the following:

"(g) RIGHT OF UNITED STATES TO EXAMINE CONTRACTOR RECORDS.--For the purpose of evaluating the accuracy, completeness, and currency of cost or pricing data required to be submitted by this section, the head of an agency shall have the authority provided by section 2313(a)(2) of this title.".

SEC. 1206. REQUIRED REGULATION.

Section 2306a of title 10, United States Code, as amended by sections 1204 and 1205, is further amended by inserting after subsection (g) the following new subsection:

~~"(h) REQUIRED REGULATIONS.--The Federal Acquisition Regulation shall contain provisions concerning the types of information that offerors must submit for a contracting officer to consider in determining whether the price of a procurement to the Government is fair and reasonable when certified cost or pricing data are not required to be submitted under this section because the price of the procurement to the United States in not expected to exceed the applicable threshold amount set forth in subsection (a) (as adjusted pursuant to paragraph (7) of such subsection). Such information, at a minimum shall include appropriate information on the prices at which the same item or similar items~~

~~have previously been sold that is adequate for evaluating the reasonableness of the price of the proposed contract or subcontract for the procurement.".~~

Appendix E. Changes to FAR 15.804, "Cost or Pricing Data and Information Other Than Cost or Pricing Data" Made as a Result of FARA

The FAR Part 15, "Contracting by Negotiation," rewrite, effective October 10, 1997, incorporated FAR 15.804 into FAR 15.404 with no material changes. FAR 15.804 was materially changed by FARA and those changes are shown.

15.804-1 Prohibition on obtaining cost or pricing data.

(a) *Exceptions to cost or pricing data requirements.* The contracting officer shall not, pursuant to 10 U.S.C. 2306a and 41 U.S.C. 254b, require submission of cost or pricing data (but may require information other than cost or pricing data to support a determination of price reasonableness or cost realism)--

(1) If the contracting officer determines that prices agreed upon are based on--

(i) Adequate price competition (see exception standards at paragraph (b)(1) of this subsection); or

(ii) **Prices set by law or regulation (see exception standards at paragraph (b)(2) of this subsection).** ~~Established catalog or market prices of commercial items sold in substantial quantities to the general public (see exception standards at paragraph (b)(2) of this subsection); or~~

~~(iii) Prices set by law or regulation (see exception standards at paragraph (b)(3) of this subsection).~~

(2) For acquisition of a commercial item, **(see exception standards at paragraph (b)(3) of this subsection).** ~~if the contracting office does not have sufficient information to support an exception under paragraph (a)(1) of this subsection, but the contracting officer can determine the price is fair and reasonable (4) and pricing requirements at 15.804-5(b));~~

(3) For exceptional cases where a waiver has been granted (see exception standards at paragraph (b)(4)~~(5)~~ of this subsection).~~; or~~

(4) For modifications to contracts or subcontracts for commercial items, if the basic contract or subcontract was awarded without the submission of cost or pricing data because the action was granted an exception from cost or pricing data requirements under paragraph (a)(1) **or (a)(2)** of this subsection and the modification does not change the contract or subcontract to a contract or

subcontract for the acquisition of other than a commercial item (see exception standards at paragraph (b)(5) ~~(6)~~ of this subsection).

(b) *Standards for exceptions from cost or pricing data requirements*--(1) *Adequate price competition.* A price is based on adequate price competition if--

(i) Two or more responsible offerors, competing independently, submit priced offers responsive to the Government's expressed requirement and if--

(A) Award will be made to a responsible offeror whose proposal offers either--

(1) The greatest value (see 15.605(c)) to the Government and price is a substantial factor in source selection; or

(2) The lowest evaluated price; and

(B) There is no finding that the price of the otherwise successful offeror is unreasonable. Any such finding must be supported by a statement of the facts and approved at a level above the contracting officer;

(ii) There was a reasonable expectation, based on market research or other assessment, that two or more responsible offerors, competing independently, would submit priced offers responsive to the solicitation's expressed requirement, even though only one offer is received from a responsible, responsive offeror and if--

(A) Based on the offer received, the contracting officer can reasonably conclude that the offer was submitted with the expectation of competition, e.g., circumstances indicate that--

(1) The offeror believed that at least one other offeror was capable of submitting a meaningful, responsive offer; and

(2) The offeror had no reason to believe that other potential offerors did not intend to submit an offer; and

(B) The determination that the proposed price is based on adequate price competition and is reasonable is approved at a level above the contracting officer; or

(iii) Price analysis clearly demonstrates that the proposed price is reasonable in comparison with current or recent prices for the same or similar items purchased in comparable quantities, under comparable terms and conditions under contracts that resulted from adequate price competition.

~~*(2) Established catalog or market prices. (i) Established catalog price.* Established catalog prices are prices (including discount prices) recorded in a catalog, price list, schedule, or other verifiable and established record that (A) are regularly maintained by the manufacturer or vendor; and (B) are published or otherwise available for customer inspection.~~

~~(ii) *Established market price*. An established market price is a price that is established in the course of ordinary and usual trade between buyers and sellers free to bargain and that can be substantiated by data from sources independent of the offeror.~~

~~(iii) *Based on*. A price may also be based on an established catalog or market price if the item or class of items being purchased is not itself a catalog or market priced commercial item but is sufficiently similar to the catalog or market priced commercial item to ensure that any differences in prices can be identified and justified without resorting to cost analysis.~~

~~(iv) *Sold in substantial quantities*. An item is sold in substantial quantities if there are sales of more than a nominal quantity based on the norm of the industry segment. In determining what constitutes a substantial quantity, the contracting officer should consider such things as the size of the market, and how recently the item was introduced into the market. Models, samples, prototypes, and experimental units are not substantial quantities. For services to be sold in substantial quantities, they must also be customarily provided by the offeror, using personnel regularly employed and equipment (if any is necessary) regularly maintained principally to provide the services.~~

~~(A) The method used to establish sales may be sales order, contract, shipment, invoice, actual recorded sales, or other records, so long as the method used is consistent, provides an accurate indication of sales activity, and is verifiable. If the item would not otherwise qualify for an exception, sales of the item by affiliates may be considered. In addition, sales of essentially the same commercial item by other manufacturers or vendors may be considered in determining whether sales are substantial, provided that the price of those sales is also considered. Data to support sales quantities may also come from other manufacturers, industry associations or marketing groups, annual financial reports, etc.~~

~~(B) An exception may apply for an item based on the market price of the item regardless of the quantity of sales of the item previously made by the offeror or the types of customers for these sales, provided that sales of the same or similar items by other sellers meet the exception criteria.~~

~~(v) *General public*. The general public ordinarily consists of buyers other than the U.S. Government or its instrumentalities, e.g., U.S. government corporations. Sales to the general public do not include sales to affiliates of the offerors or purchases by the U.S. Government on behalf of foreign governments, such as Foreign Military Sales. If the contracting office can determine without requiring information from the offeror that sales are for~~

~~Government end use, these sales need not be considered sales to the general public.~~

(2) ~~(3)~~ *Prices set by law or regulation.* Pronouncements in the form of periodic rulings, reviews, or similar actions of a governmental body, or embodied in the laws are sufficient to set a price.

(3) ~~(4)~~ *Commercial items.* **An acquisition for an item that meets the commercial item definition in 2.101 is excepted from the requirement to obtain cost or pricing data.** ~~For acquisition of a commercial item, if the contracting officer does not have sufficient information to support an exception under 15.804-1(a)(1) or (a)(4), the contracting officer shall grant an exception for a contract, subcontract, or modification of a contract or subcontract if the contracting officer obtains the pricing information described in 15.804-5(b). Cost or pricing data may be obtained for such a commercial item only if the contracting officer makes a written determination that the pricing information is inadequate for performing a price analysis and determining price reasonableness.~~

~~—~~(4) ~~(5)~~ Exceptional cases. The head of the contracting activity may, without power of delegation, waive the requirement for submission of cost or pricing data. The authorization for the waiver and the reasons for granting it shall be in writing. A waiver may be considered if another exception does not apply but the price can be determined to be fair and reasonable without submission of cost or pricing data. For example, if cost or pricing data were furnished on previous production buys and the contracting officer determines such data are sufficient, when combined with updated information, a waiver may be granted. If the head of the contracting activity has waived the requirement for submission of cost or pricing data, the contractor or higher-tier subcontractor to whom the waiver relates shall be considered as having been required to make available cost or pricing data. Consequently, award of any lower-tier subcontract expected to exceed the cost or pricing data threshold requires the submission of cost or pricing data unless and exception otherwise applies to the subcontract.

(5) ~~(6)~~ *Modifications.* This exception ~~only~~ applies when the original contact or subcontract was exempt from cost or pricing data based on adequate price competition, ~~catalog or market price, or~~ price set by law or regulation, **or was a contract or subcontract for the acquisition of a commercial item** (15.804-1(a)(1) **or (a)(2)**). For modifications of contracts or subcontracts for commercial items, the exception at 15.804-1(a)(4) applies if the modification does not change the item from a commercial item to a noncommercial item. However, if the modification to a contract or subcontract changes the nature of the work under the contract or subcontract either by a change to the commercial

item or by the addition of other noncommercial work, the contracting officer is not prohibited from obtaining cost or pricing data for the added work.

~~(e) *Special circumstances when purchasing commercial items.* (1) It is not necessary to obtain information supporting an exception for each line item. Sampling techniques may be used.~~

~~(2) If the U.S. Government has acted favorably on an exception request for the same or similar items, the contracting officer may consider the prior submissions as support for the current exception request. Relief from the submission of new information does not relieve the contracting officer from the requirement to determine reasonableness of price on the current acquisition.~~

~~(3) When acquiring by separate contract an item included on an active Federal Supply Service or Information Technology Service Multiple Award Schedule contract, the contracting office should grant an exception and not require documentation if the offeror has provided proof that an exception has been granted for the schedule item. Price analysis shall be performed in accordance with 15.805-2 to determine reasonableness of price.~~

~~(4) The contracting officer and offeror may make special arrangements for the submission of exception requests for repetitive acquisitions. These arrangements can take any form as long as they set forth an effective period and the exception criteria at 15.804-1 are satisfied. Such arrangements may be extended to other Government offices with their concurrence.~~

~~(d) *Requesting an exception.* In order to qualify for an exception, other than an exception for adequate price competition, from the requirements to submit cost or pricing data, the offeror must submit a written request. The solicitation provision at 52.215-41 or other methods may be used. It is the responsibility of the contracting officer to determine, based on the information submitted, and any other information available to the contracting officer, which exception, if any, applies.~~

15.804-5 Requiring information other than cost or pricing data.

(a) **General** (1) If cost or pricing data are not required because an exception applies, or an action is at or below the cost or pricing data threshold, the contracting officer shall **perform** ~~make~~ a price analysis to determine the reasonableness of the price and any need for further negotiation.

(2) The contracting officer **shall** ~~may~~ require submission of information other than cost or pricing data only to the extent necessary to determine reasonableness of the price or cost realism. **Unless an exception under 15.804-1(a)(1) applies, the contracting officer shall obtain, at a minimum,**

appropriate information on the prices at which the same item or similar items have previously been sold that is adequate for evaluating the reasonableness of the price. ~~The contractor's format for submitting such information shall be used unless the contracting officer determines that use of a specific format is essential. The contracting officer shall ensure that information used to support price negotiations is sufficiently current to permit negotiation of a fair and reasonable price. Requests for updated offeror information should be limited to information that affects the adequacy of the proposal for negotiations, such as changes in price lists. Such data shall not be certified in accordance with 15.804-4.~~

(3) The contractor's format for submitting such information shall generally be used (see 15.804-5(c)(2)). ~~When an acquisition is based on adequate price competition, generally no additional information is necessary to determine the reasonableness of price. However, if it is determined that additional information is necessary to determine the reasonableness of the price, the contracting officer shall, to the maximum extent practicable, obtain the additional information from sources other than the offeror. In addition, the contracting officer may request information to determine the cost realism of competing offers or to evaluate competing approaches.~~

(4) The contracting officer shall ensure that information used to support price negotiations is sufficiently current to permit negotiation of a fair and reasonable price. Requests for updated offeror information should be limited to information that affects the adequacy of the proposal for negotiations, such as changes in price lists. Such data shall not be certified in accordance with 15.804-4. ~~When cost or pricing data are not required because an action is at or below the cost or pricing data threshold, information requested shall include, as a minimum, appropriate information on the prices and quantities at which the same or similar items have previously been sold, that is adequate for evaluating the reasonableness of the proposed price. Cost information may also be required. For example, cost information might be necessary to support an analysis of material costs.~~

(b)~~(1)~~ Adequate price competition. When an acquisition is based on adequate price competition, generally no additional information is necessary to determine the reasonableness of price. However, if it is determined that additional information is necessary to determine the reasonableness of the price, the contracting officer shall, to the maximum extent practicable, obtain additional information from sources other than the offeror. In addition, the contracting officer may request information to determine the cost realism of competing offers or to evaluate competing

approaches. ~~When acquiring commercial items for which an exception under 15.804-1(a)(2) may apply, the contracting officer shall seek to obtain from the offeror or contractor information on prices at which the same or similar items have been sold in the commercial market, that is adequate for evaluating, through price analysis, the reasonableness of the price of the action.~~

~~(2) If such information is not available from the offeror or contractor, the contracting officer shall seek to obtain such information from another source or sources.~~

~~(3) Requests for sales data relating to commercial items shall be limited to data for the same or similar items during a relevant time period.~~

~~(4) In requesting information from an offeror under this paragraph (b), the contracting officer shall, to the maximum extent practicable, limit the scope of the request to include only information that is in the form regularly maintained by the offeror in commercial operations.~~

~~(5) Any information obtained pursuant to this paragraph (b) that is exempt from disclosure under the Freedom of Information Act (5 U.S.C. 552(b)) shall not be disclosed by the Government.~~

(c) Limitations relating to commercial items. (1) requests for sales data relating to commercial items shall be limited to data for the same or similar items during a relevant time period.

(2) The contracting officer shall, to the maximum extent practicable, limit the scope of request for information relating to commercial items to include only formation that is in the form regularly maintained by the offeror in commercial operations.

(3) Any information relating to commercial items obtained pursuant to this paragraph (c) that is prohibited from disclosure by 24.202(a) or exempt from disclosure under the Freedom of Information Act (5 U.S.C. 552(b)) (see 24.202(b)) shall not be disclosed by the Government. ~~If, after receipt of offers, the contracting officer concludes there is insufficient information available to determine price reasonableness and none of the exceptions applies, then cost or pricing data shall be obtained.~~

Appendix F. Changes to FAR 52.215-41, "Requirements for Cost or Pricing Data or Information Other Than Cost or Pricing Data," Made as a Result of FARA

The FAR Part 15, "Contracting by Negotiation," rewrite, effective October 10, 1997, changed FAR 52.215-41 to FAR 52.215-20 with no material changes. FAR 52.215-41 was materially changed by FARA and those changes are shown.

52.215-41 Requirements for Cost or Pricing Data or Information Other Than Cost or Pricing Data.

As prescribed in 15.804-8(h), insert the following provision:

REQUIREMENTS FOR COST OR PRICING DATA OR INFORMATION OTHER THAN COST OR PRICING DATA (**JAN 1997** ~~OCT 1995~~)

(a) *Exceptions from cost or pricing data.* (1) In lieu of submitting cost or pricing data, offerors may submit a written request for exception by submitting the information described in the following subparagraphs. The Contracting Officer may require additional supporting information, but only to the extent necessary to determine whether an exception should be granted, and whether the price is fair and reasonable.

(i) **Identification of the law or regulation establishing the price offered. If the price is controlled under law by periodic rulings, reviews, or similar actions of a governmental body, attach a copy of the controlling document, unless it was previously submitted to the contracting office.** ~~Information relative to an exception granted for prior or repetitive acquisitions.~~

(ii) **For a commercial item exception, the offeror shall submit, at a minimum, information on prices at which the same item or similar items have previously been sold that is adequate for evaluating the reasonableness of the price for this acquisition. Such information may include--**~~Catalog price information as follows:~~

(A) **For catalog items, a copy of or identification of the catalog** ~~Attach a copy of or identify the catalog~~ and its date, or the appropriate pages for the offered items, or a statement that the catalog is on file in the buying office to

which this proposal is being **submitted.** ~~made.~~ **Provide a copy or describe current discount policies and price lists (published or unpublished), e.g., wholesale, original equipment manufacturer, or reseller. Also explain the basis of each offered price and its relationship to the established catalog price, including how the proposed price relates to the price of recent sales in quantities similar to the proposed quantities.**

(B) **For market-priced items, the source and date or period of the market quotation or other basis for market price, the base amount, and applicable discounts. In addition, describe the nature of the market.** ~~Provide a copy or describe current discount policies and price lists (published or unpublished), e.g., wholesale, original equipment manufacturer, and reseller.~~

(C) **For items included on an active Federal Supply Service Multiple Award Schedule contract, proof that an exception has been granted for the schedule item.** ~~Additionally, for each catalog item that exceeds * (extended value not unit price), provide evidence of substantial sales to the general public. This may include sales order, contract, shipment, invoice, actual recorded sales or other records that are verifiable. In addition, if the basis of the price proposal is sales of essentially the same commercial item by affiliates, other manufacturers or vendors, those sales may be included. The offeror shall explain the basis of each offered price and its relationship to the established catalog price. When substantial general public sales have also been made at prices other than catalog or price list prices, the offeror shall indicate how the proposed price relates to the price of such recent sales in quantities similar to the proposed quantities.~~

~~(iii) *Market price information.* Include the source and date or period of the market quotation or other basis for market price, the base amount, and applicable discounts. The nature of the market should be described. The supply or service being purchased should be the same as or similar to the market price supply or service. Data supporting substantial sales to the general public is also required.~~

~~(iv) *Identification of the law or regulation establishing the price offered.* If the price is controlled under law by periodic rulings, or similar actions of a government body, attach a copy of the controlling document, unless it was previously submitted to the contracting office.~~

~~(v) For a commercial item exception, information on prices at which the same item or similar items have been sold in the commercial market.~~

(2) The offeror grants the Contracting Officer or an authorized representative the right to examine, at any time before award, books, records, documents, or other directly pertinent records to verify any request for an exception under this

provision, and the reasonableness of price. Access does not extend to cost or profit information or other data relevant solely to the offeror's determination of the prices to be offered in the catalog or marketplace.

(b) *Requirements for cost or pricing data.* If the offeror is not granted an exception from the requirement to submit cost or pricing data, the following applies:

(1) The offeror shall submit cost or pricing data on Standard Form (SF) 1411, Contract Pricing Proposal Cover Sheet (Cost or Pricing Data Required), with supporting attachments prepared in accordance with Table 15-2 of FAR 15.804-~~6(b)(2)~~4.

(2) As soon as practicable after agreement on price, but before contract award (except for unpriced actions such as letter contracts), the offeror shall submit a Certificate of Current Cost or Pricing Data, as prescribed by FAR 15.804-4.

~~(c) By submitting information to qualify for an exception an offeror is not representing that this is the only exception that may apply.~~

Appendix G. Sundstrand Commercial Items

NSN	Sundstrand Part Number	Buying Center	Item Description
1650-00-286-2358	710511	DSCC	Wobbler, Fixed
1650-00-295-2352	712006	DSCC	Guide, Retainer, Constant
1650-00-445-8095	709637	DSCC	Retainer, Matched
1650-00-910-9818	693601	DSCC	Ring, Quick Attached
1650-01-210-6719	718092	DSCC	Shaft Assembly, MATC
1650-01-211-2078	717328	DSCC	Stem and Sleeve Set
1650-01-211-2081	722600	DSCC	Retainer, Slipper
1650-01-234-4058	740981	DSCC	Retainer, Slipper
1650-01-246-7063	733754AGD	DSCC	Piston, Hydraulic Motor Pump
1650-01-246-9069	733754GE	DSCC	Piston, Hydraulic Motor Pump
1650-01-246-9070	733754AGE	DSCC	Piston, Hydraulic Motor Pump
1650-01-247-4210	725940	DSCC	Retainer, Guide
1650-01-248-8591	758640	DSCC	Cylinder Block, Hydraulic Motor
1680-00-624-7087	713879	DSCR	Gearshaft, Multiple Gears
1680-01-003-6885	706578	DSCR	Stator Motor
2835-00-963-1175	26966-0	DSCR	Screen Assembly
2835-01-057-3413	117558-0	DISC	Air Inlet Screen Assembly
2835-01-191-8231	162690-1	DISC	Disk, Turbine
2910-01-057-5186	43951-100	DSCC	Valve Assembly, Power Unit
2915-00-654-3553	02-12312	DISC	Coupling, Drive Shaft
2915-00-654-3609	02-11935	DISC	Support, Gearshaft
2915-00-813-9411	102-1447	DISC	Ring and Seal Assembly
3020-00-248-8956	902-160A	DSCC	Gear Set, Spur, Matched
3020-00-463-7768	695048	DSCC	Gear Cluster
3020-01-003-0975	713920	DSCC	Gear Cluster, Internal Spur
3020-01-011-7563	713921	DSCC	Gear, Spur

Appendix G. Sundstrand Commercial Items

NSN	Sundstrand Part Number	Buying Center	Item Description
3040-01-003-6888	710563	DSCC	Shaft Assembly
3040-01-008-4447	713919	DSCC	Journal, Bearing
3040-01-115-4905	952451C1	DSCC	Shaft, Driver
3110-00-282-0355	712152	DISC	Retainer, Roller Bearing
3110-00-282-0408	712153	DISC	Retainer, Roller Bearing
3110-00-282-0491	706595	DISC	Retainer, Roller Bearing
3110-01-009-8144	4333-04APG	DISC	Retainer, Roller Bearing
3120-00-484-6165	902-148	DISC	Bearing Set, Sleeve
3120-00-877-3765	02-13638	DISC	Bearing Set, Sleeve
3120-01-080-5047	728485	DISC	Bearing, Sleeve
3130-01-034-0707	706812	DISC	Housing, Bearing Unit
5305-01-122-4505	160652-1	DISC	Bolt
5340-00-126-0470	690775-8	DISC	Insert, Screw Thread
5360-00-653-4505	683841	DISC	Spring, Helical Compression
5365-01-210-0933	729918	DISC	Retainer, Guide
6105-00-457-7063	11937-1	DSCR	Stator Motor
6105-00-847-8199	4414-3	DSCR	End bell, Electrical

Appendix H. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology*
  Deputy Under Secretary of Defense (Acquisition Reform)*
  Deputy Under Secretary of Defense (Logistics)*
  Director, Defense Procurement*
  Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Air Force Audit Agency

Other Defense Organizations

Director, Defense Contract Audit Agency*
Director, Defense Logistics Agency*
  Commander, Defense Contract Management Command*
    Commander, Defense Contract Management Command Chicago-Rockford*

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Other Defense Organizations (cont'd)

Commander, Defense Supply Center Columbus*
Commander, Defense Supply Center Richmond*
Commander, Defense Industrial Supply Center Philadelphia*
Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

Office of Management and Budget
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Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations*
Senate Subcommittee on Defense, Committee on Appropriations*
Senate Committee on Armed Services*
Senate Committee on Governmental Affairs*
House Committee on Appropriations*
House Subcommittee on National Security, Committee on Appropriations*
House Committee on Government Reform and Oversight*
House Subcommittee on Government Management, Information and Technology, Committee on Government Reform and Oversight*
House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight*
House Committee on National Security*

Part III - Management Comments

The Under Secretary of Defense for Acquisition and Technology Comments

Final Report Reference

THE UNDER SECRETARY OF DEFENSE
3010 DEFENSE PENTAGON
WASHINGTON, D.C 20301-3010

ACQUISITION AND TECHNOLOGY

JAN 13 1998

MEMORANDUM FOR INSPECTOR GENERAL OF THE DEPARTMENT OF DEFENSE

SUBJECT: Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111

Thank you for the opportunity to comment on the subject report We also appreciate the opportunity you provided us to work with you in resolving this matter I know that you share our commitment to reforming our acquisition system, so that we can be smarter, work faster and buy better and cheaper products which meet the warfighter's needs We have only a few overall comments with regard to the report which follow More specific comments are attached

Generally the report is very well written and provides a thorough discussion of the Truth in Negotiation Act (TINA), the changes that were made to TINA resulting from the Federal Acquisition Streamlining Act (FASA) and the Clinger-Cohen Act (Clinger-Cohen) Many of the items reviewed were contracted for before the changes to TINA became effective In fact, it is unlikely that Sundstrand would have entered into the negotiations for the recently awarded DoD corporate contract for commercial items if FASA and Clinger-Cohen had not been in place. The contractor may well have preferred to continue selling to DoD through many small purchases, rather than accept a single, corporate contract requiring certified cost or pricing data

Given the foregoing we do not believe it is relevant to the discussion of the issues to make a distinction between cost based pricing and commercial pricing Nothing in the report demonstrates that the prices we paid would have been any different had we used cost based pricing In fact, we know the government had substantial information about the prices previously paid for these items, and that contracting officers knew prices were too high but were unable to negotiate lower prices. We recommend that you delete all distinctions between cost based pricing and catalogue or commercial pricing within the report, since the distinctions do not appear to have any relevance to the problem or its ultimate resolution

We agree with your recommendations that additional training and guidance in commercial pricing are needed and are the keys to resolving the problems you have identified We also agree that DLA should require contracting officers to procure economic order quantities on all orders placed with this company, and should determine the reliability of previous prices before using price analysis to determine whether prices are fair and reasonable

Deleted

We do not agree that contracting officers should use as a past performance evaluation factor the fact that a contractor did not comply with acquisition reform legislation and Federal regulations regarding the submission of uncertified cost or pricing data for commercial items when needed to establish price reasonableness Based on the facts presented in the report, it does not appear that this particular contractor failed to comply with acquisition reform legislation or Federal regulations

We also do not agree that uncertified cost or pricing data or access to contractor cost data is necessarily needed to establish price reasonableness for commercial items The contracting officer's tools should primarily be market research and price analysis, and they must focus on how comparable their needs are to those of commercial customers in order to determine whether they should pay the same price as commercial customers. They must decide whether they need the same terms and conditions as commercial customers, if they are buying comparable quantities, and whether they are buying spares for inventory or for direct delivery to a location that needs a part immediately – each of these factors will affect the determination of what constitutes a reasonable price. Cost data should not be needed.

At my request, DLA conducted a survey of the prices it is paying for commercial items on contracts over $25,000 awarded under FAR Part 12. DLA found, that in these contracts, prices have decreased approximately12 percent after adjusting for inflation (8.9 percent before inflation adjustment). These contracts were for the purchase of over 6,000 national stock numbers and were valued at $167.2 million. I believe that the results of the DLA survey demonstrate that the changes made by FASA and Clinger-Cohen have served to reduce prices to the government generally, that purchasing commercial items will represent overall lower prices for the Department in the future, and further support a conclusion that the situation identified in the instant report is an aberration.

J. S. Gansler

Defense Logistics Agency (Headquarters) Comments

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221

IN REPLY REFER TO DDAI

23 DEC 1997

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT Draft Audit on Commercial and Noncommercial Sole-Source Items Procured on Contract N00383-93-G-M111

We agree with the Inspector General that greater savings can be achieved by the Defense Logistics Agency (DLA) in procuring commercial items then was evident in the audit of Sundstrand items conducted by the DoDIG We also agree that DLA could have more effectively leveraged our buying power by combining requirements into value-added long-term business arrangements We are currently in an accelerated process to do just that and have already done so in the case of the Sundstrand items covered in the audit Although this addresses the immediate issue of the Sundstrand items, it leaves unaddressed the question of whether additional statutory guidance is required to prevent such situations from recurring in the future We believe additional guidance is not required at this time

We find that the current laws and regulations give us the latitude to take advantage of the efficiencies of the commercial marketplace while ensuring best-value arrangements for our customers It is true that our shift to this new way of acquiring goods and services has required some adjustments and a learning curve for our work force These adjustments include the requirement to evaluate contractor proposals on the basis of the total cost of goods and services to our customers, rather than the cost of goods alone We feel we are making that transition as rapidly and efficiently as can be expected under the circumstances In support of this statement, recent studies of items procured under Federal Acquisition Regulations (FAR) Part 12 commercial practices indicate overall price reductions of 10-12 percent were achieved after inflation

We conclude that additional statutory guidance is not required at this time In particular, we feel that a requirement to return to certified cost or pricing data would do more harm than good in that it is likely to reduce the number of contractors willing to negotiate under the commercial practices provisions of the Federal Acquisition Streamlining Act (FASA) and the Federal Acquisition Reform Act (FARA) We will continue to develop our use of these new practices under existing statutory authority with the increased vigilance proved necessary from the Sundstrand audit. Should a need for statutory change surface at a later time, we will address it at that point

Thank you for the opportunity to offer comments and recommendations

E R. CHAMBERLIN
Rear Admiral, SC, USN
Deputy Director

Federal Recycling Program Printed on Recycled Paper

TYPE OF REPORT: Draft **DATE OF POSITION:** December 19, 1997

SUBJECT: Commercial and Noncommercial Sole-Source Items Procured on Contract N00383-93-G-M111, 6CF-0068

FINDING A: Catalog Prices for Sole-Source Commercial Items

The Defense Logistics Agency (DLA) paid catalog prices for sole-source commercial items from Sundstrand Aerospace (Sundstrand). The catalog prices paid were significantly higher than the cost-based prices DoD previously paid for the items. Higher prices were paid for commercial items because:

- As a sole-source supplier with technical data rights, Sundstrand set "market-based" catalog prices for commercial items at "what the market would bear," and there was no competitive commercial market to ensure the reasonableness of the prices;

- Sundstrand refused to negotiate catalog prices for commercial items based on price analysis of previous cost-based prices, refused to provide DLA contracting officers with "uncertified" cost or pricing data for commercial catalog items, and terminated Government access to the Sundstrand cost history system; and

- Guidance on commercial items qualified any item "offered for sale, lease, or license to the general public," as a commercial item without addressing commercial pricing, even though DoD was the primary customer procuring significantly larger quantities than other commercial customers.

As a result, DLA paid about [redacted] (in 1997 constant dollars), or an average of about [redacted] percent, more than the fair and reasonable prices for the $6.1 million of commercial items purchased from Sundstrand during CYs 1994 through 1996. Based only on the data reviewed for CY 1996, we calculate that DLA could reduce costs by at least [redacted] during CYs 1998 through 2003 if fair and reasonable prices are paid for the commercial items. DLA through DCMC has established a negotiating team that is trying to negotiate a pricing arrangement with Sundstrand for commercial items that should address most of our concerns.

DLA COMMENTS: Partially concur.

DLA POSITION

- **Concur** in the statements made in the first paragraph and the subsequent three bulletized subparagraphs of this Finding A (stated above). DLA contracting officers negotiated in good faith and in accordance with the laws and regulations in effect at the time. The IG has

Darkened areas (blank spaces) of this report represent data that Sundstrand Corporation considered confidential business Information which has been deleted.

documented difficulties that were encountered in procuring sole-source Sundstrand items at fair and reasonable prices, and actions DLA initiated to overcome these difficulties. DLA concurs in the aforementioned causes the IG cites, which boil down to the fact that Sundstrand had an improved negotiation position under the streamlined rules. In some instances, even with the involvement of ICP executives, reasonable pricing was not attainable and the requirement could not be forgone. Established procedures were followed in documenting the exigent circumstances requiring award and the contracting officer's determination that the price was unfair and unreasonable.

• **Partially concur** in the DoD Inspector General (IG) conclusion (***final paragraph of the finding***) that DLA paid more than the fair and reasonable prices for the buys the IG deemed excessive; ***but*** **nonconcur** in the IG's calculation methodology and results.

•• The IG used pricing methodology that existed prior to the 1994-1996 period to measure price reasonableness achieved during that period Our calculations for that same period measure price reasonableness for the period using pricing methodology consistent with laws and regulations in existence during that period. The net effect of using pricing rules consistent with those in effect during the period of contracting (which are less costly to implement) is the substantial reduction in the calculation of overpayment discussed below.

•• Using the current rules, a DLA-led initiative (with the Services' strong participation) adapted the commercial business practice of establishing long-range business arrangements with major suppliers in singularly successful negotiations with Sundstrand which:

••• Resulted in award on December 8, 1997 by DLA's Defense Supply Center Columbus (DSCC) of a DoD corporate contract covering the combined requirements not only of DLA contracting offices, but those of the Military Departments as well, for sole-source Sundstrand commercial parts;

••• Substantially ***reduced prices*** (i.e., the quantities of the $4.1 million total expenditures during CYs 1994 through 1996 on the 31 items questioned by the IG which were also included in the corporate contract were reduced by [redacted] to a cost of [redacted] under the corporate contract). [The 9 remaining IG-challenged items, valued at $1.9 million, were not covered by the award because Sunstrand declined to quote, anticipated future demands were non-existent or minimal, and/or the commerciality of the item was questionable.];

••• Demonstrates that reasonable prices ***are*** achievable for acquisition of sole-source Sundstrand commercial items under current, streamlined Government procurement procedures; and

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●●● Provides a *valid* basis for calculating the extent of excessive price growth on most of the items in question, which DLA will now use in initiating an appropriate recoupment action with Sundstrand.

● **Partially concur** in the IG's conclusion (***second sentence, final paragraph of Finding A***) that DLA could reduce costs during CYs 1998 through 2003 if fair and reasonable prices are paid for the commercial items; ***but*** **nonconcur** in the IG's calculation methodology and results.

●● To calculate future cost avoidance amounts, the IG priced out quantities of items purchased in CY 1996 using the differences in unit prices between Sundstrand's current (1997) discounted catalog prices available to the Government, and old prices (escalated to 1997) awarded under the prior (substantially more stringent, rigid, and costly) rules of Government procurements

●● The IG's projection substantially inflated to [redacted] per year, the annual amount, which it then multiplied by 6 to produce its 6 year estimate [redacted] of potential future cost avoidance available on the items in question.

●● The projection of potential cost avoidance for future periods under the Government's streamlined rules for commercial procurements should be based on any differences between *comparable* prices—i.e., prices achieved under these same, current rules To do otherwise would totally discount the additional cost of implementing the old rules, as well as other non-price-related cost avoidances

●● The success of the team in leveraging the Government's buying power to achieve a DoD corporate contract with substantially reduced pricing, provides a proper basis for comparison, which:

●●● Has assured that [redacted] of the [redacted] (in CY 1997 dollars) of the IG-reported annual excess in purchase cost ***will be avoided*** for the 31 items on the new corporate contract (out of the 40 IG-challenged items) over the 3 year period ended December 7, 2000. [DLA calculated a more realistic, albeit smaller cost avoidance of [redacted] based on deducting the $1.3 million total value of individual CY 1996 awards for the 31 IG-questioned items if they had been ordered at corporate contract prices, from the $2.8 million actually expended for these quantities in CY 1996 on individual DLA awards using the current, streamlined commercial pricing rules.];

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●●● Has assured that an additional ***$1.15 million annually*** of purchase cost increases which ***will be avoided*** through December 5, 2000, on the 185 other sole-source commercial items managed by DLA and the Military Departments on the DoD corporate contract that were not covered by the IG audit. [Some of these items had not been purchased during CY 1996 and/or purchase history was not available (i.e., on the 47 items included on the corporate contract that are managed by the Services). Accordingly, DLA calculated this projected cost avoidance by extending the $1.5 million annual savings (***see previous paragraph***) times the ratio of the estimated annual contract value of the remaining 185 items, to the annual value of the aforementioned 31 items ($3.022 million/$3.942 million).];

●●● Has guaranteed that an additional ***$0.992 million annually*** of DLA procurement personnel and other costs ***will be avoided*** through December 7, 2000, on the 180 items managed by DLA that are covered by the DoD corporate contract because: (i) future orders under the corporate contract will be automatically processed and placed using DLA's automated ordering systems, and (ii) having these items under contract enables a significantly reduced investment in the stockage levels otherwise needed to cover the normal procurement leadtime. [We believe that similar cost avoidance savings should also accrue to the Services on their 36 items included on the corporate contract, but time did not permit follow-up to learn whether cost factors applicable to their contracting offices are available to quantify the magnitude of these additional future savings.]; and

●●● Supports the expectation that cost avoidances at similar rates to those addressed in the preceding bulletized subparagraphs, should continue after conclusion of the corporate contract, for the remainder of the IG's 6 year projection period (December 8, 2000 - December 31, 2003).

● **Concur** in the IG's conclusion that the DLA-established negotiating team that the recently completed negotiation of the Phase I DoD corporate contract with Sundstrand for commercial items, should address the IG's concerns. However, an airline industry survey that was conducted in preparation for establishing the Government's negotiating position identified numerous examples where sole-source parts had been reverse engineered and were being used in the commercial marketplace. DLA is initiating a follow-on action for instances where it appears cost-effective, to pursue approval from the cognizant Military design control activities of these alternate items, to enable future competitive buys on currently-sole-source commercial parts.

Details of these corrective actions, along with some background information, rationale, and calculations supporting the DLA position, are contained in the Attachment to this Finding

ACTION OFFICER: Jerry C. Gilbart, DLA-MMPPB, December 16, 1997.

REVIEW/APPROVAL: ROBERT L. MOLINO, DLA-MMP, December 18, 1997

COORDINATION: JEFFREY A. JONES
Principal Executive Director
Materiel Management, December 19, 1997

TIMOTHY P. MALISHENKO
Brigadier General, USAF
Commander, December 18, 1997

THOMAS M. HILLIN
Deputy General Counsel
(Acquisition), December 18, 1997

PIERSON KEMP, Management Control POC
Office of Comptroller, December 17, 1997

DLA APPROVAL: E. R. CHAMBERLIN
RADM, SC, USN
Deputy Director, December 19, 1997

1 Attachment
Backup for DLA
Position--Finding A.

BACKUP FOR DLA POSITION–FINDING A.

BACKGROUND INFORMATION

The "Audit Background" portion of the report touches on relevant former and present acquisition policies effecting the audit results. Historically, the Government's procurement rules constrained the substantiation of commercial prices to awards exceeding the present simplified acquisition threshold ($100,000) using a process involving offeror submission and certification, and Government validation, of current, accurate, and complete cost or pricing data, absent competition or a catalog or market price for an item sold in substantial quantities to the general public.

The minimum threshold for this labor-intensive evaluation process was subsequently raised to $500,000. More recently, the requirement to utilize cost analysis for commercial item purchases became recognized as largely unnecessary. Accordingly, it was supplanted by enabling legislation in 1994 and 1996 and regulatory implementation that adopted best commercial practices for use in Government procurement. As noted by the IG ***(see Finding A., third bullet)***, the definition of commercial items was also expanded to qualify any item offered for sale, lease, or license to the general public

Commercial market purchase principles Commercial product pricing is largely market driven with current cost of sales and short-term profitability playing lesser roles than other market considerations. Pricing decisions made by commercial businesses result from corporate philosophy and from strategic goals and objectives. This includes consideration of the firm's competitive position in the market, market share goals that may vary by product line, degree of customer acceptance, alternative choices available to customers, and the ability to recoup the costs of past investments in new technology and products

The Government's decision to adopt commercial practices has presented significant challenges for procurement professionals attempting to assure price reasonableness of items available in the commercial market place The absolute assurance of price reasonableness that was heretofore gained through audits and other reviews of cost or pricing data has given way to a changing business environment where Government procurement professionals are challenged to pursue alternative, less definitive, means of assuring price reasonableness

Government procurement managers recognized the conversion would entail a new learning experience as contracting officers encountered, and responded to, the lesser degree and nature of price support data available under streamlined commercial practices. The need for training and the development of new skills required to function effectively in the commercial marketplace has now been confirmed by the IG (***Recommendation A-1***).

Cost avoidances via commercial practices The decision to streamline procurement rules and adopt commercial buying practices was based in part on the recognition that reduced procurement administrative savings and lead time cost savings will accrue to the Government as a result of the recent streamlining changes that have been made. As noted in the draft *(see IG report, paragraph captioned* **"Industry Study on Cost Premium for Cost or Pricing Data,"** *under the* **"Audit Background"** *subsection of the writeup of Finding A.)*, the practice of requiring submission and certification of cost or pricing data was the second largest cost driver, having an average cost impact of 1.3 percent of overall acquisition costs.

IG approach shortcomings The IG compared award prices paid during the Government's policy transition, to award prices achieved through the more intensive audit validation process formerly required. The temporary abnormal cost growth on Sundstrand commercial parts is atypical of experiences DLA has had with virtually all other suppliers. Further, as the IG notes, the excessive pricing problem is being corrected *(see discussion in the section entitled* **"RESOLUTION OF IG-REPORTED EXCESSIVE PRICING (CYs 1994 - 1996)"** *below)*.

The IG did not recognize that the Government's conversion to commercial market practices would necessitate adjustments in some instances, from the prior levels at which the Government regularly purchased after substantiating the validity of contractor cost projections. The audit comparison also failed to address, much less monetize, the substantial improvements that have been achieved over the last several years through the Government's adoption of commercial buying practices and the streamlining of Government rules and policies; and failed to quantify the savings the Government has made as a result of the enabling legislation and regulation changes. DLA has quantified some of the additional cost avoidance savings that will accrue as a result of the newly award DoD corporate contract *(see recap under the second bullet of the section entitled* **"DLA POSITION"** *in Finding A and the discussion in paragraph entitled* **"Procurement administrative cost and administrative leadtime cost avoidances ($0.992 million/year)"** **under the section entitled "RESOLUTION OF IG-REPORTED POTENTIAL COST AVOIDANCE (CYs 1998 - 2003)"** *below)*.

DLA purchase price growth studies. In light of the Sundstrand long-term contract and questions regarding use of FAR Part 12 commercial contracting procedures, we looked at price changes in various subsets of DLA business. The subsets were Commercial Contracts, NSNs on the Sundstrand corporate contract and the total universe of awards by the DLA Hardware Inventory Control Points (ICPs) (the same three involved in procuring Sundstrand parts) plus the Defense Personnel Support Center, for clothing and textile items. Results were as follows:

1 Overall DLA About 950,000 different NSNs had been purchased from FY 1992 through FY 1997 Due to an unacceptable data loss that would occur with any comparison

methodology that would be restricted to items that were bought in all 6 FYs, it was decided instead to make five separate paired data sets to measure price growth from 1 year to the succeeding year as shown below. Each 2-year comparison would be computed using 1st year quantities for constant weighting purposes. A filter was employed to preclude bias arising from comparisons that included extended item prices achieved in 1 year of extremely small quantity purchases, to prices in the other year where extremely large quantities were purchased. The analyst threw out instances where total purchased quantities for an item varied between years of a paired data set, by a factor of 10 or more from each other. All comparisons included between 90,000 and 120,000 NSNs available for study. The DLA overall price increases from year to year were as follows:

FYs 1992 to 1993 — 2.0%
FYs 1993 to 1994 — 3.5%
FYs 1994 to 1995 — 4.5%
FYs 1995 to 1996 — 6.0%
FYs 1996 to 1997 — 2.5%

2 FAR Part 12 Commercial Contracting Awards for items bought during the 2-year period FY 1994 through 1995 (before coding for commercial contracts was implemented) were compared to prices paid for the same items on FAR Part 12 Commercial Contracts in the subsequent 2-year period (FY 1996 and FY 1997). Results show a decrease in prices using absolute dollars of about 6 ½ percent (nearly 10 percent when adjusted for inflation) There were about 400 contracts identified awarded using FAR Part 12 procedures, valued at over $900 million for FYs 1996 and 1997 and covering about 20,000 items. NSNs bought in similar quantities (within a factor of ten) pre- and post- Part 12 implementation were included in the study The value of the items included in the study was about $150 million dollars

3 Sundstrand contract items. The experience with Sundstrand is markedly different from the experiences our ICPs have encountered to date in dealing with virtually all of our other 16,000 suppliers This study grouped all buys of the items covered on the DoD corporate contract that were made in periods FYs 1992 through 1995 and in FYs 1996 through 1997. These groupings were based on the fact that FY 1992 is the oldest data readily available and that final enabling legislation became effective in early FY 1996. Unit prices in each group were compared to unit prices in the new contract

During FYs 1992 through 1995, DLA made 78 procurements against items now covered by the new contract. These buys were valued at $3.19 million (not adjusted for inflation). Using corporate contract prices, the cost would have only been $2.37 million; a reduction of 25 percent There were 114 DLA procurements on these items in FYs 1996 through 1997

at a total cost of $9.23 million. Under the new contract unit prices, the obligations would have only been $5.05 million; a reduction of 46 percent (again, not adjusted for inflation).

If the new contract unit prices are indexed at 1.0, the prices for FYs 1992 through 1995 would be indexed at 1.2 (1.34 if adjusted for 2½ percent inflation). The prices for FYs 1996 through 1997 would be indexed at 1.85 (1.93 if adjusted for inflation). Thus, prices paid on Sundstrand items seem to have climbed by 50 percent or so during the final round of streamlining legislation implementation, and have now been reduced by nearly half because of the DoD corporate contract. These price reductions are in addition to cost avoidance savings we calculated results from ALT reductions and costs associated with repetitive buys that have been obviated by the award.

IG FINDING--CAUSES OF HIGHER PRICES

As noted in the draft report, the large number of different Sundstrand commodities historically purchased by DLA were made by about least 75 DLA contracting officers throughout various commodity buying units at three DLA ICPs—the Defense Industrial Supply Center, Philadelphia, PA (DISC), the Defense Supply Center Columbus, OH (DSCC), and the Defense Supply Center Richmond, VA (DSCR). A few of these buys involved commercial items and the price was justified based on the across-the-board discount that had been negotiated off Sundstrand's commercial price list in 1992.

The IG draft reports that excess pricing occurred because Sundstrand's business strategy has been to capitalize on its position as a sole-source supplier with technical data rights, to set catalog prices for commercial items at "what the market would bear (***see Finding A.***)." Further, the IG reported that there is no competitive commercial market available to enable DLA and Military Department buyers to compete Sundstrand items ***(see Finding A.)*** Additionally, certified cost or pricing data can no longer be required as an optional, albeit the least preferable, means of obtaining and validating the contractor's cost projections as a basis for price negotiations.

Sundstrand added more and more parts to its commercial parts catalog that historically had been purchased based on cost data, and substantially increased its catalog prices. The cost growth on Sundstrand parts became excessive, both in percentage and magnitude. Further, as noted by the IG, Sundstrand refused to provide DLA contracting officers with "uncertified" cost or pricing data for commercial catalog items, and terminated Government access to the Sundstrand cost history system ***(see Finding A., second bullet)***. Faced with an adamant contractor and having little leverage to obtain greater discounts from commercial catalog prices that were excessive, individual contracting officers were unable to sustain the lower level of pricing enabled by the former procurement procedures.

DLA CORRECTIVE EFFORTS

Initial efforts. As a result of isolated but continuing complaints of excessive prices and lack of Sundstrand support for prices of items included in the Sundstrand commercial catalog, the DCMC Sundstrand office invited representatives of DLA and Military contracting offices to a fact-finding meeting and subsequent meeting with Sundstrand to address the excessive price growth of Sundstrand commercial parts (July 15-16, 1996).

IG audit initiated. Subsequently, in the fall of 1996, DLA learned that the IG had decided to expand an ongoing review of complaints of excessive prices being paid on commercial items, to include a review of prices being paid for Sundstrand parts.

Command involvement. As individual contracting offices continued to have difficulty in determining price reasonableness on a growing number of Sundstrand commercial parts, the matter was brought to the attention of senior contracting managers, and subsequently resulted in Command involvement at two Centers, and Headquarters DLA. The IG reports that a 50 percent discount from the catalog price was achieved for some commercial items when DLA executive personnel participated in the negotiations. However, such intensive efforts were impractical for individual buys on a continuing basis. The DLA Deputy Director (Acquisition) contacted the Sundstrand Chief Operating Officer in February 1997 to express the Government's concerns and to advise of his initiation of a special review team.

DLA command/policy guidance. On April 29, 1997, DLA issued a "heads up" memorandum to Commanders of the aforementioned three ICPs following an in-process status briefing on the status of ongoing audits of commercial item pricing that was given by the IG to DLA. The memorandum highlighted the need to manage the buys so there is consistent visibility and control from which to negotiate on a corporate bases, and recommended managing Center requirements for Sundstrand parts on a consolidated, centralized basis

The DLA Deputy Director (Materiel Management) issued a comprehensive follow-on "action" memorandum to the ICP Commanders on June 9, 1997, requiring a status report concerning specific action items. The memorandum provided detailed guidance on data to be required to substantiate the validity of Sundstrand's claim of "commerciality" of items appearing in its catalog and additional information to reach a price reasonableness determination Contracting officers were to escalate instances of pricing difficulties, and apprise requisitioners to expect some decline in supply availability as a result of these decisions This guidance was reissued the next day to all contracting offices (Procurement Letter 97-17, SUBJECT: Determinations of Commerciality and Price Reasonableness) with additional contracting policy guidance regarding data useful in evaluations of commerciality and data to assist in assuring price reasonableness for commercial items. These memorandums should be cited in the IG report paragraph entitled "DLA Actions During the Audit."

DLA/DCAA/SERVICES JOINT CORRECTIVE ACTION

Action plan. The report issued by the aforementioned special review team estimated the value of Sundstrand's increased prices for spares prime contracts awarded in 1996 and addressed strategies for dealing with Sundstrand on these increases. It led to the invitation from Major General Robert Drewes, then DLA Deputy Director for Acquisition, to the Military Departments to join with DLA in a comprehensive solution for the pricing problems. An ad hoc DoD Joint Component Negotiating Team, formed following the May 1997 meeting, combined anticipated defense requirements over the next 3 years for items appearing in Sundstrand's commercial spare parts catalog that are indisputably commercial. The objective was to leverage the combined buying power of DoD to achieve the favorable pricing expected by major customers. A second phase, to consolidate requirements for non-commercial items and other items for which commerciality may be questionable, was planned to follow the first phase effort.

Successful execution This first phase of a two phase effort required an intensive multi-round negotiating effort between the Team and Sundstrand management, but resulted in award on December 8, 1997, of a DoD corporate fixed price contract at substantial reductions from prices previously achievable under the Government's streamlined procurement rules. The award is an indefinite delivery type contract covering future requisitions for 216 commercial parts managed by our DLA ICPs and participating activities of the Military Departments. The Phase I corporate contract contains firm fixed prices the first year Out year prices are subject to prospective adjustment at the start of the second and third years based on any changes in a producer price index published by the Bureau of Labor Statistics, as provided by an economic price adjustment clause in the contract.

The estimated first year order quantities for the 216 items covered by the resulting award, if priced using Sundstrand's catalog prices, was $25.192 million (or a net value of [redacted] However, the combined buying power of DoD enabled the negotiating team to achieve a combined first year value of [redacted] This represents a [redacted] percent discount off Sundstrand's list prices (or an additional [redacted] percent off the prior, discounted catalog prices) that Sundstrand had heretofore utilized for pricing individual awards. Clearly, this demonstrates that the existence of commercial catalog prices does not automatically assure that such prices are fair and reasonable.

Phase II, which is seeking a similar pricing arrangement for about 1,567 other sole-source Sundstrand non-commercial parts, has just begun

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RESOLUTION OF IG-REPORTED EXCESSIVE PRICING (CYs 1994 - 1996)

Appendix G ("Market-Based Prices Versus Cost-Based Prices") of the draft audit displays the 57 buys from Sundstrand during CYs 1994 through 1996 totaling $6.1 million of 40 commercial items upon which the IG concluded that DLA paid about [redacted] (in 1997 constant dollars), or [redacted] percent, more than prices paid prior to the streamlining revisions to Federal procurement rules. A bottom line comparison of the IG finding *(see IG report, Appendix G)* to the results of the Phase I corporate contract, demonstrates that the IG calculations do not adequately portray the net benefits of the recent procurement policy streamlining on the Government's ability to contract effectively for sole-source commercial items from Sundstrand.

Purchase price reductions achieved via corporate contracting in a sole-source commercial item environment. The impact of the Phase I award is calculated below:

	(A) IG-Reported "Excess" Purchase Cost for NSNs IG Challenged in Report Appendix G (Millions) *(NOTE)*	(B) "Excess" Purchase Cost of Portion of IG-Challenged NSNs (column A) Covered by DoD Corporate Contract (Millions)	(C) Portion of IG-Challenged NSNs (column B) Recalculated Using Prices Awarded in DoD Corporate Contract (Millions)
Number of Items	40	31	31
Number of purchases	58	42	42
Purchase price difference (Impact of Streamlining)			
Purchase prices questioned by IG (columns A & B)/recalculated per DLA (column C) ('97 dollars (millions)) (I)	$5.950	$4.072	$1.498
Deduct: Previous cost-based purchase prices ('97 dollars (millions)) (II)	[redacted]	[redacted]	[redacted]
$ Difference (III) ((I)-(II))	[redacted]	[redacted]	[redacted]
% Difference ((III)/(II))	[redacted]	[redacted]	[redacted]

NOTE: **Reported audit results are misstated & Appendix G confusing** Review of Appendix G discloses a $5,949,656 total for Market-Based Delivery Order Prices. This is

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the total amount (escalated to 1997 dollars), not $6.1 million as reported in the Finding A., for the buys which the audit asserts DLA paid about [redacted] more than fair and reasonable prices. The total [redacted] under the column headed "Previous DoD Cost-Based Price (1997 Dollars)," is the amount the IG deducted from the $5.95 million figure, to conclude DLA paid about [redacted] too much. Correcting the IG's calculation yields a difference of [redacted] (not [redacted]). The amount of markup for these catalog-priced items over previous cost-based prices is [redacted] percent (net of [redacted] divided by [redacted], not [redacted] as reported in the finding (nor the [redacted] percent shown at the bottom of "Total Price Increase Percent" column of Appendix G).

Appendix G was not included in the final.

Appendix G is confusing because it is used to support the IG's calculations of potential cost avoidance in addition to its "excess pricing" calculations. Appendix G should be separated into separate sections supporting the "excess pricing" and cost avoidance calculations. As presented, it contains comparative data for calculating reported "excess pricing," but omits columns showing the actual results. A reader would assume that the column headings "Total Price Increase Amount and Percent" in Appendix G represent the net difference between the amounts in the "Market-Based Catalog Delivery Order Price" columns less those in the "Previous DoD Cost-Based Price (1997 Dollars)" columns, but they do not. Columns showing the results of these calculations should added to Appendix G and a note added to clarify the calculation methodology.

In computing potential cost avoidances, the IG deducted from amounts shown in the "Market-Based 1997 Sundstrand Catalog Price" columns, its recommended amounts (i.e., the "Previous DoD Cost-Based Price (1997 Dollars)" amounts (also used in the aforementioned "excess pricing" calculations). Further, note that the total FYs 1994 - 1996) of "Total Price Increase" column total of [redacted] is a total of differences covering the three fiscal years' of awards questioned. However, display of this three year total has little relevance since the IG based its cost avoidance calculations on the [redacted] total for FY 1996 only. If separate sections aren't created, the headings should be annotated and a note added to clarify the calculation methodology and eliminate confusion caused by using this Appendix for both "excess pricing" and cost avoidances.

Recoupment of excessive payments DLA will use the new contract prices as a baseline for calculating excessive amounts charged on past purchases of these items and requesting a voluntary refund. Information on this approach should be used to update the statement made in the final sentence of the "Management Actions" paragraph of the Executive Summary of the IG report.

RESOLUTION OF IG-REPORTED POTENTIAL COST AVOIDANCE (CYs 1998 - 2003)

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Item cost avoidances. A portion of Appendix G ("Market-Based Prices Versus Cost-Based Prices") of the draft audit includes the 36 buys on 26 items from Sundstrand during CY 1996 totaling [redacted] upon which the IG calculated a potential cost avoidance of [redacted] (in 1997 constant dollars). The discussion included in the bulletized statement of the DLA position *(see Finding A.)* explains DLAs nonconcurrence in the calculation methodology and results. A bottom line comparison of the IG finding to the results of the Phase I corporate contract demonstrates that the Government can contract effectively for sole-source commercial items from Sundstrand using the Government's new, streamlined procedures:

	(A) The IG Reported "Excess" Purchase Cost for NSNs IG Challenged in Report Appendix G (CY '96 only) (Millions)	(B) "Excess" Purchase Cost of Portion of IG-Challenged NSNs Covered by Phase I Contract (Millions)	(C) Portion of IG-Challenged NSNs Recalculated Using Prices Awarded in Phase I Contract (Millions)
Number of items	26	18	18
Number of purchases	36	26	26
Purchase price difference (Impact of Streamlining):			
CY '96 award quantities times current catalog prices per IG (columns A & B)/times CY '96 award prices per DLA (column C) ('97 dollars (millions) (I)	$4.528	$3.617	$2.840
Deduct: CY '96 award quantities times previous cost-based purchases ('97 dollars) per IG (columns A & B)/times corporate contract prices ('97 dollars) per DLA (column C) (II)	[redacted]	[redacted]	[redacted]
$ Annual cost avoidance (III) ((I)-(II))	[redacted]	[redacted]	[redacted]
% Difference (III)/(II)	[redacted]	[redacted]	[redacted]

Procurement administrative cost and administrative lead time cost avoidances ($0.992 million/year) In addition to the basic unit costs involved in any contract, there are a number of other cost considerations involved in deciding whether a change in the method of customer support is advantageous to the customer and the taxpayer. The two main areas usually affected are the impact on the organization infrastructure (cost to make purchases, etc.) and the non-material cost involved in managing the items involved (safety level sunk costs, depot handling charges, etc)

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1. Procurement administrative cost avoidance Award of the DoD corporate contract will obviate the need for repetitive manual purchase orders or bilateral contracts on the items involved. For the 173 DLA managed items proposed on the contract, there were 124 contract actions taken in FY 1997. These 124 buys break out as follows: 85 Delivery Orders (DOs) against Basic Ordering Agreements (BOAs), 34 Purchase Orders (POs), 2 Contracts, and 2 Calls against existing Blanket Purchase Agreements (BPAs).

Based on an Activity Based Costing (ABC) type study ongoing at the Defense Supply Center Columbus (DSCC), the cost to issue a PO between $2,500 and $100,000 is about $200. The cost to enter into a contract over $100,000 is about $2,000. DO against BOAs are not specifically broken out in the DSCC study, but were assumed to be analogous to issuing POs. The cost of issuing calls against BPAs will be assumed to be negligible. All of these costs include both direct and indirect labor and non-labor costs, but not center-wide general and administrative costs.

Using the estimated $200 cost to either issue a PO or a DO against a BOA for the 119 actions in these categories shows an FY 1997 infrastructure cost of $23,800 to purchase the items in question. There were also 2 contracts awarded in FY 1997, which cost an estimated $2,000 each to process. Cost of issuing the 2 BPA calls was deemed negligible. The total cost of processing these FY 1997 actions on the proposed Sundstrand items is estimated at $27,800. We estimate this amount is representative of the annual cost of separately-contract requirements that has been avoided by award of the DoD corporate contract.

2 Procurement administrative lead time cost avoidance. There has been no indication that the method of managing the DLA Sundstrand items will be altered to any significant degree by the proposed contract. Thus, the depot costs to receive and issue these items, along with transportation costs, were will be considered a wash for study purposes. However, the establishment of this fixed price contract, providing much shorter Administrative Lead Times (ALTs, estimated at 10 days), this directly reduces Safety Level Quantities (SLQs), and also contributes to reducing backorder situations. The DLA Office of Operations Research and Resource Analysis (DORRA) has performed a number of studies attempting to quantify the value of reduced lead times, as they affect SLQ sunk costs, holding costs, storage costs, etc. The values generated by these studies are on a per day basis, as a percentage of contract demand value They are: DSCC (Construction) - 0.134 percent, DSCC (Electronics) - 0.06 percent, DSCR - 0.081 percent, and DISC - 0.043 percent.

We multiplied these DORRA values against reductions in the lead time of the Sundstrand items (The calculations are only valid on replenishment type items where SLQ is actually carried) Annual demand values based on item demands in FY 1997 are used. The result was $0.964 million for the annual ALT savings. It is important to remember that these savings are in the form of releasing items for issue that were previously a sunk, SLQ cost, reducing the cost of storing these items, and reducing simple shrinkage and obsolescence on the inventory.

These projections may actually be conservative since they do not attempt to quantify the value of avoiding backorders (which may actually be the driver in lead time savings). This directly reduces SLQs and also contributes to reducing backorder situations.

Final Report Reference

TYPE OF REPORT: Draft **DATE OF POSITION: December 19, 1997**

SUBJECT: Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111, 6CF-0068

RECOMMENDATION A.1: We recommend that the Under Secretary for Acquisition and Technology:

a. Provide additional guidance and training to the DoD acquisition community on how contracting officers should obtain fair and reasonable prices for commercial items from a sole-source supplier when there is no commercial market to ensure the integrity of prices and the commercial items are exempt from certified cost or pricing data.

b. Provide guidance and training to the DoD acquisition community on the importance of ensuring non-Government commercial item sales of similar quantities or substantial non-Government sales at least greater than the current procurement quantity before contracting officers accept commercial item prices as fair and reasonable.

c Provide guidance that instructs contracting officers to use as a past performance evaluation factor for future contract awards, noncompliance with acquisition reform legislation and Federal regulations regarding the requirement for contractors to submit uncertified cost or pricing data for commercial items when needed to establish price reasonableness

Deleted

DLA COMMENTS: Defer to OSD inasmuch as this recommendation is directed thereto vice DLA

MONETARY BENEFITS: None

DISPOSITION:
( ) Action is Ongoing ECD
(X) Action is Considered Complete

ACTION OFFICER: Jerry C. Gilbart, DLA-MMPPB, December 16, 1997.

REVIEW/APPROVAL: ROBERT L. MOLINO, DLA-MMP, December 18, 1997.

COORDINATION: JEFFREY A. JONES
Principal Executive Director
Materiel Management, December 19, 1997

DISPOSITION:
( ) Action is Ongoing. ECD:
(X) Action is Considered Complete

ACTION OFFICER: Jerry C. Gilbert, DLA-MMPPB, December 16, 1997.

REVIEW/APPROVAL: ROBERT L. MOLINO, DLA-MMP, December 18, 1997.

COORDINATION: JEFFREY A. JONES
Principal Executive Director
Materiel Management, December 19, 1997

TIMOTHY P. MALISHENKO
Brigadier General, USAF
Commander, December 18, 1997

THOMAS M. HILLIN
Deputy General Counsel
(Acquisition), December 18, 1997

PIERSON KEMP, Management Control POC
Office of Comptroller, December 17, 1997

DLA APPROVAL: E. R. CHAMBERLIN
RADM, SC, USN
Deputy Director, December 19, 1997

Final Repo Reference

TYPE OF REPORT: Draft **DATE OF POSITION: December 19, 1997**

SUBJECT: Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111, 6CF-0068

RECOMMENDATION A.2: Recommend that the Director, Defense Logistics Agency:

Renumbered as Recommendation A.2

a. Require that contracting officers insist that contractors provide uncertified cost or pricing data for future commercial item procurements when needed to determine the reasonableness of prices

b Insist that Sundstrand restore access to its cost history system.

Deleted

DLA COMMENTS: Partially Concur.

DLA concurs in part a. of the recommendation, and has already issued guidance to this effect A copy of this guidance (Procurement Letter (PROCLTR 97-17, June 10, 1997, subject. Determinations of Commerciality and Price Reasonableness) was furnished to the IG Project Manager for this audit, upon its issuance. It specifically underscored that the Federal Acquisition Regulation provides that the contracting officer must obtain pricing, sales, cost information, or other information excluding [certified] cost or pricing data, as necessary to determine reasonableness when it cannot be based on adequate price competition.

During the course of the DoD Joint Component Negotiation Team efforts to reach a pricing arrangement with Sundstrand for sole-source commercial parts, the Director, DLA, received a November 5, 1997, memorandum for the Director, DLA from the Assistant Inspector General for Auditing, expressing the belief that the DoD needs current uncertified cost or pricing data because (i) there is no competitive market-place to insure the integrity of the commercial prices and (ii) the old data is questionable. As required by the guidance in FAR 15.802, the contracting officer deferred requesting information other than cost or pricing data from Sundstrand until exhausting other information sources. A written request for such information was made on November 10, 1997, during the course of negotiations, but agreement on substantially reduced prices was achieved shortly thereafter, which the contracting officer concluded obviated the need for such information.

DLA nonconcurs in part b. of the recommendation as written There is no statutory or regulatory basis for the Government to demand this access, and such access is rarely granted by commercial item suppliers

Deleted

MONETARY BENEFITS None

DISPOSITION:
( ) Action is Ongoing. ECD:
(X) Action is Considered Complete

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REVIEW/APPROVAL: ROBERT L. MOLINO, DLA-MMP, December 18, 1997.

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TYPE OF REPORT: Draft **DATE OF POSITION: December 19, 1997**

SUBJECT: Commercial and Noncommercial Sole-Source Items Procured on Contract N00383-93-G-M111, 6CF-0068

FINDING B: Negotiated Prices for Sole-Source Noncommercial Items

DLA contracting officers did not effectively negotiate prices on orders for (noncommercial) sole-source items procured from Sundstrand. Sole-source prices were not effectively negotiated because DLA:

- Did not adequately consider economic order quantities when placing individual orders;

- Used price analyses of questionable prior prices to determine price reasonableness and performed inadequate cost analyses because DCMC, Rockford was not used to verify labor and material costs on data that was submitted by Sundstrand; and

- Procured items from Sundstrand using a Navy basic ordering agreement (BOA) that required over 75 different contracting officers to negotiate and award about 1,800 individual orders totaling over $36 million, without the benefit of certified cost or pricing data.

We determined that DLA paid about [redacted] than the fair and reasonable price on 59 orders on which we performed cost analysis. We were unable to calculate a savings associated with using economic order quantities or reducing the resources needed to manage the Sundstrand contract. The goals of the DCMC negotiating team to negotiate a corporate contract for noncommercial items should help address our concerns

DLA COMMENTS: Nonconcur.

DLA POSITION

- **Nonconcur** in the IG finding (first paragraph above) that "DLA contracting officers did not effectively negotiate prices on orders for (noncommercial) sole-source items procured from Sundstrand." DLA contracting officers negotiated in good faith and in accordance with the laws and regulations in effect at the time. The IG has documented difficulties that were encountered in procuring sole-source Sundstrand items at fair and reasonable prices, and actions DLA initiated to overcome these difficulties. We believe these difficulties principally stem from the negotiation position Sundstrand assumed under the streamlined rules (i.e., which are the causes of excessive pricing the IG cited in Finding A). In some instances, even with the involvement of ICP executives, reasonable pricing was not attainable and the requirement could not be forgone. Established procedures were followed in documenting the exigent circumstances requiring award and the contracting officer's determination that the

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price was unfair and unreasonable. Accordingly, DLA does not agree that there is sufficient substantiation to conclude that DLA contracting officers failed to follow the procurement procedures in effect during the period covered by this audit (FY 1994-1996), with ineffective results. The DLA position concerning the reasons the IG believes that noncommercial sole-source prices were not effectively negotiated ***(see the three bulletized subparagraphs following the first paragraph of this finding (stated above))***, follows:

•• **Nonconcur** in the IG finding that prices were not effectively negotiated resulted in part because our buyers "did not adequately consider economic order quantities when placing individual orders." There are many factors that must be considered in reaching a decision as to whether a stock replenishment procurement, which most or all of the buys in question were, is being made, or should be made, at an economic order quantity. These considerations are detailed in comments regarding IG recommendation B.1. Based on comments received from our ICPs in response to this audit, it appears greater attention to this matter could have been given to the potential of a price break on some of these buys. As we shifted to corporate contracts, we have underscored the importance of seeking pricing that covers the full range of quantities anticipated to be ordered, and a price evaluation covering such range (PROCLTR 96-13, April 10, 1996, SUBJECT: Using Indefinite Quantity Contracts in the Reengineered Business Process Environment). Savings from EOQs will be achieved by pricing in long term contracts applicable to the estimated maximum. Where quantity discounts for individual orders are included, ordering officials will decide at the time of ordering whether the overall cost of the additional quantity is justified by the attendant price reduction. However, we note that the Phase I negotiations were able to achieve volume price breaks on only 28 percent of the 216 items on that contract. Unless the efforts to negotiate the Phase II corporate contract achieve a greater portion of items with price break pricing, the significance of this issue is substantially lessened.

•• **Nonconcur** in the IG finding that prices were not effectively negotiated occurred in part because our buyers "used price analyses of questionable prior prices to determine price reasonableness and performed inadequate cost analyses because DCMC, Rockford was not used to verify labor and material costs on data that was submitted by Sundstrand." The exhaustive level of in-depth review the IG accomplishes on a post-award audit basis is not contemplated by procurement rules governing performance of the procurement mission, nor is it practical, or even possible, in today's operational environment. The IG used actual cost information to assert that prices negotiated were questionable whenever a cost underrun resulted at contract completion. Also, the Government no longer has access to this information (except the few buys exceeding $500,000 that are subject to the Truth in Negotiations Act cost or pricing data submission and certification requirements). Therefore, such information will not be available for validation in connection with buys in the future (and would not be necessary for items required that are available on the Phase II contract, once it is awarded). These matters are addressed in further detail in response to audit recommendation B.2. However, as noted in the discussion in the penultimate paragraph

below, we will assure that the items with the greatest percentage price disparity will be subjected to further review to ascertain the degree to which these awards were effectively negotiated and whether any overpricing occurred.

●● **Nonconcur** in the IG finding that prices were not effectively negotiated in part because our buyers "procured items from Sundstrand using a Navy basic ordering agreement (BOA) that required over 75 different contracting officers to negotiate and award about 1,800 individual orders totaling over $36 million, without the benefit of certified cost or pricing data." We recognize that the organization structure at our ICPs, which was designed to concentrate expertise in dealing with specific groups of items, did not lend itself to the rapid recognition of the breadth of items for which pricing problems were being experienced. However, DLA nonconcurs in the assertion that this was a significant contributor to any excessive prices that may have resulted. More importantly, cost or pricing data would not have been provided by Sundstrand on any of these items which might qualify as "commercial." Finally, we should point out that by the time these matters were reported during an IG in-process briefing to DLA management in April 1997, the ICPs and DLA management was well aware of the overall pricing issue and had been working towards the comprehensive solution that is being achieved.

● **Nonconcur** in the IG conclusion *(final paragraph of the finding)* that "DLA paid about [redacted] or over [redacted] percent more than the fair and reasonable prices on 59 orders;" nonconcur in the IG's calculation methodology and results

●● The IG reported *(see IG's second paragraph of* **"Cost Analysis by DCMC Rockford, under "Price Analysis and Cost Analysis"** *section under this Finding B.)* that "Using actual cost data and the negotiated indirect cost rates and profit factors on the individual orders, we determined that the reasonable prices for the items reviewed were about [redacted] or [redacted] percent less than the negotiated prices."

●● Actual cost information for yet to be awarded and performed contracts does not exist at the time [preaward] of pricing any firm, fixed price contract (which these BOA orders were)

●● Prices for firm, fixed price contracts, which these BOA orders were, are negotiated before award based on limited information, and are not later subject to change. The type and extent of information other than cost or pricing data an offeror furnishes in support of any offer is largely discretionary and may be the subject of discussion and compromise balancing the Government's perceived needs and the offeror's willingness to provide such information

●●● Because various unforseen and unforeseeable circumstances can and do arise after preparation of a cost estimate and throughout the period of contract performance, often beyond the control of a contractor, cost estimating is not recognized as an exact science, by

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any means. Very rarely does a cost estimate materialize as an exact projection of the costs that ultimately were incurred during the course of contract performance. Review of Appendix H of the IG draft, which contains the 59 buys of 46 items reported in this Finding B, shows that in only one instance was there no variance between the award price and the resulting amount (incurred cost plus projected profit margin). Sundstrand's incurred cost-based price exceeded the award price on 12 contracts (and they lost money on a few). They made a greater than negotiated profit rate on the remaining 46 awards. This suggests that Sundstrand generally has been able to underrun the contract price but this fact does not indicate why this has occurred. The IG thus has not substantiated that overpricing has occurred.

••• Even in the instances of high dollar awards for clearly non-competitive, noncommercial items where cost or pricing data is submitted and subjected to the most thorough of Government audit and evaluation, a variability (e.g., within [redacted] percent), between the forecast and actual incurred amounts should be anticipated. When lower contract amounts are involved, lesser effort is spent by the offeror in estimating, and by the Government in evaluating, the procurement. Typically, in such cases, which includes the buys in question, greater variability (e.g., within as much a[redacted] percent) should be expected.

••• The median award value of these buys was $41,979, for which the IG found a price variability of[redacted] percent) in the contractor's favor. This is well within reasonable expectations Nearly one-half (27) of the awards in question fell within the[redacted] percent bounds previously discussed, and another 11 would be added using a[redacted] percent range as a *possible* indicator that the award price was excessively high (or low). DLA nonconcurs in the assertion that the variance that occurred in these buys is sufficient to suggest that Sundstrand provided misleading cost data for negotiation of these awards. Further, we note that the audited awards includes one where the IG found that the award value *underran* the IG's reasonable price calculation by[redacted] percent (and thus lost money) Appendix H indicates no historical cost information was available for this award. Lower unit prices were negotiated for the 2 follow-on audited buys of this item, for which the difference dropped to[redacted] percent underrun and[redacted] percent overrun, respectively.

••• The only valid way to determine whether overpricing occurred is to perform a review of the data available and the data that was provided by the conclusion of price negotiations Apart from the 38 buys addressed in the preceding paragraph, there are 21 remaining buys which we believe warrant such further review. We understand that the ICPs did not have the information used by the IG in some or all of these cases. We have asked that the IG provide any relevant information to the ICPs responsible for those items and will assure that the circumstances surrounding the evaluation and award of these buys are thoroughly reviewed If overpricing occurred in any instances, the cognizant ICPs will promptly initiate a recoupment action Further, we note that 26 of the 46 noncommercial NSNs cited in the report, including 19 of the 21 items discussed above, have been included in

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the group of items presently under review for inclusion in the Phase II solicitation. We have asked that the other two NSNs be considered for inclusion in the list.]

- **Concur** in the final sentence of the IG conclusion ***(second paragraph of Finding B.)*** that "The goals of the DCMC negotiating team to negotiate a corporate contract for noncommercial items should help address our concerns." The success to date of the DoD Joint Component Negotiation Team is reflected in the completion of its Phase I effort via award of the DoD corporate contract, December 8, 1997. If the team is equally successful in the Phase II effort by achieving a similar corporate contract covering other Sundstrand sole-source items, the concerns will substantially have been eliminated

ACTION OFFICER: Jerry C. Gilbart, DLA-MMPPB, December 16, 1997.

REVIEW/APPROVAL: ROBERT L. MOLINO, DLA-MMP, December 18, 1997.

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DLA APPROVAL: E. R. CHAMBERLIN
RADM, SC, USN
Deputy Director, December 19, 1997

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SUBJECT: Commercial and Noncommercial Sole-Source Items Procured on Contract N00383-93-G-M111, 6CF-0068

RECOMMENDATION B.1: Recommend that the Director, Defense Logistics Agency, require contracting officers for future procurements [to] procure economic order quantities on all orders placed with Sundstrand.

DLA COMMENTS: Nonconcur.

The recommendation stems from a portion of Finding B ("Negotiated Prices for Sole-Source Noncommercial Items")—"DLA did not adequately consider economic order quantities when placing individual orders." There was no similar finding concerning sole-source commercial items (the subject of Finding A). Neither was there any other indication in the IG's draft report, of a similar failure to adequately consider the availability of, and need to obtain, price break information and tiered prices in responses to requests for solicitations and quotes for sole-source commercial Sundstrand items. Absent such indications of a problem, the recommendation should not have been expanded to apply to all parts (including commercial parts, for which, apparently, no deficiency exists).

Various factors must be considered by the item manager and contracting officer, working in coordination, to determine whether a purchase request quantity for a stock replenishment procurement was specified for, or should be made for, an economic order quantity Reorder points are automatically calculated and updated by an inventory management program within the Requirements Subsystem of our Standard Automated Material Management System (SAMMS). SAMMS issues purchase requests for stock replenishment buys in time to result in award and receipt of stock, based on the procurement administrative and production lead time of record for each individual stock-managed item Any decision to manually override the system-determined stockage and safety levels to increase order quantities must be based on a supply control study by the item manager, which includes consideration of design stability and a determination of the extent to which a stable demand pattern has existed and whether there is any reason to expect demand quantities will increase (or decrease) in the future. A manual override to alter the SAMMS reorder point calculation for all Sundstrand orders would result in long supply in many instances. Historical prices paid and buyer knowledge of the availability of price breaks from individual suppliers also influence buyer decisions on whether to solicit the inclusion of price break levels and discounted prices.

There are additional considerations whenever the Government decides to solicit a price break for an EOQ, and a offeror decides whether there is an economic production quantity, that a price break/learning exists for an item, and that a price break should be offered. The

offeror must determine whether there are sizeable setup costs for item production and/or economies of scale in raw material/item purchase/manufacture of an economic production run Sundstrand's supplier must be willing to pass on a price break price, in the case of a buy item, and in any event, Sundstrand must be willing to share price break savings

If price breaks are offered, the Government incurs additional expense in determining whether a break for a larger quantity is sufficiently economically advantageous, and the risk of loss resulting from a potential overbuy is sufficiently low, to warrant the Government's acceptance of a price break offered for a greater quantity. Presuming it appears price breaks should be sought and funding is available for a higher quantity purchase, present value calculations are made of the impact of an earlier funding commitment and greater investment in stock over a longer period, even in the case of phased deliveries. The results may show that procurement of a larger quantity may not be the most prudent decision for the Government. The savings to the Government from an economic order must more than offset total costs to secure and make the larger buy and the total increased logistics costs to stock, store, and issue the item

If we were to buy an EOQ on every Sundstrand item, we would wind up holding years of inventory which would exceed total future demands for some items. This is why the Federal Acquisition Regulation, paragraph 7.202(a), provides flexible guidance, vice a rigid mandate, to Agencies to.

> "...procure supplies in such quantity as—(1) Will result in the total cost and unit cost most advantageous to the Government, where practicable; and (2) Does not exceed the quantity reasonably expected to be required by the agency."

In summary, EOQ level determination/buying is a dynamic, item-specific decision process, which must be selectively applied in a judicious manner. Otherwise, stockage in excess of the Government's future needs will result which ultimately will be converted to losses through the disposal process Establishment of a categorical policy as suggested by the IG is thus infeasible.

MONETARY BENEFITS: None

DISPOSITION:
( ) Action is Ongoing ECD:
(X) Action is Considered Complete

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RECOMMENDATION B.2: Recommend that the Director, Defense Logistics Agency, require contracting officers for any future procurements with Sundstrand not covered by the Defense Contract Management Command negotiating team to:

a. Determine the reliability of previous prices before using price analysis to establish prices are fair and reasonable.

b. Use Defense Contract Management Command Rockford to perform cost analysis of proposed Sunstrand labor and material costs.

DLA COMMENTS: Partially concur.

The recently negotiated corporate contract for commercial items included all items with an annual demand value down to $2,500, and lower, in some cases. The Phase II contracting effort that is presently underway is aimed at negotiating a similar corporate contract for the remaining sole-source Sundstrand items for which coverage is deemed warranted.

DLA believes it would be inappropriate to establish the recommended review requirements for purchases of any residual items not covered by the corporate contract(s). Such residual and unanticipated requirements would likely all be below the simplified purchases threshold, and many below the $2,500 micro-purchase threshold.

FAR 15.805-2 describes a number of different price analysis techniques available for use at the discretion of the contracting officer, who "is responsible for selecting and using whatever price analysis techniques will ensure a fair and reasonable price." Validation of the reliability of previous prices is not a prerequisite except when the analysis is based on comparison to prior contract prices (or proposed prices) (FAR 15.805-2(b)).

DLA **nonconcurs** in recommendation B.2.a., as written, inasmuch as it would expand the current FAR requirement to all forms of price analysis. And, for instances where the buyer is considering such price comparison, DLA has already provided for the availability of automated information on the validity of prior buys to facilitate use of the technique where deemed appropriate. Specifically, as part of the award process, data for buys made at the DLA ICPs covered by this audit is stored by DLA's automated procurement system. This "buy history" data includes coding to identify the nature of the price or cost analysis accomplished in arriving at the price reasonableness determination, and whether the analysis was accomplished by the contracting officer or involved assistance by a functional

specialist. The coding provides ready information on the reliability of each price in procurement history, which is beneficial to facilitate evaluating future prices, where appropriate, based on prior award prices We note that our contracting officers review purchase history, including codes for identifying the nature and basis of the price reasonableness determinations of each individual buys, in reaching a decision as to the reliability of previous prices.

DLA nonconcurs in recommendation B.2.b., as written, for similar reasons. FAR specifies awards are to be based on use of price analysis techniques unless cost or pricing data is required or obtained in an exceptional instance where determined necessary by the Head of the Contracting Activity (in which case price analysis is still performed as an adjunct to cost analysis) However, requesting information other than cost or pricing data is authorized in these instances to the extent necessary to determine price reasonableness or cost realism Such information may be/include data reflecting current or prior actual cost experience or estimates. Contracting officers are accorded substantial discretion on whether any such data should be requested and whether analysis of such data is necessary. This flexibility should not be abridged. However, we note that our contracting officers are well aware of the availability of a highly professional staff at DCMC Rockford that is eager to provide cost/price assistance whenever the contracting officer determines this would be beneficial Our contracting officers will continue to use this assistance where appropriate.

MONETARY BENEFITS: None.

DISPOSITION:
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(X) Action is Considered Complete

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