Audit Report

MANAGEMENT OF CONTRACT WAIVERS AND DEVIATIONS
FOR THE TRIDENT II MISSILE SYSTEM

Report No. 98-197 September 2, 1998

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September 2, 1998

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)

SUBJECT: Audit Report on Management of Contract Waivers and Deviations for the Trident II Missile System (Report No. 98-197)

We are providing this audit report for review and comment. This report is the third in a series of reports resulting from our review of contract waivers and deviations for Defense systems.

Management did not comment on a draft of this report. DoD Directive 7650.3 requires that all recommendations be resolved promptly. Therefore, we request management to provide comments on the report and its recommendations by October 2, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. John E. Meling at (703) 604-9091 (DSN 664-9091) or Mr. Douglas P. Neville at (703) 604-9076 (DSN 664-9076). See Appendix E for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

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Office of the Inspector General, DoD

Report No. 98-197 **September 2, 1998**
(Project No. 6AE-0033.02)

Management of Contract Waivers and Deviations for the Trident II Missile System

Executive Summary

Introduction. This report is the third in a series addressing the management of waivers and deviations for Defense systems. The first report, No. 96-221, "The Avenger Forward-Looking Infra-Red System," September 16, 1996, addresses waivers on the Army Avenger system. The second report, No. 97-104, "Waivers and Deviations for the C-17 Aircraft," March 6, 1997, addresses waivers on the Air Force C-17 aircraft. This report addresses waivers and deviations for the Trident II Missile System (missile and reentry body components). The Trident II Missile System is a three stage, solid-propellant, inertially guided fleet ballistic missile with a range of more than 4,000 nautical miles. The Navy first deployed the Trident II Missile System in 1990 and plans to deploy it beyond 2020.

Audit Objectives. The primary audit objective was to evaluate the management of contract waivers and deviations for Defense systems. Specifically, we assessed whether procedures for reviewing, approving, and obtaining equitable consideration for major waivers and deviations were adequately and consistently applied. We also reviewed the implementation of management controls applicable to contract waivers and deviations. The Trident II Missile System is one of seven Defense systems reviewed in our ongoing audit.

Audit Results. The Strategic Systems Programs Office adequately and consistently applied the process for reviewing and approving major* waivers and deviations on contracts for Trident II missile and reentry body components. However, the Program Office did not perform cost and price analyses to determine the adequacy of consideration obtained for the approval of major waivers and deviations. As a consequence, the Program Office's methodology for obtaining consideration for more than 300 major waivers and deviations approved since FY 1984 did not ensure that the consideration that the Government received was appropriate. Also, the waiver and deviation incentive-fee provision in the cost-plus-incentive-fee contracts did not effectively motivate the contractor to annually reduce the numbers of waivers and deviations requested. See Part I for details.

The management controls were effective in that we identified no material management control weakness. See Appendix A for details of the review of the management control program.

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* The term "major" means items that negatively impact safety, coordination, function, interchangeability, or expected life.

Summary of Recommendation. We recommend that the Director, Strategic Systems Programs Office, direct the procuring contracting officer on future contracts for Trident II missile and reentry body components to discontinue the use of the incentive-fee clause for waivers and deviations and to perform cost and price analyses to negotiate and obtain appropriate consideration for accepting major waivers and deviations.

Management Comments. Management did not comment on the draft report issued on June 25, 1998; therefore, we request the Director, Strategic Systems Programs Office, to comment on this report by October 2, 1998.

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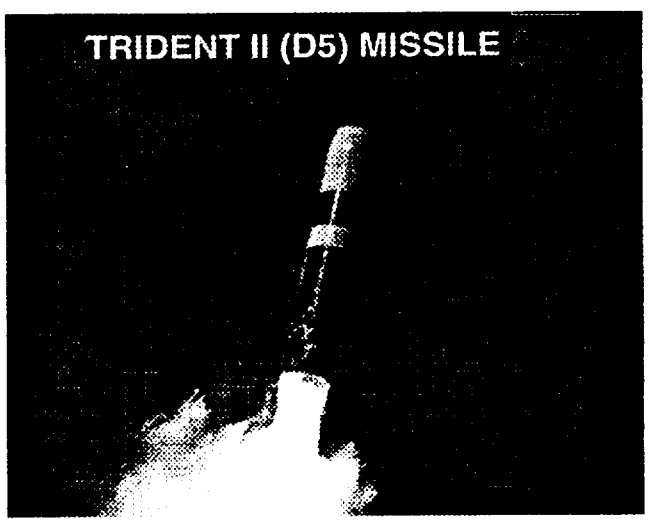

Part I - Audit Results

Audit Background

The Trident II Missile System is a three-stage, solid-propellant, inertially guided fleet ballistic missile with a range of more than 4,000 nautical miles (4,600 statute miles). The Navy designed, developed, and produced the Trident II Missile System to support its submarine-launched ballistic missile weapon systems. The Trident II Missile System is launched by the pressure of expanding gas within the launch tube. When the missile attains a sufficient distance from the submarine, the first-stage motor ignites, the aerospike extends, and the boost stage begins. Within about 2 minutes, after the third stage motor kicks in, the missile is traveling in excess of 20,000 feet (6,096 meters) per second.

The Navy first deployed the Trident II Missile System in 1990 and plans to deploy it beyond 2020. The Navy also provides the Trident II Missile System to the United Kingdom which equips the missile with United Kingdom warheads and deploys the missile on Vanguard Class submarines. Lockheed-Martin Missile and Space Company, Incorporated, Sunnyvale, California, produces the Trident II Missile System (missile and reentry body components).

The Navy Strategic Systems Programs Office (Program Office) manages the Trident II Program. From FYs 1984 through 1997, the Program Office acquired 350 missiles at an estimated total cost of $13.5 billion. The Program Office plans to acquire another 84 missiles at an estimated total cost of $4.3 billion from FYs 1998 through 2007. The average cost of a Trident II Missile System is $38 million.

Audit Objectives

The primary audit objective was to evaluate the management of contract waivers and deviations for Defense systems. Specifically, we assessed whether procedures for reviewing, approving, and obtaining equitable consideration for major waivers and deviations were adequately and consistently applied. We also reviewed the implementation of management controls applicable to contract waivers and deviations. In Appendix A, we discuss the scope and methodology used to accomplish the audit objective as well as management controls. In Appendix B, we discuss prior audit coverage.

Management of Waivers and Deviations

The Program Office adequately and consistently applied the process for reviewing and approving major waivers and deviations on contracts for Trident II missile and reentry body components. However, the Program Office did not perform cost and price analyses to determine the adequacy of consideration obtained for the approval of major waivers and deviations. The Program Office did not perform those analyses because the cost-plus-incentive-fee contracts for the missile and reentry body components included an incentive-fee provision as a means of obtaining consideration (a reduction in incentive-fee) for approved major waivers and deviations. That provision established a predetermined formula for computing Government consideration for accepting waivers and deviations that did not directly relate to the degraded value of the nonconforming materials accepted. As a consequence, the Program Office's methodology for obtaining consideration for more than 300 major waivers and deviations approved since FY 1984 did not ensure that the consideration that the Government received was appropriate. Also, the waiver and deviation incentive-fee provision did not effectively motivate the contractor to annually reduce the numbers of waivers and deviations requested. The contractor was not motivated because the incentive-fee target used for annual waiver and deviation reductions in the incentive-fee formula was not known and not included in the contracts.

Contract Waiver and Deviation Policy

Federal Acquisition Regulation. Federal Acquisition Regulation, subpart 46.407, "Nonconforming Supplies or Services," allows the contracting officer to accept nonconforming supplies in the Government's best interest. At the request of the contractor, the contracting officer can accept nonconforming supplies based on:

o advice from technical experts that the item is safe to use and will perform its intended purpose;

o information regarding the nature and extent of the nonconformance;

o a recommendation for acceptance or rejection with supporting documentation; and

o contract adjustment considered appropriate, including any adjustments offered by the contractor.

The Federal Acquisition Regulation also requires the contracting officer to modify the contract under which nonconforming items are accepted to provide for an equitable price reduction or other consideration. The Federal Acquisition

Regulation does not define "other consideration." For this audit, we define "other consideration" as compensation, services, or contract fee reduction negotiated between the contractor and the Government in exchange for accepting nonconforming goods.

Federal Acquisition Regulation, subpart 15.805, "Proposal Analysis," requires that the procuring contracting officer exercise sole responsibility for the final pricing decision and, as appropriate, coordinate a team of experts in such fields as contracting, finance, law, contract audit, packaging, quality control, engineering, traffic management, and contract pricing to evaluate the contractor's cost proposals. The procuring contracting officer makes a cost analysis to evaluate the reasonableness of individual cost elements and performs a price analysis to ensure that the overall price offered is fair and reasonable.

Program Office Policy. The Program Office established waiver and deviation policy for the Trident II Missile System in Operational Directive 40825B, "Strategic Weapon System Nonconforming Material Review and Waiver and Deviation Requests; Definitions, Classification, and Requirements," January 23, 1996. The directive superseded Naval Sea Systems Command Operational Directive 40825A, same title, May 5, 1981, which the Program Office incorporated in contracts for Trident II missile and reentry body components by reference. The directives define the terms waiver and deviation as follows:

> Waiver: An affirmative documented administrative action . . . to accept SSP [Strategic Systems Programs] cognizant items already procured, produced, processed, tested, or repaired which do not meet specified requirements of a contract, design disclosure requirements, or other applicable documentation but which are considered acceptable to the government for use.
>
> Deviation: An affirmative documented administrative action . . . to authorize, prior to the procurement, production, processing, or testing of SSP [Strategic Systems Programs] cognizant items, the departure from specified requirements of a contract, design disclosure requirements, or other applicable documentation. A deviation authorizes the subsequent acceptance of the designated items. A deviation is a temporary expedient and is limited to a specified time period or number of units.

The directives divide waivers and deviations into four categories; categories A and B represent major waivers and deviations, and categories C and D represent minor waivers and deviations. Category A waivers and deviations are defined as items that negatively impact safety, coordination, function (affecting minimum performance requirements), or interchangeability (requiring selective fit). Category B waivers and deviations are defined as items that negatively impact function (resulting in a degradation of performance), interchangeability (not requiring selective fit), or the expected life of the item. In return for accepting nonconforming materials (category A and B major waivers and deviations), the directives require the procuring contracting officer to negotiate equitable consideration.

Implementation of Contract Waiver and Deviation Policy

The Program Office adequately and consistently applied its process for reviewing and approving major waivers and deviations on contracts for the Trident II missile and reentry body components. However, the Program Office did not perform cost and price analyses to determine the adequacy of consideration obtained for the approval of major waivers and deviations. Instead, the Program Office used an incentive-fee provision in cost-plus-incentive-fee contracts to obtain consideration (a reduction in incentive-fee) for accepting nonconforming materials.

Since FY 1984, the Program Office has included a waiver-and-deviation-incentive-fee provision in annual cost-plus-incentive-fee contracts for Trident II missile and reentry body components. The incentive-fee provisions established a predetermined formula for computing Government consideration to be obtained for approving waivers and deviations. Annually, the contracting officer awards the contractor an incentive fee when the weighted value of waivers and deviations declines from that of the weighted value of waivers and deviations for the previous year. See Appendix C for details on the application of the incentive-fee clause formula. The Program Office stated that the purpose of the clause was to motivate the contractor to request fewer contract waivers and deviations each year.

The Program Office plans to continue awarding cost-plus-incentive-fee contracts for the missile and reentry body components throughout the production life of the missile, that is, through FY 2006. Further, the Program Office stated that the contracts will also contain the same incentive-fee clause to obtain consideration for the Government to approve major waivers and deviations.

Consideration Obtained For Waivers and Deviations

Consideration Obtained. FY 1991 was the latest year in which the Program Office finalized the incentive-fee determination and payment for waivers and deviations on contracts for Trident II missile and reentry body components. The contract specified that the contractor could earn a maximum incentive fee of $443,336 through application of the incentive-fee formula for waivers and deviations. By applying the formula in Appendix C, the procuring contracting officer determined that the contractor earned an incentive fee of $278,637 out of a potential incentive fee of $443,336. From FY 1990 through FY 1991, the contractor reduced the number of major waivers and deviations requested from 11 to 6. However, the amount of the incentive fee unearned ($164,699) was not based on a direct relationship to the degraded value of the nonconforming material as determined through the performance of cost and price analyses. For FYs 1984 through 1991, the contractor earned more than $2.7 million in incentive fees as a result of the contractor annually reducing the number of waivers and deviations. The Program Office approved more than 300 major waivers and deviations during that period. Appendix D provides a breakout of incentive fees that the contractor earned and did not earn for FYs 1984 through 1991.

The administrative contracting officer did not request technical personnel to perform an assessment of the amount of consideration that the Government should receive in return for accepting nonconforming materials because of the contract incentive-fee clause for waivers and deviations. When questioned, Program Office managers were unable to explain how the reduction in incentive fee earned equated to appropriate (fair and reasonable) consideration for the Government accepting nonconforming materials.

Major Waivers and Deviations Given Equal Value. Application of the formula in Appendix C resulted in all major waivers and deviations, within a given category, being given the same weight or value annually. For example, the Program Office approved 11 category B waivers in FY 1990, which included waivers for such items as nose fairings and (missile) equipment sections. Of the 11 waivers, 3 waivers involved degraded nose fairings. In one case, the disparity impacted the function of the nose fairing. In the other two cases, the disparities impacted the interchangeability of the nose fairings. In most probability, the Program Office performance of a cost and price analysis would have shown that the degraded value was different for the 11 waivers approved in FY 1990. In our opinion, the contract should provide a greater amount of consideration for major waivers and deviations that involve items with a greater relative unit price, or a greater deficiency, than those with a lesser value or deficiency. Also, as the program matures, the number of waivers and deviations would normally be expected to decline.

Adequacy of Consideration Obtained. Because the Program Office did not perform a cost and price analysis to determine the adequacy of consideration obtained for the approval of major waivers and deviations, the Program Office could not provide assurance that its methodology for obtaining consideration for more than 300 major waivers and deviations approved since FY 1984 was fair and reasonable.

Use of Waivers and Deviations Incentive-Fee Clause as a Contractor Motivator

The procuring contracting officer for the Trident II missile and reentry body components stated that the Program Office used the contract waivers and deviations incentive-fee clause to motivate the contractor to request fewer waivers and deviations each year. The methodology was not effective because, at the time the contract was awarded, the Program Office had not computed the incentive-fee targets used (the number of waivers and deviations approved the previous year). As structured, the incentive-fee formula bases the amount of fee that the contractor can earn on reducing the number of major waivers and deviations as compared with the previous year. For the incentive-fee clause formula to function as a contractor motivator, the contractor would need to know the number of waivers and deviations (the target amount) that the Program Office accepted the previous year before beginning production on the current year contract, which is not happening. Specifically, the procuring contracting officer did not establish the target amount for each year until the

contractor completed production for the previous annual contract. In the 3-year production contract awarded in FY 1990, for example, the procuring contracting officer did not establish the target amount for waivers and deviations until July 1996, 3 years after completion of the FY 1990 production contract. The situation occurred because the procuring contracting officer did not complete incentive-fee negotiations for the FY 1989 contract until July 1996. As of June 1998, the procuring contracting officer had not finalized contract waiver and deviation incentive-fee determinations on contracts awarded after FY 1991 for missile and reentry body components.

Even though the contractor reduced the number of major waivers and deviations from FYs 1984 through 1991, as shown in Appendix D, it is questionable whether the contract incentive-fee clause had any bearing on the reduction. When compared with total contract values, the amount of incentive fee that the contractor could earn was relatively small (less than one percent) of the total contracts' obligations of more than $4 billion. More importantly, the contractor did not know the target amount of the waivers and deviations before beginning production each year.

Recommendations for Corrective Action

We recommend that the Director, Strategic Systems Programs Office, direct the procuring contracting officer for Trident II missile and reentry body components to:

1. Discontinue the use of the incentive-fee clause for contract waivers and deviations in future production contracts.

2. Perform cost and price analyses to negotiate and obtain equitable consideration for accepting major waivers and deviations on future production contracts.

Management Comments Required

The Director, Strategic Systems Programs Office did not comment on the draft report. We request that the Director provide comments on the final report.

Part II - Additional Information

Appendix A. Audit Process

Scope

Work Performed. The Trident II Missile System is one of seven Defense systems reviewed in our ongoing audit. We conducted this audit from March 1996 through June 1998, and we reviewed data dated from November 1989 through June 1998. To accomplish the objective, we:

o examined Strategic Systems Programs Office, Missile and Reentry Branch Trident II production contracts N0003-84C-0100, N0003-88C-0088, N0003-89C-0089, N0003-90C-0090, and N0003-91C-0091, valued at more than $4 billion, with Lockheed-Martin Missiles and Space, Company, Incorporated, including statements of work, contract data requirements lists, contract line items, and related correspondence;

o reviewed configuration management documentation, engineering change proposals, requests for waivers and deviations, contract modifications, technical data packages, deficiency notices, system specifications, program test results, and Navy regulations; and

o discussed issues relating to the management of contract waivers and deviations for the Trident II Missile System with program, technical, and contracting personnel from the Strategic Systems Programs Office and contractor personnel.

Limitation to Audit Scope. We limited our audit of the Trident II Missile System to missile and reentry body component contracts.

DoD-wide Corporate Level Government Performance and Results Act Goals. In response to the Government Performance and Results Act, the Department of Defense has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting the objectives. This report pertains to achievement of the following objective and goal:

Objective: Prepare now for an uncertain future. **Goal:** Pursue a focused modernization effort that maintains U.S. qualitative superiority in key war fighting capabilities. (DoD-3)

General Accounting Office High Risk Area. The General Accounting Office has identified several high-risk areas in DoD. This report provides coverage of the Defense Weapons Systems Acquisition high-risk area.

Methodology

We conducted this program audit in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD, and accordingly included such tests of management controls as we deemed necessary. We did not use computer-processed data to perform this audit.

Contacts During the Audit. We visited or contacted individuals and organizations within the DoD and Lockheed-Martin, Lockheed Martin Missiles and Space Company, Incorporated, Sunnyvale, California. Further details are available upon request.

Management Control Program Review

Requirement for Management Control Reviews. DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, requires DoD managers to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of those controls.

Scope of Review of the Management Control Program. We reviewed the management of contract waivers and deviations for Defense Systems. Specifically, we assessed whether procedures in Federal Acquisition Regulation, subpart 46.407 and Naval Sea Systems Command Operational Directive 40825B, for reviewing, approving, and obtaining equitable consideration for major waivers and deviations were adequately and consistently applied. We also reviewed the implementation of management controls applicable to waivers and deviations.

Adequacy of Management Controls. Management controls were adequate in that we did not identify any material systemic management control weakness applicable to our primary audit objective.

Appendix B. Summary of Prior Coverage

During the last 5 years the Office of the Inspector General, DoD, issued two reports on the management of waivers and deviations.

Office of the Inspector General, DoD, Report No. 97-104, "Waivers and Deviations for the C-17 Aircraft," March 6, 1997, states that the Air Force C-17 System Program Office generally managed contract waivers and deviations in an effective manner. However, the report states that the Air Force cannot readily and fully trace all airframe fracture-critical and landing-gear parts for which the contract required serial numbers on the first 27 C-17 aircraft delivered. As a result, Air Force maintenance burden and costs will increase because the Air Force lacks the means to readily identify some of the critical parts that are on its aircraft and lacks the necessary information on the origin and history of the parts. The report recommended that the Air Force develop time-phased milestones, by aircraft, as to when it will have complete traceablity information, serial numbers, and part tracking implemented for all airframe fracture-critical and landing-gear, life-limited parts. The Air Force concurred with the finding and the recommendation.

Office of the Inspector General, DoD, Report No. 96-221, "The Avenger Forward-Looking Infra-Red System," September 16, 1996, states that the Army Avenger Project Office accepted 325 deficient Avenger systems without requiring the prime contractor to later correct critical Forward-Looking Infra-Red system operational performance deficiencies or to provide for an equitable contract cost reduction or other considerations for the Government waiving the Forward-Looking Infra-Red system performance requirement. As a result, the uncollected Forward-Looking Infra-Red system target acquisition screen will be cluttered with interference. Therefore, the operating crews have difficulty identifying an actual target, making the system less effective. The report recommended that the Army develop time-phased milestones to facilitate completion of the plan of action that the Weapons Systems Management Directorate proposed to correct the Avenger Forward-Looking Infra-Red system's operational performance anomalies for systems already accepted as well as systems under contract. The Army concurred with the finding and the recommendation.

Appendix C. Incentive-Fee Clause Formula and Application

Incentive-Fee Clause Formula. The Missile and Reentry Branches included in the cost-plus-incentive-fee production contracts an incentive clause to facilitate dealing with contract waivers and deviations.

Contract Waiver and Deviation Formula
Maximum amount x (DHWDT-DHWDP) / (DHWDT)

Formula Definitions:

Maximum Amount = The maximum fee that the contractor can earn under the clause.

DHWDT = delivered hardware waiver and deviation target

DHWDP = delivered hardware waiver and deviation performance

Application of Incentive-Fee Clause Formula. To apply the formula, the contracts assign 10 points to each accepted category A waiver and deviation and 1 point to each accepted category B waiver and deviation. The contract waiver and deviation target equals the weighted value of the total points assigned to contract waivers and deviations for the previous-year production contract. The contract waiver and deviation performance figure is the total points assigned to waivers and deviations for the current year. Mathematically, the contractor can earn an additional fee by having fewer waiver and deviation points than shown in the target amount. If the contractor has no contract waivers and deviations for the current year, the contractor earns the maximum fee. Further, the contractor can actually earn a negative fee if the actual performance exceeds the targeted amount. The contract limits the amount of negative fee (if any), which the procuring contracting officer then offsets against other incentive fees earned.

Appendix D. Incentive Fees Earned for Waivers and Deviations

Missile and Reentry Branch Contracts

(As of June 1998)

Contract	Obligations	No. of Waivers and Deviations	Maximum Incentive Fee	Incentive Fee Earned	Incentive Fee Unearned
N00030-84C-0100*	$609,612,964	267	$3,232,764	$1,974,630	$1,258,134
N00030-88C-0088	603,138,069	21	289,000	269,217	19,783
N00030-89C-0089	930,108,437	18	270,000	128,250	141,750
N00030-90C-0090	826,188,003	11	237,318	85,144	157,174
N00030-91C-0091	1,094,737,296	6	443,336	278,637	164,699
Totals	**$4,063,784,769**	**323**	**$4,472,418**	**$2,735,878**	**$1,741,540**

*The Program Office could not provide a year-by-year breakdown of the number of waivers and deviations approved and incentive fee earned on the FY 1984 multi-year Trident II missile system development contract for fiscal years 1984 through 1987.

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House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
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