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

REPORT NO. 92-035 January 22, 1992

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (PRODUCTION AND LOGISTICS)
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)

SUBJECT: Final Report on the Survey of Option Pricing (Project No. 1CD-0040)

Introduction

This is our final report on the Survey of Option pricing for your review and comments. The Contract Management Directorate performed the survey from April to December 1991. The objectives of the survey were to determine if DoD contracting activities were using contract options properly and if the options were fairly and reasonably priced. The survey also evaluated applicable internal management control procedures. For the contracts reviewed, all options were properly used and fairly and reasonably priced.

Scope of Survey

For the survey we selected four major acquisition programs with option contracts during fiscal years 1987 through 1991. These contracts had options totaling $4.4 billion.

The selected acquisition programs were:

- Army Mobile Subscriber Equipment Program (MSE),
- Navy Relocatable Over-the-Horizon Radar Program (ROTHR),
- Navy F-14D Infrared Search and Track Program (IRST), and
- Air Force Peacekeeper Ballistic Missile Program.

For each program, we reviewed contract files for compliance with FAR 17.202, "Use of Options," and FAR Part 6, "Requirements for Full and Open Competition." For negotiated contracts, we reviewed Defense Contract Audit Agency audit reports, price negotiation memorandums, and price analysis reports to determine if options were reasonably priced. We interviewed contracting

officers and program management personnel and reviewed operational test and evaluation reports to identify major operational deficiencies for the procured items.

Although not directly related to option pricing, we expanded our audit objectives to determine the efficiency of the Air Force operational test and evaluation plan for the Peacekeeper Ballistic Missile. On October 30, 1991, we issued a reannouncement letter that added this objective for which results will be provided in a subsequent audit report.

This economy and efficiency audit was made from April to December 1991 and was conducted in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. Accordingly, we included such tests of internal controls as were considered necessary. We did not rely on any computerized data to perform the audit. The activities and contractors visited or contacted during the survey are listed in Enclosure 1.

Internal Controls

To determine the adequacy of internal management control procedures, we reviewed the Services internal management control procedures and risk assessments. Specifically, we reviewed:

o cost price analyses to ensure that they were completed prior to contract/option award,

o contract files for sole-source contracts to verify that a certificate of current cost or pricing data was obtained at the time of the contract or option award, and

o price negotiation or business clearance memorandums to verify that negotiated prices were reasonable.

The survey disclosed no material internal control weaknesses as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38.

Background

Contract options are frequently used in Government contracting to simplify and expedite the award of a known follow-on requirement for purchase of goods or services. The Services, in their major procurement programs, almost always use option contracting. A contract option is usually defined as a "unilateral right in a contract by which, for a specified time, the Government may elect to purchase additional supplies or services called for by the contract, or may elect to extend the terms of the contract."

Prior Audits and Other Reviews

General Accounting Office Report No. NSIAD 86-59, "Procurement: The Use Of Unpriced Options And Other Practices Need Revision," April 23, 1986, found that unpriced options were being improperly used as a means of extending support services contracts, thus circumventing potential competition. As a result of the report, DoD proposed that the Defense Acquisition Regulations Council change the FAR to require that contract options be priced, as well as evaluated, during the initial award. This change was implemented in early 1988 and was considered during our survey.

Discussion

The survey showed that the Services properly used contract options to ensure that:

- methods used were most advantageous to the Government;
- funds were available before options were exercised;
- no major operational deficiencies existed in items being procured;
- all option written notices, determinations, and advertising requirements were complied with; and
- programs were not significantly over or under program estimates.

The audit survey also disclosed that:

- options were reasonably priced;
- contracting officers instituted procedures to comply with the FAR Part 6, which pertained to full and open competition;
- contracting officers obtained certified cost or pricing data before the award of any negotiated contract; and
- when appropriate, contracts were dual sourced.

Based on our survey results summarized below, no additional audit effort is considered necessary.

Army, MSE Program. The Army MSE Program is a tactical communication system. In December 1985, the contract, which consisted of a base contract with six options, was awarded to the General Telephone and Electronics (GTE) Government Systems Corporation, one of two responsible bidders.

We found no evidence that indicated that options were used improperly on the MSE or that the options were not fairly or reasonably priced. However, our review did determine that MSE failed a critical performance test on its first Follow-on Operational Test and Evaluation, which was conducted from August 9, 1988, through October 25, 1988. The Army took immediate steps to ensure that GTE would correct this deficiency, at no cost to the Government, by withholding contract payments. The payments were withheld until a Field Verification Test conducted February 12, to February 23, 1990, demonstrated that the deficiency had been corrected. Subsequently, MSE was successfully deployed and used during Operation Desert Storm.

Navy, ROTHR Program. The Navy ROTHR Program is a relocatable high-frequency radar that provides detection and tracking of aircraft and ships over wide geographical areas. The program began with a competitive solicitation for full-scale engineering development. The initial production contract included a base contract with options for two additional ROTHR systems. It was awarded sole-source to the successful bidder of the development contract.

Our review determined there was no evidence to indicate the options were used improperly or were not fairly and reasonably priced. We also determined that the Navy award of the production contract on a sole-source basis was in compliance with the FAR. Further, a review of the operational tests indicated no major problems with the program.

Navy, F-14D Tomcat IRST Program. The Navy IRST Program is a forward hemisphere, passive detection, tracking and ranging system, which will function as part of an integrated weapon control system. The IRST program was a joint Service program between the Air Force and the Navy. Under the lead direction of the Air Force, an extensive full-scale development competition was conducted. The winner was required to develop a second source for the program. However, the production requirements were significantly reduced, and an economic analysis determined a second source would not be a cost-benefit.

Our review found no evidence to indicate options were used improperly or were not reasonably and fairly priced. The IRST was working as expected and due to the economic climate, no further options will be exercised.

Air Force, Peacekeeper Missile Program. The Peacekeeper is a multiple independently retargetable intercontinental ballistic missile capable of delivering up to 10 reentry vehicles. The Air Force was the contracting integrater providing consolidation of individual hardware components into the total weapon system. Therefore, the program had many individual prime contracts for

hardware. Most of the contracts reviewed were dual sourced, where the lower bidder received a larger share of the total procurement and the higher bidder received a smaller share. Contract options were part of this overall bidding process.

We reviewed initial test reports and follow-on test and evaluation reports to verify that there were no current significant operational deficiencies. We verified that previously reported major operational deficiencies were corrected. We found no evidence to indicate that the options were used improperly or were unfairly or unreasonably priced.

Report Staffing

We provided a draft of this report to the addressees on December 5, 1991. Because there were no recommendations, no comments were required of management, and none were received. Therefore, we are publishing this report in final form. Any comments on this final report should be provided by March 23, 1992.

We appreciate the courtesies extended to the audit staff. The distribution of this report is listed in Enclosure 2. If you have any questions on this audit, please contact Mr. James McHale, Program Director, at (703) 614-6257 (DSN 224-6257) or Ms. Macie Rubin, Project Manager, at (703) 614-6273 (DSN 224-6273).

Robert J. Lieberman

Robert J. Lieberman
Assistant Inspector General
for Auditing

Enclosures

cc:
Secretary of the Army
Secretary of the Navy
Secretary of the Air Force

ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Washington, DC
Assistant Secretary of Defense (Production and Logistics), Washington, DC
Deputy Assistant Secretary of Defense (Strategic Programs), Washington, DC

Department of the Army

Assistant Secretary of the Army (Financial Management), Washington,DC
U.S. Army Communications and Electronics Command, Fort Monmouth, NJ

Department of the Navy

Assistant Secretary of the Navy (Financial Management), Washington, DC
Headquarters, Space and Naval Warfare Systems Command, Arlington, VA
Headquarters, Naval Air Systems Command, Arlington, VA

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller), Washington, DC
Air Force Audit Agency, Norton Air Force Base, CA
Ballistic Missile Office, Norton Air Force Base, CA
Strategic Air Command, Offutt Air Force Base, NE
Air Logistics Command, Hill Air Force Base, UT
90th Strategic Missile Wing, Francis E. Warren Air Force Base, WY
576th Test Squadron, Vandenburg Air Force Base, CA

Defense Agencies

Headquarters, Defense Contract Audit Agency, Alexandria, VA
Resident Office, GTE Government Systems Corporation, Needham Heights, MA
Headquarters, Defense Logistics Agency, Alexandria, VA
Defense Plant Representative Office, GTE Government Systems Corporation, Tactical Systems Division, Taunton, MA

Non-Government Activities

GTE Government Systems Corporation, Tactical Systems Division, Taunton, MA

REPORT DISTRIBUTION

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition
Assistant Secretary of Defense (Production and Logistics)
Director of Defense Procurement
Comptroller, Department of Defense

Department of the Army

Secretary of the Army
Assistant Secretary of the Army (Financial Management)
Auditor General, U.S. Army Audit Agency
Commander, U.S. Army Communications and Electronics Command

Department of the Navy

Secretary of the Navy
Comptroller, Department of the Navy
Assistant Secretary of the Navy (Financial Management)
Auditor General, Naval Audit Service
Headquarters, Naval Air Systems Command
Headquarters, Space and Naval Warfare Systems Command

Department of the Air Force

Secretary of the Air Force
Assistant Secretary of the Air Force (Acquisition)
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Air Force Audit Agency
Commander, Ballistic Missile Office

Defense Agencies

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, Defense Logistics Studies Information Exchange

Non-DoD

Office of Management and Budget
U. S. General Accounting Office, NSIAD Technical
Information Center

Congressional Committees:
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
Senate Ranking Minority Member, Committee on Armed Services
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Ranking Minority Member, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Operations
House Subcommittee on Legislation and National Security,
Committee on Govenment Operations