

June 1989

# CONTRACT PRICING

## Overpricing of Secure Voice Communication Systems



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**National Security and  
International Affairs Division**

B-219741

June 7, 1989

General A. G. Hansen  
Commander, U.S. Air Force Logistics Command  
Wright-Patterson Air Force Base, Ohio

Dear General Hansen:

As part of our continuing review of compliance with the Truth in Negotiations Act, we reviewed the pricing of contract F33600-D-86-0295. This contract was awarded noncompetitively to Electrospace Systems, Inc., Richardson, Texas, by the Wright-Patterson Contracting Center, Wright-Patterson Air Force Base, Ohio. The contract is for the supply, installation, and maintenance of secure voice communications systems. As of March 1989, the Air Force had ordered 51 voice communications systems for about \$100 million, including installation and maintenance.

Our objective was to determine whether Electrospace complied with the Truth in Negotiations Act (P.L. 87-653, as amended) by providing accurate, complete, and current cost or pricing data at the date of price agreement on this negotiated contract. We found that Electrospace

- did not disclose accurate, complete, and current cost or pricing data supporting proposed material and labor costs, which caused the contract price to be overstated by about \$2.03 million;
- could not provide supporting cost or pricing data for material costs valued at about \$4.96 million; and
- overbilled the Air Force \$876,382 for cable assembly labor not included in the installation billing rate negotiation.

Electrospace officials believe the contract was properly priced and billed, and presented various reasons for the company's position. We disagree because we believe the company was required to disclose data that it did not disclose, and was required to keep records that it did not keep. Detailed information on the problems we found, the company's comments, and our evaluation of the company's comments are included in appendix I.

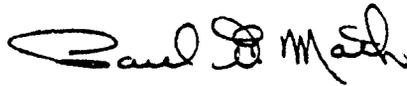
We believe the information in this report provides a basis for your initiating action to recover the overstated prices and excess billings from Electrospace, and we recommend that you take such action. We would appreciate being informed of any actions you take on this matter.

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Copies of this report are being sent to the President, ElectroSpace Systems, Inc.; the Commander, Air Force Communications Command, Scott Air Force Base, Illinois; and the Commander, Defense Contract Administration Services Region, Dallas, Texas.

Staff members who made major contributions to this report are listed in appendix II.

Sincerely yours,



Paul F. Math  
Director, Research, Development,  
Acquisition, and Procurement Issues



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## Abbreviations

AFLC	Air Force Logistics Command
DCAA	Defense Contract Audit Agency



# Prices Overstated on Air Force Communication Systems Contract

With certain exceptions, the Truth in Negotiations Act, Public Law 87-653, as amended, requires contractors to submit cost or pricing data to support proposed prices for noncompetitive contracts. The act also requires contractors to certify that the data submitted are accurate, complete, and current. When the act is applicable, the government has a right to a price reduction if, after contract award, it is determined that the contract price was overstated because the cost or pricing data submitted were not accurate, complete, or current. The Federal Acquisition Regulation requires contractors to retain and make available all cost and pricing data in connection with a noncompetitive contract for 3 years after final payment.

We reviewed a contract awarded by the Wright-Patterson Contracting Center, Wright-Patterson Air Force Base, Ohio, to upgrade voice communications systems at the Air Force Logistics Command (AFLC) Command Post at Wright-Patterson and five Air Logistics Centers. The system installed at each location was to be tailored to that location by ordering components from a list of 19 components priced in the contract. Thus, the price for each system depends on the components ordered and the actual installation hours required at each location.

On June 28, 1985, Electrospace submitted a firm fixed-price contract proposal for \$13,837,980 to supply the solicited quantities of system components. The proposal did not include installation costs. Electro-space increased its proposal on September 5, 1985, to \$18,107,316 to reflect additional unsolicited components and options, and to update the manufacturing labor cost of selected components. The Defense Contract Audit Agency (DCAA) audited the revised proposal and provided the contracting officer preliminary audit results on September 20, 1985. The final audit report was issued October 4, 1985.

A delay in the Electrospace response to DCAA requests for supporting material cost data delayed completion of the audit which, in turn, threatened to delay completion of contract negotiations beyond September 30, 1985, the end of the fiscal year. To ensure that expiring fiscal year 1985 funds were used, the contracting officer decided to award a contract to buy only the system for the AFLC Command Post before the end of the fiscal year. Another contract to be awarded after the start of fiscal year 1986 would buy the remaining systems, including installation and maintenance for all systems.

On September 26, 1985, the Air Force and Electrospace concluded negotiations on the first contract, F33600-D-86-0621, a supply contract for a

**Appendix I  
Prices Overstated on Air Force  
Communication Systems Contract**

communications system for the AFLC Command Post at Wright-Patterson Air Force Base. Electro-space certified that its cost and pricing data were accurate, complete, and current as of September 25, 1985. Contract -0621 was awarded on September 30, 1985.

On November 14, 1985, the Air Force and Electro-space completed negotiations on the second contract, F33600-D-86-0295. Contract -0295 is a requirements<sup>1</sup> contract for the communications systems components at five logistics centers and installation and maintenance billing rates for the systems at the five centers and the AFLC Command Post. Electro-space certified that its cost or pricing data supporting contract -0295 were accurate, complete, and current as of November 14, 1985. The Air Force awarded contract -0295 on December 2, 1985. Our review focused on this contract.

An unsolicited feature added to contract -0295 allowed the Air Force Communications Command to order an indefinite quantity of systems under the contract. As of June 1988, the Air Force had ordered 51 systems—1 system for the AFLC and 50 systems for the Air Force Communications Command. The 51 systems were in addition to the system bought under contract -0621 for the AFLC Command Post.

**Noncompliance With  
Public Law 87-653  
Resulted in Overstated  
Contract Price**

Electro-space did not disclose accurate, complete, and current cost or pricing data supporting proposed material and labor costs. The nondisclosures caused the price for contract -0295 to be overstated by \$2,029,642, including overhead and profit. Table I.1 lists the types and amounts of overpricing.

**Table I.1 Overstated Material and Labor Costs**

Type of cost	Amount
Material	\$878,748
Labor	
Labor rate	\$1,063,422
Escalation rate	87,472
<b>Total</b>	<b>\$2,029,642</b>

<sup>1</sup>A requirements contract provides for filling all actual purchase requirements of designated government activities for specific supplies or services during a specified contract period, with deliveries to be scheduled by placing orders with the contractor.

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## Overstated Material Costs

Electrospac provided the DCAA a consolidated bill of materials on September 5, 1985, the same day it submitted its updated proposal. The consolidated bill of materials listed 766 parts. Price agreement on contract -0295 was reached on November 14, 1985. We found more accurate, complete, and current data were available as of price agreement for 112 of the 766 parts listed on the consolidated bill of materials.

Of these 112 parts, Electrospac did not provide the Air Force the most current cost or pricing data for 92 parts;<sup>2</sup> duplicated prices for 2 parts; and proposed different prices for 18 parts that were listed in the consolidated bill of material more than once.

Nondisclosure of accurate, complete, and current cost or pricing data for the 112 parts caused the prices for the 51 systems ordered under contract -0295 to be overstated by \$878,748, including overhead and profit.

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## Overstated Labor Costs

Electrospac did not disclose accurate, complete, and current cost or pricing data supporting proposed labor installation costs. Electrospac did not disclose labor skill mix data from a prior contract and labor escalation data from a major subcontract agreement. These nondisclosures caused the authorized installation cost for the 51 systems ordered under contract -0295 to be overstated by about \$1,150,894, including overhead and profit.

Electrospac proposed a composite labor billing rate of \$43.81 per hour for installing the communications systems. The billing rate is escalated by 5 percent annually. According to the contracting officer's Price Negotiation Memorandum, the proposed rate was represented to be based on the labor skill mix experienced on a prior contract for identical installation work at Scott Air Force Base. According to the contracting officer, Electrospac represented the skill mix from the prior contract to be 45 percent technicians and 55 percent engineers.

However, we found the labor skill mix on the prior contract was substantially different—65 percent technicians and 35 percent engineers. The actual skill mix from the prior contract results in a composite labor rate of \$38.10, or \$5.71 per hour, lower than Electrospac proposed and certified as accurate, complete, and current.

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<sup>2</sup>More accurate, complete, and current data resulted from purchases occurring between the price agreement dates for the two contracts.

Through February 1988, the Air Force had authorized 188,125 hours for installation work by Electrospac under contract -0295. Thus, the contract is overpriced by \$1,063,422,<sup>3</sup> including escalation, overhead, and profit.

Electrospac also did not disclose an escalation agreement with Lear Siegler, a major installation subcontractor. On contract -0295, Electrospac proposed a fixed labor rate for subcontract installation work to be performed by Lear Siegler. The Air Force and Electrospac agreed to escalate the labor rate 5 percent annually in January of each year. However, the agreement between Electrospac and Lear Siegler which existed before negotiation of contract -0295 provided for 5 percent escalation in October of each year—not January. As a result, Electrospac recovered escalation on the subcontract labor rate from January through September—9 months before the agreed escalation date with Lear Siegler.

The differences in the escalation periods caused the subcontract labor rate negotiated for contract -0295 to be overstated by \$1.21 per hour (\$1.71 per overtime hour) in 1986 and 1987. As a result, the subcontract labor hours billed to the Air Force through January 1988 were overpriced by about \$87,472, including escalation, overhead, and profit.

## Unsupported Material Costs

We could not determine whether Electrospac had proposed accurate, complete, and current prices for 152 of the 766 parts under contract -0295 because the company was unable to give us the vendor quotes or engineering estimates used to price these parts. A standard contract clause required by procurement regulations and included in contract -0295 required Electrospac to retain supporting cost or pricing data until 3 years after final contract payment.

Our examination of other available data raises doubts about whether the prices negotiated for the 152 parts which totaled \$4,963,093 were fair and reasonable. Of these 152 parts, 117 parts may not have been required on the contract because Electrospac was unable to show that the company had purchased either those parts or other parts as substitutes. For the remaining 35 parts, we found that Electrospac purchased 32 parts at prices 60 percent below the proposed prices. Insufficient

<sup>3</sup>Since labor rates varied over the course of the contract, we calculated the overpricing using the labor rates existing at the time the labor hours were billed.

data was available for us to accurately compare the purchase and proposed prices of the three remaining parts.

The company's inability to provide cost or pricing data for the 152 parts or show that they had purchased a majority of the parts at the proposed prices raises doubt about whether fair and reasonable prices were negotiated for the 51 communications systems ordered under contract -0295.

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## **Electrospace Overbilled for Cable Assembly Labor**

In January 1986, contract -0295 was modified to add additional components. We found problems in the pricing of one of the components—a distribution cabinet. According to Electrospace records, the company's proposed price for the cabinet included, among other things, material costs for the cable required and labor costs for assembling the cabinets. However, because the quantity of cable required varied, depending on the locations where the cabinets would be installed, the Air Force and Electrospace agreed during negotiations to include the cable material costs in the time-and-materials portion of the contract. The labor cost was negotiated in the price of the cabinet.

Our analysis of Electrospace bills showed the company is billing the Air Force for cable labor under the time-and-materials portion of the contract. As a result, Electrospace is being paid twice for cable labor cost—in the fixed-price of the cabinet, as well as in the time-and-materials portion of the contract. Through January 1988, Electrospace has incorrectly billed the Air Force for about 18,600 hours, or \$876,382, based on the installation billing rate of \$43.81 per hour escalated by 5 percent annually.

The Air Force contracting officer told us that the cable labor costs were not negotiated in the time-and-materials portion of the contract nor was there discussion of moving that cost to the time-and-materials portion of the contract. Moving cable labor to the time-and-materials portion of the contract would have required a revised proposal, based on cost or pricing data, and renegotiation of the composite installation billing rate because of the low labor grades and extensive labor hours associated with cable labor.

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## Electrospace and Air Force Comments on Our Findings

Electrospace officials believe the contract was properly priced and billed, and presented various reasons for the company's position. Electrospace and Air Force comments and our evaluation follow.

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### Material Prices Overstated

Electrospace officials do not agree that material prices are overstated on contract -0295. These officials told us that material prices for both contract -0621 and contract -0295 were negotiated and agreed to on September 26, 1985, and that it was clearly both parties' intention that the material prices would apply to both contracts. The officials believe that actual prices of material purchased between the price agreement dates of the two contracts (September 26 and November 14, 1985) did not have to be disclosed and are of no consequence for defective pricing purposes. The officials also stated that the 10-percent material price reduction agreed to during negotiations more than compensates for the nondisclosed material prices we found.

We disagree with Electrospace officials. Electrospace's Certificate of Current Cost or Pricing Data states that the cost or pricing data submitted in support of contract -0295 were accurate, complete, and current as of November 14, 1985, not September 26, 1985. The purpose of the Truth in Negotiations Act is to provide the government with cost information on a par with that possessed by the contractor. The act is aimed at cases in which the contractor does not disclose all available cost or pricing information to the government, as Electrospace did in this case.

We also disagree that price reductions made in negotiations should compensate for the nondisclosed cost or pricing data we found. According to the contracting officer's Price Negotiation Memorandum, a 10-percent reduction was negotiated. However, the reduction was not for over-priced parts. Rather, the reduction was made to reflect lower escalation due to Air Force plans to purchase all the systems by December 31, 1985. In this case, the Air Force contracting officer clearly relied on the defective data in pricing contract -0295. We discussed the situation with the contracting officer who told us that had Electrospace disclosed the updated material prices, the data would have been used to negotiate the contract.

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## Overstated Labor Installation Billing Rates

Electrospace does not agree that the labor installation billing rate was overstated. Company officials assert that the proposed installation billing rate of \$43.81 per hour was an estimate, and that the company did not provide the contracting officer any information on how the estimate was derived. However, the government's Price Negotiation Memorandum on negotiations for contract -0295 shows the contracting officer believed the skill mix supporting the proposed billing rate was the same as for identical installation work on a prior contract. Electrospace officials acknowledge that while negotiating by telephone with the contracting officer on November 13, 1985, the contracting officer was told that the rate had been generally based on previous experiences.

Electrospace officials agree that they did not disclose the labor escalation agreement with Lear Siegler. However, they believe the nondisclosure gave no unfair advantage to the company. The officials assert that in negotiating the subcontract labor rates in contract -0295, "the issue was never the escalation . . . it was the value of the rates themselves." We disagree. As noted earlier, nondisclosure of the escalation agreement caused the subcontract labor rate negotiated for contract -0295 to be overstated by \$1.21 per hour (\$1.71 per overtime hour) in 1986 and 1987.

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## Overbilling of Cable Assembly Labor

Electrospace officials do not agree that problems in pricing the distribution cabinet have resulted in overbillings totaling \$876,382. The officials told us that the company cannot determine from existing records whether the cable assembly cost was included in the company's proposed price of the cabinet, and it would be speculative to estimate how many hours were included in contract -0295. The officials believe that if the cable assembly labor were in the fixed-price portion of contract -0295, it would be minimal.

As stated earlier, the contracting officer told us the cable labor costs were not negotiated in the time-and-materials portion of the contract nor was there discussion of moving cable labor costs to the time-and-materials portion of the contract. Accordingly, we do not believe Electrospace should be billing the Air Force for cable labor costs under the time-and-materials portion of contract -0295.

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## **Objective, Scope, and Methodology**

Our objective was to determine whether Electrospace is complying with the Truth in Negotiations Act by submitting accurate, complete, and current cost or pricing data on noncompetitive contracts. We reviewed contract file documents, negotiation records, purchase order files, and related price proposals for contract F33600-D-86-0295. We also interviewed contractor representatives and government officials responsible for procurement, contract administration, and contract audit. We performed our work at Electrospace's plant in Richardson, Texas, and at Wright-Patterson Air Force Base, Ohio.

Our review was limited because Electrospace was unable to provide cost or pricing data supporting 152 of the 766 parts shown on the consolidated bill of materials they prepared to support their proposal. These 152 parts represented about 44 percent of the extended value of the consolidated bill of materials. The company was also unable to provide cost and pricing data for cable labor estimates.

The results of our review were discussed with the Air Force contracting officer and Electrospace officials responsible for negotiating the contract.

Our review was performed in accordance with generally accepted government auditing standards from October 1987 to January 1989.

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