United States General Accounting Office

GAO

Report to the Heads of the National Audit Offices of Belgium, Denmark, the Netherlands, and Norway

September 1996

CONTRACT PRICING

Pricing of F-16 Mid-Life Update Program Contracts

G A O

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United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

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September 24, 1996

Baron Jerome van de Velde
First President of the Court of Accounts
Belgium

Mr. Henrik Otbo
Auditor General
Denmark

Mr. Henk E. Koning
President of the Netherlands Court of Audit
The Netherlands

Mr. Bjarne Mørk-Eidem
Auditor General
Norway

As requested, we reviewed the pricing of selected contracts and subcontracts awarded under the F-16 aircraft Mid-Life Update (MLU) program. The MLU program is designed to develop, produce, and install upgrades to F-16 fighter aircraft owned by Belgium, Denmark, the Netherlands, and Norway to improve their performance.

We determined (1) if the rates and factors used to price two selected prime contracts were the same as those used to price contemporaneous U.S. government contracts, (2) how Air Force negotiation officials used the Defense Contract Audit Agency's[1] (DCAA) recommendations in negotiating the prime contract prices, and (3) if the material and subcontract costs included in the prime contract prices were fair and reasonable. Also, as requested, we reviewed the pricing of two selected subcontracts. This report does not contain proprietary data under 18 U.S.C. 1905.

Background

On June 10, 1975, the U.S. government executed a Memorandum of Understanding with the governments of Belgium, Denmark, the Netherlands, and Norway to produce F-16 aircraft under a program known as the F-16 Multinational Fighter Program. Of the 998 aircraft produced

[1]The Defense Contract Audit Agency is responsible for performing all contract audits for the Department of Defense (DOD) and for providing accounting and financial advisory services regarding contracts and subcontracts to all DOD components responsible for procurement and contract administration.

under this program, the U.S. Air Force purchased 650 and the European participating governments purchased the remaining 348.

Under the ongoing MLU program, the Europeans are upgrading their F-16 aircraft by equipping them with new cockpits and avionics systems. On behalf of the four European participating governments, the U.S. Air Force awarded prime contracts to Lockheed Martin Tactical Aircraft Systems[2] and Northrop Grumman Corporation[3] valued at $622.7 million and $106.5 million, respectively, to provide the aircraft upgrades. The U.S. government participated in the development phase of the MLU program, but it withdrew from the production phase in November 1992.

The European countries' Supreme Audit Institutions (SAIS) have raised a number of issues regarding the pricing of the MLU contracts. The U.S. and European participating governments agreed that they would "endeavor to establish the same price for the same articles when they were procured under the same conditions from the same source." Due to the proprietary nature of the information affecting the negotiation of the contracts, SAIS are precluded from having access to this information. On December 15, 1994, a meeting, involving representatives from the U.S. and the European participating governments, was held during which agreement was reached to provide assurance that the MLU contract prices were fair and reasonable.

Among the issues discussed were the rates and factors used to price the MLU contracts. According to the minutes of the meeting, the European representatives were assured that the ". . . rates and factors that are used for MLU contracts are the same for all other LFWC [Lockheed Fort Worth Company] F-16 contracts with the U.S. Government." Since these rates and factors are proprietary, the Netherlands representative asked if the United States could provide certification that the same rates are used on all U.S. government contracts. The Defense Plant Representative Office Commander agreed to provide the certification and did so on March 24, 1995.[4]

[2]Formerly known as the Lockheed Fort Worth Company. The name was changed to Lockheed Martin Tactical Aircraft Systems as a result of the merger between Martin Marietta Corporation and Lockheed Corporation in March 1995.

[3]Formerly known as Westinghouse Electric Corporation. Northrop Grumman Corporation acquired Westinghouse's defense and electronic systems business in March 1996.

[4]Defense Plant Representative Offices are located at major contractor plants and are responsible for carrying out various contract administration activities, including negotiating rates and factors.

Results in Brief

The prime contractors proposed and Air Force negotiators accepted rates and factors to price the two MLU contracts that were different from those used to price contemporaneous U.S. government contracts. The contract prices for the European participating governments were $9.4 million higher due to the use of different rates and factors.

In the case of the Lockheed Martin contract, the Defense Plant Representative Office Commander certified that the forward pricing rate agreement[5] (FPRA) rates and factors used to price the MLU contract were the same as those used to price all other contracts awarded to Lockheed Martin during the effective period of the agreement. Despite this certification, a special set of higher rates and factors was used to price the MLU contract rather than those called for in the FPRA, thus increasing the price for the European participating governments by $8 million. In addition, the Air Force negotiated two other contracts with Lockheed Martin using the lower FPRA rates and factors on the same day the MLU contract was negotiated.

As for the Northrop Grumman contract, Air Force negotiators used a general and administrative[6] (G&A) overhead rate established for use in pricing foreign military sales contracts rather than a lower domestic rate established for pricing U.S. government contracts. In addition, Air Force negotiators used two incorrect rates in pricing the MLU contract. These two conditions increased the price to the European participating governments by $1.4 million.

DCAA conducted preaward audits of the prime contractors' price proposals and questioned various costs. In addition, DCAA reported large amounts of unresolved costs because audits had not been made of several subcontractor price proposals. Except for the rates and factors used for the Lockheed Martin contract, Air Force negotiators used DCAA's audit results to assist them in negotiating lower prices for the prime contracts.

[5]A forward pricing rate agreement is a written agreement between a contractor and the government in which the contractor agrees to make negotiated rates and factors available during a specified period for use in pricing contracts.

[6]G&A overhead includes a wide range of indirect expenses such as salaries and wages, operating supplies, telephone, insurance, and maintenance.

Lockheed Martin and Northrop Grumman employed safeguard techniques required by U.S. procurement regulations[7] to evaluate and negotiate subcontract and material prices for the prime contracts. Air Force negotiators accepted the proposed and negotiated subcontract prices as fair and reasonable based on the prime contractors' evaluation and negotiation efforts. There are indications, however, that material in the two prime contracts may be overpriced by as much as $947,000. We provided this information to the cognizant DCAA offices, and, at the time we completed our review, they were conducting postaward audits[8] of the prime contracts.

As for the two subcontracts selected by SAIs for review (Hazeltine and Honeywell), Lockheed Martin awarded the Hazeltine subcontract competitively and the Honeywell subcontract noncompetitively. In negotiating the price of the Honeywell subcontract, Lockheed Martin used rates and factors recommended by the cognizant U.S. government contract administration activity and employed the safeguard techniques required by U.S. procurement regulations. The Air Force accepted the prices of these two subcontracts as fair and reasonable.

Rates and Factors Used to Price MLU Contracts

Lockheed Martin and Northrop Grumman proposed and Air Force negotiators used rates and factors to price the two MLU prime contracts that were different from those used to price contemporaneous U.S. government contracts. Also, Air Force negotiators used two incorrect rates in pricing the Northrop Grumman prime contract. These two conditions increased the prime contract prices by a total of $9.4 million.

Lockheed Martin

The rates and factors used to price the Lockheed Martin MLU contract were not the same as those used to price U.S. government contracts. Instead, on December 23, 1994, Lockheed Martin proposed a "special" set of rates to price the MLU contract rather than using the lower FPRA rates in effect at

[7]Executive agencies of the U.S. government are required to follow a single, uniform regulation—the Federal Acquisition Regulation—in buying supplies and services. DOD has issued a supplement to the Federal Acquisition Regulation containing requirements unique to DOD. The supplement is called the Defense Federal Acquisition Regulation Supplement.

[8]DCAA conducts postaward audits, in accordance with the Truth In Negotiations Act (10 U.S.C. 2306a), to determine whether contractors submitted or disclosed accurate, complete, and current cost or pricing data to the government prior to reaching contract price agreement. The government is entitled to recover overpricing when it determines that a contractor did not submit or disclose accurate, complete, and current cost or pricing data. In the case of the MLU contracts, the participating governments would directly benefit from recovery of any overpricing.

that time. The Air Force used the special rates in negotiating the MLU contract prices. This action increased the contract price by $8 million.

During the December 1994 working group meeting involving U.S. and European representatives, the Defense Plant Representative Office Commander stated he would certify that the rates used to price the MLU contract would be the same as those used to price all U.S. government contracts. Subsequently, in a March 24, 1995, written certification, the Commander stated ". . . that the applicable FPRA rates and factors used in the MLU program are the same as all other programs negotiated between the LFWC [Lockheed Fort Worth Company] and the U.S. Government." However, contrary to the Commander's certification, the Air Force negotiated two other contracts with Lockheed Martin on the same day the MLU contract was negotiated using lower FPRA rates and factors.

Neither Lockheed Martin nor the Air Force withdrew from the FPRA that was in effect at the time the MLU contract price was agreed to. The Defense Federal Acquisition Regulation Supplement stipulates that FPRA rates must be used to price contracts unless waived by the head of the contracting activity. No such waiver was requested or obtained for the special rates used to price the MLU contract. Furthermore, there was no evidence in the contract negotiation records or files that the special rates were audited by DCAA or approved for use by the Defense Plant Representative Office. Lockheed Martin proposed and Air Force negotiators used the lower FPRA rates to establish the negotiation objective for the contract price. Before contract price agreement was reached, however, Lockheed Martin provided Air Force negotiators the special set of rates and factors that they accepted and used to price the contract.

Lockheed Martin officials told us a special set of rates and factors was required to negotiate the MLU contract because the existing FPRA was only valid through calendar year 1997. They explained that the MLU contract performance period covered calendar years 1993 through 2001 and that rates and factors for the outyears were required. They believe that the special rates benefited the MLU customers because a new FPRA, negotiated shortly after the MLU contract, included higher rates than those used for the MLU contract.

In responding to a draft of this report, the Air Force agreed a special set of rates and factors was used to price the MLU contract, but it believed the use of those rates and factors was in the best interest of the European participating governments. The Air Force also stated that the Defense

Plant Representative Office Commander signed the certification in good faith, based on his knowledge at that time, and with full intention of being consistent with the pricing agreement between the U.S. and the European participating governments. The Air Force further stated that the Defense Plant Representative Office was negotiating a new FPRA while MLU contract negotiations were going on and had already offered Lockheed Martin higher rates and factors than were in the existing FPRA. The Air Force pointed out that Lockheed Martin would never have accepted the lower existing FPRA rates and factors, which covered the period 1993 through 1997.

We agree that the certification was signed in good faith. We also agree that the existing FPRA extended only through 1997 and that rates and factors were needed to cover the MLU contract performance period. However, when changing conditions cause rates in an FPRA to be no longer valid, defense procurement regulations provide approved methods for dealing with the situation—either withdraw from the rate agreement or obtain a waiver from the head of the contracting activity. Air Force negotiators did neither. We found that the Defense Plant Representative Office had issued recommended rates and factors covering 1998 and 1999. Thus, Air Force negotiators—using the existing FPRA and recommended rates—had rates and factors covering 1993 through 1999. According to negotiation records, this period accounted for 99 percent of the MLU contract value. Furthermore, the $8-million increase to the MLU contract is not due to higher rates and factors for the years beyond the FPRA period. Rather, the increase is due to increased rates and factors for 1993 through 1997—the same period covered by the existing FPRA.

In addition, the MLU contract awarded to Northrop Grumman for radar systems encountered the same situation as the Lockheed Martin contract—that is, it extended beyond the period covered by the existing FPRA. However, in contrast to the Lockheed Martin situation, the Air Force used existing FPRA rates and factors to price the radar contract. The contract performance period extended into the year 2002, while the existing FPRA went through only 1996. Northrop Grumman proposed and the Air Force used the existing FPRA rates and factors and projected these rates and factors over the remaining contract performance period.

Northrop Grumman

Northrop Grumman proposed and the Air Force accepted a G&A overhead rate established for pricing foreign military sales contracts rather than a lower domestic rate established for pricing U.S. government contracts.

Use of the G&A rate for foreign military sales contracts increased the MLU contract price by $1.3 million.

Northrop Grumman officials told us they used the G&A rate for foreign military sales contracts because of the additional costs in doing business with foreign customers. They also stated they were unaware of any requirement to use the same rates applied to U.S. government contracts. They further stated that such a requirement was not made known to the corporation in the Air Force's request for proposal or subsequent contract award.

In commenting on a draft of this report, the Air Force pointed out that use of the foreign military sales G&A rate was proper on the Northrop Grumman MLU contract. The Air Force advised us that the contractor could not use and the Air Force could not accept the domestic G&A rate for pricing the contract because it would be a misallocation of costs. The Air Force also pointed out that use of the foreign military sales G&A rate did not violate the intent or the spirit of the agreement between the U.S. and the European participating governments.

It should be noted that while the Air Force contends that it would have been improper to use the domestic G&A rate for pricing the Northrop Grumman contract, the Air Force used a domestic G&A rate to price the Lockheed Martin MLU contract. The Air Force did not explain this inconsistency.

In addition to using the higher G&A rate for foreign military sales contracts, Air Force negotiators used two incorrect rates in pricing the MLU contract, which caused its price to be increased by $163,600. The Air Force concurred that use of the incorrect rates was an oversight. In total, the MLU contract price was increased by $1.4 million as a result of using the higher G&A rate for foreign military sales contracts and two incorrect rates.

DCAA Audit Work Used to Negotiate MLU Contracts

DCAA conducted preaward audits of both prime contract proposals and questioned various costs. DCAA also reported large amounts of proposed subcontract costs as unresolved because several subcontractor price proposals had not been audited at the time of its preaward audits. Price negotiation memorandums showed DCAA helped the Air Force evaluate updated contractor proposals during fact-finding[9] prior to contract price

[9]After issuing its preaward audit report, DCAA often helps the procurement activity review the contractor's updated cost or pricing data. This process is called fact-finding and occurs before contract price negotiations start.

negotiations. In addition to making specific recommendations on proposed costs, DCAA also provided Air Force negotiators with information on deficiencies in the contractors' estimating systems, material management and accounting systems, and other operations.

The price negotiation memorandums clearly show that Air Force negotiators used DCAA recommendations to assist in establishing objectives and negotiating lower prices for the two prime contracts. The memorandum for the Lockheed Martin contract, for example, shows DCAA reported a substantial amount of proposed subcontract costs as unresolved because audits of the subcontracts had not been completed at the time of DCAA's review. DCAA reported the same condition for the Northrop Grumman contract. Audits of the subcontractor proposals were subsequently obtained, and Air Force negotiators used the information in negotiating the contract prices.

Air Force negotiators also used other DCAA recommendations in negotiating the prices of the contracts. On the Northrop Grumman contract, for example, they extensively used DCAA's recommendations on proposed material costs. The price negotiation memorandum showed Air Force negotiators were able to obtain most of DCAA's recommended cost reductions for material.

Reasonableness of Subcontract and Material Costs

We reviewed the fairness and reasonableness of subcontract and material costs negotiated in the prime contracts because these costs comprised about 88 percent of the combined negotiated contract prices. Subcontracts and material under the Lockheed Martin contract totaled $572.7 million, or about 92 percent, of the $622.7-million contract price. Subcontracts and material under the Northrop Grumman contract comprised $66.2 million, or about 62 percent, of the $106.5-million price.

Subcontract Costs

For competitively priced subcontracts, we examined the supporting records and, if adequate competition occurred, we accepted the prices as fair and reasonable. For noncompetitively priced subcontracts, we examined the negotiation records to determine if appropriate safeguard techniques were used to negotiate the prices.

At the time of the prime contract price agreement dates, Lockheed Martin had negotiated firm prices for 10 of its 11 major subcontracts, and Northrop Grumman had negotiated firm prices for both of its major subcontracts. The contractors used the pricing techniques required by the Federal Acquisition Regulation in negotiating subcontract prices. Subcontract files and other records showed that Lockheed Martin and Northrop Grumman (1) obtained cost or pricing data,[10] (2) conducted cost analyses,[11] (3) conducted price negotiations, and (4) and obtained certificates of current cost or pricing data.[12] The cognizant Defense Plant Representative Offices also obtained audits from DCAA or the participating governments' audit agencies of the subcontractor price proposals and provided the audit reports to Air Force negotiators.

For the subcontract that was not priced at the time of prime contract price agreement, Lockheed Martin, as required by the Federal Acquisition Regulation, obtained cost or pricing data from the subcontractor and prepared a cost analysis of the subcontract proposal.

Air Force negotiators accepted the proposed and negotiated subcontract prices as fair and reasonable based on the prime contractors' evaluation and negotiation efforts.

Material Costs

We did not examine material items on the Lockheed Martin contract because they comprised less than 1 percent of the contract price. As for the Northrop Grumman contract, we examined the pricing of selected material items because material costs comprised about 9 percent of the contract price. Northrop Grumman used appropriate safeguard techniques to price material items.

None of the eight high dollar items we selected for review were priced at the time of prime contract price agreement. Northrop Grumman based its proposed prices for four of the items on supplier competitive quotations. Northrop Grumman received multiple quotations for the four items; therefore, we accepted the competitive prices as fair and reasonable.

[10]Cost or pricing data consist of all facts existing up to the time of agreement on contract price that prudent buyers and sellers would reasonably expect to significantly affect price negotiations. Cost or pricing data can be independently verified and consist of such information as vendor quotations, nonrecurring costs, and information on changes in production methods.

[11]A cost analysis is a review and evaluation of a contractor's cost or pricing data and of the judgmental factors applied in projecting estimated costs based on the data. It assesses the individual elements of a contractor's proposed cost and profit and generally establishes minimum and maximum target prices for use in subsequent contract price negotiations.

[12]In those cases where a subcontractor is required to submit cost or pricing data, the prime contractor is required to obtain from the subcontractor a certificate of current cost or pricing data certifying that to the best of its knowledge and belief, the cost or pricing data provided were accurate, complete, and current at the time agreement is reached on the subcontract price.

Northrop Grumman based its proposed prices for the other four items on noncompetitive quotations, and it conducted price analyses[13] for the items. For two of the items, the price quotations fell below the maximum prices established by the price analyses, and Northrop Grumman accepted the proposed prices as fair and reasonable. Quotations for the other two items were higher than the maximum price established by the price analyses, and Northrop Grumman decremented[14] the quotations and submitted the lower prices to Air Force negotiators.

During prime contract price negotiations, Air Force negotiators applied an additional decrement against the proposed prices for all eight items.

There are indications that material is overpriced by as much as $947,000 under the two prime contracts because the prime contractors did not provide government negotiators with accurate, complete, and current data available for the items at the time of the contract price agreement dates. We provided this information to the cognizant DCAA offices, and they are reviewing material prices in both prime contracts to determine the extent of overpricing. The amount of overpricing may change as DCAA continues its review.

Pricing of Two MLU Subcontracts

As requested, we reviewed the pricing of the subcontracts Lockheed negotiated with Hazeltine for the advanced identification friend or foe system and with Honeywell for the color multifunction display system. The Hazeltine subcontract was awarded on a competitive basis, while the Honeywell subcontract was awarded on a noncompetitive basis.

Hazeltine

The subcontract awarded to Hazeltine was competed between Hazeltine and three other vendors. Lockheed Martin subjected the responsive proposals to a technical evaluation, management evaluation, risk analysis, and cost evaluation and determined that Hazeltine had the lowest risk approach with the highest probability of successful completion. Hazeltine was the only supplier that proposed to meet all of the technical

[13] A price analysis is the process of examining and evaluating a proposed price without evaluating its separate cost elements and proposed profit. A price analysis may be done, for example, by comparing current quotations with prior prices paid for the same or similar items or with independently developed estimates.

[14] Decrement means to reduce the proposed price of an item by a percentage. Contractors normally are able to negotiate prices lower than their vendors initially quote; therefore, the decrement is a technique used to adjust the proposed price of an item to account for an anticipated reduction in price as a result of negotiations.

requirements. Lockheed Martin concluded Hazeltine's proposed price was fair and reasonable and awarded the subcontract. Air Force negotiators also accepted the subcontract price as fair and reasonable.

Honeywell

Lockheed Martin used the same safeguard techniques in negotiating the Honeywell subcontract that are required to be used in negotiating subcontracts under U.S. government prime contracts. There was not an FPRA with Honeywell at the time the subcontract price was negotiated; however, recommended rates and factors[15] had been issued for Honeywell contracts. Lockheed Martin used the recommended rates and factors in negotiating the subcontract price. Air Force negotiators accepted the negotiated price as fair and reasonable.

Air Force and Contractor Comments

Air Force and contractor officials reviewed a draft of this report and their comments have been incorporated in the text where appropriate. Their comments are presented in their entirety in appendixes I, II, and III.

Scope and Methodology

SAIS selected two prime contracts for review. The first prime contract involved the letter contract the Air Force awarded to Lockheed Martin on August 17, 1993. The contract provides for the production of modification kits to upgrade the cockpit and avionics systems on the F-16 aircraft. The Air Force and Lockheed Martin agreed on the contract price on April 21, 1995, and the final contract was signed on June 13, 1995. The second prime contract involved a letter contract the Air Force awarded to Northrop Grumman on December 3, 1993. The contract provides for the production of modification kits for the AN/APG-66(V)2 fire control radar. The Air Force and Northrop Grumman agreed on the contract price on July 15, 1994, and the final contract was signed on September 27, 1994.

SAIS also selected two subcontracts for review. Both were awarded under the prime contract to Lockheed Martin. The first involved the subcontract Lockheed Martin awarded to Honeywell (purchase order 354) on October 30, 1995, for the production of the F-16 color multifunction displays. The second involved the subcontract Lockheed Martin awarded to Hazeltine (purchase order 4XU) on September 24, 1993, for the production of the advanced identification friend or foe combined interrogator/transponder system.

[15]Forward pricing rate recommendations contain rates and factors established unilaterally by the administrative contracting officer for use by government negotiators when FPRA rates and factors are not available.

To determine whether the rates and factors used to price the two MLU prime contracts were the same as those used to price U.S. government contracts, we reviewed Air Force negotiation records to identify the rates and factors used for the MLU contracts. We then compared the MLU rates and factors to those included in FPRAS and forward pricing rate recommendations in effect at the time the MLU contracts were negotiated. Where differences were identified, we determined the effect on contract prices. We performed similar work on the Honeywell subcontract. We discussed the rates and factors with contractor, Air Force, DCAA, and Defense Plant Representative Office officials.

To determine how Air Force officials used DCAA audit recommendations in negotiating prices for the prime contracts, we reviewed the DCAA preaward audit reports and recommendations. We evaluated contract negotiation records to determine how Air Force negotiators used DCAA's work in establishing negotiation objectives and negotiating the contract prices. We discussed the use of the audit recommendations with DCAA and Air Force officials.

To determine whether subcontract and material costs included in the contract prices were fair and reasonable, we compared the pricing safeguard techniques used by the contractors with those required by the Federal Acquisition Regulation and the Defense Federal Acquisition Regulation Supplement. We verified that, when required, the contractors obtained cost or pricing data, conducted cost or price analyses, carried out negotiations with subcontractors and vendors, and obtained certificates of current cost or pricing data. We also determined whether DCAA or audit agencies of the European participating governments made audits of the subcontractor price proposals. In addition, we examined negotiation records for the subcontracts and material items and discussed them with contractor and Air Force officials.

We performed our work between May and August 1996 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Secretaries of Defense and the Air Force; the F-16 System Program Director; the Director, Defense Contract Audit Agency; the Commander, Defense Contract Management Command; and the Chief Executive Officers of Lockheed Martin and Northrop Grumman Corporations. Copies will be made available to others upon request.

If you or your staff have questions about this report, please contact me at (202) 512-4841 or David E. Cooper at (202) 512-4587. Major contributors to this report are listed in appendix IV.

Louis J. Rodrigues
Director, Defense Acquisitions Issues

Contents

Abbreviations

DCAA	Defense Contract Audit Agency
DOD	Department of Defense
FPRA	forward pricing rate agreement
G&A	general and administrative
MLU	Mid-Life Update
SAI	Supreme Audit Institutions

Comments From the Air Force

DEPARTMENT OF THE AIR FORCE
WASHINGTON DC

OFFICE OF THE ASSISTANT SECRETARY

03 SEP 1996

SAF/AQ
1060 Air Force Pentagon
Washington, D.C. 22030-1060

Mr. Louis J. Rodrigues
Director, Defense Acquisition Issues
National Security and International Affairs Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Rodrigues

This is the Air Force response to the General Accounting Office (GAO) draft report "CONTRACT PRICING Pricing of the F-16 Mid-Life Update (MLU) Program Contracts" (GAO Code 707173). The Air Force partially concurs with this report. However, we believe the report is misleading in some aspects regarding completeness of facts and the context in which the facts are presented.

Release of your report as written would seriously damage the relationship we have worked hard to develop with our European F-16 partners. It contains incorrect data that would mislead the European Participating Governments (EPG) into believing they were overcharged. Therefore, we strongly urge you to incorporate the enclosed detailed comments in the body of your report in addition to appending your report with this letter.

See p. 1.

The Air Force does not concur with GAO findings on the MLU negotiations with Lockheed Martin Tactical Aircraft Systems (LMTAS). The Air Force firmly believes the best interests of the EPG customer were served, breaking the six month negotiation impasse and achieving a price $7.1M less than otherwise would have been negotiated with the new Forward Pricing Rate Agreement (FPRA). We believe the Memorandum of Understanding (MOU) between the U.S. Government and EPGs provides the proper basis for assessing the negotiation of MLU. The GAO report mistakenly focuses only on the LMTAS Defense Plant Representative Office (DPRO) commander's Mar 95 memo, not the MOU. We believe the DPRO commander signed the memo in good faith, based on his knowledge at that time, and with full intention of being consistent with the MOU. However, MLU negotiations were completed one month after the memo was signed. The MOU states the parties will "endeavor to establish the same price for the same articles when they are procured under the same conditions from the same source." (MOU, Steering Committee Arrangement 45, para 7.d). The GAO states (draft report, page 1), "We determined if the rates and factors used to price two selected prime contracts were the same as those used to price *contemporaneous* U.S. Government contracts." The *contemporaneous* contracts negotiated on the same date as the EPG LMTAS MLU negotiation were neither for the same articles nor under the same conditions. Importantly, the two GAO-selected contracts were covered by existing FPRAs. The much longer MLU contract was not. Again, the Air Force firmly believes the best interests of the EPG customer were served. An FPRA did not exist for outyear rates, the Air Force negotiator broke a six month negotiation impasse, and achieved a price $7.1M less than otherwise would have been negotiated using the later FPRA.

The Air Force does not concur with the GAO implication that use of an FMS General and Administrative (G&A) rate on the Northrop Grumman contract was improper. While the GAO finding is true, it is at the same time also misleading without additional information. The Air Force acknowledges use of an FPRA-based, FMS G&A rate on the Northrop Grumman contract. The contractor could not utilize, and the Air Force could not accept the use of, the domestic G&A rate for this effort because it would be a misallocation of cost. The contractor would have a Cost Accounting Standard (CAS) violation and be in conflict with their own Cost Disclosure Statement. The Air Force used the FMS G&A rate because it reflects G&A costs associated with foreign customers, does not reflect domestic G&A customer costs, and is therefore the appropriate rate. Additionally, Federal Acquisition Regulation (FAR) 15.809(e) requires the Contracting Officer to use the FPRA rates for pricing all contracts covered by the agreement, unless the Administrative Contracting Officer determines that changed conditions have invalidated part or all of the agreement. Use of this particular rate does not violate the intent nor the spirit of the various agreements between the U.S. and EPG.

The Air Force concurs with the GAO finding Air Force negotiators inadvertently used two incorrect rates in pricing the MLU contract resulting in an increase in price of $163,600. We consider this a minor oversight in comparison to the significant overall cost savings resulting from the special rate study. Accordingly, the Air Force has no plans to re-open negotiations and risk losing the $7.1M saved.

The Air Force also acknowledges possible discrepancies with material prices. These discrepancies, if found to be factual, will be vigorously dealt with using standard defective pricing contractual remedies, to include appropriate reimbursement, applicable to both USAF and EPG contracts.

We again express our grave concern over release of your report as written, and implore you to properly balance your misleading findings against the framework of the MOU.

Thank you for the opportunity to comment on the subject draft report

Sincerely

George K. Muellner

GEORGE K. MUELLNER, Lt Gen, USAF
Principle Deputy, Assistant Secretary
of the Air Force (Acquisition)

Attachment
Air Force Response

cc: SAF/FMPF
DoD Inspector General

AIR FORCE RESPONSE TO 15 AUG 96 DRAFT GAO BRIEFING REPORT ON PRICING OF F-16 MID-LIFE UPDATE PROGRAM CONTRACTS (GAO CODE 707173)

Now on p. 4.

GAO FINDING: On page 13 and 14 the GAO states that the F-16 SPO used a "Special" set of rates rather than that certified by a Air Force contract administration official, (the current Forward Pricing Rate Agreement [FPRA], RS-21N effective 1993 through 1997) to price the F-16 Mid-Life Update (MLU) Production Kits increasing the price to the European Participating Governments (EPG's) by $8 million.

AIR FORCE RESPONSE: The Air Force does not agree with the GAO presentation of the facts on the MLU-EPG negotiations with Lockheed Martin Tactical Aircraft Systems (LMTAS). The Defense Contract Management Command (DCMC) rate team was negotiating a new FPRA while the Air Force Negotiation Team (AFNT) was negotiating the MLU-EPG contract. The DCMC rate team had offered LMTAS a new FPRA above the USAF MLU FPRA thus essentially voiding the FPRA for MLU. The AFNT had to utilize DCMC rate team's negotiation offers to LMTAS as forward pricing rate recommendations, and relied upon the contractor's representation that its data was accurate, current and complete in accordance with the Truth in Negotiation Act (Public Law 87-653). The AFNT did exactly what it would have done regardless of customer (EPG, Foreign Military Sales [FMS], or USAF). LMTAS would never have agreed to use the USAF MLU FPRA as the DCMC rate team had already offered LMTAS a higher FPRA. The DCMC rate team concluded negotiations on the new FPRA with LMTAS 4 days after the MLU EPG agreement. If the new FPRA had been used for the MLU EPGs, the price would have been significantly more. The Air Force believes the AFNT's actions are a "Good News Story" and actually saved the EPG's $7.1 million. The GAO also points to the two other Air Force negotiations completed the same day as the MLU price agreement. One was the FY94 USAF F-16 buy and the other was the Pakistani F-16 Program Restructure. Both agreements utilized the current FPRA because the periods of performance were essentially complete and Forward Pricing rates were not an issue as was the MLU case. Had these two programs extended significantly into the future then the current FPRA would not have been used by the two teams. We will repeat the applicable requirements of the F-16 Multinational Fighter Program Memorandum of Understanding (MOU). Steering Committee Arrangement 45 to the MOU, which governs MLU, states in paragraph 7.d. "Except for USG [US Government] charges the parties will endeavor to establish the same price for the same articles when they are procured under the same conditions from the same source." The facts support our belief we are in full compliance with the MOU.

Now on p. 6.

GAO FINDING: On page 16, paragraph 1, the GAO states that the Air Force used the higher FMS General & Administrative (G&A) rate rather than the lower domestic G&A rate used for pricing USAF contracts.

AIR FORCE RESPONSE: The Air Force believes that while the GAO finding is true, it is at the same time also misleading without additional information. The Air Force concurs that in accordance with the Forward Pricing Rate Agreement (FPRA) in effect at the time, the FMS G&A rate rather than the domestic G&A rate was used to develop the Air Force objective and negotiate a fair and reasonable price. The contractor could not utilize and the Air Force could not accept the use of the domestic G&A rate for this effort because it would be a misallocation of cost. The contractor would have a Cost Accounting Standard (CAS) violation and be in conflict with their own Cost Disclosure Statement. The FPRA rates are audited by Defense Contract Audit Agency (DCAA) and recommended by the Defense Plant Representative Office (DPRO). The Air Force would have used the FMS G&A rate whether or not it was higher or lower than the domestic G&A rate charged to the Air Force because it reflects the G&A costs associated with foreign customers, does not reflect domestic G&A customer costs, and is therefore the appropriate rate. Indeed Federal Acquisition Regulation (FAR) 15.809(e) requires the Contracting Officer to use the FPRA rates for pricing all contracts covered by the agreement, unless the Administrative Contracting Officer determines that changed conditions have invalidated part or all of the agreement. This does not violate the intent nor the spirit of the MOU between the U.S. and EPG.

Now on p. 7.

GAO FINDING: On page 16 paragraph 4 the GAO states that the Air Force used two incorrect rates in pricing the MLU contract resulting in an increase in price of $163,600.

AIR FORCE RESPONSE: The rates referred to in this comment by the GAO were inadvertently used by the Air Force. The rates were incorporated into the Air Force objective and the final negotiated price in error. The Air Force takes no exception to the GAO finding.

Now on p. 10.

GAO FINDING: On page 29 the GAO states that there are some material items that may be overpriced because the contractor did not provide the Air Force with current, complete and accurate data as of the date of price agreement.

AIR FORCE RESPONSE: The Air Force in coordination with DCAA and in accordance with clause 52.215-23 Price Reduction for Defective Cost or Pricing Data-Modifications, will take action necessary to resolve any defective pricing issues and vigorously pursue any reimbursement determined to be appropriate by the facts of the case. It should be noted that because the Air Force utilized the same terms and conditions in this contract as would be found in any USAF contract, the MLU program enjoys the benefit of this contractual remedy.

Comments From Lockheed Martin

Lockheed Martin Tactical Aircraft Systems
Post Office Box 748 Fort Worth, TX 76101

LOCKHEED MARTIN

14 August 1996
FCM:lfd
MISC-FW#0121-56418

Subject: Comments to General Accounting Office (GAO) Draft Report - Contract Pricing, Pricing of F-16 Mid-Life Update Program Contracts

To: U.S. General Accounting Office
National Security & International Affairs Division
441 G Street NW
Washington, D.C. 20548

Attention: Louis J. Rodrigues
Director, Defense Acquisition Issues

Reference: (a) Meeting between Lockheed Martin Tactical Aircraft Systems (LMTAS) and U.S. GAO Personnel on 1 August 1996
(b) LMTAS Letter MISC-FW#0121-55107 dated 30 May 1996

Enclosure: (A) MLU/FY94 Negotiation Fact Sheet

1. Lockheed Martin Tactical Aircraft Systems (LMTAS) acknowledges receipt of the subject draft report on 7 August 1996. We appreciate the opportunity to review and provide comments to the draft report. We understand, based on comments made by GAO personnel in the reference (b) meeting, that our comments will be included in the body and made a part of your final report. A copy of the briefing charts we provided the GAO during the reference (b) meeting is enclosed.

2. The specific comments we wish to provide are as follows:

- There was no FPRA for Calendar Years 1998 and on; therefore, FPRA RS21N could not have been used in the final MLU settlement.
- The MLU and USAF FY94 proposals were, indeed, negotiated on 21 April 1995.
- New Forward Pricing Rate Agreement (FPRA) Schedule RS51N, replacing old FPRA RS21N, was issued on 25 April 1995, four days after negotiation of MLU and USAF FY94.

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- FPRA RS21N was negotiated only through Calendar Year 1997. Since there were no negotiated rates, there was a difference between the USAF and Lockheed negotiating positions, creating an impasse of some $6.5 Million.
- The program span time for MLU was 1993 through 2001. For USAF FY94, it was 1993 through 1997.
- On 23 December 1994, LMTAS provided an MLU counteroffer based on a special rate study. This special rate study included rates to cover the entire MLU period of performance.
- The special rate study impact versus FPRA RS21N was $7 Million for MLU and $56,000 for USAF FY94.
- The FPRA RS51N rate schedule impact versus FPRA RS21N was $14.1 Million and $993,000 for USAF FY94.
- The MLU contract could not have been negotiated until the RS51N rates came out without the use of the special rate study. This would have increased the final negotiated price by $7.1 Million. It should also be noted that the USAF FY94 price would have been $993,000 higher. The Government and ultimate customers clearly benefitted by the use of the special rate study in the MLU settlement.

3. Regarding the minor procurement issues raised during the GAO evaluation, LMTAS is working with the Defense Contract Audit Agency in accordance with established regulations and practices to resolve said issues.

4. LMTAS appreciates the professionalism of the GAO evaluation team and their willingness to listen to all facts concerning the MLU negotiation and include our perspective in the final report.

5. In conclusion, please be cognizant of our concern and position presented to you in our reference (b) letter regarding the release of LMTAS Proprietary Data. Also, please be advised that LMTAS is available to further assist the GAO as required. Please direct any questions to Mr. Rick Harwell at (817) 777-0381 or the undersigned at (817) 777-4157.

LOCKHEED MARTIN CORPORATION

Frank C. Martin

Frank C. Martin, Director
F-16 Proposing & Contracting
Tactical Aircraft Systems

MLU/FY94 NEGOTIATION FACT SHEET

	MLU	FY94
• ACSN	04/09/92	02/04/94
PROPOSAL	02/25/93	05/27/93
AUTHORIZATION	08/17/93	07/26/93
PROPOSAL UPDATE	06/08/94	09/29/93
NEGOTIATION COMPLETE	04/21/95	04/21/95
• SPECIAL RATE STUDY USED	12/23/94	
• RS51N ISSUED	04/25/95	
• RATE SCHEDULE 21N PROVIDED NEGOTIATED RATES THROUGH 1997.		
• PROGRAM SPAN	CY93-CY01	CY93-CY97
• RATES FOR 1998 THROUGH 2001 WERE NOT NEGOTIATED UNDER RS21N AND THEREFORE CAUSED A DIFFERENCE IN AIR FORCE AND LOCKHEED POSITION OF $6.5M.		
• SPECIAL RATE STUDY IMPACT VS. RS21N	$7,000,000	$56,229
• RS51N IMPACT TO FINAL SETTLEMENT	$7,103,295	$993,096
• FINAL NEGOTIATED VALUE	COST $551.133M PRICE $622.673M FPI	$123.141M FFP

8/1/96
FCM
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MLU/FY94 NEGOTIATION FACT SHEET

CONCLUSION

- ANOTHER SET OF RATES WAS REQUIRED IN ORDER TO NEGOTIATE MLU BECAUSE FPRA RATE SCHEDULE RS21N WAS ONLY VALID THROUGH CY 1997.
- ALL CONTRACTS ARE "CHARGED" OR BOOKED AT THE SAME RATES IN THE COMPANY ACCOUNTING SYSTEM FOR PURPOSES OF BOOKS OF RECORD AND BILLINGS.
- THE MLU CONTRACT COULD NOT HAVE BEEN NEGOTIATED UNTIL THE RS51N RATES CAME OUT WITHOUT THE USE OF THE SPECIAL RATE STUDY WHICH WOULD HAVE INCREASED THE FINAL NEGOTIATED PRICE. THE GOVERNMENT AND ULTIMATE CUSTOMERS CLEARLY BENEFITED BY THE USE OF THE SPECIAL RATE STUDY IN THE MLU SETTLEMENT.

8/1/96
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Comments From Northrop Grumman

NORTHROP GRUMMAN

Letter No. C96-8277-420

12 August 1996

Director, Defense Acquisition Issues
National Security & International Affairs Division
United States General Accounting Office
Washington, D.C. 20548

Attention: Mr. Louis J Rodrigues

Subject: AN/APG-66(V)2 Mid Life Update Program

Reference: GAO Contract Pricing Report - Contract F33657-93-C-2016

Mr. Rodrigues:

Northrop Grumman Corporation, Electronics Sensors & Systems Division (ESSD) has reviewed the draft GAO Audit Report for the F-16 Mid Life Update Program and would like to reiterate its position with regard to the issue of applying the FMS G&A versus the Fixed Price (US Government) G&A rate.

As previously stated, Northrop Grumman was not aware and had not seen the Memorandum of Understanding between the United States and The Governments of Belgium, Denmark, the Netherlands and Norway pertaining to this program that allegedly required the use of identical rates that would have been applied to a USAF contract. In addition, this requirement was not flowed down to Northrop Grumman for this contract, either in the Request for Proposal (RFP) or subsequent contract award.

Please contact the undersigned on (410) 765-3957 or Fax (410) 765-1397 if you have any additional questions relative to this submittal.

Very truly yours,

NORTHROP GRUMMAN CORPORATION

Daniel J Stultz
F-16 Contracts, MS 200

Major Contributors to This Report

National Security and International Affairs Division, Washington, D.C.

David E. Cooper, Associate Director

Atlanta Field Office

George C. Burdette, Evaluator-in-Charge
Maria Storts, Evaluator
Erin B. Baker, Evaluator

Dallas Field Office

Joe D. Quicksall, Assistant Director
Jeffrey A. Kans, Evaluator
Kimberly S. Carson, Evaluator

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