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Report to the Chairman, Subcommittee
on Federal Services, Post Office and
Civil Service, Committee on
Governmental Affairs, U.S. Senate

February 1991

OMB CIRCULAR A-76

Expected Savings Are Not Being Realized in Ft. Sill's Logistics Contract



93-23525



General Government Division

B-240992

February 11, 1991

The Honorable David Pryor
Chairman, Subcommittee on
Federal Services, Post Office
and Civil Service
Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

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This report responds to your request that we review a contract awarded by the Army at Ft. Sill, Oklahoma, to Northrop Worldwide Aircraft Services, Inc. for Directorate of Logistics support services. You asked us to determine (1) whether the savings estimated at the time the decision was made to contract out the work to Northrop are being realized and (2) what level of service Ft. Sill is getting from Northrop on this contract.

Before this contract, the logistics services—supply, maintenance, and transportation—were operated by federal employees. As required by the Office of Management and Budget (OMB) Circular A-76, Ft. Sill officials reviewed the logistics function to determine whether it would be more economical to do the work in-house or contract it out. The A-76 cost study for the logistics function took nearly 8 years to complete. The study results showed that it could be done more economically by private industry. As a result, a cost-plus-award-fee contract¹ was awarded to Northrop for a term of 1 year with 4 option years. It was estimated that savings from contracting out would be \$2.7 million over the 5-year period. Northrop started operating the logistics function on October 1, 1988.

Results in Brief

The \$2.7 million 5-year savings estimated when the decision was made to contract out the logistics function are not being realized. Instead, Ft. Sill projections show larger-than-anticipated increases of about \$14.8 million in contract costs and that contract costs (exclusive of award fees) over the 5-year period will be higher than estimated in-house costs. Although projected in-house costs would have also risen had the logistics function remained in-house, they would have been significantly

¹A cost-plus-award-fee contract provides that the contractor will be reimbursed for allocable, allowable, and reasonable costs and includes the potential for an award fee sufficient to motivate the contractor to provide excellence in performance.

lower because of such factors as federal pay increasing at a lower rate than contractor employees' wages.

Approximately \$6.8 million of the estimated \$14.8 million in increased contract costs occurred, or was projected to occur, during fiscal years 1989 and 1990. Because only about 3 years remain on the contract, it will be difficult to make up for these costs, even if the contractor significantly improves its performance. The major cost component of the contract is labor, which is integral to carrying out the mission and therefore not easily adjustable in order to achieve savings.

Ft. Sill's projections also showed that the \$14.8 million estimate could be further increased if the contractor's productivity does not improve. Productivity for the first 17 months of the contract was lower than that of the previous in-house employees. Ft. Sill's analysis indicated that continued operation at this productivity level could contribute about another \$4.5 million to the projected \$14.8 million of increased contract costs. In any event, the decline in productivity from the in-house levels before the A-76 study has already resulted in about \$1.8 million in excess direct labor costs and affected Ft. Sill's equipment readiness requirements for the units the contractor supports at Ft. Sill.

Similarly, the estimated 5-year savings have been adversely affected by Ft. Sill's failure to correctly administer revised award fee provisions in the contract. Ft. Sill's administration (1) resulted in the contractor receiving awards for performance in the three major logistics components, some of which is below minimum standards; (2) provided no motivation for excellence in performance; and (3) could result in Northrop, by improving its performance, being paid an additional \$2.4 million over the 4 final years for meeting—not exceeding—performance standards.

Although both Army headquarters and the Training and Doctrine Command (TRADOC), the command to which Ft. Sill reports, knew that problems with the award-fee approach had occurred during the logistics A-76 cost study, neither had determined whether the problems persisted. They were not aware that Ft. Sill paid Northrop award fees for less-than-minimum performance, that Ft. Sill accepted uneven contractor performance, and that equipment readiness had been affected by reduced productivity.

Background

OMB Circular A-76 applies to federal agencies' commercial activities—such as custodial services, data processing, and vehicle maintenance.

The circular requires that such activities be studied to determine whether they could be done more economically by private contractors or by government employees. Inherently governmental functions—those intimately related to the public interest—are to continue to be done by federal employees.

An A-76 cost study involves comparing estimated contract and in-house costs for doing an activity to determine the more cost-effective approach. OMB's Cost Comparison Handbook, a supplement to the circular, furnishes the guidance for computing cost comparison amounts. Department of Defense (DOD) Instruction 4100.33 and Army Regulation 5-20 furnish additional implementation guidance. The Federal Acquisition Regulation (FAR) and the DOD Federal Acquisition Regulation Supplement (DFARS) are to be followed in developing and administering DOD contracts.

The responsible activity is to do a management study to determine how the in-house work force should be organized and equipped to most efficiently do the work. The activity also is to develop a performance work statement—a description of the required work. A government quality assurance surveillance plan is required for measuring actual contractor performance in the event a contractor wins the competition.

The activity is to prepare a document containing the government's estimate of the lowest number and types of employees required to do the work described in the work statement. From these data and other estimated costs, a total estimated cost for in-house performance is to be prepared. For contractor performance, the selected bid or offer is added to other estimated costs, such as contract administration, to develop a total projected cost for contracting out.

The circular requires comparison of the two estimates to determine which alternative is more cost effective. A contract is to be awarded if the total projected cost to contract out is less than the government's estimate and the margin of difference by the contractor is more than 10 percent of the estimated in-house personnel costs (conversion differential). The government work force is then reassigned or terminated.

Ft. Sill is an artillery training installation under the command of TRADOC. As of September 30, 1989, Ft. Sill housed, trained, and employed approximately 19,000 military personnel and 6,700 civilians. Forces Command, with 22 deployable and 3 nondeployable units, is the only

major tenant—other than TRADOC at Ft. Sill. The Ft. Sill logistics function, under the Directorate of Logistics, includes three components—supply of materials, parts, and equipment; maintenance of hundreds of large artillery pieces and military vehicles; and transportation of military and civilian personnel. Maintenance represents 45 percent of the dollar value of the logistics function contract, supply 34 percent, and transportation 21 percent.

Objectives, Scope, and Methodology

Our objectives were to determine (1) whether the savings estimated at the time the decision was made to contract out the work to Northrop were being realized and (2) what level of service Ft. Sill was getting from the contractor. To meet these objectives, we reviewed the original cost estimates, contract modifications, and actual cost and work load data. We also reviewed reported in-house cost comparison amounts for their reasonableness and adherence to OMB's guidance. We interviewed Army and Northrop officials and key customers of the logistics function. Appendix I contains a more comprehensive discussion of our objectives, scope, and methodology.

Estimated Savings Are Not Being Realized

The savings estimated during the logistics cost study are not being realized. One of the factors contributing to eliminating these savings is the greater than anticipated increase in the total costs² of the logistics contract, exclusive of award fees. Under the provisions of a cost-plus-award-fee contract, the contractor is to be paid for its allowable, allocable, and reasonable costs to operate the function. In August 1987, Northrop's total cost to do the required work, exclusive of award fees, was estimated to be \$53.2 million over 5 years. The cost comparison was reviewed by an Army Appeals Board, and on the basis of Appeals Board adjustments, the estimated savings from contracting out were determined to be \$2.7 million for the 5-year period. However, actual contract costs as of April 30, 1990, combined with recent Ft. Sill projections show that over 5 years the contract could cost Ft. Sill at least \$68 million. (See table 1.)

²Total costs include the contract price and contract administration, one-time conversion, and additional costs. Deducted from this amount to arrive at the total contract costs are federal income taxes and Social Security and savings plan costs.

Table 1: Difference Between Original and Current Projections of Contract Costs as of April 30, 1990

Dollars in millions						
	FY 89	FY 90	FY 91	FY 92	FY 93	Total ^b
Current	\$13.7 ^a	\$14.0	\$13.3	\$13.5	\$13.5	\$68.0
Original	10.3	10.6	10.7	10.7	10.8	53.2
Difference	+\$3.4	+\$3.4	+\$2.6	+\$2.8	+\$2.7	+\$14.8

^aRepresents actual costs incurred and reported under the logistics contract.

^bSome totals do not add due to rounding.

Contractor Personnel and Other Costs Reduced Estimated Savings

One reason for the projected \$14.8 million cost increase was changes in personnel costs such as employees' wages. Because contractor employees' wages are determined by the Department of Labor, Ft. Sill had no control over increases in these wage rates. The Service Contract Act of 1965, as amended (41 USC 351 *et seq.*), requires federal contractors to pay their employees not less than the prevailing minimum wage, as determined by the Department of Labor, based on the type of work and the locale. Contractor bids and in-house cost estimates made during an A-76 cost study do not include costs for future wage increases. When the prevailing minimum wage increases, contracts must be modified to reimburse contractors for the increased wages.

One contract modification alone accounts for \$7.7 million of the \$14.8 million. This modification resulted from the need to reflect various cost changes that had occurred between the time the cost comparison was made and costs when the contractor finally began work. Contract costs were updated from fiscal year 1985 data used in the A-76 study to fiscal year 1988 costs, resulting in a cost increase that is projected to be \$7.7 million for the 5-year period. About 17 percent of this \$7.7 million increase involved Department of Labor wage rate increases. Table 2 lists types and amounts of the cost changes resulting from updating the contract.

Table 2: Factors and Cost Increases Involved in Updating Logistics Contract

Dollars in millions	
Factor	Increase (decrease)
Department of Labor wage increases (hourly employees)	\$1.3
Salary inflation (salaried employees)	.4
Negotiated change in productive and paid hours	.8
Changes in tax rates on fringe benefits and overhead rates	(.3)
Deletion of nontactical vehicle work load	(1.9)
Increased staffing for work load update adjustments	5.3
Materials, supplies, and other direct costs	1.9
General and administrative costs	.2
Total	\$7.7

It will be difficult to make up for the cost increases for two reasons. First, about \$6.8 million of the \$14.8 million increase occurred, or is expected to occur, early in the contract period. Because only about 3 years remain on the contract, it will be difficult to recoup costs in such a short period, even if the contractor improves its performance. Second, labor represents the major cost component of the contract, and labor is also integral to carrying out the mission of the logistics function. It therefore cannot be readily adjusted in an effort to bring down contract costs.

OMB's supplement to the circular requires that A-76 contracts be monitored to ensure that they continue to be cost effective. If a contract's costs become unreasonable, the agency is to recompetete the contract. If recompetition does not result in reasonable prices—and in-house performance is feasible—the supplement provides that a new A-76 cost study be done.

However, the DOD Inspector General has recently reported³ that DOD Instruction 4100.33, DOD's guidance for implementing the A-76 program, does not provide criteria for determining at what point contract costs exceed in-house cost estimates or contract cost increases become so unreasonable that contracts are to be resolicited. The Inspector General's report recommended that DOD Instruction 4100.33 be modified to include policies and procedures for managing the A-76 program that require the services to, among other things, resolicit contracts when costs exceed DOD in-house cost estimates. If this recommendation is

³Procedures for Monitoring Commercial Activities' Functions After Completion of A-76 Competitions, DOD OIG Report No. 90-096, July 5, 1990.

implemented, it could help TRADOC and Ft. Sill officials decide whether to continue the current logistics contract.

In-house Costs Also Would Have Increased

Ft. Sill staff estimated that if the in-house employees had won the competition for the logistics function, their costs also would have risen but would not be as high as total contract costs. To determine the extent to which in-house costs also would have increased as of April 30, 1990, if the logistics function's employees had won the competition, Ft. Sill compared Northrop's actual and projected costs for the 5-year contract period with estimated in-house costs. In this comparison, Ft. Sill assumed that materials, supplies, and certain additional costs would have been essentially the same for the government or a contractor.

On the basis of this comparison, in-house costs would have increased significantly less over the 5-year period than the \$14.8 million that Ft. Sill projected under the Northrop contract. Two factors causing contract costs to be higher in this comparison were (1) contractor employees' pay increasing at a higher rate than federal employees' wages and (2) contract administration costs being charged against the contractor. Because Ft. Sill is contemplating a new A-76 cost study for the logistics function, in-house cost figures are confidential. We are therefore unable to provide a detailed discussion of in-house costs compared to contract costs.

Ft. Sill's Treatment of Award Fee Was Contrary to Army Instructions

Contrary to the Army's instructions to Ft. Sill, Ft. Sill's administration of the award fee provisions of the contract did not motivate the contractor to provide excellence in performance. As implemented by Ft. Sill, the award fee administration provided for Northrop to be paid the entire award fee for meeting—not exceeding—minimum contract standards and for a portion of the award fees to be paid for performance below the minimum standard.

Using a basis of 100 as the top score that Northrop's performance could achieve, Ft. Sill's evaluators were to rate Northrop's performance using criteria in a quality assurance surveillance plan. However, under the approach taken in administering the contract, if Northrop were to achieve 100 points, it would only be meeting minimum performance standards. For example, if, hypothetically, upon Ft. Sill's performance evaluation, Northrop scored 61 (of a possible 100), it would receive 1 percent of the available award fee. A performance score of 80 would result in Northrop being paid 39 percent of the fee. If Northrop scored 100, it would get 100 percent of the available fee.

FAR and DFARS contemplate that a contract that includes award fees is to be structured to provide a contractor motivation for performing at a level exceeding the minimum acceptable performance level. After being advised by TRADOC that the proposed contract provisions for award fees were unacceptable, revisions were made to conform to procurement regulations. As written, the logistics contract does not violate procurement regulations: it contemplates award fee provisions being administered so that they motivate contractors to excellence in contract performance. Nevertheless, in administering the provisions of the contract regarding award fees, Ft. Sill paid award fees for less than minimum performance. As a result, Northrop had no motivation for exceeding contract standards and by improving its performance had the potential to earn an additional amount of about \$2.4 million over the final 4 years of the contract for merely meeting minimum performance standards.

The original solicitation package for the logistics function called for maximum award fees to be paid for minimum performance—which the contracting officer said was the level achieved by the previous in-house staff—and contained no motivation for contractor performance above this level. Army headquarters officials directed that all provisions for paying maximum award fees for fully meeting contract standards be removed from the contract. The TRADOC contracting officer who reviewed the documents removed language from the contract calling for (1) award fees to be paid for minimum acceptable performance and (2) no additional fees being paid for “performance in excess of standards.” TRADOC also instructed the Ft. Sill contracting officer not to pay any award fee to Northrop for minimum performance. However, contrary to Army instructions, Ft. Sill improperly administered the award fee provisions and paid Northrop for performance that was below minimum acceptable standards. Consequently, Northrop had no motivation to exceed contract standards.

Initially, Northrop had the potential to earn about \$3.1 million in award fees over the 5-year period of the contract. As a result of the approach used by Ft. Sill, even though Northrop's overall performance was below minimum standards it earned a portion of the available award fees. For fiscal year 1989, Northrop was paid approximately \$239,000 (of a potential of about \$664,000) in award fees for its overall performance. On the basis of Ft. Sill's approach to determining award fees, if Northrop's overall performance continues to be below minimum standards, Northrop could be paid about \$1.2 million (\$238,769 each year)

in award fees over the entire 5 years. Further, by improving performance to meet Ft. Sill's minimum standards, Northrop has the potential to earn about \$2.4 million for the final 4 years of the contract.

The approach taken by Ft. Sill in administering the award fee was used solely to motivate the contractor to meet—not exceed—performance standards. The contracting officer said that exceeding contract standards would cost Ft. Sill more money because the contractor's reimbursable costs would rise. He reasoned that Northrop would add employees in an effort to exceed performance standards, which would increase costs. In his opinion, exceeding contract standards would not result in benefits to the government adequate to justify the additional costs. He said that in setting standards he wanted no less—and no more—than the in-house staff had been doing.

A Ft. Sill Logistics official said that this approach had been used by other Army installations. Army headquarters and TRADOC officials told us they did not know of any other Army installation using this approach.

Ft. Sill Accepted Uneven Contractor Performance

Under OMB Circular A-76 guidelines, whoever wins the bid—either a contractor or in-house employees—is to provide the government's actual minimum requirements. Ft. Sill defined its minimum requirements as the level of work done by its in-house employees before the cost study. Performance standards in the logistics contract were based on this in-house performance. In two of the three components of the logistics contract—maintenance and supply—the level of contractor performance was below the standard set by the in-house staff before the cost study. In one component—transportation—the contractor did perform well. In addition, Ft. Sill contracting officials said Northrop's internal controls over supply inventory recordkeeping and inventory management were inadequate. According to a Logistics official, vehicle maintenance backlogs were at an all-time high. Ft. Sill officials said that although they had frequently brought the performance problems to Northrop's attention, the contractor had in some instances been slow to remedy the problems.

Between October 1, 1988, and May 15, 1990, Ft. Sill logistics function's quality assurance evaluators (QAE)—personnel assigned to monitor the contractor's operations—reported issuing 83 contract discrepancy reports on Northrop's performance of supply and maintenance duties.

These involved areas in which the contractor was not performing to contract standards. These logistics QAES said they issue discrepancy reports immediately after (1) one major safety or security violation occurs, (2) three instances of noncompliance with the contract's established standards have occurred without corrective action being taken, or (3) five or six minor operations problems have occurred without corrective action being taken.

One discrepancy report was issued because Northrop had not properly accounted for supplies. During a periodic inventory of supplies, Ft. Sill's Accountable Supply Officer and QAES discovered and reported what Ft. Sill termed significant problems in an April 1990 supply inventory report submitted by Northrop. Some supplies were misclassified, and others were miscoded. Shortages and oversupplies had occurred. The logistics contract provides that Northrop must maintain sufficient inventories to meet the function's needs. As a result of the problem, Ft. Sill officials did not know the dollar magnitude of the inventory discrepancies.

According to TRADOC and Ft. Sill Logistics officials, Ft. Sill employees will have to help the contractor clear up these supply problems by making physical counts of the inventory. A Logistics official said that Ft. Sill considered taking measures that would require the contractor to correct the discrepancy within 30 days or be terminated from operating the supply component of the contract. However, according to this official, it was decided that Northrop would continue to operate the supply component, with Ft. Sill's employees helping contractor employees clear up the supply problems. The official also said that the decision was made to continue with Northrop for two reasons. First, Ft. Sill officials reasoned that because the supply and maintenance components are so closely intertwined, it would be difficult to have another contractor operate only the supply component. Second, Ft. Sill is currently under a hiring restriction and could not hire additional federal employees to staff the supply component.

Northrop's contract administrator said that corrective action had been implemented on each of the 83 discrepancy reports. Ft. Sill maintenance and supply QAES said that Northrop was not always prompt in correcting problems noted in discrepancy reports. The QAES said they often had to submit multiple deficiency reports for the same problem areas. According to Ft. Sill Logistics officials, between October 1, 1988, and May 15, 1990, 14 repeat deficiency reports had been issued in various areas of the contract.

Other performance problems included backlogs of work, especially in the vehicle maintenance activity. As of May 15, 1990, QAES reported issuing to Northrop 20 monthly reports on the status of backlogged work since the contractor began operating the function. A Northrop official pointed out that backlogs also existed when the logistics function was operated by in-house employees. According to Ft. Sill officials, backlogs of maintenance of tactical and nontactical vehicles had increased to an all-time high. Ft. Sill officials attributed the backlogs to lack of supervision and qualified mechanics and failure to set priorities on vehicle maintenance.

It is not fully clear why performance in the supply and maintenance components was not better. Ft. Sill QAES had one theory. They said that the contractor seemed to have hardworking people who wanted to do a good job, but, unfortunately, contractor employees did not seem qualified—they lacked training and expertise in the jobs they held. Also, according to these QAES, Northrop had experienced a high level of turnover in the maintenance and supply components of the contract, resulting in a further reduction of skilled employees.

Northrop had performed well in the third component of the logistics contract, the transportation function. Army military and civilian personnel at Ft. Sill said that performance in the transportation component was as good as that of the previous in-house operation. Although we could not precisely determine the reasons for the contractor's performance of this component being rated higher than the others, one difference was that, according to Ft. Sill officials, nearly all the contractor transportation personnel were civilian or military personnel who had worked in the transportation component when it was operated by Ft. Sill. In addition, Ft. Sill officials said that little personnel turnover had occurred in the transportation component of the contract.

Productivity Was Below Standards

Ft. Sill's productivity measurements showed that over the first 17 months of the contract, Northrop's productivity averaged about 82 percent of the standard that was established on the basis of federal employees' performance prior to the cost study. This actual in-house performance was established in the A-76 cost study as the most efficient organization (MEO)—the model for how the in-house work force should

be organized and equipped to "most efficiently do the work."⁴ The reduced productivity affected the areas of labor costs and equipment readiness.

Reduced Productivity Could Increase Costs Over Contract Life

In a cost-plus-award-fee contract, the government is required to pay the contractor's allocable, allowable, and reasonable costs, regardless of the amount of contractor output. To determine how reduced productivity affected costs, Ft. Sill compared Northrop's actual level of performance with the expected level, given Northrop's staffing and other operating costs. For the first 17 months of the contract, Ft. Sill officials estimated that reduced productivity had resulted in about \$1.8 million in excess direct labor costs for Ft. Sill. If Northrop continues to operate the logistics function at this productivity level, Ft. Sill's analysis indicated that additional costs of about \$4.5 million could be incurred over the remaining term of the contract.

Equipment Readiness Was Affected by Reduced Productivity

According to Ft. Sill officials, reduced productivity had affected the logistics function's equipment readiness for the units that Northrop supports at Ft. Sill. The Ft. Sill contracting officer said that the logistics contract provided for maintenance and supply department activities being managed to ensure compliance with the readiness needs for these components. Ft. Sill had established written priorities for complying with readiness requirements. Northrop was required to analyze each priority issue and its impact on installation or unit readiness and to schedule its work to meet these priorities. Ft. Sill Logistics officials said that this requirement means that Northrop must maintain minimum backlogs and turnaround time, in accordance with the performance standards established in the contract and award fee determination plan. However, the requirement was not being fully met.

Logistics officials reported that from May 1989 through February 1990, combat units supported by Northrop had an average of 85 percent of their equipment available. In contrast, from fiscal year 1985 through fiscal year 1988—when federal employees were operating the function—readiness ratings were consistently above 90 percent. According to the Director of Logistics, for a unit to be considered fully deployable—ready for combat—at least 90 percent of its equipment must be available. He said that during the mobilization for Operation Desert

⁴When the logistics A-76 cost study was announced, hiring at Ft. Sill was frozen. Consequently, when employees left the logistics function, they were not replaced. Because of this hiring restriction, the MEO staffing was achieved and operating the function before Northrop took over.

Shield, reduced equipment readiness in the logistics function had resulted in Ft. Sill's mission of troop deployment not being carried out at the full wartime equipment requirements.

Army Should Have Provided Oversight

Army headquarters and TRADOC officials said there was no requirement for them to focus on the Ft. Sill logistics contract after the cost study decision was made. Under procedures, TRADOC officials are to review contract solicitation packages before the solicitation is issued. However, Army headquarters and TRADOC officials said that once a decision was made to contract out the logistics function, the responsibility for managing the contract was Ft. Sill's. They said they had not been told of Ft. Sill's approach to paying award fees, of the contractor's uneven performance, and of reduced productivity's effect on equipment readiness.

For accountability of costs and performance, oversight is necessary to ensure that the government gets what it contracted for. Although there was no requirement for Army or TRADOC to oversee individual contracts, both Army headquarters and TRADOC officials knew that there had been a problem with the Ft. Sill award fee approach during the A-76 cost study. They had directed Ft. Sill to change the award fee provision of the logistics contract, but they did not follow up to determine whether their instructions had been followed. They also did not attempt to learn whether contractor performance was adequate. They did not know of these problems until we told them.

Conclusions

Estimated savings are not being realized in Ft. Sill's logistics contract. The Army had been paying more than it had anticipated for the function and generally getting fewer results. It will be difficult to make up for cost increases, given the relatively short period left in the contract term and the fact that labor, the major cost component of the contract, is also integral to carrying out the mission of the logistics function.

The approach to paying award fees was contrary to instructions. It called for Northrop to be paid the entire available award fee for meeting, not exceeding, minimum performance standards and for a portion of the fee to be paid for less than minimum performance. As a result, the contractor was paid for performance that was below minimum standards and had no motivation for exceeding minimum performance standards. We believe more needs to be done to ensure Ft. Sill does not pay award fees for minimum or below minimum performance. Although a Ft. Sill Logistics official indicated that the approach to

paying award fees had been used at other Army installations, Army headquarters and TRADOC officials said they did not know of any other Army installation using this approach.

Contractor performance in two of the three logistics components was below the level reportedly accomplished by Ft. Sill's in-house employees. Northrop's internal controls over elements of the supply and maintenance functions were also lacking, resulting in problems such as supply inventory errors. Vehicle maintenance backlogs were at an all-time high. Reduced productivity had resulted in excess labor costs for Ft. Sill and had impaired the logistics function's equipment readiness.

After Northrop took over the logistics function, Army headquarters and TRADOC did not oversee the contract, even though both knew there had been problems with the award fee approach during the cost study. We believe that better oversight by Army headquarters and TRADOC officials could pinpoint areas for improvement and enable the Army to ensure it is getting the service it contracted for.

Recommendations

In order that the Army gets the service it contracted for and at an advantageous cost, we recommend that the Secretary of the Army direct TRADOC's Commander to take the following actions:

- ensure that Ft. Sill's contracting officer stops using the current contract administration approach of paying award fees for minimum and below minimum performance;
- ensure that Ft. Sill's contracting officer requires the contractor to provide, within a specific time frame, a plan that will demonstrate how it proposes to meet minimum performance standards; and
- establish oversight of Ft. Sill's logistics contract and ensure that the award fee provisions of other TRADOC cost-plus-award-fee contracts are being properly administered.

Agency Comments and Our Evaluation

DOD commented on a draft of this report. DOD partially agreed with our findings and recommendations. DOD asserted that the extent of savings originally estimated are not being realized and blamed the problem on wage and materials cost increases and staffing increases resulting from work load adjustments. It said these increases would happen whether the government or a contractor is providing the services. DOD also asserted that savings, although reduced from initial estimates, have actually been realized by contracting out the Ft. Sill logistics function.

We do not agree with DOD's assertion that savings have actually been realized. DOD said that even if all of the \$7.7 million cost increase could be solely attributed to contractor performance, the \$8.7 million difference between the in-house costs and the contractor's adjusted bid was enough to result in savings. In fact, as we show in table 1, the projected contract cost increase totaled \$14.8 million, not \$7.7 million. As we further explained, the \$7.7 million made up part of the total \$14.8 million increase and occurred through a contract modification. Therefore, DOD's assertion is incorrect.

Further, we recognize that in-house costs also would have risen. However, as indicated in a comparison done by Ft. Sill, contract costs were higher than in-house costs would have been because of such factors as contractor employees' pay increasing at a higher rate than federal employees' pay and contract administration costs.

DOD also said that we erred in treating the conversion differential as an expense and in deducting the differential from savings. It should be noted that the conversion differential represents a potential expense to an agency. OMB, in its Cost Comparison Handbook, says that the conversion differential is to take into account factors such as the loss of production, the temporary decrease in efficiency and effectiveness, and the cost of retained grade and pay for the displaced federal employees when converting to contract from an in-house operation. These are all potential costs to an agency. DOD's comments are reproduced in their entirety in appendix II.

As arranged with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its issue date. At that time, we will send copies to other appropriate congressional committees and Members, the Secretary of Defense, the Secretary of the Army, and the Director of OMB. We will also send copies to other interested parties upon request.

Major contributors to this report are listed in appendix III. Please contact me at 275-8676 if you or your staff have any questions concerning this report.

Sincerely yours,

A handwritten signature in cursive script that reads "L. Nye Stevens". The signature is written in black ink and is positioned above the typed name.

L. Nye Stevens
Director, Government Business
Operations Issues

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Abbreviations

DFARS	DOD Federal Acquisition Regulation Supplement
DOD	Department of Defense
FAR	Federal Acquisition Regulation
MEO	most efficient organization
OMB	Office of Management and Budget
QAE	quality assurance evaluator
TRADOC	U.S. Army Training and Doctrine Command

Objectives, Scope, and Methodology

We did this assignment at the request of the Chairman of the Subcommittee on Federal Services, Post Office and Civil Service, Senate Committee on Governmental Affairs. Our objectives were to determine (1) whether the savings estimated at the time the decision was made to contract out the work to Northrop are being realized and (2) what level of service Ft. Sill is getting from Northrop on the logistics contract.

To determine whether the estimated savings are being realized, we reviewed the original cost estimates, modifications to the contract, and actual cost data. We reviewed the reported in-house cost comparison amounts only for their reasonableness and adherence to OMB's guidance. We did not do a complete review or audit of the cost figures used to estimate the costs of the contract if it had stayed in-house, but we did review the criteria used for both the in-house and contractor figures. The same criteria were used for both parties: if the number of employees, or the work load requirements increased or decreased, we assumed that both parties were affected the same way. The only variables were the labor wage rates for either party—federal wage scales differed from the Department of Labor wage rates—and contract administration fees being charged against the contractor.

To determine the level of service Ft. Sill was getting from Northrop on the logistics contract, we reviewed data prepared by the directorates of Logistics, Contracting, and Resources Management on work load productivity. This information was based on a comparison of previous in-house performance data with data on Northrop's current performance. Our analyses involved verifying the productivity amounts generated by Army officials to supporting and source documentation. We also interviewed key customers of the logistics function and Northrop officials about productivity and levels of service.

To evaluate internal controls over the maintenance, supply, and transportation components, we tested the propriety of vendor payments, contract reimbursements, and contract monitoring procedures.

We obtained information from, and discussed our findings and conclusions with, officials from the offices of the assistant secretaries of the Army for Research, Development, and Acquisition and for Installations, Logistics, and Environment, the Management Directorate of the Army Chief of Staff, and Northrop. We also interviewed and discussed our findings and conclusions with officials from TRADOC's Commercial Activities and Contracting functions and Ft. Sill's directorates of Logistics and Contracting. We discussed our findings and conclusions with Ft. Sill's

Appendix I
Objectives, Scope, and Methodology

Chief of Staff. In addition, we reviewed prior reports on the A-76 program issued by GAO, DOD, and the services and other background information.

We obtained written comments on our report from DOD.

We generally did our work between January and June 1990 in accordance with generally accepted government auditing standards.

Comments From the Department of Defense

Note GAO comments supplementing those in the report text appear at the end of this appendix



PRODUCTION AND
LOGISTICS

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D. C. 20301-6000

6 DEC 1990

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Division
US General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "OMB CIRCULAR A-76: Army Is Paying More And Getting Less For Its Logistics Contract At Fort Sill, Oklahoma," dated October 12, 1990, (GAO Code 240009/OSD Case 8501). The Department takes exception with some of the findings and recommendations.

The amount we thought we would save by contracting out was not realized because of wage and materiel cost increases and staffing increases in response to workload adjustments. These increases occur whether the Government or a contractor is providing the services. In the final analysis, the Department realized savings by contracting out the Fort Sill Logistics function to Northrop Worldwide Aircraft Services, Inc.

The detailed DoD comments on the report's findings and recommendations are provided in the enclosure. The Department appreciates the opportunity to comment on this draft report.

Sincerely,

David J. Berteau
David J. Berteau
Principal Deputy

Enclosure

See p 15

Appendix II
Comments From the Department of Defense

GAO DRAFT REPORT GAO/GGD-91--DATED OCTOBER 12, 1990
(GAO CODE 240009) OSD CASE 8501

"OMB CIRCULAR A-76: ARMY IS PAYING MORE AND GETTING LESS FOR ITS
LOGISTICS CONTRACT AT FORT SILL, OKLAHOMA"

DEPARTMENT OF DEFENSE COMMENTS

* * * * *

FINDINGS

- **FINDING A: Office of Management and Budget Circular A-76.** The GAO explained that Office of Management and Budget Circular A-76 requires Federal agencies to do the following:
 - determine what commercial activities can be done more economically by private contractors than by Government employees;
 - conduct a management study to determine how the in-house workforce should be organized and equipped to do the work most efficiently and develop a performance work statement;
 - prepare a document containing the Government's estimate of the lowest number and types of employees required to do the work described in the work statement; and
 - compare the Government estimate to contractor bids to determine which alternative is more cost-effective.

The GAO further explained that a contract is to be awarded if the total projected cost to contract out is less than the Government estimate. The GAO noted that inherently Governmental functions are to continue to be done by Federal employees.

The GAO observed that the Fort Sill logistics function includes three commercial activities--(1) supply of materials, parts and equipment, (2) maintenance of hundreds of vehicles, and (3) transportation of military and civilian personnel. According to the GAO, maintenance represents 45 percent, supply represents 34 percent, and transportation represents 21 percent of the dollar value of the logistics function contract. (pp. 3-5/GAO Draft Report)

DoD RESPONSE: Concur.

Enclosure 1

- **FINDING B: Estimated Savings Are Not Being Realized.** The GAO observed that savings estimated during the logistics cost study at Fort Sill were not being realized. According to the GAO, one of the factors contributing to eliminating the estimated savings is the greater-than-anticipated increase in the total costs of the logistics contract, exclusive of award fees. The GAO noted that the contract (awarded to Northrop) was estimated to be \$53.2 million over five years. The GAO observed, however, that based on recent Fort Sill projections, the contract could result in costs of at least \$68 million. The GAO pointed out that some of the cost increase was due to the Department of Labor requirement that Federal contractors pay at least the prevailing minimum wage rates for the work in the locale. The GAO indicated that one modification to reflect cost changes accounts for \$7.7 million of the \$14.8 million. (pp. 5-6, p. 18/GAO Draft Report)

DoD RESPONSE: Concur. The Department agrees that the amount of savings originally estimated for the Fort Sill logistics contract are not being realized because of wage and materiel cost increases and staffing increases in response to workload adjustments. The Department would add, however, these increases cited by the GAO, would have been the same for either contractor or in house operation.

- **FINDING C: Impact of Contract Changes and Labor Costs on the Logistics contract.** The GAO reported that the cost increases will be difficult to recover because (1) \$6.8 million of the \$14.8 million increase occurred early in the contract period and (2) labor is the major cost component of the contract. The GAO did note, however, that the Circular A-76 supplement requires a new cost study be done if contract costs become unreasonable.

According to the GAO, the Fort Sill staff estimated that, if the in-house employees had won the competition for the logistics function, their costs also would have risen--but would not be as high as the total contract. The GAO stated that it was unable to provide a detailed analysis of in-house and contract costs because Fort Sill is contemplating a new A-76 cost study for the logistics function. (pp. 5-9, p. 18/GAO Draft Report)

DoD RESPONSE: Nonconcur. The GAO inaccurately stated that saving resulting from cost competition total \$2.7 million. The total estimated cost of in-house operation in the cost comparison was \$61.9 million. The Northrop bid, plus all cost adjustments, totaled \$53.2, for a net savings of over \$8.7 million. The GAO erred by deducting the conversion differential from the savings. The conversion differential is not an expense to either Fort Sill or the Army, but rather is a decision threshold. It is the minimum savings (ten percent of

See comment 1

See p 15

Government personnel cost) required to justify converting operation of a commercial activity. Therefore, even if all of the \$7.7 million cost increase could be solely attributed to Northrop's performance, the operation would still be performing at a lower cost than the in-house proposal.

- **FINDING D: Fort Sill's Treatment of Award Fee Was Contrary to Army Instructions.** The GAO found that contrary to Army instructions to Fort Sill, the Fort Sill administration award fee provisions of the contract did not motivate Northrop to provide excellence in performance and allowed award fees to be paid for less-than-minimum performance. The GAO concluded that Northrop has no motivation to exceed contract standards and if it improves its performance could earn an additional amount of about \$2.8 million over 5 years for merely meeting minimum performance standards. The GAO pointed out that the Training and Doctrine Command advised Fort Sill that the proposed contract provisions for award fees were unacceptable and the revisions were to conform to procurement regulations. The GAO indicated, however, that the logistics contract, as written, does not violate procurement regulations: it contemplates award-fee provisions being administered to motivate contractors to excellence in contract performance.

According to the GAO, the Fort Sill contracting officer stated that exceeding contract standards could cost Fort Sill more money because Northrop would add more employees in an attempt to exceed performance standards. The GAO indicated that Army headquarters and the Training and Doctrine Command did not know of any other Army installation using the Fort Sill approach to administration of award fee contracts. (pp. 10-12, pp. 18-19/GAO Draft Report).

DoD RESPONSE: Partially concur. The Department disagrees with the contention that Northrop's exceeding minimum performance would increase reimbursable costs. A properly structured award fee plan includes an incentive for controlling costs. Fort Sill has such an incentive in their award fee plan.

- **FINDING E: Northrop's Performance Was Uneven.** The GAO stated that, under Circular A-76 guidelines, whoever wins the bid is to provide the actual minimum requirements of the Government. The GAO noted that Fort Sill defined the minimum requirement as the level of work done by its in-house employees before the cost study. The GAO observed that Northrop's performance was below that standard in two of the three components--maintenance and supply. The GAO found that Fort Sill had issued 83 discrepancy reports on Northrop's performance. The GAO also learned that Fort Sill had considered issuing a cure notice to Northrop; however, it was decided that Northrop would continue to operate the supply component, with Fort Sill employees helping the contractor to clear up the supply problems.

See comment 2

Appendix II
Comments From the Department of Defense

The GAO also found that Northrop's performance included backlogs of work, especially in the vehicle maintenance activity. The GAO stated that Fort Sill officials attributed the all-time high maintenance backlogs of tactical and nontactical vehicles to the lack of supervision, the lack of qualified mechanics, and the failure to set priorities on vehicle maintenance.

The GAO did find, however that Northrop performed the transportation component equal to or better than the previous in-house operation. The GAO indicated that Fort Sill officials attributed that performance to the low turnover in personnel that occurred when the activity was awarded to Northrop. (pp. 12-15, p. 19/GAO Draft Report)

DoD RESPONSE: Concur.

- **FINDING F: Productivity Was Below Standard.** The GAO found that productivity measures showed that over the first 17 months of the contract, Northrop productivity averaged about 82 percent of the standard and affected the areas of (1) labor costs and (2) equipment readiness. The GAO also found that the reduced productivity resulted in about \$1.8 million in excess direct labor costs for the first 17 months and may reach \$4.5 million over the term of the contract. The GAO observed that combat units supported by Northrop had an average readiness of 85 percent--which resulted in the Desert Shield troop deployment not being carried at the full wartime equipment requirements level. The GAO pointed out that the previous in-house operation had performed at 90 percent. (pp. 15-17, p. 19/GAO Draft Report)

DoD RESPONSE: Partially concur. The GAO statement that Northrop productivity was below standard is partially correct regarding two of the three main functional areas, but is misleading for several reasons. First, these standards include timeliness, quality and cost of performance which for the most part were met. Second, Fort Sill Unit Readiness and Materiel Readiness Reports do not substantiate that equipment maintenance adversely affected unit readiness and support for Operation Desert Shield. Third, there is no substantiation that contract costs will increase an additional \$4.5 million for the remaining term of the contract. Last, the GAO statement that the Government is required to pay a contractor cost regardless of the amount of output is incorrect. The Government is required to pay only allocable, allowable, and reasonable costs.

See comment 3

- **Finding G: Oversight Was Lacking.** The GAO found that there was no requirement for Army headquarters and Training and Doctrine Command officials to monitor the Fort Sill logistics contract after the cost study decision was made and that, in fact, those organizations maintained managing the contract was the responsibility of Fort Sill. The GAO also found that Army headquarters and the Training and Doctrine Command were unaware (1) of the Fort Sill approach to paying award-fees, (2) of the contractor's uneven performance, or (3) the effect of reduced productivity on equipment readiness. The GAO concluded, however, that although there was no requirement for Army headquarters or the Training and Doctrine Command to oversee individual contracts, officials of both organizations knew there had been a problem with the Fort Sill award-fee approach during the A-76 cost study. The GAO stated that they also did not attempt to learn whether Northrop's performance was adequate--not learning of Fort Sill problems until they were advised by the GAO during the on-site audit work. (pp. 17-18/ GAO Draft Report)

See comment 4.

DOD RESPONSE: Partially concur. The GAO finding that oversight was lacking is misleading. The Army performed a contract management review at Fort Sill in February 1989. One of the contracts reviewed during the visit was the Northrop contract which included discussions with the Northrop contract manager. There was no evidence of contract management problems from either the contractor or Fort Sill contracting personnel. Since the contract and award fee plan comply with contracting regulations and no contract problems were evident, the Fort Sill administration of the award fee could not have been anticipated.

* * * * *

RECOMMENDATIONS

- **RECOMMENDATION 1:** The GAO recommends that the Secretary of the Army direct the Fort Sill Commander to ensure that the contracting officer (1) stops using the current contract administration approach of paying award-fees for minimum and below-minimum performance and (2) requires Northrop to provide, within a specified time frame, a plan that will demonstrate its ability to meet minimum performance standards--and ensure that the contractor is performing satisfactorily. (pp. 19-20/GAO Draft Report)

See comment 5.

DoD RESPONSE: Partially concur. The Department disagrees with the GAO recommendation that the Army direct the contracting officer require the contractor to submit a plan for improvement and to terminate the contract if the contractor fails to submit an acceptable plan. This action is inappropriate. The Assistant Secretary of the Army for Research, Development, and Acquisition will instruct the Commander, Training and Doctrine Command to ensure that the Fort Sill contracting officer (1) does not pay award-fees for minimum or below-minimum performance and (2) the contractor complies with the performance requirements in the contract. This will be accomplished within the second quarter of fiscal year 1991.

- **RECOMMENDATION 2:** The GAO recommends that the Secretary of the Army direct the Training and Doctrine Command to establish oversight of the Fort Sill logistics contract and ensure that the award-fee provisions of other Command cost plus-award-fee contracts are being properly administered. (p. 20/GAO Draft Report)

DoD RESPONSE: Concur. The Assistant Secretary of the Army for Research, Development, and Acquisition will advise the Commander of the Army Training and Doctrine Command to intensify oversight of Fort Sill's logistics contract, and ensure that award fee provisions of all cost plus award fee contracts are properly administered. This will occur within the second quarter of fiscal year 1991.

Army guidance already exists on proper construction of award fee provisions and post-decision monitoring of A-76 contracts. The Assistant Secretary of the Army for Research, Development, and Acquisition and the Director of Management will request the Commander, Training and Doctrine Command, ensure compliance with this guidance. This will occur within the second quarter of fiscal year 1991.

The following are additional GAO comments on the Department of Defense's December 6, 1990, letter.

GAO Comments

1. We disagree with DOD's assertion that the \$2.7 million figure we use throughout the report for savings estimated as the result of the study is not accurate. Records show that the A-76 cost study comparison of contractor to in-house costs initially indicated that contracting for the services could save the government about \$3.2 million over the 5-year period. The cost comparison, done by Ft. Sill's A-76 staff, was reviewed by the Army Audit Agency and an Army Appeals Board. The Army Appeals Board adjusted the estimated savings to \$2.7 million. We have modified the report to indicate that the \$2.7 million was the Appeals Board's estimate. During our review, a key Ft. Sill A-76 official agreed that the final savings amount estimated from converting to the logistics contract was \$2.7 million.

2. When the contractor began to operate the logistics function in October 1988, there was no incentive in the contract to control costs. A December 1989 modification to the contract provided such an incentive. The contractor had operated for over a year without an incentive to control costs. Further, in our report we are simply saying that Ft. Sill's contracting officer said that reimbursable contract costs would rise because the contractor would add more employees in an effort to exceed minimum performance standards.

3. We do not agree that our report statement that the contractor's productivity was below standards is misleading. Productivity data provided us by Ft. Sill shows that Northrop's productivity level was below that of the previous in-house employees. The standards used to measure contractor productivity were based, as the report says, on the in-house staff's performance before the cost study was done. The aspects of timeliness, quality, and cost of performance were components of the productivity analysis done by Ft. Sill. When we asked Army headquarters officials to supply documentation showing what they believed contractor productivity was, they did not provide it.

Ft. Sill's Director of Logistics was the source of our information that reduced equipment readiness in the logistics function adversely affected support for Operation Desert Shield. We agree that readiness reports did not specifically mention Desert Shield, which was unanticipated at the time our work was done. The reports do, however, lend credence to the Director's statement in that they show the units Northrop supports at

Ft. Sill did not meet the requirements for readiness. Further, the Department of the Army could provide no documentary evidence to show that there had been no adverse impact.

Also, our report does not say that contract costs will increase by \$4.5 million as the result of reduced productivity. We say it is a projected increase based on Ft. Sill's analysis.

We have modified our report language to clarify that only allocable, allowable, and reasonable costs are to be paid.

4. In the course of our work, we interviewed a TRADOC official who did the contract management review at Ft. Sill. He said the reviewers never looked specifically at the logistics contract during their work. He also said that neither the Department of the Army nor TRADOC knew that Ft. Sill was paying award fees for minimum performance.

The original solicitation package called for maximum award fees to be paid for minimum performance and provided no motivation for performing above the minimum performance level. Army headquarters and TRADOC officials objected to the provision, ensured that it was removed from the package, and directed that no award fee be paid for minimum performance. We believe that because both Army headquarters and TRADOC officials knew there had been problems with the solicitation package provision for paying award fees, they should have overseen the contract more closely. Such oversight might have detected the problem earlier in the contract period.

5. We have deleted language from our second recommendation that called for Army to take action to terminate the contractor if an acceptable plan is not provided. The change was made in order to allow Army more flexibility in deciding how to remedy the problems we have discussed. We continue to believe, however, that Ft. Sill should require a plan from the contractor showing how it proposes to meet performance standards. After it reviews the plan, Ft. Sill can determine what its next steps should be.

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Related GAO Products

OMB Circular A-76: DOD's Reported Savings Figures Are Incomplete and Inaccurate (GAO/GGD-90-58, Mar. 15, 1990).

Army Procurement: Fort Benjamin Harrison's Commercial Activity Study Should Be Redone or Updated (GAO/NSIAD-89-90, Feb. 24, 1989).

Army Procurement: Allegations of Unfair Treatment at Fort Lee, Virginia, Found to Be Unmerited (GAO/NSIAD-89-46, Dec. 6, 1988).

Federal Productivity: DOD's Experience in Contracting Out Commercially Available Activities (GAO/GGD-89-6, Nov. 28, 1988).

Army Procurement: No Savings From Contracting for Support Services at Fort Eustis, Virginia (GAO/NSIAD-89-25, Oct. 31, 1988).

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DOD Functions Contracted Out Under OMB Circular A-76: Contract Cost Increases and the Effects on Federal Employees (GAO/NSIAD-85-49, Apr. 15, 1985).

Synopsis of GAO Reports Involving Contracting Out Under OMB Circular A-76 (GAO/PLRD-83-74, May 24, 1983).

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