

July 1998

**DEFENSE
CONTRACTOR
RESTRUCTURING**

**DOD Risks Forfeiting
Savings on Fixed-Price
Contracts**



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

National Security and
International Affairs Division

B-277897

July 17, 1998

The Honorable Strom Thurmond
Chairman
The Honorable Carl Levin
Ranking Minority Member
Committee on Armed Services
United States Senate

The Honorable Floyd Spence
Chairman
The Honorable Ike Skelton
Ranking Minority Member
Committee on National Security
House of Representatives

Section 818 of the National Defense Authorization Act for Fiscal Year 1995 (P.L. 103-337) requires us to report periodically to the Congress on the implementation of the Department of Defense's (DOD) policy on defense contractor restructuring. We have issued three reports pursuant to this legislative requirement.¹ This report focuses on DOD's use of contract price adjustment clauses, also called reopener clauses, which can be used to ensure that DOD receives its fair share of contractor restructuring savings on fixed-price contracts awarded to companies involved in a business combination between the time a combination is announced and the time that restructuring savings are reflected in the mechanism used for pricing contracts.² Specifically, we discuss (1) DOD's limited use of reopener clauses for these contracts and (2) the potential benefits of using reopener clauses in future business combinations.

Background

As a result of the significant decline in defense expenditures since the late 1980s, defense contractors have been consolidating and restructuring their operations to increase efficiencies and become more competitive in the defense marketplace. Many of the consolidation and restructuring activities resulted from defense contractor acquisitions and mergers. In July 1993, the Under Secretary of Defense for Acquisition concluded that it was in the government's best interest to encourage defense contractors to consolidate and restructure their operations, which was expected to reduce costs to DOD. To achieve that goal, the Under Secretary stated that

¹See Related GAO Products for these and other reports on defense contractor restructuring issues.

²See appendix I for examples of restructuring savings reopener clauses.

DOD would pay restructuring costs on contracts transferred as part of a merger or acquisition if the business combination was expected to result in overall reduced costs for DOD or preserve a critical capability that might otherwise be lost.

Due to concerns about DOD paying defense contractors to restructure their operations after a business combination, the Congress enacted section 818 of Public Law 103-337 in October 1994. This legislation prohibited payment of any restructuring costs until a senior DOD official certified that projections of restructuring savings from the business combination were based on audited cost data and should result in overall reduced costs to DOD. In the conference report on this legislation, the conferees stated that contracting officers and auditors should understand that they have no obligation to pay restructuring costs in the absence of detailed evidence of the benefit to the government. DOD codifies federal acquisition policy in its Defense Federal Acquisition Regulation Supplement (DFARS).

The Congress further limited DOD's authority for paying restructuring costs in section 8115 of the DOD Appropriations Act for Fiscal Year 1997. That legislation prohibited payment of these costs for business combinations occurring after September 30, 1996, unless (1) restructuring savings for DOD were projected to exceed allowed costs by a factor of at least two to one or (2) the projected savings to DOD were to exceed the costs allowed and the Secretary of Defense determined that the business combination would result in the preservation of a critical capability. The Secretary of Defense is currently required by 10 U.S.C. 2325 to determine in writing that the projected savings will be at least twice the amount of allowed costs or that the savings will exceed costs allowed and that the combination will result in the preservation of a critical capability.³

DOD projects that its share of restructuring savings will amount to \$4.1 billion and that its share of the restructuring costs will amount to \$856 million, which represent a net savings of \$3.3 billion.⁴ Restructuring savings come from both direct and indirect costs. Direct costs are identified specifically for each contract. Indirect costs, on the other hand, represent the general operation of the business. Indirect costs are often referred to as overhead costs and include expenses that benefit all contracts at a particular business segment, such as maintenance, plant

³National Defense Authorization Act for Fiscal Year 1998, Public Law 105-85, November 18, 1997.

⁴These figures include the six certified combinations as well as one combination that is not subject to the certification requirement but is included in DOD's reports to the Congress on defense industry restructuring.

security, and legal and accounting expenses. The contractor recovers these overhead costs through forward pricing rates, which are rates negotiated between the government and the contractor to use in pricing future contracts. When restructuring activities reduce indirect costs, DOD realizes the savings through lower overhead charges to its contracts.

Results in Brief

The time it takes for restructuring savings to be included in DOD contract prices can be considerable. For the contractor business segments we examined, it took an average of about 21 months from the announcement of the acquisition or merger to the time that contractors reflect the restructuring savings in reduced overhead rates. During this period, DOD awarded over 600 fixed-price contracts or contract modifications worth about \$3.9 billion. However, despite repeated recommendations from the Defense Contract Audit Agency and Defense Contract Management Command, contracting officers rarely included reopener clauses for savings in fixed-price contracts awarded during this period. With reopener clauses, contract prices that were negotiated before savings were included in overhead rates used to price DOD contracts could be adjusted downward once savings were determined, thereby reducing contract costs. Without reopener clauses, DOD cannot recoup its share of restructuring savings.

DOD contracting officers cited various reasons for not using reopener clauses. These reasons included the desire to have contracts with no loose ends and concerns that the use of the clauses would cause an excessive administrative burden in renegotiating contract price adjustments. Another factor that appeared to influence the use of reopener clauses is the level of contractor resistance. Also, one contractor commented that such a clause was not required by current DOD regulations.

The use of reopener clauses can result in substantial savings to DOD. In one case in which a reopener clause was exercised, the contract price was reduced by almost 4 percent, or about \$1.8 million. Unless DOD takes steps to include reopener clauses in its fixed-price contracts with companies forming business combinations, it risks losing further substantial savings resulting from contractor restructuring.

Reopener Clauses for Savings Have Been Rarely Used

The Defense Contract Audit Agency (DCAA) and the Defense Contract Management Command (DCMC) have repeatedly recommended that contracting officers use reopener clauses for savings when negotiating fixed-price contracts with business combinations. Despite billions of

dollars in contracts awarded between the announcement of the acquisition or merger and the time that contractors reflect the restructuring savings in reduced overhead, reopener clauses for savings have rarely been used. In fact, the business segments we reviewed identified only 12 instances in which reopener clauses were included in contracts. One of those reopener clauses has been successfully exercised, resulting in \$1.8 million in recouped restructuring savings, or about 4 percent of the contract price.

DOD Awarded Billions to Business Combinations

The time between the announcement of a business combination and the point at which restructuring savings are reflected in reduced contract prices to DOD can be considerable. For the contractor business segments we reviewed, the time ranged from 11 months to 3 years and averaged almost 21 months. During this period, DOD continued to negotiate noncompetitive fixed-price contracts with the contractors involved in business combinations. DOD awarded the contractor business segments we reviewed over 600 noncompetitive fixed-price contracts worth about \$3.9 billion.

In those contract awards we reviewed, uncertainty over the impact of restructuring on overhead rates was frequently discussed during negotiations and, as a result, some overhead rates fluctuated significantly. For example, records of one negotiation stated that the buyer received new overhead rates about every 45 days. Records from another negotiation stated that the contractor had used five different sets of rates to develop its proposal. In addition, some contractors were involved in more than one business combination. For example, one contractor was involved in four business combinations between November 1992 and April 1996. In some cases, contractors had merged or acquired again before overhead rates could be updated to include savings from the prior combination, which started the whole process over as restructuring costs and savings were calculated for the new combination.

In this fluid and uncertain environment, fixed-price contracts would normally be risky for both the buyer and the seller because such contracts, once awarded, cannot be repriced. This risk is particularly significant for DOD because restructuring savings are expected to significantly exceed restructuring costs and are more difficult to estimate than restructuring costs.

DOD addressed the contractors' risk by allowing restructuring costs to be included in their overhead rates before certification, provided that the

contract include a downward reopener clause to remove restructuring costs if the combination was not certified. However, DOD does not require reopener clauses to ensure that it receives its appropriate share of restructuring savings. Rather, DOD leaves the use of such clauses to the discretion of the contracting officer.

Reopener Clauses for Savings Are Frequently Recommended but Rarely Used

DCAA and DCMC have repeatedly cautioned buying commands and contracting officers to protect the government's interest when negotiating fixed-price contracts with companies involved in business combinations, often recommending the use of downward reopener clauses to ensure that the government can claim its share of restructuring savings. In some cases, DCAA provided examples of reopener clauses that could be used.

Although DCAA and DCMC can recommend reopener clauses for savings, the contracting officers ultimately decide whether to use them. Contractors identified only 12 instances in which contracting officers included reopener clauses in fixed-price contracts with the business segments we reviewed. DOD awarded these contractors over 600 noncompetitive fixed-price contract actions worth about \$3.9 billion between the time the combination was announced and the time that restructuring savings were reflected in overhead rates. Six of these awards with reopener clauses—all at the same business segment—have a combined value of less than \$12 million; DOD awarded that business segment 142 noncompetitive fixed-price actions worth almost \$873 million during this period.

Contracting officers and negotiation records cited various reasons for not using reopener clauses, including the preference to have contracts without loose ends and concerns about the administrative burden of reopening a contract. Another factor that appears to influence the use of reopener clauses is contractor resistance. In one Navy buying command, where reopener clauses for savings were generally not used, we found three instances in which the clauses were considered but not used partly due to contractor resistance. For example, in the case of a \$116 million award for electronic test equipment, the contracting officer said that the contractor was not receptive to a reopener clause and was even less receptive to another proposal that the Navy not pay restructuring costs or pay reduced restructuring costs instead of including a reopener clause.

The Navy also considered reopener clauses in a \$63 million aircraft retrofit contract and an initial \$123 million aircraft production contract.⁵ These

⁵The final award for this contract after negotiation was \$511 million.

contracts were awarded in June and December 1994, respectively, with performance through 1997 and 1998. This business combination had been announced in March 1994, but there was no restructuring proposal or restructuring agreement with the government until 1996. For the two business segments affected by these contracts, the savings were not reflected in overhead rates until September 1995 and March 1996. According to the Navy lead negotiator, the contractor did not believe that there would be any restructuring savings during the contract performance periods and was not receptive to downward reopener clauses.

Some contracting officers and negotiation records also state that reopener clauses were not used because of the administrative burden of reopening a contract. When a reopener clause is exercised, the contractor submits a repricing proposal to the buyer that meets the criteria established in the clause. This proposal is then audited by DCAA and negotiated with the contractor.

One contract that contained a reopener clause, a \$49 million foreign military sales award, has been repriced. That contract, awarded in April 1995, was modified in September 1997 to include \$1.8 million in recouped restructuring savings, or about 4 percent of the total contract price. According to the contracting officer and price analyst, an administrative burden was associated with reopening the contract, but these officials did not believe that the burden was unreasonable or excessive, particularly in light of the return. The officials also said that the interpretation of the reopener clause language was never in dispute; the contractor knew that it had to provide a repricing proposal that was auditable and separated restructuring savings from any other changes to the contract.

DOD Is Still at Risk for Lost Savings From Future Business Combinations

More recently, contracting officers appear to be recognizing the benefits of reopener clauses, and their use seems to be increasing. However, the use of these clauses is still limited. Unless DOD takes steps to include reopener clauses in its noncompetitive fixed-price contracts for companies forming business combinations, it risks losing further substantial savings resulting from contractor restructuring.

With recent business combinations, contracting officers appear to be using reopener clauses more often than in the past. For example, reopener clauses for savings were not included in any DOD awards made to one business segment while it was undergoing restructuring during 1994 and

early 1995. However, that business segment subsequently identified 14 contracts awarded by DOD that included reopener clauses for savings. These reopener clauses related to additional acquisitions after the initial business combination. In addition, a Navy contract awarded to that contractor in September 1997 included a reopener clause for savings in connection with a restructuring project remaining from the initial combination.

Some DOD buying commands have also expressed more interest in reopener clauses. At one Navy command, a proposed reopener clause was disseminated to staff from the Office of the Assistant Secretary of the Navy. Contracting officers at that command said that the use of reopener clauses for savings is being stressed by the head of contracts and, as a result, reopener clauses have begun to appear in awards. One contracting officer cited the increasing number of mergers as part of the reason for this increased interest. Other buying offices have also acknowledged that reopener clauses can be a useful tool to protect the government's interest.

While some DOD buyers have shown more interest in the use of reopener clauses for savings, some new business combinations emphatically oppose their use. Several DOD buying commands expressed interest in using reopener clauses for savings in awards to a contractor involved in two business combinations formed during 1997. In August 1997, a senior DCMC executive provided a recommended reopener clause to contract administrators at the affected business segments, who forwarded the language to DOD buying commands. The contractor, however, informed DCMC and DOD buyers that it would not accept the proposed reopener clause because current DOD regulations do not require it. The contractor stated that, under those regulations, a downward reopener clause is only required to remove restructuring costs if restructuring savings are not certified by DOD. However, DOD officials noted that the regulations are flexible and that contracting officers are permitted to add reopener clauses in addition to the one required by regulations.

Conclusions and Recommendation

DOD auditors and contract administrators have repeatedly recommended to DOD buyers that reopener clauses for savings be used in pricing contracts with companies involved in business combinations. However, contracting officers have generally declined to use the clauses for a variety of reasons, including the desire to have contracts without loose ends and to avoid the burden of reopening them. Contractors may also use the lack of DOD policy requiring the use of reopener clauses as a bargaining tool in

negotiations with DOD contracting officers. Recent attempts to use reopener clauses appear to have increased. However, some new business combinations actively oppose their use and refuse to accept them. In one instance, the contractor cited the absence of a DOD requirement as support for its position. Thus, DOD faces a challenge in negotiating timely contracts while protecting the government's interests, and it remains at risk for lost savings as defense industry consolidation continues.

We believe that the contracting officers' negotiation position would be strengthened and they would be more likely to use reopener clauses if there were a DOD policy requiring their use. Therefore, we recommend that the Secretary of Defense revise DFARS to require that contracting officers (1) include reopener clauses for savings in noncompetitive fixed-price contracts negotiated before the benefits of restructuring savings are reflected in reduced overhead rates used to price contracts or (2) provide a written justification in the negotiation records as to why a reopener clause is not needed.

Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD partially concurred with our recommendation. DOD agrees that the use of reopener clauses will ensure that it receives its share of restructuring savings on non-competitive fixed-price contracts awarded to defense contractors involved in business combinations. However, DOD does not believe that the mandatory use of reopener clauses in all noncompetitive fixed-price contracts is appropriate. DOD stated that contracting officers must use their professional judgment on a case-by-case basis to decide when a reopener clause is warranted. DOD said it would revise DFARS to require that contracting officers consider using a reopener clause in noncompetitive fixed-price contracts. While we believe DOD's commitment to revise DFARS is a step in the right direction, it does not, in our view, go far enough. Because the evidence indicates that few contracting officers are using reopener clauses, in spite of continuing recommendations to do so, we believe that DOD should (1) require contracting officers to use reopener clauses or (2) clearly document in the contract file their reasons for not using them. Implementing this recommendation would more clearly convey DOD's support of reopener clauses, while still providing contracting officers with the flexibility to not use them, when justified. In this regard, a number of business combinations are pending and others are likely as the defense industry continues to respond to reduced defense spending. If reopener clauses continue to be excluded from the majority of contracts awarded to business combinations, DOD will not receive its share of

restructuring savings. At a minimum, regardless of how DOD revises DFARS, it should require that any decision not to use a reopener clause be clearly justified in the contract file.

In addition, DOD commented that our description of DOD's procedures used to price restructuring costs and savings into new contracts is incomplete and gives the erroneous impression that restructuring savings are not included. DOD maintains that its regulations ensure that restructuring costs and savings are priced into new contracts as quickly as possible. Even though DOD contracting officers may be adjusting forward pricing rates (the mechanism used to price new contracts) as quickly as possible, our work shows it is taking an average of 21 months from the announcement of an acquisition or merger to the time that contractors reflect the restructuring savings in reduced overhead rates. During that time, DOD continued to negotiate and award substantial amounts of new contracts. DOD's comments appear in appendix II.

Scope and Methodology

To obtain background and program history information, we reviewed the pertinent legislation and legislative history dealing with defense contractor restructuring costs and DOD savings, including committee reports and hearings regarding restructuring. We also reviewed DOD regulations related to restructuring; DCAA and DCMC guidance and analyses regarding restructuring savings; and reports and analyses on restructuring by the DOD Inspector General, the Office of Management and Budget's Cost Accounting Standards Board, the Congressional Research Service, and us.

For our review, we included all the business combinations that had been certified by the Under Secretary of Defense for Acquisition and Technology as of September 30, 1997: United Defense Limited Partnership, Martin Marietta-General Electric Aerospace, Northrop-Grumman-Vought, Martin Marietta-General Dynamics Space Systems, Lockheed-Martin Marietta, and Hughes-CAE-Link. For all business combinations except Northrop-Grumman-Vought, we reviewed specific business segments. For Northrop-Grumman-Vought, we reviewed the largest restructuring project, which was the consolidation of corporate headquarters. We obtained information from buyers representing all the services: the U.S. Army Aviation and Missile Command, the U.S. Army Tank Automotive Command, the Air Force Materiel Command's Aeronautical Systems Center, the Naval Sea Systems Command, and the Naval Air Systems Command.

We reviewed selected contracts for the buyers and business combinations in our review to determine whether DOD auditors and price analysts are recommending, and DOD procuring contracting officers are using, reopener clauses for restructuring savings in noncompetitive fixed-price contracts. We used the DOD Individual Contracting Action Report (DD350) database to identify such fixed-price actions. We used this primary source data for our analyses because it is the official record of all DOD contract actions over \$25,000. We did not validate or verify this data, but we cross-checked it with buying offices when possible. In some cases, the buyers told us that the DD350 data was the only complete data they had.

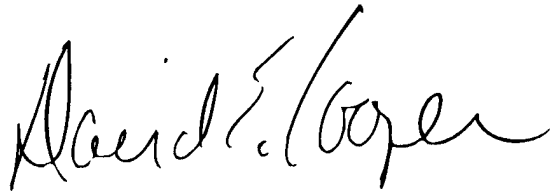
From the DD350 database, we obtained data for all contracts of \$20 million or more that DOD awarded to the business combinations in our review. For Hughes-CAE-Link, we dropped this threshold to all contracts of \$5 million or more because of the company's smaller business base (training systems rather than weapon systems). According to the DD350 database, 625 fixed-price actions totaling about \$3.9 billion were awarded to the business segments in our review during the relevant periods. The buyers included in our review accounted for about 38 percent of these actions and 40 percent of the dollar amount, or 239 actions totaling over \$1.5 billion.

For contract actions, we reviewed negotiation memorandums, portions of the contract awards, DCAA audit reports, and DCMC price analyses. We spoke with DOD contracting officers, other DOD procurement officials, DCAA auditors, and DCMC price analysts. We reviewed guidance and other directives provided to contracting officers by DOD buying commands. In addition, we obtained and reviewed all restructuring-related price adjustment clauses included in contracts with the business segments in our review, as identified by DOD analysts and contractor officials. For those contracts for which price adjustment clauses for savings were included, we determined whether the clauses had been exercised and what the result had been. To do this, we spoke with responsible officials and reviewed contract data and buying office guidance.

We conducted our work from August 1997 to April 1998 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Secretary of Defense; the Commander, DCMC; the Director, DCAA; and appropriate congressional committees. Copies will also be made available to others on request.

Please contact me at (202) 512-4841 if you or your staff have any questions concerning this report. Major contributors to this report are Charles W. Thompson, Maria Storts, and George C. Burdette.

A handwritten signature in black ink that reads "David E. Cooper". The signature is written in a cursive style with a large, sweeping initial "D".

David E. Cooper
Associate Director
Defense Acquisitions Issues

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Abbreviations

DCAA	Defense Contract Audit Agency
DCE	Defense Corporate Executive
DCMC	Defense Contract Management Command
DFARS	Defense Federal Acquisition Regulation Supplement
DOD	Department of Defense

Examples of Restructuring Savings Reopener Clauses

The following reopener clauses for restructuring savings have been included in Department of Defense (DOD) awards to business combinations. Some of these awards were made to business combinations that have occurred since the six combinations included in our review.

"[Contractor] agrees to modify the subject contract to address any cost savings derived from [the contractor's acquisition of another contractor]. Any cost adjustments will be made on a downward adjustment basis only."

". . . Within the contractually required period of performance of this contract, [the contractor] anticipates the negotiation of the external restructuring proposal which may impact [the Forward Pricing Rate Proposal] which formed the basis of the negotiated price on this contract. Both parties agree to recalculate the negotiated price on a downward only basis based on the results of the negotiation of the external restructuring proposal. This contract price adjustment, if required, will be executed within 90 days of DOD approval of the external restructuring agreement . . ."

". . . At the time of negotiations for [this contract, the contractor] and the Government did not have a negotiated forward pricing rate agreement on indirect rates. A mutual agreement has been formed where the contract effort may be billed with the rates as given in this contract until a negotiated Forward Pricing Rate Agreement is available with the indirect rates. At that time, negotiations will reopen to finalize agreement on indirect rates, . . . all of which will be subject to downward only adjustment from the date of contract award . . ."

". . . The Government and the contractor acknowledge that under Public Law 103-337, in order for the Government to allow the restructuring costs, such costs must result in an overall net savings to the Government. The Government and the contractor agree that, following [Under Secretary of Defense (Acquisition and Technology)] certification, and the following subsequent approval of the Forward Pricing Rates which include the [business combination's] restructuring impact, a net downward only price adjustment shall be effected . . ."

"The parties hereto acknowledge that [the contractor has formed a business combination] and plans to submit a restructuring proposal to the Defense Corporate Executive (DCE). All parties also acknowledge that this contract has been negotiated without consideration of the costing rate impact resulting from the submittal of the restructuring proposal and therefore any cost impact resulting from the final negotiation of the restructuring proposal shall be downward only. After review and verification of the impact with the DCE, [the contractor] and the Government agree to modify the contract price accordingly."

Comments From the Department of Defense



ACQUISITION AND
TECHNOLOGY

DP/CPF

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

June 12, 1998

Mr. David E. Cooper
Associate Director, Defense Acquisitions Issues
National Security and International
Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Cooper:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report "DEFENSE CONTRACTOR RESTRUCTURING: DoD Risks Forfeiting Savings on Fixed Price Contracts," dated May 12, 1998 (GAO Code 707295/OSD Case 1615).

The DoD partially concurs with the GAO recommendation and selected finding of the draft report. Our detailed comments are provided in the enclosure.

Thank you for providing us the opportunity to comment on the draft report.

Sincerely,

A handwritten signature in cursive script that reads "Eleanor R. Spector".

Eleanor R. Spector
Director, Defense Procurement

Enclosure



**GAO DRAFT REPORT
DEFENSE INDUSTRY RESTRUCTURING:
DoD Risks Forfeiting Savings on Fixed Price Contracts
(GAO Code 707295 / OSD Case 1615)**

**DOD COMMENTS
ON SELECTED GAO FINDING**

FINDING: The GAO overall finding is that DoD is at risk for forfeiting restructuring savings on non-competitive fixed-price contracts awarded during the time between when a business combination is announced and the time that restructuring savings are reflected in the mechanism used for pricing contracts. GAO stated that in this fluid and uncertain environment, fixed-price contracts without reopener clauses would normally be risky for both the buyer and the seller since, once awarded, they cannot be repriced. GAO believes that this risk is particularly significant for DoD because restructuring savings are expected to significantly exceed restructuring costs and are more difficult to estimate than restructuring costs.

The GAO reported that DoD addressed the contractors' risk by allowing restructuring costs to be included in the contractor's overhead rates prior to certification, provided that the contract includes a downward reopener clause to remove restructuring costs if the business combination was not certified. The GAO further reported that DoD does not require reopener clauses to ensure that it receives its appropriate share of restructuring savings. Rather, it leaves their use to the discretion of the contracting officer. (p. 7/Draft Report)

DOD RESPONSE: Partially concur. The GAO description of DoD's procedures used to price restructuring costs and savings into new contracts is incomplete and gives the erroneous impression that restructuring savings are not included.

Existing DoD regulations ensure that restructuring costs and savings are priced into new contracts as quickly as possible. Under current DFARS procedures, DoD requires the cognizant administrative contracting officer (ACO) to adjust forward pricing rates (which is the mechanism used to price new contracts) as soon as practicable upon receipt of the contractor's restructuring proposal, to reflect the impact of projected restructuring savings. Restructuring costs may also be included in the forward pricing rates prior to the completion of the certification process if a repricing (reopener) clause is included in each fixed-price action that is priced based on the forward pricing rates. The repricing clause provides for a downward price adjustment to remove restructuring costs if the certification is not obtained.

Now on pp 6-7.

GAO DRAFT REPORT
DEFENSE INDUSTRY RESTRUCTURING:
DoD Risks Forfeiting Savings on Fixed Price Contracts
(GAO Code 707295 / OSD Case 1615)

DOD COMMENTS
ON THE GAO RECOMMENDATION

RECOMMENDATION: The GAO recommended that the Secretary of Defense revise the Defense Federal Acquisition Regulation Supplement (DFARS) provision on restructuring costs to require that contracting officers include reopener clauses for savings in any fixed-price contracts negotiated before the benefits of restructuring savings are reflected in reduced overhead rates used to price contracts. (p. 12/Draft Report)

DOD RESPONSE: Partially concur. The DoD agrees that the use of a reopener clause will ensure that the Department receives its share of restructuring savings on non-competitive fixed-price contracts awarded to defense contractors involved in business combinations prior to the time that restructuring savings are quantified and used for pricing contracts. However, the Department does not believe that the indiscriminate, mandatory use of reopener clauses in all such fixed-price contracts is appropriate.

The Department believes that reopener clauses must be used judiciously to serve the best interests of the Department and conserve limited contracting and audit resources. Contracting officers must use their professional judgment on a case-by-case basis to decide when a reopener clause is warranted. The use of a reopener clause depends upon the circumstances involved, including when the restructuring will take place, when restructuring savings will begin to be realized, and the contract performance period.

Under existing regulations, contracting officers have the flexibility to use reopener clauses. However, it appears that some contracting officers may be unaware of this flexibility or may be reluctant to use reopener clauses for various reasons. Accordingly, the Department will revise the DFARS to require contracting officers to consider using a reopener clause in non-competitive fixed-price contracts that are negotiated and awarded between the time a business combination is announced and the time that the contractor's forward pricing rates are adjusted to reflect the impact of restructuring.

Now on p. 8.

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Related GAO Products

Defense Industry Restructuring: Updated Cost and Savings Information
(GAO/NSIAD-98-156, Apr. 30, 1998).

Defense Industry Restructuring: Clarification of Cost and Savings Issues
(GAO/NSIAD-97-186R, June 17, 1997).

Defense Industry Restructuring: Cost and Savings Issues (GAO/T-NSIAD-97-141,
Apr. 15, 1997).

Defense Restructuring Costs: Information Pertaining to Five Business
Combinations (GAO/NSIAD-97-97, Apr. 1, 1997).

Defense Restructuring Costs: Projected and Actual Savings From Martin
Marietta Acquisition of GE Aerospace (GAO/NSIAD-96-191, Sept. 5, 1996).

Defense Contractor Restructuring: First Application of Cost and Savings
Regulations (GAO/NSIAD-96-80, Apr. 10, 1996).

Defense Restructuring Costs: Payment Regulations Are Inconsistent With
Legislation (GAO/NSIAD-95-106, Aug. 10, 1995).

Overhead Costs: Defense Industry Initiatives to Control Overhead Rates
(GAO/NSIAD-95-115, May 3, 1995).

Defense Industry Consolidation: Issues Related to Acquisition and Merger
Restructuring Costs (GAO/T-NSIAD-94-247, July 28, 1994).

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