



REPLY
REFER TO

J-33

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221

SEP 15 2000

MEMORANDUM FOR COMMANDERS, INVENTORY CONTROL POINTS
DIRECTOR, DEFENSE ENERGY SUPPORT CENTER
COMMANDER, DEFENSE REUTILIZATION AND MARKETING SERVICE
COMMANDER, TELEVISION-AUDIO SUPPORT ACTIVITY
DIRECTOR, DOCUMENT AUTOMATION AND PRODUCTION SERVICE
ADMINISTRATOR, DEFENSE NATIONAL STOCKPILE CENTER
DIRECTOR, DLA SUPPORT SERVICES

SUBJECT: Price Reasonableness Determinations

As a follow-through to risk assessments conducted in 1998, a special Procurement Management Review (PMR) of spare parts pricing was conducted at DLA's three hardware centers during the first part of fiscal year 2000. The risk assessments were determined to be necessary after several DoD Inspector General (DoD IG) audits alleged that some spare parts purchased by DLA were overpriced. The PMR team focused on five categories of potentially overpriced acquisitions at each center: corporate contracts, other long-term "D" contracts, traditional "C" contracts, orders against basic ordering agreements, and simplified acquisitions ("M" and "W" purchase orders). The purpose of the reviews was to assess the overall risk to the Agency of overpricing in each category.

The attachment provides some of the lessons learned from the DoD IG audits and DLA's Special Pricing PMR. Not every lesson is applicable to every contracting activity. Each Commander should ensure that relevant process corrections, adjustments, and training are accomplished to minimize the risk of overpricing. Continuous improvement in the area of contract pricing is critical to meeting the current needs of our customers as well as to our success in shifting to commercial practices.

My staff is available to assist you in any aspect of contract pricing. Please contact Mr. Robert Morrison, (703) 767-3778, DSN 427-3778, or email robert_morrison@hq.dla.mil if you need any assistance.

William J. Kenny
WILLIAM J. KENNY
Executive Director
Logistics Policy and Acquisition Management

Attachment



ATTACHMENT
LESSONS LEARNED ON PRICING

1. **Contract Execution.** One Inspector General (IG) report substantiated that DLA paid commercial prices to a contractor for spare parts where the costs for the contractor to manage, stock, and deliver items directly to the users were contained in the item prices. Buyers subsequently purchased those items for inventory and applied their full cost recovery rates to manage, stock, and delivery those items to their customers, thus duplicating costs. The same corporate contract was established to procure only ¹sole source items from the contractor. However, during contract execution, competitive items were included that could have been procured from the actual manufacturers at lower prices. Contracting personnel need to exercise care to ensure that only those items intended for the acquisition are included in the contract, and that direct vendor delivery prices are not used to purchase material for inventory.
2. **Catalog Prices.** Another IG report substantiated that DLA buyers were documenting prices as "fair and reasonable" based on the fact that the price was a certain percentage lower than the commercial catalog price. Catalog prices are not necessarily "fair and reasonable" and a "percentage below catalog price" cannot be the sole determinant of "fair and reasonable" regardless of whether the catalog is "commercial."
3. **Historical Prices.** For purchases exceeding the micro-purchase threshold, DLAD 13.106-2(d)(iii) requires contracting personnel to "address the comparability to prior prices (emphasis added) paid for the same or similar items." In addition, FAR 15.404-1(b)(2)(ii) identifies this requirement as one of the various price analysis techniques available to contracting personnel which they may use to determine prices fair and reasonable. Comparison to historical prices paid might indicate that current offered prices are significantly higher, requiring additional analysis to determine the reason for the price escalation. It is often necessary to review more than just the most recent historical price. We saw many examples where there was an unexplained spike at some point in the past that became the basis for every subsequent price paid for the item. Buyers need to review all relevant pricing history and use additional price analysis techniques as necessary.
4. **Competition.** The existence of price competition among vendors is not, in itself, a basis for determining prices fair and reasonable. There needs to be an affirmative determination that the competition has resulted in a fair and reasonable price.
5. **Total Cost vs. Unit Price** – As we shift toward more innovative business practices it is imperative to look beyond the unit price of individual NSNs. "Fair and reasonable" must be determined within the context of the entire business arrangement. Likewise, we must ensure that we are not accepting "commercial" prices as fair and reasonable if they included levels of service that are of no benefit to the Government.
6. **Business Case Analysis (BCA).** Use of the BCA process is helpful in determining the most cost effective method of support. BCAs allow for the methodical identification of the costs and other factors which impact on each alternative. The BCA ensures that every aspect of the business initiative is examined to determine if the proposed initiative is viable and, when implemented properly, produces a sufficient return on investment (ROI). Several prime vendor initiatives have recently been withdrawn after considerable time and effort due to findings in the BCA that indicate insufficient cost savings and ROI. The BCA process was instrumental in averting implementation of several programs that would have ultimately proven too costly.

7. **Breakout Procedures.** The Breakout Program is designed to remove constraints for competitive procurement by researching sole source items to develop fully competitive data packages, find alternate sources, or reverse engineer an item. These efforts ensure that competition on future awards result in reasonable prices. As part of the Breakout Program, one center has partnered with Grumman Data Systems. Grumman builds technical data packages on its sole source items and provides them to DLA for use in future procurements. A byproduct of the Breakout Program is price reductions. Whether developing technical data packages, changing the method of procurement, finding alternate sources, or product improvement techniques, proactive value management efforts can be directly related to price reductions. In situations where contracting personnel have indications that offered prices are questionable, consideration should be given to enlisting the help of the Breakout Program.
8. **Teaming within the Activity.** Achieving fair and reasonable prices depends on the integrated efforts of several functional experts. A buyer's ability to get a good deal is limited by the amount of leverage they have in the marketplace. Commercial specifications, appropriate grouping of requirements, and aligning demand patterns with production schedules are a few of the ways integrated product teams of market analysts, supply analysts, and technicians can place the buyer in a better market position. Once a buyer enters the market for a low demand, sole source item, the ability of even the best negotiator to influence the contract price is negligible. Teaming is also critical in situations where prices offered are significantly out of line with previous award prices or with the Standard Unit Price (SUP). Communications among the functional experts and with the customer are essential to ensure that all alternatives (substitute item; replace next higher assembly; forego requirement; grant local purchase authority, etc.) are considered before paying an exorbitant price.
9. **Teaming with Industry.** The creation of a Strategic Alliance whereby senior company and Government managers partner to establish business rules on how item prices will be derived for future procurements is one example of a teaming arrangement that serves to benefit both contracting parties. The business rules segregate the items into groups such as built-to-order items, catalog items, on-demand items, and replenishment items. When a solicitation is issued, contractors use the business rules to submit their offer, making price analysis easier and more reliable. Rapid Improvement Teams with all stakeholders are typically used to facilitate the Strategic Alliance process.
10. **Reliance on Pricing Experts.** The Special PMR results showed a high correlation between the quality of the price analysis (and subsequent price reasonableness determination) when designated Cost/Price Analysts participated in the procurement. This should not be surprising. However, we found some reluctance to use these pricing experts. For more complex procurements, Cost/Price Analysts should be brought into the procurement process early and allowed adequate time to perform the appropriate analysis. In addition, contracting personnel can benefit from partnering with the Defense Contract Management Agency and the Defense Contract Audit Agency personnel on large dollar value, complex procurements. Their knowledge and understanding of a contractor's cost structure can be instrumental in obtaining a comprehensive business arrangement at fair and reasonable prices.
11. **Management Responsibility.** It is incumbent upon management to place the appropriate emphasis on pricing. We recognized the difficulties associated striking a balance between meeting customer's immediate needs, moving out on innovative business practices, and putting forth the extra effort that is sometimes required to ensure that contract prices are the best the government can obtain. It is especially difficult to issue any kind of effective policy or guidelines

or policy on how much time and effort should be spent pricing contracting actions at various dollar levels. We recommend that (at least the Hardware ICPs) implement a periodic price escalation review process at some level within the organization. For example, each Commodity Business Unit, Product Center, or Application Group could use existing databases to identify the (10,25, or some other number) most significant instances of price increases. The list would be provided to management for review. Contracting officers would be accountable for justifying the contract pricing decision. In most cases the contracting officers are likely to have a sound basis for their pricing decisions. If there were no particularly egregious price increases, management may decide not to review any awards for the period. The awareness that potential overpricing is going to be reviewed systemically is likely to encourage better pricing and documentation in all award files.

- 12. The "25% Increase Rule" and the Common Sense "Evening News" Test.** Defense Federal Acquisition Regulation (FAR) Supplement (DFARS) 217.7504 implements Section 1215 of P.L. 98-94. That site sets forth the "25% Rule" i.e., if the proposed price for spare parts or support equipment exceeds by 25% the lowest price paid by the Government within the most recent 12-month period additional scrutiny is required (for sole source items a written certification to the Head of the Contracting Activity is required). FAR, DFARS, and DLAD Parts 13 and 15 contain additional pricing guidance directed at various contracting situations, including micro-purchases, first-time buys, and buys that kick-out of automated systems for pricing reasons. Collectively, this guidance is designed to reasonably mitigate the risk of overpricing commensurate with the dollar value of the procurements. Each Hardware Center also has automated post award review programs for automated procurements. Refunds are requested when appropriate.

The guidelines and review processes in place are excellent safeguards against the majority of potentially overpriced contracts. However, contracting personnel need to always be aware that there are too many variables to ever construct a set of rules and safeguards to highlight or eliminate all possible overpricing. The contracting officer is always required to use all the tools and training available, along with common sense to preclude any "newsworthy" overpricing. The subjective judgment of the contracting office must take all reasonably knowable information into account, including the value of the procurement and the cost of completing additional analysis (see FAR 13.202(a)(3) for a discussion of micro-purchases).

- 13. Tools.** In less complex acquisitions, performing a price analysis with a pencil or a calculator is sometimes sufficient to allow contracting personnel to determine prices fair and reasonable. However, as we continue to diversify and enter into more complex, high dollar value partnerships with industry, performing a price analysis takes a considerable amount of time and a higher level of pricing skills to complete. It would be difficult to perform price analysis with a calculator on offers with hundreds or thousands of items. Therefore, various automated tools are in place, or are being developed, to assist contracting personnel with performing price analysis on these acquisitions. For example, the Vendor Stock Retention Model can be used to evaluate the benefits of changing an item's method of support from stock to direct vendor delivery. The DLA Headquarters Pricing Web page on the Internet, at <http://www.procregs.hq.dla.mil/Pricing>, contains a list with hyper-links of the various pricing tools available and under development. In addition, the Price-Based Acquisition (PBA) Study Report issued by the Under Secretary of Defense (Acquisition Reform) provides information on other tools available to aid contracting personnel. The Pricing web page will only be successful if field personnel use it, and, provide the feedback and constructive input necessary to allow all DLA personnel to have access to lessons learned, tools, and insights of other filed activities.

14. **Training.** Since most contracting personnel completed the mandatory DAWIA training courses before acquisition reform initiatives were implemented, DLA's *Leveraging the Commercial Marketplace – An Integrated Product Team Approach to Customer Support Course*, and the DoD-sponsored web-based course *Integrating Commercial Business Practices with Government Acquisition Process* are excellent training opportunities available to provide contracting personnel information necessary to excel in our changing environment. Additional training opportunities are listed on the DLA Pricing Home Page noted above. We continue to solicit input from field activities to help identify and meet future training needs.
15. **Sole-Source “Commercial” Item Pricing** – We continue to see evidence that prices for sole-source items, which now meet the definition of “commercial item,” may be increasing without justification. This appears to be happening even in situations where the contracting officers have used all of the appropriate rules and tools to no avail. An integrated process team with Cost/Price Analysts from DLA HQs and the Hardware Centers is being formed to identify and document the extent of this problem.
16. **“Fair and Reasonable” vs. “Best Interest of the Government.”** There will be times when awards must be made at other than fair and reasonable prices. For example, the cost of not having the item (e.g., equipment out of service or a repair line stoppage) does not justify additional efforts to negotiate a better price. Likewise, a price determined to be “fair and reasonable” may not be in the best interest of the Government. For example, \$750 may be a fair and reasonable price for the one-time production of one repair part that cost less than a dollar when it was last purchased many years ago. However, it may not be in the best interest of the Government to make the purchase. In a situation like this the customer and technical specialist should be consulted to determine if the requirement *could be met another way, or foregone in* light of the exorbitant price. Contracting Officers should always look beyond the corners of the contract to determine if an action is in the best interest of the Government.
17. **Documentation.** The best pricing effort in the world will be subject to unnecessary scrutiny if the documentation does not support the contracting officer's decisions. Also, the poorly documented file provides few clues that will be useful to the next contracting officer who pulls that file as point of reference.