

LETTER CONTRACTS AND CHANGE ORDERS,  
USE AND ABUSE

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The Armed Services Procurement Regulation (ASPR) defines a Letter Contract as a "preliminary contractual instrument which authorizes immediate commencement of manufacture." Although it is "preliminary," it is a binding contractual document, but lacks some of the essential elements of substance, all of which would be necessary for a fully definitive contract. These lacking elements are either not available or there has been insufficient time to conclude negotiations and obtain agreement between contractor and Government. Usually a letter contract defines what we want and contains many of the terms and conditions but generally lacks agreement as to price. Letter contracts which are expected to be definitized to a fixed price type frequently contain an absolute ceiling price;—that is, an agreed price that the definitive contract will not exceed. All letter contracts do contain temporary limits (called a limit of authorization) beyond which the Government is not obligated, pending final price agreement.

Now, I would like to describe how and why we use letter contracts. Generally, we use letter contracts to save several months of production lead-time which would be lost in a long term negotiation process. In a letter contract, the Government's requirements and specifications are presented as clearly as possible and most of the normal ASPR standard clauses are incorporated as they would be in a definitive contract. The contractor's most recent price proposal, if received on a fixed price type contract basis, is utilized if possible as the ceiling price for the letter contract. There is very little reason why it should not be so used. The primary justification for use of letter contracts in the past few years has been the increased and urgent need for aircraft and associated equipment, and for all types of surface, subsurface and airborne weaponry where the decision to buy and the availability of funds occur so close to the required delivery dates that normal contract negotiation and processing time cannot be afforded. These late program decisions, funding constraints, and early delivery dates are Government responsibilities, and we are doing what we can to change this.

Immature or incomplete specifications also cause letter contracts. This is especially true when urgency or technological breakthroughs cause the premature transition from the development stage of a weapon system to the production stage. Funding changes, both upward or downward, thus altering the quantity of the product to be delivered also contribute to letter contracts, since a new or revised proposal from the contractor may eat up valuable production leadtime. Further, if funds for a project become available and must be spent immediately or revert to some other purpose, letter contracts have been used, sometimes improperly.

The Armed Services Procurement Regulation specifies that letter contracts are to be used only where interests of national defense demand that the contractor be given a binding commitment so that work may commence immediately.

The use of letter contracts is abused by both Government and contractor. Our program managers have a responsibility to keep their program on schedule. Sometimes, however, it is felt that this sense of urgency or desire to make up for time lost elsewhere overwhelms the also important requirement for sound business practice and a fully priced agreement prior to commencement of work. In some projects, especially those related to efforts supporting Southeast Asia commitments, the use of letter contracts is proper, but some other lower priority programs should not justify them. There is another reason why letter contracts are frequently abused: the inability or perhaps unwillingness of a contractor, especially when in a virtual sole source position, to submit a timely proposal or to participate in meaningful and timely negotiations. It is easily seen that this can sometimes force a letter contract situation.

Why does the Government desire to avoid letter contracts? Primarily, they place the Government in a relatively poor bargaining position and shift the contractual risk heavily to the Government. An unscrupulous contractor can delay submission of his proposal until most of his costs are known. He can also revise or resubmit his proposal alleging changed conditions. Negotiations can be delayed for a number of reasons so that costs can be accumulated and risk is reduced or eliminated. The result, of course, is potential or actual increased cost of the item over what it would have been had a definitive contract been possible at the outset, to say nothing of the increased administrative expense to both parties, in that we have been unable to date to design and harness a suitable incentive for the contractor to control costs during the letter contract period.

Once a letter contract is issued the herculean task of definitization or conversion begins. The most frequent cause for delay in conversion is delay by the contractor in submission of a good proposal. Many times the factor that forced use of a letter contract also prevents timely conversion. Some of these factors are changes in requirements, changes in funding, technical changes, delays in getting subcontractors' proposals, and delays in getting reports from the Defense Contract Audit and Contract Administration agencies or the Navy Plant Representative. Sometimes the conversion of letter contracts is delayed because procurement personnel are forced to process new and other urgent requirements. It remains, however, that the most frequent cause for delay in conversion to a definitive contract is delay by the contractor in submitting a good or final proposal. Delays in conversion can be charged to both the Government and contractors. Regulations

In order to curb the use of letter contracts and to encourage swift definitization, the Department of Defense and the Navy have taken positive action. In the Navy, the use of a letter contract requires the written approval of the Commander of the appropriate Systems Command involve or his Deputy Commander for Purchasing. Considerable checking and re-checking is done to determine the real need for each use. Monthly status reports must be submitted to the Chief of Naval Material by the Systems Commands. These monthly reports include predictions of conversions and explanations as to why these dates are not attained.

We attempt to hold changes so as not to delay negotiations, expedite our audits and reviews, and generally put as much pressure on ourselves as possible toward rapid definitization. Where negotiations are so delayed as to considerably reduce the risk of the contractor when performance approaches completion, an appropriate reduction in profit is expected in the definitized contract. The General Accounting Office has held in certain cases, where a fixed price type definitization is anticipated and production is virtually complete due to delayed negotiation, that the conversion will be to a fixed price contract using a CPFF approach and that a post completion audit be used as a basis for pricing. In one case it was agreed to in the letter contract that failure of the parties to arrive at a final price within a specified reasonable time permits the contracting officer to determine unilaterally a fair and reasonable price as a finding of fact subject to appeal by the contractor under the Disputes Clause. It is the frequent delay by the contractor in proposal submission and in meaningful negotiations that has made this new approach necessary. It has been under discussion by ASPR Committee members for possible adoption as a standard alternate approach. Briefings and presentations are given to the Chief of Naval Material and the Secretary of the Navy to provide them the present position and problems, Navy-wide, regarding letter contracts.

Top level management of letter contracts has paid off. In the past year, the number of letter contracts outstanding in the Navy has dropped from about 275 to about 200 and the total dollar value has dropped from \$2.7 billion to about \$1 billion. While great progress has been made, our work is not complete and our pressures are not diminishing. Letter contracts will still have to be awarded and definitized. A letter contract is a useful device in the contracting officers' tool kit, but must be used with caution and carefully controlled. Industry can help by submitting a complete proposal as soon as possible and by cooperating with the Government in timely negotiations. Our common objective is a fair and reasonable price.

Let us now turn our attention to Change Orders and Constructive Changes. A Change Order is the authorized action of the contracting officer by written order to the contractor at any time during the performance and within the general scope of the contract to comply with unilateral changes in drawings, designs, specifications, or in method of packing and shipping, or place of

delivery. The only way to stop the need for Change Orders completely is to have perfect specifications, an irrevocable decision as to delivery, and a halt in technological advance. We all know these are impossible or undesirable. We will always have Change Orders, and here is why. Inadequate acquisition planning and lack of early, clear definition of the military requirements at contract execution have contributed to increased changes in many of our weapon system acquisitions. Inadequate planning may result, in part, from late definition or changes of requirements, which do not allow sufficient lead time for the proper design and procurement of major components or subsystems or for the orderly preparation of procurement, financial, and interface plans. Late delivery of requirements is the inevitable result, and changes, schedule slippages, and claims become almost inescapable. Another factor impacting the number of contract changes is that of concurrent development and production. Additionally, Change Orders result from the delivery of incomplete, defective or late Government-Furnished-Material or information. Another cause of Change Orders is changes in technology. Because of the relatively long acquisition cycle for many of our weapon systems, we are tempted to incorporate improvements resulting from advances in technology which occur during the acquisition cycle in order to meet changing requirements and weapon threats developed in other countries. These Change Orders may occur at any time during the acquisition process. The disruptive effects of such changes vary greatly depending upon the state of progress at the time the change is incorporated.

We certainly would not desire to do without the majority of these Change Orders. We simply cannot in most complicated weapon systems afford the time necessary to develop a complete and foolproof specification nor would we want to complete the weapon through lengthy development and production without invoking, via changes, the most recent technically important developments. If these changes are a part of our way of life in defense contracting, why are we so concerned about them? We are concerned because these changes generally result in increased costs, sometimes costs which cannot be funded without degradation of some other part of the applicable project or weapon system or some other system, for that matter. The military has been attacked on all sides with accusations ranging from mismanagement to down-right stupidity. Statements on cost overruns in reports by the General Accounting Office, statements in the Congressional Record, reports by the Senate Armed Services Committee, and public commentary in the newspapers and on radio and television have not been favorable. These charges or allegations, sometimes founded and many times unfounded, seriously jeopardize funding and approval for many of our weapon systems, necessary for maintaining the proper level of our National Defense. I would like to discuss "cost overruns" as a side issue for a moment. The term "cost overruns" has about as many meanings as there are people who discuss them. As a contracting officer it means to me the amount in excess of the estimated cost in a cost-plus-fixed-fee contract which the Government may wish to fund

in order to attain completion of the work. A fixed-price contract has no cost- overrun as far as the Government is concerned. If there is one, it is the contractor's problem. These are tight definitions. Other persons in discussing cost overruns mean, in loose terminology, a comparison of

Original defense budget estimate with initial contract price  
Original estimate with final contract price regardless of contract type  
Original contract price with final contract price including all Change Orders

etc. etc. --there are many other comparisons and each person has his own opinion depending upon his knowledge of defense contracting and the atmosphere of discussion.

What is the Navy doing to reduce or otherwise control Change Orders? The Formal Configuration Management Program was established in the hardware systems commands in August 1968. All new contract awards for weapons systems include a contractual requirement for the contractor to establish a formal Configuration Management Program in consonance with the procuring systems command. The organization and procedures of acquisition managers have also been strengthened. In the Navy Ships Systems Command, for instance, the Ship Acquisition Project Managers are required to exercise direct responsibility for approval of changes under their acquisition cognizance. Improvements are also being made in the administration of changes and change proposals. The Chief of Naval Material has directed each systems command to establish a program to speed the evaluation of proposed changes and the definitization of unpriced Change Orders. Quarterly progress reports of undefinitized change actions in specific age categories, will be reported in order to pinpoint adverse trends and to take corrective action as necessary. Working through the Defense Contract Administration Service, efforts are being made to better control GFM. The systems commands and project managers are reinforcing their methods and procedures relating to GFM, particularly in obtaining and disseminating information on GFM transaction and delivery status, shortages, and delays in support of production requirements for large system acquisitions. Better system definition is being achieved through earlier firm determination of requirements, better specifications preparation and review, and the expanded use of full or modified Contract Definition. We are attempting to separate more the development and production phases. We are attempting to bunch our changes into blocks to decrease their number.

Change Orders are abused by both Government and contractor. Change Orders are relied upon by contracting too early, and completing by Change Order what should have originally been included in the contract. Change Orders once issued are little different than letter contracts. The Government is in a poor bargaining position and the contractor abuses his rights in the situation by delaying submission of his proposal for definitization of the Change

Order or by repeatedly revising his proposal and delaying negotiation as cost experience is gained. There is evidence that contractors have withheld the inclusion of technical advances from original contract negotiations for later submission as Engineering Change Proposals, knowing that price increases can be negotiated for these necessary improvements.

Finally, I would like to take a minute to mention a special type of change which is causing the Navy headaches—the Constructive Change. This type change can be defined as any conduct by a Government representative which is not a formal Change Order, but which has the effect of requiring the contractor to perform work different from that prescribed by the original terms of the contract. An example could be an item built in strict accordance with military specifications, which, when tested, won't work. In an attempt to correct the deficiency or incomplete specification, the Government, and usually an inspector or technician, may experiment with changes in design or take other action to change the specifications. If these actions have the effect of disrupting or delaying production, the contractor is entitled to relief for the increased costs of performance. Obviously, it is dangerous for a contractor to accept or make a change without a written Change Order signed by the Administering or Procuring Contracting Officer. They can result in deterioration of Government/Contractor relations and result in at least added legal costs and delays in reimbursement, if any, for the contractor while his claims are in litigation.

In summary, letter contracts, in many cases, are useful as a contractual instrument. The contractor can save dollars for both himself and the Government by submitting complete and prompt proposals and by cooperating in prompt negotiations. We must learn to live with Change Orders, but understand that they are costly and bothersome to both the Government and the contractor if abused.

The Navy appreciates your fine cooperation and outstanding technical capability in supplying our weapon systems and training devices.