Ch 7 - Account for Differences

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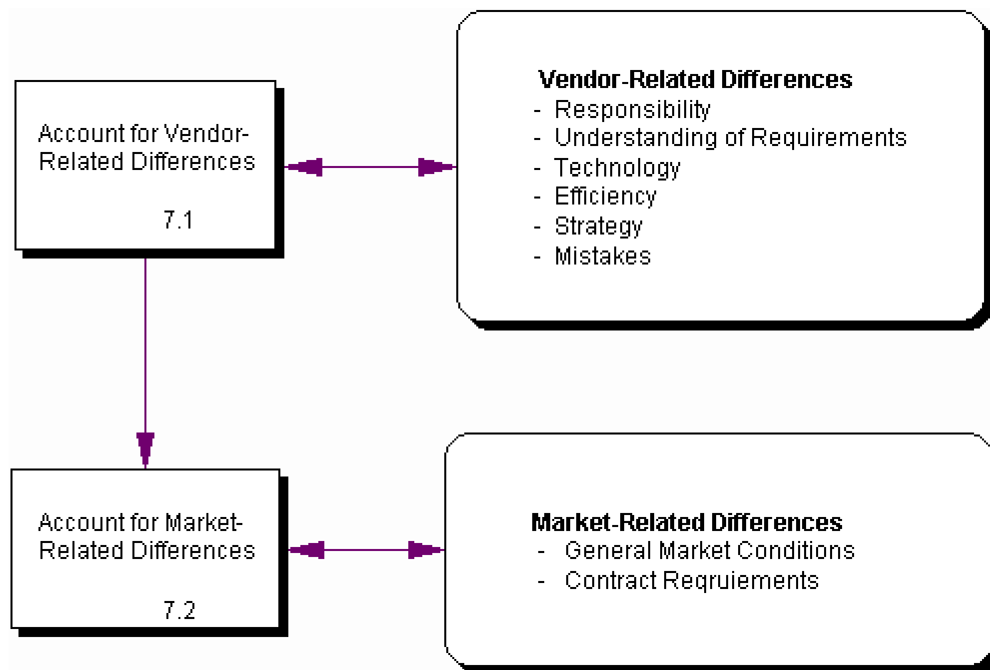
7.0 Chapter Introduction

Identification and Accounting Process. The figure below depicts the process involved in identifying and accounting for differences between the offered price and the should-pay price.



When to Account for Differences. Your price analysis should compare the offered price with available estimates

of a reasonable price -- should-pay price estimates. The offered price may not be the same as any single should-pay price estimate. However, the offered price should fall within the range of should-pay estimates.

If the apparent successful offer is substantially above or below your best should-pay price estimate(s), you should attempt to account for differences. Remember that performance risk associated with a firm fixed-price that is too low may be as unacceptable as a price that is too high. In cost-reimbursement contracting, an unreasonably low cost estimate may result in a substantially higher final price, because the Government must reimburse all allowable costs.

Accounting for Differences. Accounting for differences between offered prices and should-pay estimate(s) should be part of your continuing market research during the contracting process.

You should attempt to collect additional information about the apparent successful offeror or the market in general that will account for apparent differences between an offered price and should-pay price estimate(s). Then consider your findings as you make the price-related decisions identified in the next two chapters.

Based on your findings, you might eventually determine that:

- The price of the apparent successful offer is reasonable despite the identified differences;
- The price of the apparent successful offer is unreasonable;
- The differences result from problems with the solicitation or other mistakes that require solicitation cancellation; or
- Some other course of action is appropriate.

7.1 Identifying Vendor-Related Differences

Introduction. In this section, you will learn the most common vendor-related reasons for differences between the low offer, other offers, and various estimates of reasonable prices.

- 7.1.1 - Responsibility
- 7.1.2 - Understanding Of Requirements
- 7.1.3 - Technology
- 7.1.4 - Efficiency
- 7.1.5 - Strategy
- 7.1.6 - Mistakes

Vendor-Related Differences. Vendor differences are circumstances that result primarily from the action or inaction of an individual firm. Buyers often look at a source list as a homogenous group of firms. However, individual firms have personalities, just like people do, with different needs and wants. These differences manifest themselves in the prices offered, as well as in the way each firm will perform any contract awarded.

7.1.1 Responsibility

Price Analysis and Offeror Responsibility (FAR 9.103(c)). There may be a direct connection between the apparent successful offer and the firm's ability to perform. The firm's price may be very attractive because the firm does not understand the contract requirements, or because it does not have the required investment in technology and equipment to perform the contract.

Always remember that a contractor who cannot perform is never a good deal at any price. In the words of the FAR:

> The award of a contract to a supplier based on lowest evaluated price alone can be false economy if there is subsequent default, late deliveries, or other unsatisfactory performance resulting in additional contractual or administrative costs. While it is important that Government purchases be made at the lowest price, this does not require an award to a supplier solely because that supplier submits the lowest offer. A prospective contractor must affirmatively demonstrate its responsibility...

Hence, if the low offer is significantly lower than other offers or your estimate of the should-pay price, the burden is on the offeror to affirm its ability to perform

at that price. In sealed bidding, a "mistake in bid" procedure has been established in part to provide you with an opportunity to verify that a bidder can perform at a price that is greatly out of line with other bids. In negotiated procurements, you can directly ask the offeror to affirm its ability to perform at the proposed price during discussions.

Effect on Contract Pricing. You cannot make a determination of price reasonableness based on a price comparison with an offer that is technically unacceptable or an offer submitted by a firm that is not responsible.

7.1.2 Understanding Of Requirements

Introduction. The price offered by a firm represents the firm's **understanding of the contract requirements**. Even with a responsible firm and well-defined contract requirements, misunderstandings and varying interpretations are possible.

Misunderstandings. Misunderstandings are particularly likely when the solicitation contains unusual requirements that are different from what the offerors typically see in solicitations for similar requirements. The unusual requirement could be the inclusion of unique requirements or a change in requirements since the last similar contract. For example, there could be a change from a Federal Specification to a commercial purchase description for an item. Some firms may not recognize the change and continue to price based on the superseded Federal Specification. Others will recognize the change and price based on the actual solicitation requirements.

Varying Interpretations. Varying interpretations are particularly likely to occur in situations where performance requirements are used. For example, remember the "8-ounce coffee container" requirement. One offeror could interpret the requirement to mean "provide an 8-ounce ceramic mug." Another could interpret it to mean "provide an 8-ounce paper cup."

Effect on Contract Pricing. The effect of either misunderstandings or varying interpretations of specification requirements may be wide differences in

prices. Not only will prices be different from each other, they may also be different from other comparison bases used for price analysis.

- **Misunderstandings.** A firm that does not understand that the solicitation requirements have changed will offer a price based on its expectations about the contract requirements. In the example above, a firm that continued to price based on the Federal Specification will likely offer a higher price than a firm that did identify the change to a commercial specifications.
- **Varying Interpretations.** A firm that devises a more costly solution to meet the requirements of a performance specification will normally offer a higher price than a firm with a less expensive solution. In the example above, the paper cup will be substantially cheaper than the ceramic mug. However, the reasonableness of the price of the paper cup cannot be based on a competitive price comparison with the price of a ceramic mug. Comparisons with other bases for price analysis may also be complicated by similar differences in interpretation of the specification.

7.1.3 Technology

Introduction. Pricing differences may involve technology in differences related to:

- Costs associated with special technology requirements; or
- Cost patterns associated with different technologies.

Special Technology Requirements. If an offeror must have a special product or production technology to meet Government requirements, there may be an effect on contract price. Some firms may have the required technology, while others may not.

- **Product Technology.** If the product technology is within a firm's existing capabilities, it will not need to conduct expensive research and development or purchase the technology from other firms.
- **Production Technology.** If a unique production technology, required for contract performance, is

currently available to a firm, it will not need to invest in new plant and equipment to perform the contract. If the technology is not available, investment, or possibly expensive subcontracting, will be required. There may also be schedule delays during the period that the firm is acquiring the new technology. Dealing with the effects of schedule delays may further increase the cost of the contract.

Different Cost Patterns Associated with Different Technologies. Differences in the cost patterns associated with different production technologies can also affect contract price. Firms can produce the same product with different types of equipment and different related costs. One firm may use a labor-intensive method of production, and, as a result, have a low fixed cost of production. Another firm might have an automated facility with high fixed costs of production and high set-up costs. For small quantities, the labor intensive firm will have the lower cost per unit. For large quantities, the automated firm will have the lower cost per unit because the fixed costs of production are spread over more units.

Effect on Contract Pricing. Technology can have a substantial effect on the prices offered by different firms:

- **Special Technology Requirements.** If costs are increased by the need to acquire a special product or production technology, prices are likely to increase because of the increased costs. If the required investment in technology has application to other products produced by the firm, the costs may be shared. If the technology requirements are unique, the costs will have to be charged to a single product.

If only one firm has access to the necessary technology, that firm may have a lock on the competition. If that happens, prices may be held at an artificially high level and expected price reductions from continuing production may not occur.

- **Different Technology Cost Patterns.** Differences in production technology may produce prices that are substantially different from what would be expected

from analysis of historical prices for substantially different quantities. For smaller quantities, the labor intensive firms may have a competitive advantage. For larger quantities, the automated firm may have a competitive advantage.

7.1.4 Efficiency

Introduction. Firms with exactly the same equipment and technology can have substantially different cost structures, even when they are producing exactly the same products.

Efficiency Differences. The differences in cost structures result from operating at different levels of efficiency. Measures of efficiency examine the input, labor, materials, and equipment, required to obtain a given level of output. When compared with less efficient firms, more efficient firms can produce the same amount of product with less input, or more output with the same amount of input.

The difference lies mainly in the organization and operation of the firm's management. Concepts like total quality management have been developed to identify areas of operation that do not add value. The objective is to eliminate non-value-added effort and increase efficiency.

Effect on Contract Pricing. As stated above, efficiency is a comparison of input and output. When you examine a firm's efficiency in producing a product, the comparison is normally made in terms of dollars per unit of output. More efficient firms can produce a product at a lower cost than less efficient competitors. A firm that is substantially more efficient than its competitors can produce a unit of a product at a substantially lower cost. If the firm can produce at a substantially lower cost, it can sell for less and still make a greater profit than its competitors.

7.1.5 Strategy

Introduction. Most firms have the same general pricing objectives, to:

- Cover costs; and
- Contribute to attaining corporate operational objectives.

However, different firms have different pricing strategies. And pricing strategies within a single firm can change with changes in the product and the market situation.

Strategies. Some offerors pursue **cost-based pricing strategies** and others pursue **market-based pricing strategies**. A single firm may follow different pricing strategies in different acquisition situations. Three cost-based and seven market-based pricing strategies are described in detail in the text Introduction.

Effect on Contract Pricing. Firms pursuing different pricing strategies may offer different prices, even when they have essentially the same production costs. As a result, you should consider differences between these strategies as you analyze price differences.

Be particularly careful if you believe that the apparent successful offeror's pricing strategy involves pricing the contract below cost. The Comptroller General has repeatedly dismissed protests against alleged below-cost, buy-in offers. In one case, the Comptroller General noted that a "bidder, for various reasons, in its business judgment may decide to submit a below-cost bid; such a bid is not invalid. ... Whether the awardee can perform the contract at the price offered is a matter of responsibility." (See Diemaster Tool, Inc., CGEN B-238877, April 5, 1990 and Tech. Appl., Inc., CGEN B-238259, May 4, 1990.)

Hence, when confronted with what appears to be a buy-in price, your challenge is to determine whether the price represents an unacceptable performance risk (i.e., to judge the degree of risk by calculating the extent to which the proposed price falls short of the amount the agency believes is required to perform as proposed).

7.1.6 Mistakes

Introduction. Like individuals, businesses, even major corporations, are not perfect, and can make mistakes.

Types of Mistakes. You have already considered one form of mistake as part of your consideration of offeror understanding of the Government requirement. In pricing, you may also see mistakes that involve simple mathematical errors. The more complex the task, the more opportunity there is for error.

Mathematical mistakes may occur, even when prices are prepared by computer. Computers only do what they are programmed to do. If the programming is incorrect, the answer will also be incorrect.

Effect on Contract Pricing. Even a simple mathematical error can have a significant effect on contract pricing. Pricing is usually the last step in offer development. In the pressure to submit the offer, the mistake may be missed by the offeror's review process.

For example: A construction task requires remodeling of 20 identical buildings. The bidder estimates the price for one building and multiplies the price by 2 instead of 20. The bid price is one-tenth what the estimator meant it to be.

7.2 Identifying Market-Related Differences

Introduction. In this section, you will learn about the most common market-related reasons for differences between the low offer, other offers, and various estimates of reasonable prices.

- 7.2.1 - General Market Conditions
- 7.2.2 - Contract Requirements

Market-Related Differences. Market-related differences are circumstances that are beyond the control of an individual firm and that affect all firms, but not always in the same way. Just like vendor differences, market differences can also affect price comparisons.

7.2.1 General Market Conditions

Introduction. A general market condition is any factor that affects the general industry conditions under which products are bought and sold.

Differences in General Market Conditions. Consider changes in the contracting situation and in general economic conditions, whenever you are using historical prices as a comparison base for determining price reasonableness.

Three circumstances are worthy of special consideration:

- Changes in the level of competition;
- Limited competition and collusion; and
- Differing economic conditions.

Changes in the Level of Competition. Changes in the level of competition can affect offeror pricing strategies. If competition decreases from historical levels, firms typically will be less concerned about the threat of price competition. If the level of competition increases, firms will be more concerned.

Limited Competition and Collusion. In Government contracting, you normally assume that you have adequate price competition whenever there are two or more sources. However, you must be careful in assuming competition, particularly in situations where there are only two or three firms that can meet Government requirements.

Limited competition encourages collusion. Any agreement or mutual understanding among competing firms that restrains the natural market forces should be considered collusion. The understanding does not have to be the result of an active agreement. It can be a passive understanding that aggressive competition will lower profit margins for all competitors without increasing volume for any single competitor. As long as each firm gets its "fair share" of the business, all the firms can increase profit by not competing aggressively.

You may find it is often difficult to detect collusion and antitrust law violations. Practices or events that may evidence violation of antitrust laws include (FAR 3.303(c)):

- The existence of an "industry price list" or "price agreement" to which contractors refer when formulating offers.
- A sudden change from competitive bidding to identical bidding.
- Simultaneous price increases or follow-the-leader pricing.
- Rotation of offers or proposals, so that each competitor takes a turn in sequence as low offeror, or so that certain competitors submit low offers on some sizes of contracts and high on other sizes.
- Division of the market, so that certain competitors only offer low prices for contracts let by certain agencies, or for contracts in certain geographical areas, or on certain products, and offer high prices on all other contracts.
- Establishment by competitors of a collusive price estimating system.
- The filing of a joint bid by two or more competitors when at least one of the competitors has sufficient technical capability and productive capacity for contract performance.
- Any incidents suggesting direct collusion among competitors, such as the appearance of identical calculation or spelling errors in two or more competitive offers or the submission by one firm of offers for other firms.
- Assertions by the employees, former employees, or competitors of offerors, that an agreement to restrain trade exists.

Differing Economic Conditions. A firm can have a competitive advantage because of the economic conditions in the area in which it operates. Expect production costs to be different in different parts of the country. You may be able to use index numbers to consider the effect that different area costs will have on contract price.

Effect on Contract Pricing (FAR 3.303 (f)). General market conditions can have a substantial effect on prices:

- **Changes in the Level of Competition.** Changes in the level of competition will affect the accuracy of price estimates based on historical prices. As firms become less concerned about competition, prices may be expected to increase faster than national averages. As

firms become more concerned about competition, price increases may be slower than national averages.

- **Limited Competition and Collusion.** Collusion, active or passive, will increase prices. Carefully review any of the practices or events that may indicate evidence of violation of the antitrust law. Some events such as certain competitors being low only for contracts let by certain agencies, or for contracts in certain geographical areas, or on certain products, and high on all other jobs, may have economic explanations other than collusion. If your review confirms collusion, you should report your conclusions to the U.S. Department of Justice.
- **Differing Economic Conditions.** Differences in the area economic conditions can have a significant effect on production costs, including labor rates and material costs. Depressed economic conditions (e.g., high local unemployment rates) in an area can lower costs. Depressed sales can make suppliers more willing to cut prices to make a sale. Lower labor and material costs will permit a firm to produce a product more cheaply than its competitors operating in areas with better general economic conditions.

7.2.2 Contract Requirements

Introduction. Contract requirements include more than just product requirements. They include any element of the solicitation or contract that defines what the contractor must do to complete the contract successfully. Changes in requirements and defective requirements can both affect price analysis comparisons.

Defective Requirements. The different elements of the solicitation/contract are termed defective when they do not adequately describe contract requirements. A contract should define, **who, what, when, where, and how** for any task that must be performed under the contract. If the contract is not clear, or the requirements are open to interpretation, widely different interpretations may result. If contract terms conflict, the contract may be impossible to perform.

Changes in Contract Requirements. Changes in contract terms can be particularly important when you use historical

prices as a comparison base to determine price reasonableness. Changes in type of contract, f.o.b. point, delivery requirements, quantities, and other terms can affect the contractor's cost and risk.

Effect on Contract Pricing. Contract requirements have a substantial effect on contract pricing:

- **Defective Requirements.** If requirements are unclear or conflict, firms may attempt to guess what the Government really wants. Some may underestimate, and others may overestimate actual requirements. The result may be a wide range of prices, depending on the interpretation of the individual offeror.

Some firms may even attempt to "game" the offer by assuming the lowest requirement possible in the belief that a contract change will be required to correct the conflict. Remember, judges normally interpret disputes over contract ambiguities and conflicts against the writer of the contract. In Government contracting, the Government writes the contract.

- **Requirements Changes.** Any element that will affect contractor cost or risk will also affect contract price. Changes from historical contract terms that increase cost or risk should increase price. Changes from historical terms that decrease cost or risk should decrease contract price.