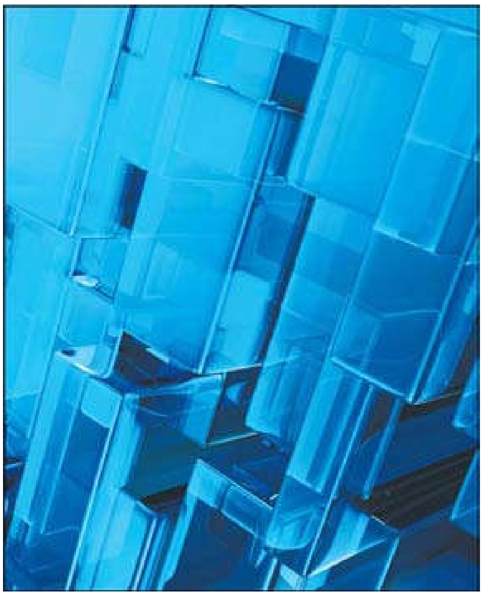


Telestar International

On November 15, 1998, the Department of Energy Resources awarded Telestar a $475,000 contract for the developing and testing of two waste treatment plants. Telestar had spent the better part of the last two years developing waste treatment technology under its own R&D activities. This new contract would give Telestar the opportunity to "break into a new field"—that of waste treatment.

The contract was negotiated at a firm-fixed price. Any cost overruns would have to be incurred by Telestar. The original bid was priced out at $847,000. Telestar's management, however, wanted to win this one. The decision was made that Telestar would "buy in" at $475,000 so that they could at least get their foot into the new marketplace.

The original estimate of $847,000 was very "rough" because Telestar did not have any good man-hour standards, in the area of waste treatment, on which to base their man-hour projections. Corporate management was willing to spend up to $400,000 of their own funds in order to compensate the bid of $475,000.

By February 15, 1999, costs were increasing to such a point where overrun would be occurring well ahead of schedule. Anticipated costs to completion were now $943,000. The project manager decided to stop all activities in certain functional departments, one of which was structural analysis. The manager of the structural analysis department strongly opposed the closing out of the work order prior to the testing of the first plant's high-pressure pneumatic and electrical systems.

Structures manager: "You're running a risk if you close out this work order. How will you know if the hardware can withstand the stresses that will be imposed during the test? After all, the test is scheduled for next month and I can probably finish the analysis by then."

Project manager: "I understand your concern, but I cannot risk a cost overrun. My boss expects me to do the work within cost. The plant design is similar to one that we have tested before, without any structural problems being detected. On this basis I consider your analysis unnecessary."

Structures manager: "Just because two plants are similar does not mean that they will be identical in performance. There can be major structural deficiencies."

Project manager: "I guess the risk is mine."

Structures manager: "Yes, but I get concerned when a failure can reflect on the integrity of my department. You know, we're performing on schedule and within the time and money budgeted. You're setting a bad example by cutting off our budget without any real justification."

Project manager: "I understand your concern, but we must pull out all the stops when overrun costs are inevitable."

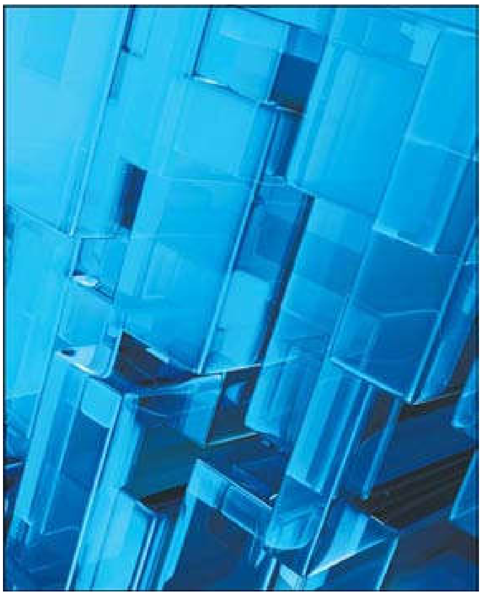
Structures manager: "There's no question in my mind that this analysis should be completed. However, I'm not going to complete it on my overhead budget. I'll reassign my people tomorrow. Incidentally, you had better be careful; my people are not very happy to work for a project that can be canceled immediately. I may have trouble getting volunteers next time."

Project manager: "Well, I'm sure you'll be able to adequately handle any future work. I'll report to my boss that I have issued a work stoppage order to your department."

During the next month's test, the plant exploded. Postanalysis indicated that the failure was due to a structural deficiency.

QUESTIONS

1. Who is at fault?
2. Should the structures manager have been dedicated enough to continue the work on his own?
3. Can a functional manager, who considers his organization as strictly support, still be dedicated to total project success?



Is It Fraud?[1]

BACKGROUND

Paul was a project management consultant and often helped the Judge Advocate General's Office (JAG) by acting as an expert witness in lawsuits filed by the U.S. government against defense contractors. While most lawsuits were based upon unacceptable performance by the contractors, this lawsuit was different; it was based upon supposedly superior performance.

MEETING WITH COLONEL JENSEN

Paul sat in the office of Army Colonel Jensen listening to the colonel's description of the history behind this contract. Colonel Jensen stated:

> We have been working with the Welton Company for almost ten years. This contract was one of several contracts we have had with them over the years. It was a one year contract to produce 1500 units for the Department of the Navy. Welton told us during contract negotiations that they needed two quarters to develop their manufacturing plans and conduct procurement. They would then ship the Navy 750 units at the end of the third quarter and the

remaining 750 units at the end of the fourth quarter. On some other contracts, manufacturing planning and procurement was done in less than one quarter.

On other contracts similar to this one, the Navy would negotiate a firm-fixed-price contract because the risk to both the buyer and seller was quite low. The Government's proposal statement of work also stated that this would be a firm-fixed-price contract. But during final contract negotiations, Welton became adamant in wanting this contract to be an incentive-type contract with a bonus for coming in under budget and/or ahead of schedule.

We were somewhat perplexed about why they wanted an incentive contract. Current economic conditions in the United States were poor during the time we did the bidding and companies like Welton were struggling to get government contracts and keep their people employed. Under these conditions, we believed that they would want to take as long as possible to finish the contract just to keep their people working.

Their request for an incentive contract made no sense to us, but we reluctantly agreed to it. We often change the type of contract based upon special circumstances. We issued a fixed-price-incentive-fee contract with a special incentive clause for a large bonus should they finish the work early and ship all 1500 units to the Navy. The target cost for the contract, including $10 million in procurement, was $35 million with a sharing ratio of 90%–10% and a profit target of $4 million. The point of total assumption was at a contract price of $43.5 million.

Welton claimed that they finished their procurement and manufacturing plans in the first quarter of the year. They shipped the Navy 750 units at the end of the second quarter and the remaining 750 units at the end of the third quarter. According to their invoices, which we audited, they spent $30 million in labor in the first nine months of the contract and $10 million in procurement. The Government issued them checks totaling $49.5 million. That included $43.5 million plus the incentive bonus of $6 million for early delivery of the units.

The JAG office believes that Welton took advantage of the Department of the Navy when [they] demanded and received a fixed-price-incentive-fee contract. We want you to look over their proposal and what they did on the contract and see if anything looks suspicious.

CONSULTANT'S AUDIT

The first thing that Paul did was to review the final costs on the contract.

Labor:	$30,000.000
Material:	$10,000,000
	$40,000,000
Cost overrun:	$5,000,000
Welton's cost:	$500,000
Final profit:	$3,500,000

Welton completed the contract exactly at the contract price ceiling, also the point of total assumption, of $43.5 million.

The cost overrun of $5 million was entirely in labor. Welton originally expected to do the job in twelve months for $25 million in labor. That amounted to an average monthly labor expenditure of $2,083,333. But Welton actually spent $30 million in labor over nine months, which amounted to an average monthly labor cost of $3,333,333. Welton was spending about $1.25 million more per month than planned for during the first nine months. Welton explained that part of the labor overrun was due to overtime and using more people than anticipated.

It was pretty clear in Paul's mind what Welton had done. Welton overspent the labor by $5 million and only $500,000 of the overrun was paid by Welton because of the sharing ratio. In addition, Welton received a $6 million bonus for early delivery. Simply stated, Welton received $6 million for a $500,000 investment.

Paul knew that believing this to be true was one thing, but being able to prove this in court would require more supporting information. Paul's next step was to read the proposal that Welton submitted. On the bottom of the first page of the proposal was a paragraph entitled "Truth of Negotiations" which stated that everything in the proposal was the truth. The letter was signed by a senior officer at Welton.

Paul then began reading the management section of the proposal. In the management section, Welton bragged about previous contracts almost identical to this one with the Department of the Navy and other government organizations. Welton also stated that most of the people used on this contract had worked on the previous contracts. Paul found other statements in the proposal that implied that the manufacturing plans for this contract were similar to those of other contracts and Paul now wondered why two quarters were needed to develop the manufacturing plans for this project. Paul was now convinced that something was wrong.

QUESTIONS

1. What information does Paul have to support his belief that something is wrong?
2. Knowing that you are not an attorney, does it appear from a project management perspective that sufficient information exists for a possible lawsuit to recover all or part of the incentive bonus for early delivery?
3. How do you think this case study ended? (It is a factual case and the author was the consultant.)