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APPROVED FOR RELEASE  
DATE: MAR 2002

5 June 1956

MEMORANDUM FOR: Director of Central Intelligence

SUBJECT: Contracts - Project AQUATONE

1. This memorandum is for your information.
2. The first phase of our procurement activities under Project AQUATONE is in concrete form and all the contracts are sufficiently developed to allow an appraisal. It appears appropriate to review the situation at this time when the Air Force plans an additional procurement phase of the equipment, particularly from our prime contractor, the Lockheed Aircraft Corporation. To this point the procurement has been joint in nature. The CIA has signed the contracts and has provided the funds for the major procurement items; the Air Force is providing certain Government-furnished equipment and is procuring certain other items which it is in a better position to develop and procure.
3. In considering this joint procurement, it should be kept in mind that the CIA is authorized to exercise the authorities contained in the Armed Services Procurement Act of 1947, including Section 10 thereof. Section 10 is specifically designed to facilitate procurement of supplies and equipment by one agency for another, and the joint procurement of supplies and services required by the agencies. It provides for such assignments and delegations of procurement responsibilities within the Agency as may be desirable and the assignment and delegations of procurement responsibilities from one agency to another or the creation of joint or combined offices to exercise the procurement responsibilities. The procurement program for Project AQUATONE, therefore, is clearly within the contemplation of Section 10 of the Armed Services Procurement Act of 1947.
4. In general, the various contracts let under Project AQUATONE follow normal Government procurement standards although they may differ as to type. In certain instances security or the urgency involved has required alteration of procedures or waivers of certain specific limitations. Insofar as the security precautions are concerned, we

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rely on Section 10(b) of the CIA Act of 1949 in order to have some of the contracts appear either Agency sterile or Government sterile and to issue payments in a secure manner. It is probable that the Air Force does not have the legal authority to achieve such cover arrangements in precisely the same way, although commercial cover has been achieved by the Department of Defense through other devices. On the waiver of limitations, however, we have had little occasion to issue any substantive waivers or exercise unusual authorities which were not available to the Air Force under its own authorities. Consequently, the procurement by the CIA has, to date, been basically no different from that which could be accomplished by the Air Force. A potential difference, however, arises from the fact that we can waive any and all limitations in the event Project security or other considerations requires us to do this, whereas the Air Force could be limited in what can be done in this regard.

5. Consideration was given to the Air Force undertaking this procurement and the following facts were ascertained. A similar proposal from the corporation had previously been rejected by the Air Research and Development Command. The processing in the Air Force under the proposal known as CL 282 had gone on for six to nine months before rejection. If the present proposal in which the CIA had an interest were to be sponsored by the Air Force, it would have to be referred back again to the ARDC for full justification which would of necessity include the CIA's interest. If approved by ARDC it would then have to go through the Air Materiel Command with full coordination under all the Air Force rules and procedures. Only after that could negotiations on the contract itself be instigated. No estimate of the time involved could be made, except that it would be a long drawn out procedure and that necessarily during this procedure a considerable number of offices and individuals would get at least an indication of the purposes for which the procurement was aimed. With time a vital factor and absolute security indispensable, the Air Force channel of procurement was patently impossible.

6. In the opinion of the Air Force officers and officials concerned, there was no method by which the Air Force could short cut this procedure without raising as many questions as might be raised by going through the full coordination process. On the other hand, the CIA from the procurement standpoint alone could enter into the transaction almost

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instantly upon approval by the Director, and it would be necessary to inform only a handful of people outside of those who would know the substantive nature of the Project in any case. Not only would there be far closer security, but also there would be much greater flexibility, which is essential in view of the unknowns to be encountered and the extreme urgency in solving them. It was unanimously agreed, therefore, that the CIA should handle the contracts and funds in an amount estimated to cover the 1955 Fiscal Year needs were allocated. This was approved by the Bureau of the Budget.

7. From the outset it was apparent that if the CIA were to execute the contract, it would have to be some form of a redeterminable fixed-price contract. Fixed-price contracts have the advantage of (i) simpler administration, (ii) minimum of time-consuming delays, (iii) less complex audit procedures, (iv) more responsibility on the Contractor, and (v) generally greater flexibility to cope with unusual conditions which this type of procurement would involve. Security problems, likewise, are simplified. I, therefore, entered into negotiations with Mr. Johnson, the Lockheed Project Engineer, on the basis of a fixed-price arrangement. He set forth a proposal in which the price was stated to be [redacted]. At this time we had the information from the Air Force that the similar proposal, previously considered by ARDC as CL-282, had been estimated to involve [redacted]. I stated that due to the uncertainty on costs we should probably have some redetermination provision and asked Mr. Johnson if the [redacted] were an outside figure. He asserted that it was, and accordingly I prepared a letter contract which obligated the amount of [redacted]. We then began negotiation for a definitive contract with Lockheed, and their Contracting Officer, Mr. Bias, told me that when Mr. Johnson mentioned the figure of [redacted] to the Corporation Comptroller and that there would be a price-redetermination clause, the Comptroller had deemed it prudent to ask for provision for price redetermination upwards from [redacted]. I stated that the Agency did not have additional funds to obligate for this purpose at this time, but that if the need arose they could be made available and I would commit the Agency to an upward and downward price redetermination with the profit factor varying inversely with any increase in cost. This was further discussed with Mr. Johnson, who indicated that he had considerable confidence in his estimate of [redacted] as an outside figure, but that there were obviously some unpredictable items. I undertook to point out to Mr. Johnson the method by which we planned

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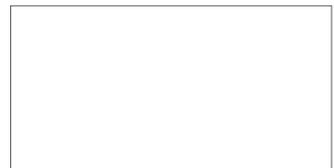
to operate, including direct negotiation, elimination of detailed and current audit procedures, and over-all simplification of contract procedures, all of which I felt would allow Lockheed to make savings not normally available. Mr. Johnson agreed that this should not only expedite production but also should lead to savings on his estimate, although he was careful to point out that wage rates would be somewhat above normal as they would be utilizing the cream of the Lockheed employees for this Project. The definitive contract was, therefore, negotiated on the [ ] price with negotiation upwards if cost experience justified; unlimited downwards. No price profit factor was established although we indicated to Messrs. Bias and Johnson that at [ ] we could not go over the average profit factor on Government contracts, which appeared to be in the neighborhood of 9-1/2% unless substantial savings through economy and efficiency were achieved and that contrariwise, if the expenditures ran over [ ] we would propose that the profit factor would be reduced.

8. It is important to keep in mind that in the prime contract as well as the others executed by this Agency for Project AQUATONE, the responsibility for performance was put on the Contractor. By performance here is meant more than the actual flight performance of the plane. It is the performance of the whole system with all its interrelated parts, so that the responsibility was not only for a machine which flew at a certain height for a certain distance at a certain speed but also to assure that the flight performance was capable of sustaining the camera, communications, navigation, and other necessary equipment. In normal Air Force procurement, each part and all materiel must meet rigid Air Force specifications and inspection so that as the product comes off the line its performance is largely the result of the Air Force's supervision. Under our Contract No. SP-1913, the contractor was aware of the performance which was required and it is his responsibility to produce this performance in such manner as he deems most effective and efficient. Lockheed, therefore, worked directly with Perkin-Elmer, Hycon, Ramo-Wooldridge, and the rest as a member of a team to evolve a complete and balanced system. In the event of disputes or the need for policy determinations, Lockheed could turn to one place to provide the answers instead of having each aspect staffed through separate staff components as in the Air Force. In certain instances modifications have been required for the Government's purposes over

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and above the original specifications, which will add to costs otherwise contemplated, but these have been or will be reflected in change orders so that the basic concept of SP-1913 is not affected.

9. In considering the circumstances under which SP-1913 was negotiated, it appears that the definitive contract is advantageous both to the Contractor and to the Government. To the Contractor it gave the greatest possible freedom from inspection and supervision while, of course, throwing upon him responsibility for results. Since the contract with the CIA is small for this particular corporation, the incentive is to produce results which would then be attractive to the Air Force and larger procurement. This places a premium on efficiency and performance. From the Government's viewpoint, the price redetermination procedure with provision for upward redetermination tends to eliminate those contingencies which the corporation would put into a fixed-price contract on a new production item. Furthermore, the profit percentage-wise and dollarwise will go up as the Government's expenses are reduced; on the other hand the percentage will go down and perhaps the dollar amount too if the cost to the Government goes up. As of March 25, 1956, the Contractor is ahead of schedule and actual expenditures are some [redacted] under what it was anticipated expenditures would be as of this date. However some [redacted] additional work has been added since inception of the contract. This means that the original work, plus that which has been added by change orders, will still be accomplished under the original contract price, with some residue, provided that no unusual costs are encountered during the next six or seven months.

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10. Due to the Contractor's long years of experience with Government contracts, the negotiation on the price redetermination is not inordinately difficult since all cost factors are well established, including such items as overhead allocations. This is bolstered by the fact that the contract provides for inspection and audit of the books and records of the corporation at any time and arrangements are now being made to have the Air Force audit the contract on a secure basis and in accordance with procedures familiar to Lockheed and to the Air Force. Consequently, the contract has the usual benefits and ease of administration and performance of a fixed-price contract with the further benefit to the Government of recovering any contract funds not actually expended for the contract work, by virtue of the redetermination factor. This, of course, is feasible only where a company has had such an extensive course of dealings with the Government that cost elements are well

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settled and both parties are thoroughly familiar with Government procurement practices. Negotiation of the final fee or profit (as a percentage or as a lump sum) is the only area in which difficulties may arise.

11. In connection with procurement which the CIA is undertaking as agent for the Air Force through Contract SP-1914; generally the same practices and procedures are being followed as applied to SP-1913. Since the CIA is, however, the agent of the Air Force, a detailed agreement outlining this agency has been executed between the Agency and the Air Force. In this the Air Force clearly undertakes responsibility for requirements and specifications and for inspection and acceptance and the Central Intelligence Agency performs the contractual functions and administers the contract and any changes thereto, in accordance with the written request of the Air Force. Present known requirements of the Air Force indicate that some 20 to 30 contracts on behalf of the Air Force will have to be processed by us under this arrangement.

12. In the foregoing we have discussed in considerable detail SP-1913, both because it is the major and basic contract and because of all the contracts it is the only one in which there was a departure from normal Government procurement practices as opposed to procedures. Even on that point, which involved the implied commitment of additional funds over and above the immediate obligation of funds, the same result could be achieved by other devices available to armed services procurement agencies. Other contracts with Perkin-Elmer, Hycon, and Westinghouse, etc., are all similar to SP-1913 in the procurement methods utilized and, again, probably are all within the legal authority of the Air Force to procure in this manner. The contract with Ramo-Wooldridge is in all substantive aspects the same as the Air Force would write—a standard cost-plus-a-fixed-fee contract. It is interesting to note that in the so-called unusual type contracts written to date (Lockheed, Perkin-Elmer, Westinghouse, etc.) which provide for upward redetermination of price, no such request for additional funds has been made as yet, and will not, in all probability be made. However the CPFF standard contract has increased considerably in cost over that originally budgeted. This indicates only that it is the nature of the work that determines the ultimate cost to the Government rather than the method of contracting. The administration of the contracts has not followed the normal service practices, as for security reasons it was

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decided to limit the number of contract officers to the minimum, and the large staffs which normally review contracts in varying aspects were here reduced to one small staff. Within these limitations, however, the administration has been meticulous with particular attention to change orders. All contracts and all changes thereto have been reviewed by the General Counsel or his Deputy and specific approvals on policy or fiscal matters have been obtained from the appropriate approving officers in all cases. Again, granting that this system may work only when dealing with companies which are themselves competent in the running of their business and are familiar with Government procurement, under the circumstances surrounding this Project, we believe the procurement system involved adequately protected the Government, was effective in meeting procurement needs, and through its efficiency and simplicity was economical for the Government.

(Signed)  
LAWRENCE R. HOUSTON  
General Counsel

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