

February 23, 2006



# Acquisition

## Spare Parts Procurements From TransDigm, Inc. (D-2006-055)

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### **Acronyms**

DLA	Defense Logistics Agency
DSCC	Defense Supply Center, Columbus, Ohio
DSCR	Defense Supply Center, Richmond, Virginia
FAR	Federal Acquisition Regulation
FASA	Federal Acquisition Streamlining Act
GAO	Government Accountability Office
NSN	National Stock Number
OEM	Original Equipment Manufacturer
OIG	Office of Inspector General
TINA	The Truth in Negotiations Act



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

February 23, 2006

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Report on Spare Parts Procurements From TransDigm, Inc.  
(Report No. D-2006-055)

We are providing this report for review and comment. We considered management comments on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Defense Logistics Agency comments were partially responsive. We request additional comments on Recommendation 6 by March 24, 2006. If possible, please send management comments in electronic format (Adobe Acrobat file only) to [joseph.bucsko@dodig.mil](mailto:joseph.bucsko@dodig.mil). Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Henry F. Kleinknecht at (703) 604-9324 (DSN 664-9324) or Mr. Joseph P. Bucsko at (703) 604-9337 (DSN 664-9337). For the report distribution, see Appendix F. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

A handwritten signature in black ink, appearing to read "Richard B. Jolliffe".

Richard B. Jolliffe  
Assistant Inspector General  
Acquisition and Contract Management

### Special Warning

This special version of the report has been revised to omit contractor proprietary data.

## Department of Defense Office of Inspector General

Report No. D-2006-055

February 23, 2006

(Project No. D2004-D000CH-0189.000)

### Spare Parts Procurements From TransDigm, Inc.

#### Executive Summary

**Who Should Read This Report and Why?** Acquisition and contracting personnel within DoD and the Military Departments should read this report because it concerns the rapidly increasing cost of spare parts and its adverse impact on the DoD challenge to maintain a superior level of combat readiness and force structure as well as improve equipment quality and responsiveness. Since the terrorist attacks of September 11, 2001, and with the ongoing operations in Afghanistan and Iraq, demands for spare parts have increased. The procurement of spare parts is essential in assisting war fighters with carrying out their missions.

**Allegation.** This audit was initiated in response to a Defense Hotline allegation that AeroControlex was charging the Defense Logistics Agency excessive prices and using the commercial item definition to avoid the Federal requirement to provide cost or pricing data. Specifically, the complaint involved the procurement of an oil pump assembly housing with a military application to the Air Force F-15 aircraft. The Defense Logistics Agency procured the oil pump assembly from AeroControlex after Honeywell International transferred the intellectual property, design authority, and manufacturing responsibility. The allegation was substantiated; see Appendix C for more details on the allegation and the audit results.

**Background.** AeroControlex, Adams Rite Aerospace, Adel Wiggins, Champion Aerospace, and Marathon Norco Aerospace are subsidiaries of TransDigm, Inc., which was established in July 1993 and is controlled by Warburg Pincus Private Equity VIII L.P. In 2003, TransDigm reported net sales totaling approximately \$293.3 million, of which 72 percent was generated from the commercial sector and 28 percent from the defense sector, with DoD as TransDigm's largest customer.

**Results.** Given the constraints of a sole-source contracting environment, Defense Logistics Agency contracting officers were unable to effectively negotiate prices for spare parts procured from TransDigm subsidiaries. We recognize the difficulty contracting officers have had obtaining cost data since the inception of the Federal Acquisition Streamlining Act of 1994 and Federal Acquisition Reform Act of 1996; however, we believe that cost analysis is the most effective means to validate prices for sole-source spare parts. Using cost analysis, we calculated that the Defense Logistics Agency paid about \$5.3 million or <sup>1</sup> percent more than the fair and reasonable price for 77 parts that cost \$ <sup>1</sup> (based on annual demand). If problems are not addressed, the Defense Logistics Agency will pay about \$31.8 million more than fair and reasonable prices for the same items over the next 6 years. The Defense Logistics Agency also needs to seek a voluntary refund of about \$2.6 million for overpriced parts identified in

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<sup>1</sup> Contractor proprietary data omitted.

the report where contracting officers made a reasonable attempt to obtain cost data but were denied the information. See Appendix D for the amount overpaid for each of the 77 parts and Appendix E for more specific information on recommended voluntary refunds.

We recommend that the Director, Defense Logistics Agency alert contracting officers, when using price analysis of previous Government prices to determine price reasonableness for sole-source spare parts, to perform periodic cost analysis to establish the validity of the comparison and the reasonableness of the previous prices; discontinue using the Navy Price Fighters to perform price analyses similar to the work performed by DLA contracting representatives on spare parts procurements; and emphasize the importance of validating the reasonableness of previous Government prices when using price analysis as a tool to justify fair and reasonable prices. We recommend the Director emphasize the importance of obtaining cost or pricing data and the necessity to provide adequate justifications for waivers to cost or pricing data for sole-source items; seek a voluntary refund of about \$2.6 million for overpriced parts identified in the report; and require the Commanders of the Defense Supply Centers Columbus, Ohio, and Richmond, Virginia, to discontinue using competition between sole-source manufacturers and dealers to determine price reasonableness. We recommend the Director require the Commander, Defense Supply Center Columbus, Ohio to develop procedures and appropriate controls to ensure option year pricing for delivery orders is accurate; and to either establish a strategic supplier alliance with TransDigm subsidiaries using cost data to negotiate fair and reasonable prices or develop and execute a strategy to reengineer and compete high dollar value spare parts. See the Finding section of the report for the detailed audit results and recommendations.

**Management Comments and Audit Response.** We received comments from the Director of Logistics Operations, Defense Logistics Agency on the draft report. The Director generally concurred with the report finding and recommendations. However, management comments did not meet the intent of the recommendation discussing the use of competition between a sole-source manufacturer and dealers to determine price reasonableness.

Therefore, we request that the Director, Defense Logistics Agency provide additional comments on Recommendation 6 by March 24, 2006.

See the Finding section of the report for a discussion of management comments on the recommendations and our audit response. See the Management Comments section of the report for the complete text of comments.

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## Background

During the last 9 years, the DoD Office of Inspector General (OIG) has worked closely with the Defense Logistics Agency (DLA) and other DoD components to achieve fair and reasonable prices for sole-source commercial and noncommercial spare parts. See Appendix B for a list of the prior audit reports. This audit was initiated in response to a Defense Hotline allegation that AeroControlex Group was charging the Government excessive prices and avoiding the Federal requirement to submit cost or pricing data by declaring that items were commercial. The Defense Hotline complaint involved an oil pump assembly housing procured for the first time since Honeywell International transferred the intellectual property, design authority, and manufacturing responsibility to AeroControlex. See Appendix C for the allegation and audit results.

**Honeywell Product Line Licensing Agreement.** During 2001, AeroControlex reached a series of agreements with Honeywell International that granted AeroControlex an exclusive worldwide license to produce and sell products comprising Honeywell's lubrication and scavenge pump product line for a minimum of 40 years. From these agreements, AeroControlex also acquired \$5.9 million of related inventory<sup>1</sup>. Figure 1 shows a lubrication and scavenge pump supplied by AeroControlex.

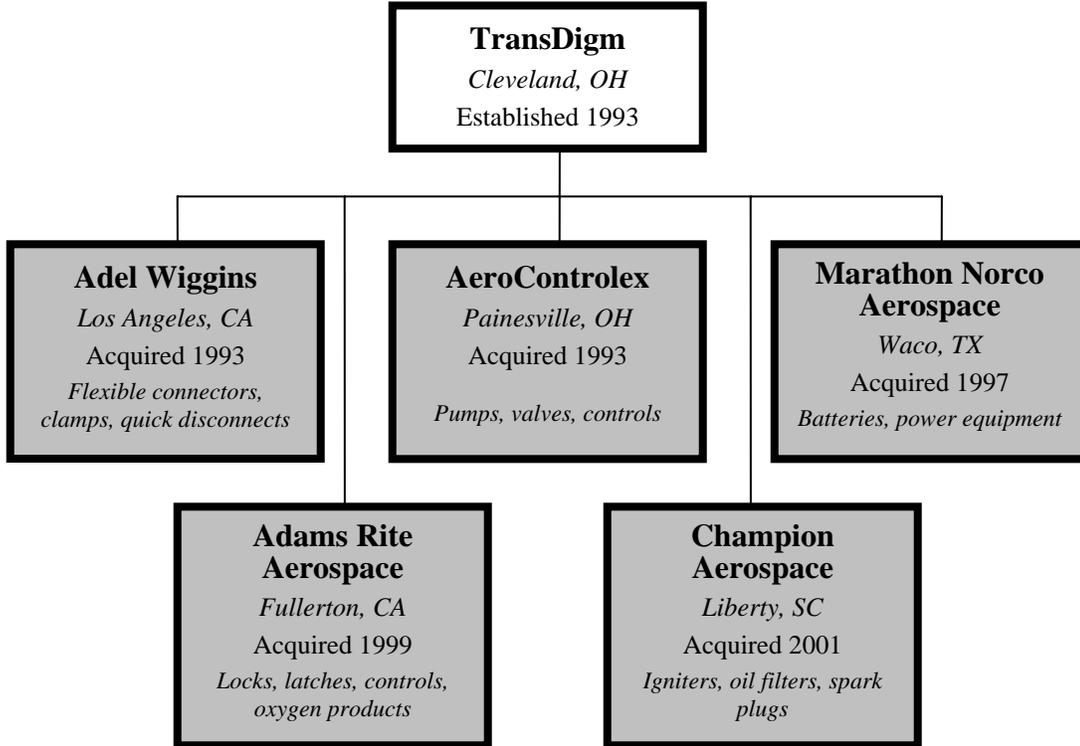


**Figure 1. AeroControlex Lubrication and Scavenge Pump**

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<sup>1</sup> Licensing agreement data obtained from TransDigm's 2003 10-K filed with the Securities and Exchange Commission.

**TransDigm.** AeroControlex, Adams Rite Aerospace, Adel Wiggins, Champion Aerospace, and Marathon Norco Aerospace are subsidiaries of TransDigm, which was established in July 1993 and is controlled by Warburg Pincus Private Equity VIII L.P. Figure 2 shows the organizational structure of TransDigm, the location of each subsidiary, when the subsidiary was acquired, and each subsidiary's main product lines.



**Figure 2. TransDigm, Inc. Organization Chart**

In 2003, TransDigm reported net sales totaling approximately \$293.3 million, of which 72 percent was generated from the commercial sector and 28 percent from the defense sector, with DoD as TransDigm's largest customer.

## Objective

Our overall audit objective was to evaluate whether prices charged by AeroControlex for spare parts were fair and reasonable. We expanded our scope of review to AeroControlex's parent company, TransDigm, and all its subsidiaries. Due to the limited scope of the overall audit, we did not review the DLA managers' internal control program. See Appendix A for a discussion of the scope and methodology.

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## Prices for Sole-Source Spare Parts

Given the constraints of a sole-source contracting environment, DLA contracting officers were unable to effectively negotiate prices for spare parts procured from TransDigm subsidiaries. This condition occurred because the contracting officers or the head of the contracting activity:

- used price analysis of questionable prior Government prices to determine price reasonableness and were unable to perform cost analysis to validate the offered prices,
- inappropriately waived the submission of cost or pricing data for a long-term indefinite-quantity contract with an estimated total value over \$10 million, and
- wrongly considered prices to be reasonable based on competition between a sole-source manufacturer and dealers.

We calculated that DLA paid about \$5.3 million or <sup>2</sup> percent more than the fair and reasonable price<sup>3</sup> for 77 parts that cost about \$ <sup>2</sup>. If problems are not addressed, DLA will pay about \$31.8 million more than fair and reasonable prices for the same items over the next 6 years. DLA also needs to seek a voluntary refund of about \$2.6 million for overpriced parts identified in the report where contracting officers made a reasonable attempt to obtain cost data but were denied the information. We recognize the difficulty contracting officers have had obtaining cost data to ensure the integrity of prices for sole-source spare parts since the inception of the Federal Acquisition Streamlining Act of 1994 (FASA) and the Federal Acquisition Reform Act of 1996.

## Guidance

**Legislative Guidance.** The Truth in Negotiations Act of 1962 (TINA) allows DoD to obtain cost or pricing data (certified cost information) from Defense contractors to ensure the integrity of DoD spending for military goods and services that are not subject to marketplace pricing. FASA and the Federal Acquisition Reform Act of 1996 were designed to streamline acquisition laws, facilitate the acquisition of commercial products, and eliminate unnecessary statutory impediments to efficient and expeditious acquisition. The Acts significantly broaden the commercial item definition and allow more sole-source items to qualify for the “commercial item” exception to cost or pricing data.

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<sup>2</sup> Contractor proprietary data omitted.

<sup>3</sup> Fair and reasonable prices were calculated using cost analysis and include a profit in line with other DLA strategic supplier alliances. For consistency, we used annual demand quantities and the most recent purchase price (as of July 18, 2005) to calculate total amounts that exceeded the fair and reasonable price.

**Federal Acquisition Regulation.** The Federal Acquisition Regulation (FAR) 15.402, “Pricing Policy,” requires contracting officers to purchase supplies and services from responsible sources at fair and reasonable prices. Contracting officers can determine fair and reasonable prices based on adequate competition, information related to prices such as price analysis, or information related to costs.

FAR 15.404-1(b)(2)(ii) requires the contracting officer to determine both the validity of the comparison and the reasonableness of the previous price when performing price analysis. Specifically, the Regulation states:

(ii) Comparison of previously proposed prices and previous Government and commercial contract prices with current proposed prices for the same or similar items, *if both the validity of the comparison and the reasonableness of the previous price(s) can be established.* [emphasis added]

## Price Negotiations

DLA contracting officers did not effectively negotiate prices for sole-source spare parts procured from TransDigm subsidiaries. We calculated that DLA paid about \$5.3 million or <sup>4</sup> percent more than the fair and reasonable price for 77 parts that cost about \$

Table 1 shows the excessive profits paid to each TransDigm subsidiary.

<u>TransDigm Subsidiary</u>	<u>Items</u>	<u>Total Price</u>		<u>Excessive Profit</u>	
		<u>Contract</u>	<u>OIG Cost-Based Price<sup>1</sup></u>	<u>Amount</u>	<u>Percent</u>
Adams Rite	3	\$	\$	\$	3
Adel Wiggins	19	3	3	3	3
AeroControlex	33	3	3	3	3
Champion	15	3	3	3	3
Marathon Norco	7	3	3	3	3
<b>Total</b>	<b>77</b>	<b>\$ 3</b>	<b>\$ 3<sup>2</sup></b>	<b>\$ 3<sup>2</sup></b>	<b>3</b>

<sup>1</sup> The OIG cost-based prices were calculated by using cost analysis and include a profit in line with other DLA strategic supplier alliances.

<sup>2</sup> Slight rounding inconsistencies may exist because auditor calculations went beyond two decimal places.

<sup>3</sup> Contractor proprietary data omitted.

See Appendix D for the amount overpaid for each part.

<sup>4</sup> Contractor proprietary data omitted.

Table 2 shows the different methods contracting officers used to determine price reasonableness and the amount overpaid to TransDigm.

<u>Basis for Price Reasonable</u>	<u>Items</u>	<u>Total Price</u>		<u>Excessive Profit</u>	
		<u>Contract</u>	<u>OIG Cost- Based Price</u>	<u>Amount</u>	<u>Percent</u>
<u>Price analysis</u>					
Determined reasonable	34	\$ 2	\$ 2	\$ 2	2
Waiver of cost or pricing data	15	2	2	2	2
Determined unreasonable	22	2	2	2	2
Dealer/manufacturer competition	6	2	2	2	2
<b>Total</b>	<b>77</b>	<b>\$ 2</b>	<b>\$ 2</b>	<b>\$ 2</b>	<b>1 2</b>

<sup>1</sup>Slight rounding inconsistencies may exist because auditor calculations went beyond two decimal places.  
<sup>2</sup>Contractor proprietary data omitted.

## Price Analysis

**Determined Reasonable.** We calculated that DLA paid about \$2.3 million or <sup>5</sup> percent more than fair and reasonable prices for 34 items determined reasonable by DLA contracting officers. The excessive prices were paid because the contracting officers relied on questionable price analysis of previous Government procurements, including price analysis performed by the Navy Price Fighters, and made other questionable decisions to determine fair and reasonable prices. DLA contracting officers determined prices fair and reasonable for the 34 items based on the comparison of previous Government contract prices without establishing the validity of the comparison and the reasonableness of the previous prices. In addition, DLA contracting officers typically did not request information other than cost or pricing data and perform cost analysis to verify cost elements and establish the validity of the comparison.

For example, in July 2004, the Defense Supply Center Columbus, Ohio (DSCC) purchased 70 quick disconnect couplings (National Stock Number [NSN] 4730-00-720-2000) at a unit price of \$3,066 from AeroControlex. The contracting officer determined the price fair and reasonable by using the price analysis technique of comparison with a 2001 Government contract price of \$4,147 each for 22 items. The July 2004 price was 26.1 percent less than the 2001 price. We calculated that the fair and reasonable unit price for the item was only \$ <sup>5</sup> and determined that DLA paid <sup>5</sup> more than a fair and reasonable price in July 2004. Further, we calculate that DLA paid <sup>5</sup> more than a fair and reasonable price when contracting officers purchased 23 quick disconnect couplings at a unit price of \$4,147 in February 2005. This example shows that price analysis of previous Government prices is not effective once an inaccurate price is accepted into the procurement system and reinforces the need for the contracting officer to establish the validity of the comparison price.

<sup>5</sup> Contractor proprietary data omitted.

Table 3 shows the purchases for the disconnect coupling since 1997, the percent difference from the previous procurement, and the percent increase from the OIG cost-based price.

**Table 3. Purchase History Since 1997 for Quick Disconnect Couplings (NSN 4730-00-720-2000) from AeroControlex**

<u>Contract</u>	<u>Award Date</u>	<u>Qty</u>	<u>Unit Price</u>	<u>Percent Difference</u>	
				<u>Previous Purchase</u>	<u>OIG Cost-Based Price<sup>1</sup></u>
SP0770-97-C-4261	April 4, 1997	70	\$1,900	-	-
SP0740-00-M-3972	June 14, 2000	16	4,595	141.8	-
SP0740-00-M-3974	June 16, 2000	17	4,595	0	-
SP0740-00-M-4056	July 27, 2000	14	4,595	0	-
SP0740-01-C-5202	November 21, 2000	47	3,564	(22.4)	-
SP0740-01-C-6210	April 30, 2001	22	4,147	16.4	-
SP0720-04-C-0121	July 29, 2004	70	3,066	(26.1)	<sup>2</sup>
SP0720-05-M-6035	February 1, 2005	23	4,147	35.3	<sup>2</sup>

<sup>1</sup> OIG cost-based price was calculated by using cost analysis and includes a profit in line with other DLA strategic supplier alliances.

<sup>2</sup> Contractor proprietary data omitted.

DLA contracting officers, when using price analysis of previous Government prices to determine price reasonableness for sole-source spare parts, should perform periodic cost analysis to establish the validity of the comparison and the reasonableness of the previous prices.

**Navy Price Fighters Analysis.** DLA contracting officers also relied on the Navy Price Fighters to support price justifications. Federal regulations encourage the contracting officer to request field pricing assistance when the information available at the buying activity is inadequate. However, the Navy Price Fighters were not able to obtain data beyond what was already available to DLA; they could only perform the same price analysis of previous Government prices that DLA contracting representatives performed. As a result, the analysis performed by the Navy Price Fighters was of no additional value to the price evaluation process for these procurements.

For example, the Navy Price Fighters performed price analysis for a coupling assembly (NSN 1680-01-203-7389). The Navy Price Fighters determined the April 2003 unit price of \$2,677, which was a 21.8 percent increase from the September 2002 unit price of \$2,198.67, was consistent with historical pricing. The September 2002 unit price of \$2,198.67 included a unit price increase from \$1,753 or 25.4 percent for accelerated delivery. The Navy Price Fighters requested technical and cost data from TransDigm to help explain the price increases from September 2002 to April 2003, but TransDigm refused to provide the information. Subsequently, the Navy Price Fighters reported that the increasing prices were the result of manufacturing and overhead costs being amortized over decreasing procurement quantities, despite the fact that they had no cost data to support this conclusion. The contracting officer relied on the

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Navy Price Fighters price analysis to determine the April 2003 price fair and reasonable and ignored a December 2002 purchase with a unit price of \$1,535, despite the offered unit price of \$2,677 being 74.4 percent higher. With cost data obtained from the contractor, we calculated that the fair and reasonable unit price for the coupling assembly was \$<sup>6</sup> and that the January 2005 contract unit price of \$3,015 was <sup>6</sup> percent more than a fair and reasonable price.

DLA should discontinue using the Navy Price Fighters to perform price analyses similar to the work performed by DLA contracting representatives on spare parts procurements.

**Other Questionable Decisions.** Contracting officers applied other ineffective price analysis techniques to determine fair and reasonable prices for seven items. Specifically, the contracting officers relied on an incomplete technical analysis and inadequate commercial sales comparisons, and made determinations based on unsupported judgments. For example, a contracting officer relied on an incomplete technical analysis conducted by DSCC value engineering personnel and on a commercial sales comparison to determine the price fair and reasonable for spur gear shafts (NSN 3040-01-037-8554). The unit price increased from \$1,080.95 in December 2001 to \$2,127 in March 2003 or 96.8 percent. The DSCC technical analysis was incomplete because it failed to identify the similar item used in the comparison. Consequently, we were unable to verify how the decision was made, what data existed, and whether the data established a reliable basis for price justification. The commercial sales invoices provided by TransDigm contained significantly lower quantities than the current DoD requirement and did not represent a valid commercial marketplace because the sales were to Honeywell, the original equipment manufacturer of the item. DLA paid \$2,127 for each spur gear shaft. We calculated that DLA paid <sup>6</sup> percent more than the fair and reasonable price of \$<sup>6</sup>. Therefore, we calculated that DLA paid \$<sup>6</sup> (based on an annual demand quantity of 83), which is \$<sup>6</sup> more than a fair and reasonable price of \$<sup>6</sup>.

Similarly, another contracting officer made an unsupported determination that the offered price for regulator valves (NSN 4820-01-004-6588) was reasonable. The unit price increased 48.6 percent from \$1,833.59 in September 1999 to \$2,724.80 in January 2003. The DSCC contracting officer justified the price increase by stating “the administrative costs to verify the reasonableness of this offered price may outweigh the offset of potential savings from detecting an instance of overpricing.” The contracting officer lacked a valid basis for determining the price reasonable. We calculated a fair and reasonable unit price for the regulator valves of \$<sup>6</sup>; therefore, based on the December 2004 unit price of \$2,795.52, DLA will pay \$<sup>6</sup> for 47 items (annual demand quantity), which is \$<sup>6</sup> (<sup>6</sup> percent) more than a fair and reasonable price of \$<sup>6</sup>.

DLA needs to emphasize the importance of validating the reasonableness of previous Government prices when using price analysis as a tool to justify fair and reasonable prices.

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<sup>6</sup> Contractor proprietary data omitted.

**Cost or Pricing Data Waiver.** On September 13, 2002, the Commander, DSCC inappropriately waived the submission of cost or pricing data for long-term indefinite-quantity contract SP0740-02-D-1041 with an estimated total value of more than \$10 million (as of July 18, 2005, about \$3.4 million has been purchased), based solely on the price analysis of previous procurements. We calculated that DSCC will pay (based on annual demand) \$ \_\_\_\_\_, which is \$372,273 ( \_\_\_\_\_ percent) more than a fair and reasonable price of \$ \_\_\_\_\_ for the 15 sole-source items reviewed on the long-term contract. These 15 items represented 58.9 percent of the annual contract value for sole-source parts. DSCC negotiated prices as high as \_\_\_\_\_ percent more than a fair and reasonable price and over \_\_\_\_\_ percent more than a fair and reasonable price for 7 of the 15 items. Table 4 shows the excessive profit negotiated for the 15 items on the contract with Adel Wiggins.

**Table 4. DLA Negotiated Prices for 15 Selected Items on Contract SP0740-02-D-1041**

NSN	Qty <sup>1</sup>	Contract		OIG Cost-Based Price		Excessive Profit	
		Unit Price <sup>2</sup>	Total	Unit Price <sup>3</sup>	Total	Amount	Percent
4730-00-057-3074	4	\$1,291.85	\$ 4	\$ 4	\$ 4	\$ 4	4
4730-00-077-0965	4	722.83	4	4	4	4	4
4730-00-111-2538	4	469.04	4	4	4	4	4
4730-00-111-2539	4	319.69	4	4	4	4	4
4730-00-275-7943	4	1,209.85	4	4	4	4	4
4730-00-309-2678	4	309.64	4	4	4	4	4
4730-00-333-5311	4	412.19	4	4	4	4	4
4730-00-555-9263	4	724.27	4	4	4	4	4
4730-00-803-7727	4	194.03	4	4	4	4	4
4730-01-029-7790	4	607.62	4	4	4	4	4
4730-01-054-1118	4	479.73	4	4	4	4	4
4730-01-123-6898	4	1,401.43	4	4	4	4	4
4730-01-200-0850	4	1,420.53	4	4	4	4	4
4820-00-100-4337	4	341.81	4	4	4	4	4
4820-01-030-7160	4	1,714.64	4	4	4	4	4
<b>Total (15 Items)</b>			<b>\$ 4</b>		<b>\$ 4</b>	<b>\$ 4</b>	<b>4</b>

<sup>1</sup> The quantity is the FY 2005 annual demand provided by DLA.  
<sup>2</sup> The contract unit price is the second option year price for each item on this contract. Slight rounding inconsistencies may exist because auditor calculations went beyond two decimal places.  
<sup>3</sup> The OIG cost-based unit price is the most recent unit cost as presented by the contractor, plus a profit in line with other DLA strategic supplier alliances.  
<sup>4</sup> Contractor proprietary data omitted.

<sup>7</sup> Contractor proprietary data omitted.

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Although the DSCC contracting officer was able to negotiate lower prices for 5 of the 15 items reviewed, the negotiated prices were still excessive because the DSCC contracting officer failed to obtain cost data to validate the comparison and the reasonableness of the prior price. For example, Adel Wiggins originally proposed \$<sup>8</sup> per unit for a quick disconnect coupling (NSN 4730-01-029-7790). The DSCC contracting officer counteroffered a base year unit price of \$604.40 (option year unit price of \$607.62). This counteroffer was accepted by Adel Wiggins. However, a fair and reasonable unit price for the item was \$<sup>8</sup>; thus, DSCC negotiated an option year unit price that was <sup>8</sup> percent more than the fair and reasonable price.

According to the justification document, the purpose for waiving the cost or pricing data requirement was to expedite the contract award, “as price reasonableness can be determined without the added time and expense of acquiring cost and pricing data.” Specifically, the waiver states:

Pursuant to FAR 15.403-4(a)(1), TransDigm would be required to submit cost and pricing data as defined in FAR 15.403, together with the certificate set forth in FAR 15.406-2. *However, a waiver of submission of cost and pricing data is being requested for the following reasons: (a). All 96 NSNs being awarded to TransDigm have historical pricing from which a comparison can be made using the movement of the Producer’s Price Index for Aircraft Parts and Auxiliary Equipment (PPI 1425) to substantiate a fair and reasonable price. (b). The price history was reviewed for the 96 NSNs currently being considered for award to TransDigm. For evaluation purposes, the historical price that most closely matched the current demand quantity while still being one of the most recent awards was selected for comparison to the price developed using price analysis. Historical prices that appeared out of the ordinary (spikes) were not selected as they may have been based on an unreasonable price or an urgent situation which would not be the normal procurement situation. (c). Since only NSNs determined fair and reasonable through extensive price analysis will be considered for award, certified cost and pricing data is believed to be unnecessary based on the ability to determine price reasonableness through other means.* [emphasis added]

**Guidance for Granting Waivers.** FAR Part 15, “Contracting by Negotiation,” establishes that the requirement of submitting cost or pricing data may be waived in exceptional cases. Specifically, FAR 15.403-1(c)(4), “Waivers,” states:

The head of the contracting agency (HCA) may, without power of delegation, waive the requirement for submission of cost or pricing data in exceptional cases. The authorization for the waiver and the supporting rationale shall be in writing. *The HCA may consider waiving the requirement if the price can be determined to be fair and reasonable without the submission of cost or pricing data. For example, if cost or pricing data were furnished on previous production*

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<sup>8</sup> Contractor proprietary data omitted.

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*buys and the contracting officer determines such data are sufficient, when combined with updated information, a waiver may be granted.*  
[emphasis added]

In response to Government Accountability Office (GAO) Report 02-502, “Contract Management: DOD Needs Better Guidance on Granting Waivers for Certified Cost or Pricing Data,” the Director, Defense Procurement and Acquisition Policy, issued a memorandum on February 11, 2003, clarifying an “exceptional case” waiver. The Director requires that all three criteria must be satisfied in order for the contracting officer to grant a waiver. Specifically, the memo states:

. . . the grant of an exceptional case waiver shall be made only upon a determination that (1) the property or services cannot reasonably be obtained under the contract, subcontract, or modification, without the grant of the waiver; (2) the price can be determined to be fair and reasonable without the submission of certified cost or pricing data; and (3) there are demonstrated benefits to granting the waiver.

The DSCC contracting officer believed the waiver request for contract SP0740-02-D-1041 also satisfied the recent acquisition guidance that the price could be determined fair and reasonable without the submission of cost or pricing data. The contracting officer also believed granting the waiver would eliminate added time and expense of obtaining and assessing cost or pricing data. The president of Adel Wiggins stated that the DSCC contracting officer never requested cost or pricing data. In addition, the contract file did not contain any documentation of a written request for cost or pricing data. Granting a waiver of cost or pricing data based solely on price analysis, especially for sole-source items, increases the risk that DoD will not accurately establish a fair and reasonable price and will pay excessive prices.

DLA needs to emphasize the importance of obtaining cost or pricing data and the necessity to provide adequate justifications for waivers to cost or pricing data for sole-source items.

**Determined Unreasonable.** DLA contracting officers determined that prices for 22 of the 77 parts (28.6 percent) could not be found reasonable but purchased the items to ensure an adequate supply of needed spare parts was available for the war fighter. We calculated that DLA paid <sup>9</sup> percent or about \$1.9 million more than fair and reasonable prices for these items. TransDigm had significantly increased prices for its sole-source spare parts and would not provide “information other than cost or pricing data” to include uncertified cost data when requested by contracting officials, despite the requisite authority provided in FAR 15.403-3. TransDigm applies a commercial pricing strategy to its sole-source military-unique items although no commercial market exists to establish reasonable prices by the forces of supply and demand for the vast majority of items. This pricing strategy results in overpriced spare parts and increases the burden placed on the DoD budget.

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<sup>9</sup> Contractor proprietary data omitted.

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For example, on contract SPO740-04-C-4647, the DSCC contracting officer purchased 578 oil pump assembly housings (NSN 2990-01-259-0589) used on the F-15 fighter aircraft at a unit price of \$3,663.36 in December 2003. The unit price for the item, in March 2002, was \$2,132.82; thus, the unit price increased 71.8 percent in 21 months. The DSCC contracting officer had requested certified cost or pricing data to explain the substantial price increase; however, AeroControlex stated that the oil pump assembly housing was a commercial item and provided commercial sales information. The DSCC contracting officer then inappropriately determined the item was commercial despite the insufficient documentation. After the commercial determination was made, AeroControlex refused to provide more detailed cost data to support the substantial price increase. The DSCC contracting officer elevated the problems with this procurement to top officials in the chain of command, but again AeroControlex refused to provide requested information to support its price. Instead, AeroControlex offered a lower unit price of \$<sup>10</sup> to DSCC, contingent on a fair and reasonable price determination. DSCC management officials rejected this offer because the substantial price increase could not be adequately explained. Based on increasingly urgent demand, the DSCC contracting officer eventually purchased 578 oil pump assemblies at a unit price of \$3,663.36 for a total price of \$2,117,422. We calculated that a fair and reasonable unit price for the item was only \$<sup>10</sup>, for a total price of \$<sup>10</sup>. Consequently, DSCC paid <sup>10</sup> percent or over \$<sup>10</sup> more than a fair and reasonable price for this item. For more details surrounding this procurement, see the results of the Defense Hotline allegation in Appendix C.

**Voluntary Refund.** DLA needs to seek a voluntary refund of about \$2.6 million for overpriced parts for which contracting officers made a reasonable attempt to obtain cost data but were denied the information. Appendix E lists items for which DLA should seek a voluntary refund.

## Dealer/Manufacturer Competition

DLA paid <sup>10</sup> percent or \$766,430 more than fair and reasonable prices for the six items reviewed because contracting officers wrongly considered prices to be reasonable based on competition between a sole-source manufacturer and dealers. A sole-source manufacturer and a dealer cannot compete independently when the dealer is reliant on the sole-source manufacturer to fill the Government requirement. In the procurements reviewed, the prices quoted by the dealers were higher than the sole-source manufacturer and the delivery terms were mostly favorable to the sole-source manufacturer. As a result, the sole-source manufacturer was able to set the market price and had an inherent advantage in winning contract awards. Further, we surveyed 10 dealers about their normal processes when they quote prices for a Government requirement. The dealers consistently stated that they do not stock these parts and normally contact the sole-source manufacturer when a Government requirement becomes known. As a result, the dealers are not independent of the sole-source manufacturer. Further, because the Government accepted the contract prices as fair and reasonable,

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<sup>10</sup> Contractor proprietary data omitted.

future procurements will be affected because those awards will be considered a valid basis for the next price comparison.

**Dealer Competition Example.** In July 2003, DSCC purchased nine linear valves (NSN 4820-01-155-0138) at a unit price of \$10,009, totaling \$90,081 on contract SP0750-03-M-P418. We determined that DLA paid <sup>11</sup> percent more than the calculated fair and reasonable unit price of \$ <sup>11</sup>. In February 2005, the unit price for this item increased to \$13,546 for a quantity of eight units, which is <sup>11</sup> percent more than the fair and reasonable price.

Table 5 shows the unit price and the delivery terms from six offerors (the sole-source manufacturer and five dealers quoting the sole-source manufacturer’s part). The contract was awarded to the sole-source manufacturer based on the lower unit price and favorable delivery terms.

<u>Quotes</u>	<u>Qty</u>	<u>Unit Price</u>	<u>Delivery Days</u>	Percent	
				<u>Increase From Prior Price</u>	<u>Excessive Profit</u>
<b>AeroControlex (sole-source manufacturer)</b>	<b>9</b>	<b>\$10,009.00</b>	<b>150</b>	<b>115.2</b>	<b>*</b>
Pioneer Valve and Fitting Co. (dealer)	9	11,449.91	260	146.2	*
S&L Valves (dealer)	9	11,482.33	210	146.9	*
Comptech Corporation (dealer)	9	11,560.90	170	148.6	*
Kampi Components Co., Inc. (dealer)	9	11,821.67	210	154.2	*
Southeast Power Systems (dealer)	9	12,511.36	180	169.0	*
<u>Part Prices</u>					
Previous Government contract (December 2002)	17	\$ 4,650.29			
OIG cost-based price (December 2004)	*	\$ *			

\* Contractor proprietary data omitted.

By using “competition” between a sole-source manufacturer and dealers, the contracting officer incorrectly determined the price fair and reasonable despite the fact that the price for this item increased over 115 percent from the previous procurement only seven months earlier. In addition, the contracting officer did not attempt any price negotiations, determine the reasons for the significant price increase, or follow established supply center procedures to elevate procurements to management when prices have increased over 25 percent within a 12-month period.

FAR Part 15, “Contracting by Negotiation,” defines when adequate competition exists. Specifically, FAR Part 15.403-1(c)(1)(i), “Adequate Price Competition,” states:

A price is based on adequate price competition if two or more responsible offerors, *competing independently*, submit priced offers

<sup>11</sup> Contractor proprietary data omitted.

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that satisfy the Government's expressed requirement... [emphasis added]

**DSCC Guidance.** DSCC Acquisition Guide, Part 13, discusses price reasonableness determinations for simplified acquisitions. DSCC Acquisition Guide Part 13.106-3(d)(3)(i) states:

Competitive quotations from two or more sources will normally produce a price that can be determined fair and reasonable. For acquisitions within the SAT [simplified acquisition threshold] competition between one manufacturer and its dealer(s), or two dealers offering the product of the same manufacturer is acceptable.

**DSCR Guidance.** The DSCR Acquisition Procedures Exhibit 15.A-2 defines the meaning of each price reasonableness code. Specifically the guidance states:

PRC [Price Reasonableness Code] "BB" shall be used when there is adequate price competition involving either 1 manufacturer plus at least 1 independent non-manufacturing source for the item or 2 or more independent non-manufacturing sources.

DLSC [Defense Logistics Support Command] has advised the fact that a non-manufacturer purchases an item from a manufacturer does not totally imply the manufacturer has control over the price at which the non-manufacturer will offer that item to the Government, nor does it preclude independent competition between the two offerors. The FAR requirement that offerors compete independently relates to the possibility of situations involving price fixing, collusion, or offers from companies whose financial relationship is such that the manufacturer exercises substantial control or influence over the non-manufacturers price.

Buyers are cautioned about manufacturers who arbitrarily create a network of non-manufacturers by only selling these products to these sources to insulate their pricing from government scrutiny. The buyer should be alert to situations where the non-manufacturer appears to provide no value to the procurement process.

Sound judgment is required of the buyer when using PRC "BB". The buyer must establish the extent of any control the manufacturer exercises over the non-manufacturers.

The supply center guidance fails to meet the FAR definition of adequate price competition because the sole-source manufacturer has direct knowledge and control of both the sales price and the delivery terms of its competitor (the dealer), which creates an unfair advantage and prevents independent competition.

DLA needs to require the Commanders of DSCC and DSCR to discontinue using competition between sole-source manufacturers and dealers to determine price reasonableness.

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## Other Matters of Interest

DSCC contracting officials failed to adequately administer option year pricing for contract SP0740-02-D-1041. As of July 2005, for the 15 items reviewed, a total of 129 orders were placed during the option years. The Government paid the wrong price for 61 of the 129 orders (47.3 percent). Contract prices are adjusted each year according to the Producers Price Index. Contract prices for the first option year were lower than during the base contract period because the index decreased slightly. However, because 44 purchases were made during the first option year at base year prices, the Government paid more for those orders than necessary. The index increased during the second option year and resulted in the second option year prices being higher than both the base and first option year prices. However, because 17 orders during the second option year were paid at prices from the first option year, the Government actually paid less for those orders. The effect of these wrong option year prices was a net overpayment of \$165.17. Although the dollar value of overpayment is not significant, the fact that almost half of the option year orders placed for these 15 items were paid at the wrong price indicates a larger systemic contract administration problem. According to the contracting officer, this problem is repeatedly seen at DSCC because many of the employees completing the option year delivery orders are new contracting officials who lack the necessary experience.

DLA needs to require the Commander, DSCC to develop procedures and appropriate controls to ensure option year pricing for delivery orders is accurate.

## Conclusion

The acquisition of sole-source spare parts presents a unique problem for DoD contracting officers because of the absence of market forces and a competitive pricing strategy to control prices. Contracting officers must also deal with the increasing use of the commercial item exception to cost or pricing data for sole-source military-unique parts without the existence of a true commercial market.

In June 1995, the Director, Defense Procurement provided comments on the benefits of TINA, marketplace pricing, and the differences between DoD and commercial procurement environments.

The requirements of TINA are necessary to ensure the integrity of DoD spending for military goods and services that are not subject to marketplace pricing. When there is a market that establishes prices by the forces of supply and demand, the market provides the oversight. DoD procures many highly complex military systems in the absence of supply/demand situations for these relatively low volume, unique military goods. The requirements of TINA address legitimate and necessary differences between DoD and commercial procurement environments.

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While DoD recognizes the need for TINA, it also is moving to increase competition and decrease the number of pricing actions that would require cost or pricing data. The implementation of FASTA [now commonly referred to as FASA], with its emphasis on encouraging the acquisition of commercial end items and increased competition, will bring the requisite market forces to bear on prices, and thus exempt contractors from the requirement to submit cost or pricing data. Absent this competition, the quantitative benefit to the Government of TINA compliance far exceeds the cost of Government oversight.

The Boeing KC-767A Aerial Refueling Tanker program highlighted the abuses of the commercial item definition that can occur. DoD IG Report No. D-2004-064, "Acquisition of the Boeing KC-767A Tanker Aircraft," found that a commercial market did not exist to establish a reasonable price, which placed DoD at high risk of paying billions more than necessary for the new weapon system. When a sole-source item is determined commercial, contracting officers are limited in the amount of information that they can request, and the contractor is exempt from the requirement to submit cost or pricing data.

Contracting officers can request information other than cost or pricing data when sufficient information is not available to establish price reasonableness through other means. However, contractors do not always comply with the contracting officers' requests for information. For example, contracting officers had difficulty obtaining cost data or sufficient timely responses to requests for information from TransDigm. When contracting officers requested information other than cost or pricing data to support substantial price increases, TransDigm routinely refused to provide the requested data. TransDigm's refusal to provide requested information delayed negotiations, resulting in longer administrative lead times, rising military demands, and in some cases urgent procurements. The following are examples from contract documentation of specific responses from TransDigm when DLA contracting representatives requested information other than cost or pricing data.

- TransDigm does not provide informal cost breakdowns or cost data for small purchases (2 instances).
- TransDigm is unable to provide a cost breakdown for orders under \$100,000 (2 instances).
- TransDigm no longer offers cost breakdowns.
- TransDigm does not provide cost data for purchases under \$550,000.
- TransDigm considers this item proprietary and commercial and will not provide any cost breakdown.
- TransDigm accepts the Government counteroffer instead of providing a cost breakdown.
- Due to the total dollar value of the request for quote, an informal cost breakdown cannot be prepared at this time. The prices quoted are based

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on TransDigm's current material costs, labor, overhead, and general and administrative rates, which have been audited by the U.S. Government.

- TransDigm is unable to provide informal cost breakdowns due to limited accounting resources.
- TransDigm's quote is based on increases in material and labor costs. Material has escalated <sup>12</sup> percent while labor and overhead has increased close to <sup>12</sup> percent.
- TransDigm did not respond to the request (6 instances).
- TransDigm stated it is not the company's policy to give cost data (2 instances).
- TransDigm offered a lower unit price only if that price is found fair and reasonable by the contracting officer.

Sole-source contractors, like TransDigm, are increasingly less willing to provide cost data to ensure the integrity of prices and enable DoD contracting officers to negotiate fair and reasonable prices. The more frequent use of price analysis of previous Government prices instead of price analysis of commercial sales in similar quantities to non-Government customers is often ineffective without validating the comparison or the reasonableness of the prior price.

Consequently, DoD contracting officers have limited tools to obtain sole-source spare parts at fair and reasonable prices. DLA has had success using strategic supplier relationships with key sole-source manufacturers and obtaining cost information to support fair and reasonable prices. For example, the DLA-Honeywell International strategic supplier alliance uses cost analysis to support fair and reasonable prices. This strategic supplier alliance enabled DLA to place over 10,000 items on long-term contracts that reduced prices, increased availability, enabled more accurate forecasting, and reduced administrative lead times and inventory.

Another option is for DLA to reengineer or develop a Government-owned technical data package and qualify new sources to establish a competitive market for high dollar sole-source parts. For example, DLA and the Air Force are attempting to address TransDigm's unreasonable prices by funding a reengineering project to develop a fully competitive technical data package for the oil pump assembly housing (NSN 2990-01-259-0589). That technical data package could be solicited to other vendors to obtain reasonable prices. However, this process is lengthy and can be expensive.

DLA needs to either establish a strategic supplier alliance with TransDigm subsidiaries using cost data to negotiate fair and reasonable prices or develop and execute a strategy to reengineer and competitively procure high dollar value spare parts.

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<sup>12</sup> Contractor proprietary data omitted.

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## Recommendations, Management Comments, and Audit Response

**We recommend that the Director, Defense Logistics Agency:**

**1. Alert contracting officers, when using price analysis of previous Government prices to determine price reasonableness for sole-source spare parts, to perform periodic cost analysis to establish the validity of the comparison and the reasonableness of the previous prices.**

**Management Comments.** The Director of Logistics Operations, DLA partially concurred with the recommendation. The Director commented that cost analysis can be a beneficial supplement to price analysis for determining price reasonableness, but the best intentions of procurement personnel to obtain cost data can and often have been thwarted. The Director also commented that guidance will be standardized, disseminated, and incorporated into local training. All actions will be completed by September 29, 2006.

**Audit Response.** We consider the DLA comments responsive.

**2. Discontinue using the Navy Price Fighters to perform price analyses similar to the work performed by DLA contracting representatives on spare parts procurements.**

**Management Comments.** The Director of Logistics Operations, DLA partially concurred with the recommendation. The Director commented that the identification of one instance of an apparent support deficiency by the IG has enabled both DLA and the Navy to make procedural adjustments to prevent future occurrences. All actions were considered complete.

**Audit Response.** We consider the DLA comments responsive.

**3. Emphasize the importance of validating the reasonableness of previous Government prices when using price analysis as a tool to justify fair and reasonable prices.**

**Management Comments.** The Director of Logistics Operations, DLA concurred with the recommendation. The Director commented that emphasis will be placed on improved analyses and thorough documentation at forthcoming training seminars for their procurement personnel. All actions will be completed by June 30, 2006.

**Audit Response.** We consider the DLA comments responsive.

**4. Emphasize the importance of obtaining cost or pricing data and the necessity to provide adequate justifications for waivers to cost or pricing data for sole-source items.**

**Management Comments.** The Director of Logistics Operations, DLA concurred with the recommendation. The Director commented that the validation of the

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offeror's current or recent cost data in conjunction with price analysis provides the greatest assurance of determining fair and reasonable prices. The Director commented that lesser results are achieved when a supplier refuses to provide any cost information and negotiate a fair and reasonable price as documented in the report. The Director also commented that DLA will communicate to procurement personnel and managers the importance of obtaining cost data, adequate justifications for waivers, and the vigorous pursuit of alternative actions. All actions will be completed by September 29, 2006.

**Audit Response.** We consider the DLA comments responsive.

**5. Seek a voluntary refund of about \$2.6 million for overpriced parts identified in the report where contracting officers made a reasonable attempt to obtain cost data but were denied the information.**

**Management Comments.** The Director of Logistics Operations, DLA partially concurred with the recommendation. The Director commented that prompt action is planned, although the profit rate used in the calculations is under further review to determine if it is excessive. All actions will be completed by March 31, 2006.

**Audit Response.** We consider the DLA comments responsive.

**6. Require the Commanders of the Defense Supply Centers in Columbus, Ohio, and Richmond, Virginia, to discontinue using competition between sole-source manufacturers and dealers to determine price reasonableness.**

**Management Comments.** The Director of Logistics Operations, DLA partially concurred with the recommendation. The Director commented that research of the individual circumstances of the procurements summarized in the report will determine whether the competition was properly or improperly used to determine price reasonableness. The Director also commented that because the dealer/manufacturer competition can be valid in some instances, DLA will not prohibit the practice. All actions will be completed by June 30, 2006.

**Audit Response.** Although DLA partially concurred with the recommendation, we do not feel their comments meet the intent of the recommendation. As shown in the report, the sole-source manufacturer and dealers did not operate independently and thus fail to meet the FAR definition of adequate competition because the dealers are reliant on the sole-source manufacturer to obtain the parts necessary to fill the Governments requirements. Further, the sole-source manufacturer has complete control over key contract terms (price and delivery), which clearly provides an advantage to the sole-source manufacturer. Dealers stated that they do not stock the item, but attempt to obtain the item from the sole-source manufacturer when the Government requirement becomes known. Given these circumstances, competition between a sole-source manufacturer and dealers will not provide appropriate information to establish price reasonableness for sole-source items. We request that the Director, DLA provide additional comments to the final report explaining how competition between a sole-source manufacturer and dealers that do not stock large quantities of items meets the

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FAR definition of adequate competition and is effective in obtaining appropriate information to determine price reasonableness.

**7. Require the Commander Defense Supply Center Columbus, Ohio, to develop procedures and appropriate controls to administer accurate option year pricing for delivery order contracts.**

**Management Comments.** The Director of Logistics Operations, DLA partially concurred with the recommendation. The Director commented that DSCC will determine the nature and cause of the errors and determine whether it is an isolated or systemic problem. DSCC will, as appropriate, develop procedures and conduct training in calculating option year prices. All actions will be completed by September 29, 2006.

**Audit Response.** We consider the DLA comments responsive.

**8. Either establish a strategic supplier alliance with TransDigm subsidiaries using cost data to negotiate fair and reasonable prices or develop and execute a strategy to reengineer and competitively procure high dollar value spare parts.**

**Management Comments.** The Director of Logistics Operations, DLA partially concurred with the recommendation. The Director commented that a shared benefit partnership with TransDigm is desired. The Director plans to hold discussions with TransDigm to achieve improvements in the relationship, to include obtaining information and other means of supporting price reasonableness. The Director also commented that supply chains have been asked to report on the suitability of reverse engineering TransDigm items. All actions will be completed by June 30, 2006.

**Audit Response.** We consider the DLA comments responsive.

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## Appendix A. Scope and Methodology

We visited and contacted individuals at DLA and TransDigm (AeroControlex, Adel Wiggins, Adams Rite Aerospace, Champion Aerospace, and Marathon Norco Aerospace). During site visits to the Defense Supply Centers in Columbus, Ohio; Richmond, Virginia; and Philadelphia, Pennsylvania; we interviewed buyers and contracting officers and reviewed contract documentation relating to acquisitions and buying experiences with the contractor. We also reviewed contract documentation to evaluate how contract prices were determined fair and reasonable. Specifically, we reviewed Price Negotiation Memorandums, quotations received, evaluation of offers, negotiations, and justification for awarding the contract. We also determined whether buyers and contracting officers followed applicable rules and regulations in awarding the contracts. We reviewed Price Reasonableness Codes assigned to the contracts to determine whether the codes accurately reflected the methodology used by the buyer when making a fair and reasonable price determination. In addition, we surveyed 10 dealers to determine their process for bidding on a Government requirement.

**Contract Selection Process.** We used the DD350 database to identify FY 2003 contract actions by TransDigm and its subsidiaries. For FY 2003, we identified 208 contract actions totaling \$19.4 million for 3 subsidiaries of TransDigm (AeroControlex, 142 actions valued at \$14.2 million; Marathon Norco Aerospace, 49 actions valued at \$4.5 million; and Adel Wiggins, 17 actions valued at \$0.7 million).

As shown in the DD350 database, DSCC and DSCR were the top two contracting offices, representing 68 percent of total contract actions with TransDigm. We selected 85 contracts to review, which represented at least 80 percent of the total contract actions from each contracting office. The FY 2003 actions in the DD350 database for the 85 contracts totaled \$10.6 million (DSCC, 31 contracts valued at \$4.2 million; DSCR, 54 contracts valued at \$6.4 million). In addition, we included eight contracts (three at DSCC, five at DSCR) that contained parts covered under the Honeywell lubrication and scavenge pump product line licensing agreement. Five contracts we requested (one at DSCC, four at DSCR) could not be located and three additional contracts were added for items included in our scope. Consequently, we reviewed a total of 91 contracts valued at \$17.9 million<sup>1</sup> (DSCC, 36 contracts valued at \$10.16 million; DSCR, 55 contracts valued at \$7.73 million).

**Cost Data Selection Process.** From selected contracts, we identified NSNs for spare parts DLA purchased, and we obtained FY 2004 demand and pricing information from the DLA Standard Automated Material Management System, provided by the Defense Operations Research and Resource Analysis Office. We selected a total of 41 sole-source items with an annual demand of \$5.6 million and obtained information other than cost or pricing data from the contractor for those

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<sup>1</sup> The contract value was calculated based on the actual contractual amounts purchased and for two indefinite-quantity contracts by reviewing procurement histories from Haystacks Online for Windows as of July 18, 2005.

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items. Of those, 23 items had an annual demand of at least \$100,000, 16 items had the highest demand from DSCC contract SPO740-02-D-1041, and 2 items were selected based on correspondence contained in a contract file and a previous audit.

**Expansion of Review.** After we found significant pricing problems with the initial population, we obtained FY 2005 demand and pricing information for 16 TransDigm subsidiaries' commercial and Government entity codes from the Standard Automated Material Management System. The data identified 15,166 parts that had an FY 2005 demand of \$<sup>2</sup>. We identified 373 parts that represented over 80 percent of demand and determined whether the item was competitive or sole-source. Of the 373 parts, 211 were sole-source to TransDigm and had an annual demand of \$<sup>2</sup>. From this population, we selected the 36 highest demand sole-source items not already in our review with an FY 2005 annual demand of \$<sup>2</sup> and obtained information other than cost or pricing data and commercial sales histories for these items. Therefore, we reviewed a total of 77 items that had an FY 2005 annual demand of \$<sup>2</sup><sup>3</sup> or 61.8 percent of the total sole-source item demand. We also reviewed 49 contracts (37 at DSCR, 11 at DSCC, and 1 at the Defense Supply Center Philadelphia) for the additional items. Thus, we reviewed a total of 140 contracts during the course of the audit.

**Information Obtained From Contractors.** We obtained and reviewed information other than cost or pricing data and commercial sales histories from TransDigm subsidiaries. We performed cost analysis to determine whether DLA was paying fair and reasonable prices for these items and reviewed sales histories to determine if a viable commercial market existed for these sole-source spare parts. We added a profit in line with other DLA strategic supplier alliances to the contractor costs to calculate a cost-based price when performing our analysis. Due to time constraints, we did not evaluate the selling, general, and administrative expenses, corporate allocations, or the facilities capital cost of money rates charged by TransDigm. We applied these costs as proposed by TransDigm.

We performed this audit from June 2004 through August 2005 in accordance with generally accepted government auditing standards.

**Use of Computer-Processed Data.** To perform the work, we relied on computer-processed data from DoD, DLA, and commercial sources. We used data from the DD350 database to identify contracts, items, and contracting offices to review during the audit. We obtained Standard Automated Material Management System data from the Defense Operations Resource and Research Analysis Office to include demand data, pricing information, and part numbers. We also obtained the procurement history for all items reviewed from Haystacks Online for Windows, a commercial system. The computer-processed data and

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<sup>2</sup> Contractor proprietary data omitted.

<sup>3</sup> We calculated annual demand dollars used for selecting the additional items by using the DLA mean acquisition unit cost. The mean acquisition unit cost represents an average of all contract purchases within 1 year. The annual demand of \$[contractor proprietary data omitted] used throughout the remainder of the report is based on the most recent contract price as of July 18, 2005.

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procurement history data were determined reliable based on a comparison with actual source documents. In addition, we have used Haystacks Online for Windows for the past several audits and have not found any material errors or discrepancies.

We also relied on information other than cost or pricing data and commercial sales histories provided by TransDigm subsidiaries to determine whether prices charged were fair and reasonable and whether a viable commercial market existed for the spare parts reviewed. We did not validate the data, but we compared the data to actual source documents and found no material errors. We also reviewed Defense Contract Audit Agency reports on proposed rates and accounting systems for TransDigm subsidiaries.

We did not find errors that would preclude the use of the computer-processed data to meet the audit objectives or that would change the conclusions reached in the report.

**Government Accountability Office High-Risk Area.** The Government Accountability Office has identified several high-risk areas in DoD. This report provides coverage of the Defense Contract Management high-risk area.

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## Appendix B. Prior Coverage

During the last 8 years, the Government Accountability Office (GAO) and the DoD IG have issued 26 reports discussing spare parts pricing or waivers to the cost or pricing data requirement. Unrestricted GAO reports can be accessed at <http://www.gao.gov>. Unrestricted DoD IG reports can be accessed at <http://www.dodig.mil/audit/reports>.

### GAO

GAO Report No. GAO-05-169, “Contract Management: The Air Force Should Improve How It Purchases AWACS Spare Parts,” February 15, 2005

GAO Report No. GAO-02-565, “Defense Acquisitions: Navy Needs Plan to Address Rising Prices in Aviation Parts,” May 31, 2002

GAO Report No. GAO-02-452, “Defense Inventory: Trends in Services’ Spare Parts Purchased from the Defense Logistics Agency,” April 30, 2002

GAO Report No. GAO-02-502, “Contract Management: DoD Needs Better Guidance on Granting Waivers for Certified Cost or Pricing Data,” April 22, 2002

GAO Report No. GAO-02-505, “Defense Acquisitions: Status of Defense Logistics Agency’s Efforts to Address Spare Part Price Increases,” April 8, 2002

GAO Report No. GAO-01-23, “Defense Acquisitions: Prices of Navy Aviation Spare Parts Have Increased,” November 6, 2000

GAO Report No. GAO-01-22 (OSD Case No. 2080), “Defense Acquisitions: Price Trends for Defense Logistics Agency’s Weapon Systems Parts,” November 3, 2000

GAO Report No. NSIAD-00-123, “Defense Acquisitions: Prices of Marine Corps Spare Parts Have Increased,” July 31, 2000

GAO Report No. NSIAD-00-30 (OSD Case No. 1920), “Defense Inventory: Opportunities Exist to Expand the Use of Defense Logistics Agency Best Practices,” January 26, 2000

GAO Report No. NSIAD-00-22 (OSD Case No. 1903), “Contract Management: A Comparison of DoD and Commercial Airline Purchasing Practices,” November 29, 1999

GAO Report No. NSIAD-99-90 (OSD Case No. 1808), “Contract Management: DoD Pricing of Commercial Items Needs Continued Emphasis,” June 24, 1999

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## DoD IG

DoD IG Report No. D-2004-012, "Sole-Source Spare Parts Procured From an Exclusive Distributor," October 16, 2003

DoD IG Report No. D-2002-112, "Industrial Prime Vendor Program at the Air Force Logistics Centers," June 20, 2002

DoD IG Report No. D-2002-059, "Results of the Defense Logistics Agency Strategic Supplier Alliance with Honeywell International, Incorporated," March 13, 2002

DoD IG Report No. D-2001-171, "Industrial Prime Vendor Program at the Naval Aviation Depot – Cherry Point," August 6, 2001

DoD IG Report No. D-2001-129, "Contracting Officer Determinations of Price Reasonableness When Cost or Pricing Data Were Not Obtained," May 30, 2001

DoD IG Report No. D-2001-072, "Industrial Prime Vendor Program at the Naval Aviation Depot – North Island," March 5, 2001

DoD IG Report No. D-2001-001, "Contract Award for the Fluid Flow Restrictor Spare Part," October 3, 2000

DoD IG Report No. D-2000-192, "Results of the Defense Logistics Agency Strategic Supplier Alliance for Catalog Items," September 29, 2000

DoD IG Report No. D-2000-099, "Procurement of the Propeller Blade Heaters for the C-130 and P-3 Aircraft," March 8, 2000

DoD IG Report No. D-2000-098, "Spare Parts and Logistics Support Procured on a Virtual Prime Vendor Contract," March 8, 2000

DoD IG Report No. 1999-218, "Sole-Source Noncommercial Spare Parts Orders on a Basic Ordering Agreement," July 27, 1999

DoD IG Report No. 1999-217, "Sole-Source Commercial Spare Parts Procured on a Requirements Type Contract," July 21, 1999

DoD IG Report No. 1999-026, "Commercial Spare Parts Purchased on a Corporate Contract," October 30, 1998

DoD IG Report No. 1998-088, "Sole-Source Prices for Commercial Catalog and Noncommercial Spare Parts," March 11, 1998

DoD IG Report No. 1998-064, "Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111," February 6, 1998

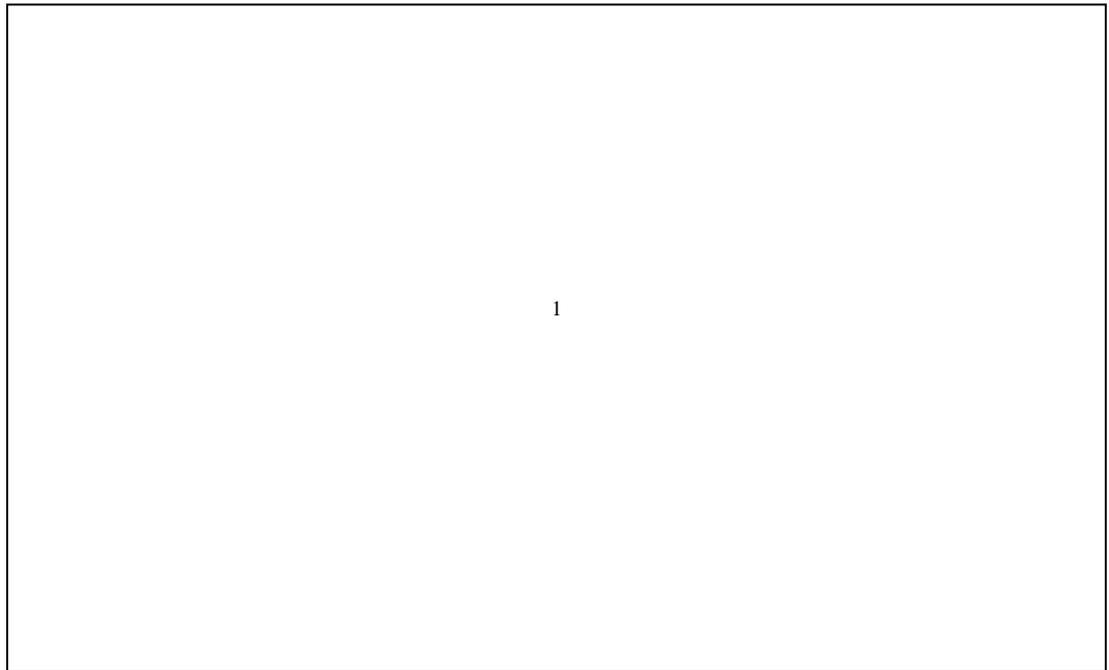
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## Appendix C. Defense Hotline Allegation

**Allegation.** AeroControlex erroneously claimed an oil pump assembly housing for the F-15 aircraft (NSN 2990-01-259-0589) to be a commercial item in order to be exempt from the Federal requirement to provide cost or pricing data and failed to provide uncertified cost data to support substantially increasing prices.

**Manufacturing History.** The oil pump assembly housing used on the F-15 aircraft has been supplied from Honeywell, the original equipment manufacturer (OEM), since 1988. AeroControlex began providing this part to DoD when manufacturing responsibility was transferred from Honeywell International in a 2001 licensing agreement. AeroControlex does not actually manufacture the part; they purchase it from <sup>1</sup>.

**Audit Results.** The allegation was substantiated. DLA paid <sup>1</sup> percent or over \$ <sup>1</sup> more than a fair and reasonable price for 578 oil pump assembly housings because AeroControlex erroneously claimed the item was commercial and refused to provide any cost data to support their price. The figure below shows the oil pump assembly supplied by AeroControlex.



**Oil Pump Assembly Housing supplied by AeroControlex**

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<sup>1</sup> Contractor proprietary data omitted.

The table below shows the profit AeroControlex was paid and the OIG cost-based price.

<b>Excessive Profit Paid to AeroControlex for 578 Oil Pump Assembly Housings (NSN 2990-01-259-0589)</b>				
		<u>Unit Price</u>	<u>Percent</u>	<u>Total Price</u>
<sup>3</sup>	Price to AeroControlex	\$ <sup>3</sup>	-	-
	AeroControlex Burden Applied <sup>1</sup>	<sup>3</sup>	3	-
	Total AeroControlex Cost	<sup>3</sup>	-	-
	Contract Price	3,663.36	3	\$2,117,422
	OIG Cost-Based Price <sup>2</sup>	<sup>3</sup>		<sup>3</sup>
	Excessive Profit		3	3

<sup>1</sup> The burden cost consists of the following cost elements: material overhead, sales, general and administrative, and facilities capital cost of money.

<sup>2</sup> The OIG cost-based price was calculated based on current cost data provided by the company plus a profit in line with other DLA strategic supplier alliances.

<sup>3</sup> Contractor proprietary data omitted.

**Request for Cost or Pricing Data.** On May 22, 2003, DSCC made their initial request for cost or pricing data. AeroControlex did not respond to the DSCC request, so on May 30, 2003, the contracting officer again requested cost or pricing data and notified AeroControlex that the Air Force was experiencing a work stoppage. Throughout June and July 2003, the DSCC contracting officer repeatedly e-mailed, called, and sent facsimiles to AeroControlex regarding the urgent need for the item. According to contract documentation, the DSCC contracting officer notified three additional individuals within AeroControlex about the work stoppage during this period. In each case, AeroControlex failed to respond to the contracting officer's urgent requests. In a November 7, 2003, letter, the president of AeroControlex acknowledged DoD's urgent requirement for the item.

**Commerciality Claim.** On June 4, 2003, AeroControlex claimed the item to be a commercial item despite the fact that the OEM, Honeywell, had never claimed the item to be commercial. AeroControlex stated they sell a similar component to the commercial market and provided the following documentation in support of their claim:

- commercial catalog price;
- sales order for a quantity of one to a foreign firm for the commercially similar part; and
- sales orders for the exact part to Honeywell, the OEM, to support an existing DoD contract.

AeroControlex stated the documentation was sufficient to determine the quoted price fair and reasonable. However, the limited documentation failed to meet the

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intent of FAR 52.215-20, “Requirements for Cost or Pricing Data or Information Other Than Cost or Pricing Data,” which requires information on prices for the same or similar items sold in the commercial market. That information must be adequate for evaluating the reasonableness of the price for current acquisitions. The documentation provided did not adequately meet the intent of the regulation because the quantities sold were not comparable to Government requirements. AeroControlex provided 1 invoice for 1 item claimed to be commercially similar, while the current Government requirement was 578 units.

On June 24, 2003, the DSCC contracting officer requested additional commercial sales information. On September 8, 2003, AeroControlex provided one invoice showing sales of seven units of the exact item to Honeywell, the OEM. Further, on November 12, 2003, DSCC requested additional commercial sales data from the president of AeroControlex. On November 21, 2003, the president of AeroControlex provided 2 invoices showing sales of 49 units of the exact item to Honeywell, the OEM. The DSCC contracting officer inappropriately determined the item was commercial even though the information provided by AeroControlex was insufficient to meet Federal requirements.

**Request for Information Other Than Cost or Pricing Data.** The contracting officer requested additional information to determine whether the offered price was fair and reasonable because the price increased significantly—71.8 percent from the most recent procurement from Honeywell 21 months earlier. AeroControlex did not respond to the request, so the contracting officer properly raised this procurement issue through the chain of command beginning on August 18, 2003. DSCC management officials negotiated pricing with AeroControlex over several months. AeroControlex eventually offered a unit price of \$ <sup>2</sup> contingent on the contracting officer determining the price fair and reasonable. DSCC management officials determined that the offered price was not fair and reasonable and ultimately awarded the contract to AeroControlex at the unit price of \$3,663.36 because the Government’s need for the item was urgent.

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<sup>2</sup> Contractor proprietary data omitted.

# Appendix D. Comparison of Contract and OIG Cost-Based Prices

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NSN	Contractor	Qty <sup>1</sup>	Date	Contract Price		OIG Cost-Based Price		Excessive Profit	
				Unit <sup>2</sup>	Total	Unit <sup>3</sup>	Total	Amount	Percent
1680-01-043-6817	Adams Rite <sup>4</sup>	6	Sept. 17, 2004	\$ 471.63	\$ 6	\$ 6	\$ 6	6	6
1680-01-095-7507	Adams Rite <sup>4</sup>	6	Nov. 22, 2004	464.96	6	6	6	6	6
1680-01-102-6066	Adams Rite <sup>4</sup>	6	Dec. 29, 2004	977.37	6	6	6	6	6
<b>Adams Rite Subtotal (3 Items)</b>					<b>\$ 6</b>		<b>\$ 6</b>	<b>\$ 6</b>	<b>6</b>
2835-00-545-9285	Adel Wiggins	6	Apr. 17, 2005	\$1,238.00	\$ 6	\$ 6	\$ 6	6	6
4730-00-057-3074	Adel Wiggins	6	Mar. 17, 2005	1,291.85	6	6	6	6	6
4730-00-077-0965	Adel Wiggins	6	Jan. 7, 2004	722.83	6	6	6	6	6
4730-00-111-2538	Adel Wiggins	6	Dec. 23, 2004	469.04	6	6	6	6	6
4730-00-111-2539	Adel Wiggins	6	Apr. 18, 2005	319.69	6	6	6	6	6
4730-00-275-7943	Adel Wiggins	6	Mar. 31, 2005	1,209.85	6	6	6	6	6
4730-00-309-2678	Adel Wiggins	6	Feb. 10, 2005	309.64	6	6	6	6	6
4730-00-333-5311	Adel Wiggins	6	Apr. 8, 2005	412.19	6	6	6	6	6
4730-00-555-9263	Adel Wiggins	6	Sept. 30, 2004	724.27	6	6	6	6	6
4730-00-803-7727	Adel Wiggins	6	Feb. 11, 2005	194.03	6	6	6	6	6
4730-00-837-2459	Adel Wiggins	6	Apr. 24, 2003	496.00	6	6	6	6	6
4730-01-029-7790	Adel Wiggins	6	Feb. 10, 2005	607.62	6	6	6	6	6
4730-01-054-1118	Adel Wiggins	6	Apr. 15, 2005	479.73	6	6	6	6	6
4730-01-080-4723	Adel Wiggins	6	Sept. 6, 2002	2,453.88	6	6	6	6	6
4730-01-123-6898	Adel Wiggins	6	Jan. 21, 2005	1,401.43	6	6	6	6	6
4730-01-200-0850	Adel Wiggins	6	Aug. 23, 2004	1,420.53	6	6	6	6	6
4820-00-100-4337	Adel Wiggins	6	Apr. 18, 2005	341.81	6	6	6	6	6
4820-01-030-7160	Adel Wiggins	6	Apr. 5, 2005	1,714.64	6	6	6	6	6
4930-00-516-0839	Adel Wiggins	6	May 28, 2004	634.00	6	6	6	6	6
<b>Adel Wiggins Subtotal (19)</b>					<b>\$ 6</b>		<b>\$ 6</b>	<b>\$ 6</b>	<b>6</b>
1615-01-172-5065	AeroControlex	6	Oct. 22, 2004	\$4,287.00	\$ 6	\$ 6	\$ 6	6	6
1615-01-172-5066	AeroControlex	6	Dec. 7, 2004	4,980.00	6	6	6	6	6

Note: See the footnotes at the end of the appendix.

## Appendix D. Comparison of Contract and OIG Cost-Based Prices (cont'd)

NSN	Contractor	Qty <sup>1</sup>	Date	Contract Price		OIG Cost-Based Price		Excessive Profit	
				Unit <sup>2</sup>	Total	Unit <sup>3</sup>	Total	Amount	Percent
1615-01-172-5067	AeroControlex	6	Nov. 29, 2004	\$ 5,266.00	\$ 6	\$ 6	\$ 6	6	6
1615-01-172-5068	AeroControlex	6	Apr. 21, 2004	3,381.00	6	6	6	6	6
1680-01-115-7063	AeroControlex	6	Nov. 10, 2004	2,504.00	6	6	6	6	6
1680-01-115-7064	AeroControlex	6	July 22, 2004	2,221.35	6	6	6	6	6
1680-01-203-7388	AeroControlex	6	Dec. 10, 2004	1,607.00	6	6	6	6	6
1680-01-203-7389	AeroControlex	6	Jan. 12, 2005	3,015.00	6	6	6	6	6
1680-01-235-2571	AeroControlex	6	Sept. 20, 2004	4,576.00	6	6	6	6	6
2835-00-040-2951	AeroControlex	6	June 26, 2003	45.40	6	6	6	6	6
2835-00-111-8035	AeroControlex	6	Aug. 9, 2004	3,187.00	6	6	6	6	6
2835-00-335-7565	AeroControlex	6	Oct. 29, 2004	469.00	6	6	6	6	6
2835-00-676-9858	AeroControlex	6	Apr. 11, 2005	1,388.70	6	6	6	6	6
2835-00-707-8245	AeroControlex	6	Apr. 14, 2005	3,825.00	6	6	6	6	6
2835-00-898-2354	AeroControlex	6	Apr. 22, 2005	1,797.00	6	6	6	6	6
2835-01-224-5834	AeroControlex	6	Mar. 11, 2005	2,035.00	6	6	6	6	6
2835-01-269-2835	AeroControlex	6	Mar. 5, 2005	296.00	6	6	6	6	6
2915-01-170-1224	AeroControlex	6	Apr. 15, 2005	1,554.00	6	6	6	6	6
2990-01-259-0588	AeroControlex	6	June 26, 2003	4,112.00	6	6	6	6	6
2990-01-259-0589	AeroControlex	6	Jan. 14, 2004	3,663.36	6	6	6	6	6
2995-00-605-2785	AeroControlex	6	Dec. 31, 2004	2,340.00	6	6	6	6	6
3010-00-578-3545	AeroControlex	6	Oct. 4, 2002	6,578.50	6	6	6	6	6
3040-01-037-8554	AeroControlex	6	Mar. 18, 2003	2,127.00	6	6	6	6	6
4460-00-241-6141	AeroControlex	6	Feb. 14, 2005	490.26	6	6	6	6	6
4730-00-397-3112	AeroControlex	6	Oct. 1, 2004	6,639.00	6	6	6	6	6
4730-00-585-8437	AeroControlex	6	Oct. 29, 2004	5,380.00	6	6	6	6	6
4730-00-720-2000	AeroControlex	6	Feb. 1, 2005	4,147.00	6	6	6	6	6
4820-01-003-1395	AeroControlex	6	May 27, 2003	1,011.75	6	6	6	6	6
4820-01-004-6588	AeroControlex	6	Dec. 23, 2004	2,795.52	6	6	6	6	6
4820-01-155-0138	AeroControlex	6	Feb. 25, 2005	13,546.00	6	6	6	6	6

Note: See the footnotes at the end of the appendix.

# Appendix D. Comparison of Contract and OIG Cost-Based Prices (cont'd)

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NSN	Contractor	Qty <sup>1</sup>	Date	Contract Price		OIG Cost-Based Price		Excessive Profit	
				Unit <sup>2</sup>	Total	Unit <sup>3</sup>	Total	Amount	Percent
4820-01-221-5864	AeroControlex	6	June 29, 2004	\$2,605.00	\$ 6	\$ 6	\$ 6	6	
5905-01-437-4949	AeroControlex	6	Nov. 5, 2004	6,427.00	6	6	6	6	
6610-01-137-5463	AeroControlex	6	Jan. 18, 2005	6,722.00	6	6	6	6	
<b>AeroControlex Subtotal (33)</b>					<b>\$ 6</b>	<b>\$ 6</b>	<b>\$ 6</b>	<b>6</b>	
2840-01-147-0479	Champion <sup>5</sup>	6	Dec. 28, 2004	\$2,200.00	\$ 6	\$ 6	\$ 6	6	
2920-00-770-1641	Champion <sup>5</sup>	6	Sept. 22, 2004	381.00	6	6	6	6	
2920-00-776-4482	Champion <sup>5</sup>	6	Sept. 30, 2004	63.42	6	6	6	6	
2920-01-074-4992	Champion <sup>5</sup>	6	Nov. 18, 2003	141.00	6	6	6	6	
2925-01-033-8948	Champion <sup>5</sup>	6	Feb. 21, 2005	162.00	6	6	6	6	
2925-01-034-3141	Champion <sup>5</sup>	6	Oct. 3, 2003	185.63	6	6	6	6	
2925-01-093-5479	Champion <sup>5</sup>	6	Jan. 16, 2004	178.25	6	6	6	6	
2925-01-107-7939	Champion <sup>5</sup>	6	Feb. 28, 2004	104.37	6	6	6	6	
2925-01-190-9352	Champion <sup>5</sup>	6	Feb. 4, 2005	176.00	6	6	6	6	
2925-01-301-1727	Champion <sup>5</sup>	6	Aug. 14, 2003	209.00	6	6	6	6	
2925-01-389-1683	Champion <sup>5</sup>	6	Apr. 1, 2005	102.20	6	6	6	6	
2925-01-486-2496	Champion <sup>5</sup>	6	Oct. 28, 2004	1,250.00	6	6	6	6	
2925-01-486-2499	Champion <sup>5</sup>	6	Oct. 8, 2004	854.60	6	6	6	6	
4730-01-169-1734	Champion <sup>5</sup>	6	Jan. 28, 2005	194.35	6	6	6	6	
6130-00-781-3990	Champion <sup>5</sup>	6	Dec. 11, 2002	4,900.00	6	6	6	6	
<b>Champion Subtotal (15)</b>					<b>\$ 6</b>	<b>\$ 6</b>	<b>\$ 6</b>	<b>6</b>	
1560-00-116-7222	Marathon Norco	6	Apr. 16, 2005	\$1,231.43	\$ 6	\$ 6	\$ 6	6	
1560-01-143-8041	Marathon Norco	6	Mar. 16, 2005	755.00	6	6	6	6	
6140-00-712-3053	Marathon Norco	6	Jan. 26, 2005	2,185.28	6	6	6	6	
6140-00-866-6815	Marathon Norco	6	Mar. 30, 2004	1,784.00	6	6	6	6	
6140-01-086-3440	Marathon Norco	6	Apr. 14, 2005	1,185.00	6	6	6	6	

Note: See the footnotes at the end of the appendix.

## Appendix D. Comparison of Contract and OIG Cost-Based Prices (cont'd)

NSN	Contractor	Qty <sup>1</sup>	Date	Contract Price		OIG Cost-Based Price		Excessive Profit	
				Unit <sup>2</sup>	Total	Unit <sup>3</sup>	Total	Amount	Percent
6140-01-289-8566	Marathon Norco	<sup>6</sup>	Oct. 22, 2004	\$4,318.00	\$ <sup>6</sup>	\$ <sup>6</sup>	\$ <sup>6</sup>	\$ <sup>6</sup>	<sup>6</sup>
6140-01-339-2305	Marathon Norco	<sup>6</sup>	Sept. 30, 2004	74.17	<sup>6</sup>	<sup>6</sup>	<sup>6</sup>	<sup>6</sup>	<sup>6</sup>
<b>Marathon Norco Subtotal (7)</b>					<b>\$ <sup>6</sup></b>	<b>\$ <sup>6</sup></b>	<b>\$ <sup>6</sup></b>	<b>\$ <sup>6</sup></b>	<b><sup>6</sup></b>
<b>Total (77 Items)</b>					<b>\$ <sup>6</sup></b>	<b>\$ <sup>6</sup></b>	<b>\$ <sup>6</sup></b>	<b>\$ <sup>6</sup></b>	<b><sup>6</sup></b>

<sup>1</sup>Quantity represents the FY 2005 annual demand provided by the DLA Standard Automated Material Management System.

<sup>2</sup>The contract unit price is the most recent contract price listed in Haystacks for a TransDigm company as of July 18, 2005, or the most recent option year price for a long-term contract.

<sup>3</sup>The OIG cost-based price is based on cost analysis of the most recent unit cost data provided by the contractor and includes a profit in line with other DLA strategic supplier alliances. Slight rounding inconsistencies exist because some auditor calculations went beyond two decimal places.

<sup>4</sup>Due to direct sales from Adams Rite's exclusive distributor, [contractor proprietary data omitted], we used [contractor proprietary data omitted] contract prices.

<sup>5</sup>Champion provided [contractor proprietary data omitted].

<sup>6</sup>Contractor proprietary data omitted.

# Appendix E. Items Identified for Voluntary Refunds

NSN	Contract Number	Date	Qty	Contract Price		OIG Cost-Based Price		Excessive Profits	
				Unit	Total	Unit <sup>1</sup>	Total	Amount	Percent
1680-01-095-7507	SP0460-04-C-0084	July 9, 2004	1,560	\$ 352.36	\$ 549,682	\$ <sup>2</sup>	\$ <sup>2</sup>	\$ <sup>2</sup>	<sup>2</sup>
1680-01-102-6066	SP0407-05-C-2105	Dec. 29, 2004	353	977.37	<u>345,012</u>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
<b>Adams Rite Subtotal (2 items)</b>					<b>\$ 894,693</b>		<b>\$ <sup>2</sup></b>	<b>\$ <sup>2</sup></b>	<b><sup>2</sup></b>
1615-01-172-5067	SP0407-05-M-G030	Nov. 29, 2004	7	\$5,266.00	\$ 36,862	\$ <sup>2</sup>	\$ <sup>2</sup>	\$ <sup>2</sup>	<sup>2</sup>
1615-01-172-5068	SP0460-04-C-0066	Apr. 21, 2004	95	3,381.00	321,195	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
1680-01-203-7388	SP0475-03-M-GC38	Nov. 30, 2002	60	1,487.00	89,220	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
2835-00-111-8035	SP0480-02-C-1399	Nov. 4, 2002	110	3,537.07	389,078	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
2835-00-676-9858	SP0480-04-M-A060	Dec. 19, 2003	12	1,786.24	21,435	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
2835-00-707-8245	SP0480-04-M-4181	Nov. 28, 2003	18	3,723.50	67,023	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
2835-01-269-2835	SP0480-04-M-4651	June 15, 2004	312	319.00	99,528	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
2990-01-259-0589	SP0740-04-C-4647	Dec. 11, 2003	578	3,663.36	2,117,422	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
6610-01-137-5463	SP0406-05-M-N807	Jan. 18, 2005	7	6,722.00	<u>47,054</u>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
<b>AeroControlex Subtotal (9)</b>					<b>\$3,188,817</b>		<b>\$ <sup>2</sup></b>	<b>\$ <sup>2</sup></b>	<b><sup>2</sup></b>
2840-01-147-0479	SP0407-05-C-2007	Dec. 28, 2004	105	\$2,200.00	\$ 231,000	\$ <sup>2</sup>	\$ <sup>2</sup>	\$ <sup>2</sup>	<sup>2</sup>
2925-01-301-1727	SP0480-02-D-0744	Jan. 21, 2003	1,614	201.00	324,414	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
	Option Year	Aug. 18, 2003	807	209.00	168,663	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
2925-01-486-2496	SP0480-05-M-3165	Oct. 28, 2004	31	1,250.00	38,750	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
6130-00-781-3990	SP0430-03-C-0931	Nov. 15, 2002	44	4,625.00	203,500	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
	Option Year	Dec. 6, 2002	44	4,900.00	<u>215,600</u>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>	<sup>2</sup>
<b>Champion Subtotal (4)</b>					<b>\$1,181,927</b>		<b>\$ <sup>2</sup></b>	<b>\$ <sup>2</sup></b>	<b><sup>2</sup></b>
<b>Total (15 Items)</b>					<b>\$5,265,437</b>		<b>\$ <sup>2</sup></b>	<b>\$ <sup>2</sup></b>	<b><sup>2</sup></b>

<sup>1</sup>OIG cost-based unit price is calculated based on cost analysis of the most recent cost data provided by the contractor and includes a profit in line with other DLA strategic supplier alliances. Slight rounding inconsistencies exist because some auditor calculations were beyond two decimal places.

<sup>2</sup>Contractor proprietary data omitted.

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## **Appendix F. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition, Technology, and Logistics  
Director, Acquisition Resources and Analysis  
Under Secretary of Defense (Comptroller)/Chief Financial Officer  
Deputy Chief Financial Officer  
Deputy Comptroller (Program/Budget)  
Director, Program Analysis and Evaluation  
Director, Defense Procurement and Acquisition Policy

### **Department of the Army**

Auditor General, Department of the Army

### **Department of the Navy**

Naval Inspector General  
Auditor General, Department of the Navy

### **Department of the Air Force**

Assistant Secretary of the Air Force (Financial Management and Comptroller)  
Auditor General, Department of the Air Force

### **Other Defense Organizations**

Director, Defense Logistics Agency  
Commander, Defense Supply Center, Columbus, Ohio  
Commander, Defense Supply Center, Richmond, Virginia  
Commander, Defense Supply Center, Philadelphia, Pennsylvania

### **Non-Defense Federal Organization**

Office of Management and Budget

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## **Congressional Committees and Subcommittees, Chairman and Ranking Minority Member**

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Homeland Security and Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Government Reform  
House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform  
House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform  
House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

# Defense Logistics Agency Comments



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

FEB 06 2006

IN REPLY  
REFER TO J-33

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING  
DEPARTMENT OF DEFENSE

SUBJECT: Draft Audit Report on Spare Parts Procurements From TransDigm, Inc.,  
October 31, 2005, Project No. D2004-D000CH-0189.000

Our memorandum of January 13, 2006 forwarded the Defense Logistics Agency (DLA) comments to the finding and recommendations of the subject draft report. Subsequently, members of your staff engaged members of my staff in discussions regarding some minor changes being made to the report finding, which have resulted in some changes in our response. This response supersedes our earlier response and provides DLA's position concerning the draft as revised.

We appreciate the opportunity to comment on the draft report. Questions may be referred to Mr. Jerry Gilbert, Procurement Integrity and Pricing Branch (J-3313), 703-767-1350 or Ms. Annell Williams, Internal Review Office (J-308), 703-767-6274.

BENNIE E. WILLIAMS  
Major General, USA  
Director, Logistics Operations

Attachment

Federal Recycling Program



Printed on Recycled Paper

SUBJECT: Draft Audit Report on Spare Parts Procurements From TransDigm, Inc.,  
October 31, 2005, Project No. D2004-D000CH-0189.000

**Finding:** Given the constraints of a sole-source environment, DLA contracting officers were unable to effectively negotiate prices for sole source spare parts procured from TransDigm subsidiaries. This condition occurred because either the contracting officers or the head of the contracting activity:

- used price analysis of questionable prior Government prices to determine price reasonableness and were unable to perform cost analysis to validate the offered prices,
- inappropriately waived the submission of cost or pricing data for a long-term indefinite-quantity contract with an estimated total value over \$10 million, and
- wrongly considered prices to be reasonable based on competition between a sole-source manufacturer and its dealers.

We calculated that DLA paid about \$5.3 million or \* percent more than the fair and reasonable price for 77 parts that cost about \$ \* . If problems are not addressed, DLA will pay about \$31.8 million more than fair and reasonable prices for the same items over the next six years. DLA also needs to seek a voluntary refund of about \$2.6 million for overpriced parts identified in the report where contracting officers made a reasonable attempt to obtain cost data but were denied the information. We recognize the difficulty contracting officers have had obtaining cost data to ensure the integrity of prices for sole-source spare parts since the inception of the Federal Acquisition Streamlining Act of 1994 (FASA) and the Federal Acquisition Reform Act of 1996.

**DLA Comments:** Partially concur.

DLA concurs in the IG conclusion (final sentence of the above finding) that contracting officers negotiated prices for these sole source spare parts from TransDigm subsidiaries under difficult circumstances, and that this occurred for the following reasons (stated on pages 15 and 16 of the draft):

- "...DoD contracting officers have limited tools to obtain sole-source spare parts at fair and reasonable prices.";
- "Sole-source contractors, like TransDigm, are increasingly less willing to provide cost data to...enable DoD contracting officers to negotiate fair and reasonable prices.";
- "When a sole-source item is determined commercial, contracting officers are limited in the amount of information that they can request, and the contractor is exempt from the requirement to submit cost or pricing data."; and
- "Contracting officers can request information other than cost or pricing data when sufficient information is not available to establish price reasonableness....However... TransDigm routinely refused to provide the requested data....or negotiate in a timely manner."

\* Contractor proprietary data omitted.

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Using cost data which the IG alone was able to obtain from AeroControlex and four other TransDigm entities, the IG reportedly calculated a "cost-based price" for a recent DLA award to these entities. The IG reportedly included a profit rate in line with that of DLA strategic supplier alliances, and characterized any overage as "excessive profit."

Absent statutory authority to obtain cost data under the circumstances of these buys, DLA contracting officers were obliged to base their price reasonableness decisions on price analyses of the offered prices. Had our contracting officers been granted *access* to such data, they would have been able to perform cost analysis to validate the offered prices. However, DLA does not concur in the audit conclusion that this was a cause of the reported "excessive profits" (i.e., the first bullet within the statement of IG finding shown above). In our view, "excessive profits" are the result of an unwillingness to negotiate a price that is fair and reasonable to *both* parties.

DLA nonconcur in the second of the three bullets the IG attributes to the reported failure to "effectively negotiate prices for these sole-source spare parts."---i.e., because the Head of the Contracting Activity "inappropriately waived the submission of cost or pricing data..." The waiver was granted by the HCA on September 13, 2002, in conformance with the existing Federal Acquisition Regulation guidance---"The HCA may consider waiving the requirement if the price can be determined to be fair and reasonable without the submission of cost or pricing data" (cited on page 9 of the draft). The offered prices were determined reasonable by comparison to recent award prices that had been determined reasonable. An indefinite delivery contract, which enabled individual orders as requirements arise, was awarded for administrative expediency and savings. The contract value exceeded the cost data threshold merely because it covered a sizeable number of items having annual demand values well below the cost data threshold.

Also, DLA does not fully concur in the third bullet attributed to the reported failure, applicable to 6 of the 77 items---"competition between a sole-source manufacturer and its dealers." We recently obtained identification of the buys for the 6 items summarized in Table 2 (page 5 of the draft report) as based on dealer/manufacturer competition. We are seeking a clear understanding of the individual circumstances of each of the 6 buys, including the approximate dollar value, the type of source selection procedures chosen, nature of the distributor/dealership relationship (arms length, agency, financial ownership, or other), whether the dealers maintained any item stockage, whether the solicitation requirements involved any services beyond routine supply, the competitive coding/status of the item, potential for the buyer to use any other alternative forms of price or cost analyses, whether public exigency or other urgent condition required expedited contracting, whether any set-aside or similar restriction applied, and other specific circumstances that existed at the time of each buy. This insight is a necessary prerequisite to determining whether the reported competition was properly or improperly used to determine price reasonableness. Only then will we be able to reach a conclusion regarding this reported failure.

The amount the IG calculated is merely a proxy of any actual "excessive profit" that has occurred. This is because they used the contractor-supplied data in calculating such "excess" on the most recent award for each of the 77 items, then extended such amounts using DLA-supplied annual demand forecast beginning as of the second quarter fiscal year 2005. Since forecasted demands for each item vary over time, the actual quantities purchased over the forthcoming 12 month period and amounts of any actual "excess profits" will likewise vary. Further, changes in the aforementioned circumstances affecting such future buys may substantially affect future

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outcomes. A contractor willing to substantiate its price and to negotiate a price that is fair and reasonable to *both* parties can substantially alter the IG's forecast. DLA is fully committed, and we will seek a similar commitment from TransDigm, to counter the adverse results the IG noted.

**Recommendation No. 1:** Director, Defense Logistics Agency alert contracting officers, when using price analysis of previous Government prices to determine price reasonableness for sole-source spare parts, to perform periodic cost analysis to establish the validity of the comparison and the reasonableness of the previous prices.

**DLA Comments:** Partially concur.

We agree that the ability to perform a cost analysis can, at times, be a beneficial supplement to traditional forms of price analysis for determining price reasonableness. However, the best intentions and efforts of procurement personnel to obtain cost data and related information can, and often have been, thwarted. This was well-documented in the draft report. We will address these matters in correspondence to our operational personnel.

We received some comments and suggestions regarding local guidance and training regarding this matter which warrant further consideration for DLA-wide adoption. We will work to standardize this guidance and assure its dissemination and incorporation into local training.

**Disposition:**

- (X) Action is ongoing. ECD: September 29, 2006.
- ( ) Action is considered complete.

**Recommendation No. 2:** Director, Defense Logistics Agency, discontinue using the Navy Price Fighters to perform price analyses similar to the work performed by DLA contracting representatives on spare parts procurements.

**DLA Comments:** Partially concur.

As noted on page 6 of the draft, "Federal regulations encourage the contracting officer to request field pricing assistance when the information available at the buying activity is inadequate." Accordingly, contracting officers where warranted and appropriate, occasionally request Price Fighter assistance. Normally a "should cost analysis" is requested, but occasionally, they provide DLA with a technical reviews of potential alternative sources or items, or a cost comparison. The identification by the IG of one instance of an apparent support deficiency has been beneficial in enabling both DLA and the Navy to make procedural adjustments to guard against such a recurrence in the future.

**Disposition:**

- ( ) Action is ongoing. ECD:
- (X) Action is considered complete.

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**Recommendation No. 3:** Director, Defense Logistics Agency, emphasize the importance of validating the reasonableness of previous Government prices when using price analysis as a tool to justify fair and reasonable prices.

**DLA Comments:** Concur.

The draft identifies several instances where improved analyses or a more thorough documentation of the analysis performed was needed. These matters will be emphasized at forthcoming training or seminars for their procurement personnel of our Air, Land and Maritime supply chains.

**Disposition:**

- (X) Action is ongoing. ECD: 30 June 2006.
- ( ) Action is considered complete.

**Recommendation No. 4:** Director, Defense Logistics Agency, emphasize the importance of obtaining cost or pricing data and the necessity to provide adequate justifications for waivers to cost or pricing data for sole-source items.

**DLA Comments:** Concur.

The receipt and validation of the offeror's current or recent cost data (certified or otherwise), when used in conjunction with price analyses, provides the greatest assurance of determining a fair and reasonable price. Lesser assurance results when the efforts of Government procurement personnel to establish price reasonableness of sole source parts from a supplier that refuses to provide any cost information and negotiate a fair and reasonable price accordingly. The impact of these refusals is well documented in the draft report. We will assure the importance of obtaining cost data, adequate justifications for waivers and the vigorous pursuit of alternative actions that are warranted and necessary given the currently existing statutory and regulatory constraints, is communicated, *and underscored*, to our procurement personnel and managers.

**Disposition:**

- (X) Action is ongoing. ECD: 29 September 2006.
- ( ) Action is considered complete.

**Recommendation No. 5:** Director, Defense Logistics Agency, seek a voluntary refund of about \$2.6 million for overpriced parts identified in the report where contracting officers made a reasonable attempt to obtain cost data but were denied the information.

**DLA Comments:** Partially concur.

DLA is planning prompt action concerning this recommendation, which we understand is based on total cost plus an average profit markup. However, the profit rate used in the calculations is under further review as it appears excessive given the level of risk associated with manufacturing mature spare parts.

**Disposition:**

- (X) Action is ongoing. ECD: 31 March 2006.
- ( ) Action is considered complete.

**Recommendation No. 6:** Director, Defense Logistics Agency, require the Commanders of the Defense Supply Centers in Columbus, Ohio, and Richmond, Virginia, to discontinue using competition between sole source manufacturers and their dealers to determine price reasonableness.

**DLA Comments:** Partially concur.

DLA will seek identification of the individual circumstances of the buys for the 6 items summarized in Table 2 (page 5) of the draft report as having been based on dealer/manufacturer competition. This insight is a necessary prerequisite to determining whether the reported competition was proper, or improperly used, to determine price reasonableness. Once gained, we will promptly take any appropriate corrective actions. However, because the type competition can be valid in some instances, we do not envision the practice will be prohibited.

**Disposition:**

- (X) Action is ongoing. ECD: 30 June 2006.
- ( ) Action is considered complete.

**Recommendation No.7:** Director, Defense Logistics Agency, require the Commander Defense Supply Center Columbus, Ohio, to develop procedures and appropriate controls to administer accurate option year pricing for delivery order contracts.

**DLA Comments:** Partially concur.

Concur to the extent that the option years' prices were properly calculated. Although the IG noted (p. 14 of the draft) that this occurred on only one contract and the net overpayment for the 15 items reviewed was an aggregate overpayment of \$165.17, DSCC advised they will ask their Internal Review Group to determine the nature and cause of the errors, and determine if it is an isolated or systemic problem. At our request, the IG provided a detailed spreadsheet showing its methodology and each error to assist DSCC. DSCC will, as appropriate, develop procedures and conduct training in calculating option year prices.

**Disposition:**

- (X) Action is ongoing. ECD: 29 Sep 2006.
- ( ) Action is considered complete.

**Recommendation No. 8:** Director, Defense Logistics Agency, establish either a strategic supplier alliance with TransDigm subsidiaries using cost data to negotiate fair and reasonable prices or develop and execute a strategy to reengineer and procure competitively high dollar value spare parts.

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**DLA Comments:** Partially concur.

DLA's strategic goals and objectives include providing best value supplies/services to our customers and meeting or beating our cost and pricing commitments while seeking reduced total customer costs. This recommendation addresses several initiatives supporting our strategic plan.

First, DLA has developed various types of Government-supplier relationships, including strategic supplier alliances (SSA) and supply chain alliances (SCA), over the years. Such partnerships normally seek, and achieve, improvements in other aspects of our business relationships such as decreased response times, more accurate forecasting, reduced inventory, and decreased administrative costs. Our alliances therefore result in shared benefits among DLA, our business partners and our customers. We desire a shared benefits partnership with TransDigm. We have therefore initiated planning for discussions with senior TransDigm management concerning means of achieving similar improvements, including information and other means of supporting price reasonableness.

Second, breakout and reverse engineering are two long-standing DoD/DLA initiatives seeking to achieve the benefit of reduced pricing for noncompetitive items. Our customers have benefited from the reduced item costs achieved by the aggressive breakout/reverse engineering programs run by our Air, Land and Maritime supply chains. For example, the Air supply chain recently achieved a 3/5ths reduction in the purchase cost on one, and a 2/5<sup>th</sup> reduction on another, of the items involving substantial "excess profits" cited in the draft. Cost avoidance achieved to date on the two competitive buys of each item since development of competitive data packages totals \$1.1 million. We've asked our supply chains to report on the suitability and status of projects covering other TransDigm items cited in the draft to have resulted in excessive profitability.

**Disposition:**

(X) Action is ongoing. ECD: 30 June 2006.

( ) Action is considered complete.

## **Team Members**

The Department of Defense Office of the Deputy Inspector General for Auditing, Acquisition and Contract Management Directorate prepared this report. Personnel of the Department of Defense Office of Inspector General who contributed to the report are listed below.

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