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Report No. D-2008-048

February 6, 2008

Inspector General

United States
Department of Defense



Procuring Noncompetitive Spare Parts Through an Exclusive Distributor

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To request copies of this report, contact Mr. Henry Kleinknecht at (703) 604-9324 (DSN 664-9324) or Mr. Joseph P. Bucsko at (703) 604-9337 (DSN 664-9337).

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Acronyms

CPSR	Contractor Purchasing System Review
DCAA	Defense Contract Audit Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DLA	Defense Logistics Agency
DLAD	Defense Logistics Acquisition Directive
DSCC	Defense Supply Center, Columbus, Ohio
DSCP	Defense Supply Center, Philadelphia, Pennsylvania
DSCR	Defense Supply Center, Richmond, Virginia
FAR	Federal Acquisition Regulation
GAO	Government Accountability Office
IG	Inspector General
NAVICP-P	Naval Inventory Control Point, Philadelphia, Pennsylvania
NSN	National Stock Number
OIG	Office of Inspector General

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

February 6, 2008

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION,
TECHNOLOGY, AND LOGISTICS
DIRECTOR, DEFENSE LOGISTICS AGENCY
NAVAL INSPECTOR GENERAL
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Report on Procuring Noncompetitive Spare Parts Through an Exclusive
Distributor (Report No. D-2008-048)

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 Procurement and Acquisition Policy; Defense Logistics Agency; and Naval Inventory Control Point, Philadelphia, Pennsylvania, comments were responsive to the recommendations. However, Army Aviation and Missile Life Cycle Management Command comments did not meet the intent of or specifically address the recommendations. Therefore, we request additional comments from the Army Aviation and Missile Life Cycle Management Command on Recommendations A.2.a. through A.2.d. by March 7, 2008. If possible, please send management comments in electronic format (Adobe Acrobat file only) to 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). The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

Richard B. Jolliffe
Assistant Inspector General
Acquisition and Contract Management

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Department of Defense Office of Inspector General

Report No. D-2008-048

(Project No. D2006-D000CH-0056.000)

February 6, 2008

Procuring Noncompetitive Spare Parts Through an Exclusive Distributor

Executive Summary

Who Should Read This Report and Why? Acquisition and contracting personnel within DoD should read this report because it concerns the rapidly increasing prices for noncompetitive spare parts used on Defense weapon systems.

Background. An exclusive distributor is a nonmanufacturer that has an agreement with parts manufacturers to be the sole representative for their Government sales. Distributors serve as “middlemen” who perform all of the administrative tasks necessary to respond to and fill Government orders, including quoting, procuring, and receiving the item from the manufacturer and selling and shipping the item to the Government. The distributor model adds a duplicate layer of administration and shipments to the traditional procurement process. Congress has expressed concern with DoD paying excessive pass-through charges on contracts entered into or on behalf of DoD when the prime contractor provides negligible or no added value and most of the work is performed by subcontractors.

Dutch Valley Supply, headquartered in Lawrenceville, Georgia, was established in August 1963 as a commercial supplier of hard-to-find nuts, bolts, and fasteners. Dutch Valley Supply entered the Government spare parts market in 1991 and now Government sales account for approximately [REDACTED] percent of business revenues. According to Dutch Valley Supply, the company has partnered with 24 single-source manufacturers to distribute approximately 150,000 spare parts to the Government. Dutch Valley Supply, as an exclusive distributor, states that it provides value to DoD through reduced costs, improved readiness, and increased competition.

For more than 10 years, the DoD Office of Inspector General has worked with the Defense Logistics Agency (DLA) and other DoD Components to achieve fair and reasonable prices for noncompetitive spare parts. We found that DoD has paid excessive prices and profit to single-source contractors for noncompetitive spare parts when cost analysis is not performed; we issued a previous report on the reasonableness of prices from an exclusive distributor. See Appendix B for a list of prior reports.

Results. DoD contracting officers were unable to effectively negotiate prices or obtain best value for noncompetitive spare parts procured through Dutch Valley Supply. As a result, DoD paid about \$3.0 million (75.0 percent) more than the fair and reasonable prices for 33 parts that cost about \$6.9 million. Dutch Valley Supply accepted prices from manufacturers that were about \$ [REDACTED] ([REDACTED] percent) higher than fair and reasonable and then applied [REDACTED] pass-through charges of [REDACTED] percent for negligible or no added value totaling about [REDACTED]. If problems are not addressed, DoD will

pay about \$17.8 million more than fair and reasonable prices for the same items over the next 6 years and this valuable procurement money will not be available to support other urgent warfighter needs. In addition, the exclusive distributor model increased lead times and associated inventory levels [REDACTED]. We do not believe the current exclusive distributor model is a viable procurement alternative for DoD (finding A).

We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics develop and issue guidance in the acquisition regulations that permits contracting officers to require consent to subcontract for fixed-price contracts from prime contractors that exhibit significant risk of charging excessive prices. We also recommend that the Under Secretary issue guidance that requires the Military Departments and Defense agencies to collect information on and take appropriate action to address problem contractors that refuse to provide requested information necessary to determine price reasonableness. We further recommend that the Under Secretary review DLA dealer competition policies and determine whether the policies comply with the Federal Acquisition Regulation (FAR) 15.403-1 definition of adequate price competition. Finally, we recommend that the Under Secretary take appropriate action to identify and address contractors that require contracting officers to procure noncompetitive items through exclusive distributors.

We recommend that the Commanders, Army Aviation and Missile Life Cycle Management Command and Navy Inventory Control Point, Philadelphia; and the Director, DLA instruct contracting officers to ensure prime contractors, like Dutch Valley Supply, conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices and include the results of these analyses in the price proposal as required by FAR 15.404-3, "Subcontracting Pricing Considerations;" determine the adequacy of the cost or price analyses performed by Dutch Valley Supply; and if the prime contractor did not perform adequate cost or price analyses of subcontract prices, review and determine the reasonableness of subcontractor prices to include obtaining cost data when necessary before awarding future contracts. We also recommend that the commanders and the director instruct contracting officers to perform cost analysis in noncompetitive environments when price analysis does not provide sufficient information and a reliable baseline price has not been established, and take action to discontinue using exclusive distributors unless they can develop a business model that provides sufficient added value.

We recommend that the Director, DLA request the Defense Contract Management Agency immediately begin a review of Dutch Valley Supply's purchasing system; instruct the commanders of the Defense Supply Centers to discontinue granting inappropriate waivers from cost or pricing data based primarily on price analysis; and continue initiating reverse engineering efforts for items that have unreasonable pricing from single-source offerors. We also recommend that the director instruct contracting officers to discontinue coding an analysis of dealer costs as cost analysis unless a cost analysis of manufacturing costs has also been performed, and discontinue using dealer competition to determine price reasonableness in a noncompetitive environment. We further recommend that the director emphasize to contracting officers the importance of making price reasonableness determinations, properly documenting the contract file, and ensuring cost or pricing data is requested as required by FAR 15.403-4, "Requiring Cost or Pricing Data."

DLA contracting officers failed to correctly calculate the threshold for requiring cost or pricing data as required by FAR 15.403-4. As a result, DLA failed to require cost or pricing data for eight items procured on three contracts valued at about \$3.5 million. (finding B).

We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics review and determine whether DLA's policy for determining the cost or pricing data threshold is consistent with the Federal Acquisition Regulation. We also recommend that the Director, DLA modify the Defense Logistics Acquisition Directive to ensure that cost or pricing data threshold is calculated based on the final anticipated dollar value of the action, inclusive of all options.

Review of Internal Controls. DLA internal controls were not adequate. We identified material internal control weaknesses for procurement relating to the acquisition of noncompetitive spare parts. Specifically, DLA did not have the internal control procedures for procurement to determine the independence of offerors or dealers for noncompetitive items before relying on the offered prices to determine price reasonableness, to perform an effective cost or price analysis of the subcontractors price, or to ensure that waivers from cost or pricing data are appropriate and comply with legislative and DoD guidance.

Management Comments and Audit Response. We received comments from the Director, Defense Procurement and Acquisition Policy, Under Secretary of Defense for Acquisition, Technology, and Logistics; the Director of Acquisition Management, DLA; the Deputy Director of Contracts, Naval Inventory Control Point, Philadelphia, Pennsylvania; and the Chief of Staff, Army Aviation and Missile Life Cycle Management Command. The Director, Defense Procurement and Acquisition Policy concurred with the report findings and recommendations. The director issued a policy memorandum, dated November 7, 2007, reinforcing and relating the requirements of FAR Part 15.4 to exclusive distributors. The memorandum also required contracting officers to obtain cost data and perform cost analysis, as well as to report companies that refuse to provide the required cost data.

DLA concurred or partially concurred with the report findings and recommendations. DLA has issued guidance and is implementing new guidance from the Defense Procurement and Acquisition Policy office to correct the problems identified in the report. The Naval Inventory Control Point, Philadelphia, Pennsylvania, concurred with and will implement the recommendations to improve its operations.

The Army Aviation and Missile Life Cycle Management Command nonconcurred with Recommendations A.2.a. through A.2.e. Further, the Army comments did not meet the intent of or specifically address the recommendations relating to the responsibilities of the prime contractor and the reasonableness of subcontract costs. Therefore, we request that the Army Aviation and Missile Life Cycle Management Command provide additional comments to the final report on Recommendations A.2.a. through A.2.d. by March 7, 2008.

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

Procurement Process. An exclusive distributor is a nonmanufacturer that has an agreement with parts manufacturers to be the sole representative for their Government sales. Distributors serve as “middlemen” who perform all of the administrative tasks necessary to respond to and fill Government orders, including quoting, procuring, and receiving the item from the manufacturer and selling and shipping the item to the Government. Spare parts distributors normally do not stock items; instead ordering items from single-source manufacturers when the Government need becomes known. Thus, the items ordered just “pass through” the distributor on their way to DoD. The distributor model adds a duplicate layer of administration and shipments to the traditional procurement process. Figure 1 shows the traditional spare part procurement process and the process with a distributor.

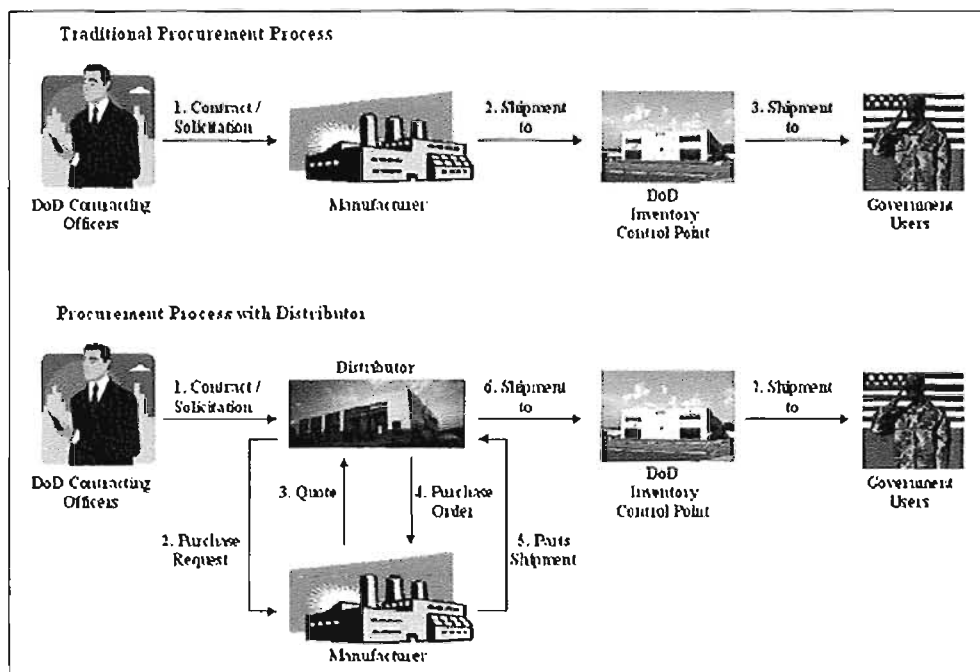


Figure 1. Spare Part Procurement Process With and Without a Distributor

Legislation on Pass-Through Charges. Congress has expressed concern with DoD paying unnecessary or excessive pass-through charges¹ on contracts entered into or on behalf of DoD when prime contractors provide negligible or no added value and most of the work is performed by subcontractors. Public Law 109-364, “John Warner National Defense Authorization Act for Fiscal Year 2007,” prohibits DoD from paying excessive pass-through charges in relation to the cost of work performed by the relevant contractor or subcontractor. Further, the Act

¹ An excessive pass-through charge is defined as a charge to the Government by a contractor or subcontractor that provides no or negligible value for overhead or profit on work performed by a low-tier contractor or subcontractor.

requires the Secretary of Defense to establish policy and an implementation plan to prevent DoD from paying excessive pass-through charges.

Company Overview. Dutch Valley Supply, headquartered in Lawrenceville, Georgia, was established in August 1963. Originally, Dutch Valley Supply's business model was geared towards commercial customers seeking hard-to-find nuts, bolts, and fasteners. In 1991, after the Gulf War, their business model shifted towards the Government spare parts aftermarket. Now, according to Dutch Valley Supply management, about [REDACTED] percent of Dutch Valley Supply's business consists of Government sales. During FYs 2003 through 2006, Dutch Valley Supply sales to the Defense Logistics Agency (DLA) totaled approximately \$63.9 million, or average annual sales of approximately \$16 million.

Manufacturing Partners. According to Dutch Valley Supply, the company has partnered with 24 single-source manufacturers to distribute approximately 150,000 spare parts to the Government. Table 1 lists Dutch Valley Supply's single-source partners.

Table 1. Manufacturers Represented by Dutch Valley Supply

[REDACTED]	
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Affiliations. Dutch Valley Supply is a private family-held company with affiliates at JDC Industries and ECI Defense Group located in Lyles, and Bon Aqua, Tennessee. The three companies are separate entities that share common ownership. JDC Industries and ECI Defense Group have the same business model and entered into similar distributor arrangements with other single-source manufacturers [REDACTED]

[REDACTED] For example, since February 27, 2006, ECI Defense Group has been the sole reseller of all spare parts manufactured by [REDACTED] and its subsidiaries. JDC Industries had sales to DLA, totaling approximately \$10.5 million from FYs 2003 through 2006. Additionally, ECI Defense Group began its business in FY 2005 and achieved DLA sales of approximately \$3.2 million from FY 2005 through FY 2006.

Prior Audits. For more than 10 years, the DoD Office of Inspector General (OIG) has worked with DLA and other DoD Components to achieve fair and reasonable prices for noncompetitive spare parts. We found that DoD has paid excessive prices and profits to single-source contractors for noncompetitive spare

parts when cost analysis is not performed, including our findings in a previous report on the reasonableness of prices from an exclusive distributor. DoD Inspector General (IG) Report No. D-2004-012, "Sole-Source Spare Parts Procured From an Exclusive Distributor," October 16, 2003, showed that the Army Aviation and Missile (now referred to as Aviation and Missile Life Cycle Management) Command and DLA paid about \$ [REDACTED] ([REDACTED] percent) more than fair and reasonable prices for noncompetitive spare parts, procured from AAR Defense Systems, an exclusive distributor for Hamilton Sundstrand. AAR Defense Systems failed to effectively negotiate prices with Hamilton Sundstrand resulting in \$ [REDACTED] million of the excessive prices. Further, the remaining \$ [REDACTED] ([REDACTED] percent) of the excessive prices represented unnecessary pass-through charges considering that the exclusive distributor failed to provide sufficient added value. See Appendix B for a list of previous audit reports.

Objective

Our overall audit objective was to evaluate whether DoD is obtaining the best value and purchasing spare parts at fair and reasonable prices from Dutch Valley Supply. See Appendix A for a discussion of the scope and methodology and Appendix B for prior audit coverage.

Review of Internal Controls

We identified material internal control weaknesses for DLA as defined by DoD Instruction 5010.40, "Managers' Internal Control (MIC) Program Procedures," January 4, 2006. DLA did not have the following internal control procedures for procurement to:

- determine the independence of offerors or dealers for noncompetitive items before relying on the offered prices to determine price reasonableness,
- perform an effective cost or price analysis of the subcontractors' price, and
- ensure that waivers from cost or pricing data are appropriate and comply with legislative and Departmental guidance.

Implementing Recommendations A.1.c., A.2.a., A.2.b., A.2.c., A.2.d., A.3.a., A.3.b., and A.3.e. will improve DLA procurement procedures. If these procedures are implemented, potential recurring monetary benefits of about \$2.7 million can be achieved. A copy of the report will be provided to the DLA senior official responsible for internal controls.

A. Procuring Noncompetitive Spare Parts Through an Exclusive Distributor

DoD contracting officers were unable to effectively negotiate prices or obtain best value for noncompetitive spare parts procured through Dutch Valley Supply, an exclusive distributor for numerous single-source manufacturers. Negotiations were not effective for the following reasons.

- Dutch Valley Supply did not effectively negotiate prices with single-source manufacturers (subcontractors) including obtaining cost data when necessary.
- DoD contracting officers primarily relied on ineffective tools such as price analysis, cost analysis of dealer costs, and dealer competition to support price reasonableness determinations. In several instances price reasonableness determinations were not made.
- The current exclusive distributor model used to procure items does not provide best value and is less effective than the traditional DLA supply and strategic supplier models.

As a result, DoD paid about \$3.0 million (75.0 percent) more than the fair and reasonable prices² for 33 parts that cost about \$6.9 million. Dutch Valley Supply accepted prices from manufacturers that were about \$██████ (██████ percent) higher than fair and reasonable and then applied ██████ pass-through charges of ██████ percent for negligible or no added value totaling about \$██████. If problems are not addressed, DoD will pay about \$17.8 million more than fair and reasonable prices for the same items over the next 6 years and this valuable procurement money will not be available to support other urgent warfighter needs. In addition, the current exclusive distributor model increased lead times and associated inventory levels by ██████. We do not believe the current exclusive distributor model is a viable procurement alternative for DoD.

Guidance

Prime Contractor Responsibilities. Federal Acquisition Regulation (FAR) 15.404-3, "Subcontract Pricing Considerations," requires contracting officers to determine price reasonableness for the prime contract, including subcontracting costs. Further, the prime contractor must evaluate subcontractor prices to

² We calculated fair and reasonable prices by performing cost analysis and including a profit in line with DLA strategic supplier alliances. For consistency and accuracy, we used average annual demand quantities to calculate total amounts that exceeded fair and reasonable prices.

establish price reasonableness as part of the prime contract proposal. Specifically, the FAR states:

- (a) The contracting officer is responsible for the determination of price reasonableness for the prime contract, **including subcontracting costs**. The contracting officer should consider whether a contractor or subcontractor has an approved purchasing system, has performed cost or price analysis of proposed subcontractor prices, or has negotiated the subcontract prices before negotiation of the prime contract, in determining the reasonableness of the prime contract price. This does not relieve the contracting officer from the responsibility to analyze the contractor's submission, including subcontractor's cost or pricing data.
- (b) The **prime contractor** or subcontractor shall –
 - (1) **Conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices;**
 - (2) **Include the results of these analyses in the price proposal;**and
- (3) When required by paragraph (c) of this subsection, **submit subcontractor cost or pricing data to the Government as part of its own cost or pricing data.**
- (c) Any contractor or subcontractor that is required to submit cost or pricing data also shall obtain and analyze cost or pricing data before awarding any subcontract, purchase order, or modification expected to exceed the cost or pricing data threshold, unless an exception in 15.403-1(b) applies to that action. **[emphasis added]**

Contractor Purchasing System Review. FAR 44.3, "Contractors Purchasing Systems Reviews," permits the administrative contracting officer to perform contractor purchasing system reviews (CPSR) to evaluate the efficiency and effectiveness with which the contractor executes Government funds and complies with Government policy when subcontracting. The administrative contracting officer relies on the results of the review to grant, withhold, or withdraw approval of the contractor's purchasing system. When a CPSR is conducted, special attention will be given to the degree of price competition obtained and pricing policies and techniques used by the contractor. The FAR establishes criteria for when the administrative contracting officer should perform a CPSR. Specifically, FAR 44.302, "Requirements," states:

- (a) The ACO [administrative contracting officer] shall determine the need for a CPSR based on, but not limited to, the past performance of the contractor, and the volume, complexity and dollar value of the subcontracts. If a contractor's sales to the Government (excluding competitively awarded firm-fixed-price and competitively awarded fixed-price with economic price adjustment contracts and sales of commercial items pursuant to Part 12) are expected to exceed \$25 million during the next 12 months, perform a review to determine if a CPSR is needed. Sales include those represented by prime contracts, subcontracts under Government prime contracts, and modifications. Generally, a CPSR is not performed for a specific contract. The head of the agency responsible for contract administration may raise or lower the \$25 million review level if it is considered to be in the Government's best interest. **[emphasis added]**

Consent to Subcontract. FAR 44.2, "Consent to Subcontracts," prescribes policies and procedures for consent to subcontract or advance notification of subcontracts. Specifically, FAR 44.201-1, "Consent requirements," states:

(a) If the contractor has an approved purchasing system, consent is required for subcontracts specifically identified by the contracting officer in the subcontracts clause of the contract. The contracting officer may require consent to subcontract if the contracting officer has determined that an individual consent action is required to protect the Government adequately because of the subcontract type, complexity, or value, or because the subcontract needs special surveillance. These can be subcontracts for critical systems, subsystems, components, or services. Subcontracts may be identified by subcontract number or by class of items (e.g., subcontracts for engines on a prime contract for airframes).

(b) If the contractor does not have an approved purchasing system, consent to subcontract is required for cost-reimbursement, time-and-materials, labor-hour, or letter contracts, and also for unpriced actions (including unpriced modifications and unprice [sic] delivery orders) under fixed-price contracts that exceed the simplified acquisition threshold. . . [emphasis added]

Further, FAR 44.202-2, "Considerations," informs the contracting officer to consider risks associated with procurements.

(a) The contracting officer responsible for consent must, at a minimum, review the request and supporting data and consider the following:

.

(8) Has the contractor performed adequate cost or pricing analysis or price comparisons and obtained accurate, complete, and current cost or pricing data, including any required certifications?

.

(b) Particularly careful and thorough consideration under paragraph (a) of this section is necessary when—

(1) The prime contractor's purchasing system or performance is inadequate;

(2) Close working relationships or ownership affiliations between the prime and subcontractor may preclude free competition or result in higher prices;

(3) Subcontracts are proposed for award on a non-competitive basis, at prices that appear unreasonable, or at prices higher than those offered to the Government in comparable circumstances . . . [Emphasis added]

Negotiations With Single-Source Manufacturers (Subcontractors)

Dutch Valley Supply failed to effectively negotiate prices with single-source manufacturers including obtaining cost data when necessary.

Subcontractor Prices. Dutch Valley Supply accepted the single-source manufacturers (subcontractors) prices as proposed without performing appropriate cost or price analysis to determine price reasonableness. We calculate, using cost analysis, that Dutch Valley Supply accepted manufacturer prices that were \$ [REDACTED] ([REDACTED] percent) more than fair and reasonable prices. Table 2 shows the excessive prices that Dutch Valley Supply accepted from its subcontractors (single-source manufacturers) by not performing appropriate cost analysis or effectively negotiating prices. This valuable procurement money could have been put to better use supporting other urgent warfighter needs.

Table 2. Excessive Prices Paid to Subcontractors					
Manufacturer		Total Price		Excessive Profit	
Manufacturer	Items	Manufacturer	OIG Cost-Based ¹	Amount	Percent
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	33	\$5,744,843 ²	\$3,947,016 ²	\$1,797,827 ²	45.5

¹The OIG cost-based prices were calculated by using cost analysis of manufacturing costs and included a profit in line with DLA strategic supplier alliances.

²Slight rounding inconsistencies exist because auditor calculations included decimal places.

³[REDACTED]

Dutch Valley Supply management believed that performing cost or price analysis on every offered price was too burdensome, stating that only one-third of requirements solicited by DoD results in a contract award, implying that two-thirds of the time their effort was wasted because no contract was awarded. Dutch Valley Supply provided only recent procurement histories to assist manufacturers in developing their prices and focused more on saving administrative costs rather than negotiating a fair and reasonable price.

Spare Parts Catalogs. Dutch Valley Supply preferred to use parts catalogs in order to eliminate negotiations and further reduce the administrative costs involved with quoting DoD requirements. According to Dutch Valley Supply, parts catalogs were developed with [REDACTED] and [REDACTED]. However, parts catalogs are not appropriate unless the prices are based on commercial sales of quantities similar to actual DoD requirements or purchases.

For example, the [REDACTED] parts catalog listed a unit price of \$1,213.76 based on a quantity of one for the electrical solenoid [National Stock Number (NSN) 5945-01-274-3967]. However, the DoD annual demand for the part is

127 and the contract quantity we reviewed was 81. We calculate, using cost analysis, that the fair and reasonable unit price for the electrical solenoid was \$[REDACTED]. Thus, the [REDACTED] catalog price is [REDACTED] percent higher than a fair and reasonable price. Relying on parts catalogs is high risk unless the prices are based on similar quantities of commercial sales.

Interactions With Manufacturers. Dutch Valley Supply did not negotiate prices proposed by single-source manufacturers unless DoD contracting officers questioned the reasonableness of the price.

For example, in December 2004, the Defense Supply Center, Richmond, Virginia (DSCR), awarded contract SP0407-05-C-2105 to Dutch Valley Supply for 353 door handles (NSN 1680-01-102-6066) used on the H-60 Blackhawk helicopter. Figure 2 shows the door handle used on the Blackhawk helicopter.



Figure 2. Blackhawk Helicopter Door Handle NSN 1680-01-102-6066

Dutch Valley Supply originally submitted an offer for 353 units at \$1,012.40 each. [REDACTED] the single-source manufacturer, quoted Dutch Valley Supply a unit price of \$[REDACTED], which was [REDACTED] percent more than the previous Government contract unit price of \$506.11, in December 2003, about 1 year earlier. However, Dutch Valley Supply did not question the large price increase until the DSCR contracting officer submitted a counteroffer of \$485 each on September 30, 2004. On October 7, 2004, a Dutch Valley Supply client coordinator wrote an e-mail to ask [REDACTED] whether it wanted to lower the price.

[REDACTED]

[REDACTED] lowered its unit price by [REDACTED] percent to \$[REDACTED]. Dutch Valley Supply subsequently reduced its unit price to \$[REDACTED] and a contract was awarded, totaling \$345,012. The price negotiated was still 93.1 percent more than the previous contract price. Using cost data obtained from a previous audit, we calculated that the fair and reasonable manufacturer unit price was \$[REDACTED] for the door handle. As a result, DoD paid \$[REDACTED] ([REDACTED] percent) more than

necessary for the door handles, including Dutch Valley Supply pass-through charges.

Threshold for Purchasing System Review and Consent to Subcontract. A CPSR is the control DoD normally uses to ensure that prime contractors are efficiently and effectively spending Government funds and complying with Government policy when subcontracting. The system review requires the administrative contracting officer to give special attention to the degree of price competition obtained and contractor pricing policies and techniques, including methods of obtaining accurate, complete, and current cost or pricing data and certification as required. However, Dutch Valley Supply's purchasing system has not been reviewed because its annual sales were below the \$25 million threshold established in the FAR. From 2003 through 2006, Dutch Valley Supply averaged annual DLA sales of \$16 million with the highest sales total of \$20 million in FY 2004.

Our review of Dutch Valley Supply purchases identified significant problems that show that Dutch Valley Supply is not properly ensuring Government funds are spent wisely and prime contractor responsibilities are not being followed. Further, Dutch Valley Supply has not demonstrated an adequate purchasing system that will alleviate concerns within the areas of special attention. Specifically, Dutch Valley Supply did not obtain adequate price competition because the items sold were noncompetitive from single-source manufacturers. Dutch Valley Supply managers believed that evaluating the reasonableness of subcontractor prices was "burdensome" and failed to effectively negotiate prices with its subcontractors to include obtaining cost data when necessary. As a result, Dutch Valley Supply passed on \$[REDACTED] in excessive subcontractor prices to DoD.

Dutch Valley Supply does not have incentive to negotiate lower prices from its subcontractors because its markup is applied as a percent of the subcontract price. Thus, a higher price will result in more profit than a lower price. Clearly, prime contractors or exclusive distributors of noncompetitive parts, like Dutch Valley Supply, that operate just below the FAR threshold of a CPSR have a high risk of passing on excessive prices to DoD. DoD needs to recognize this additional risk and apply appropriate controls necessary to ensure that the risk has been mitigated.

In addition, the FAR does not specifically allow contracting officers to withhold consent to subcontract for prime contractors, like Dutch Valley Supply, that do not have an approved purchasing system and consistently employ fixed-price contracts with DoD. These prime contractors appear to have "implied" consent to subcontract and contracting officers have no power to limit their actions. FAR 44.202-2 alerts contracting officers to consider situations when the prime contractor's purchasing system or performance is inadequate; close working relationships or ownership affiliations between the prime and subcontractor result in higher prices; or subcontracts that are proposed for award on a noncompetitive basis, at prices that appear unreasonable, or at prices higher than those offered to the Government in comparable circumstances. Clearly, based on our audit results, Dutch Valley Supply, acting as an exclusive distributor for noncompetitive spare parts, has exhibited significant risk in each of the areas.

However, the regulation does not permit contracting officers to take appropriate action to address this problem because fixed-price contracts were used.

Given the significant problems we identified with Dutch Valley Supply subcontracts, DLA should request the Defense Contract Management Agency to immediately begin a review of Dutch Valley Supply's purchasing system. DoD contracting officers need to ensure prime contractors, like Dutch Valley Supply, conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices and include the results of these analyses in the price proposal as required by FAR 15.404-3. DoD contracting officers need to determine the adequacy of the cost or price analyses performed by Dutch Valley Supply. If the prime contractor did not perform adequate cost or price analyses of subcontract prices, DoD contracting officers need to review and determine the reasonableness of subcontractor prices to include obtaining cost data when necessary before awarding future contracts.

The Under Secretary of Defense for Acquisition, Technology, and Logistics needs to develop and issue guidance in the acquisition regulations that permits contracting officers to require consent to subcontract for fixed-price contracts from prime contractors that exhibit significant risk of charging excessive prices.

Price Reasonableness

DoD contracting officers primarily relied on ineffective tools such as price analysis, cost analysis of dealer costs, and dealer competition to support price reasonableness determinations. In several instances price reasonableness determinations were not made. Table 3 shows the different methods DoD contracting officers used to determine price reasonableness and the amount of excessive profit paid.

Table 3. DoD Price Reasonableness Determination and Excessive Profit					
<u>Price Reasonableness</u>	<u>Items</u>	<u>Total Price</u>		<u>Excessive Profit</u>	
		<u>Contract</u>	<u>OIG Cost-Based¹</u>	<u>Amount</u>	<u>Percent</u>
Price analysis					
Determined reasonable	16	\$2,923,053	\$1,772,832	\$1,150,221	64.9
Determined unreasonable	7	1,856,759	832,014	1,024,745	123.2
Subtotal	23	\$4,779,812	\$2,604,846	\$2,174,966	83.5
Cost analysis ²	4	\$1,094,118	\$731,696	\$362,422	49.5
Dealer competition	3	\$436,936	\$191,750	\$245,186	127.9
No determination	3	\$ 595,638	\$ 418,724	\$ 176,914	42.3
Total	33	\$6,906,504	\$3,947,016	\$2,959,488	75.0

¹The OIG cost-based prices were calculated by using cost analysis of manufacturing costs and included a profit in line with DLA strategic supplier alliances.

²For three of the four items cost analysis was not performed on the manufacturing costs.

Price Analysis. DoD paid about \$2.2 million (83.5 percent) more than fair and reasonable manufacturer prices for 23 items that used price analysis of previous Government prices to determine price reasonableness. According to the price reasonableness determinations, 16 of the 23 items were determined reasonable, while 7 items could not be determined reasonable but the contracting office had to procure the items anyway to ensure an adequate supply for the warfighter.

Determined Reasonable. DoD paid about \$1.2 million (64.9 percent) more than fair and reasonable manufacturer prices for 16 items after performing price analysis of questionable previous Government contract prices to determine prices reasonable. For example, on January 30, 2004, the Defense Supply Center, Columbus, Ohio (DSCC), purchased 155 remote control levers (NSN 3040-01-045-8779) used on the Super Cobra (AH-1W) helicopter at a unit price of \$1,839.10 on contract SP0740-04-C-4522. Figure 3 shows the remote control lever used on the Super Cobra (AH-1W) helicopter.



Figure 3. Remote Control Lever NSN 3040-01-045-8779

To determine price reasonableness, the contracting officer performed price analysis by comparing the proposed price to the previous procurement. The previous contract, awarded in March 2003, was also awarded to Dutch Valley Supply at the same unit price of \$1,839.10 but for a significantly lower quantity of 30 units. The price negotiation memorandum stated:

... pricing received from DVS [Dutch Valley Supply] shows an in line price comparison with no indication of over pricing. Negotiation will not be conducted for the Government accepts the price from DVS as fair based on this analysis conducted. [emphasis added]

Table 4 shows the contractors, contract prices, and method used by DSCC contracting officers to determine price reasonableness for the remote control lever in the contract we reviewed (awarded in January 2004) and the two preceding awards.

Table 4. Price Reasonableness Determinations for the Remote Control Lever (NSN 3040-01-045-8779)				
<u>Date</u>	<u>Contractor</u>	<u>Unit Price</u>	<u>DLA Buyer Code-Definition</u>	<u>Percent Increase</u>
November 4, 2002	██████████	\$1,361.60	BB – Dealer Competition	
March 7, 2003	Dutch Valley Supply	1,839.10	BI – Other Price Analysis Techniques	35.1
January 30, 2004	Dutch Valley Supply	1,839.10	BI – Other Price Analysis Techniques	0.0

The previous contract price awarded in March 2003 was also determined fair and reasonable based on price analysis techniques despite a 35.1 percent increase in about 4 months of the preceding contract. In November 2002, DSCC paid \$1,361.60 per unit for 65 units to ██████████, the single-source manufacturer. However, that unit price of \$1,361.60 is also questionable because the price was determined reasonable based on ineffective dealer competition, which we discuss in more detail later in the report. The contracting officer failed to understand and document the cause of the significant price increase seen between the November 2002 and March 2003 procurements before relying on the price to determine price reasonableness.

Although the contracting officer saw “no indication of over pricing,” we performed cost analysis and calculate that the fair and reasonable manufacturer unit price was \$██████████. Thus, we calculate that DSCC, by relying on ineffective price analysis techniques and dealer competition to determine prices reasonable, paid ██████████ percent (\$██████████) more than the fair and reasonable price for remote control levers, including excessive pass-through charges. Table 5 shows the comparison of the DSCC pricing method and the fair and reasonable manufacturer price we calculated using cost analysis.

Table 5. Comparison of Dealer Competition/Price Analysis and Cost Data for Remote Control Lever (NSN 3040-01-045-8779)							
<u>Method</u>	<u>Annual Demand</u>	<u>DSCC Contract Price</u>		<u>Comparison Price</u>		<u>Difference</u>	
		<u>Unit</u>	<u>Total</u>	<u>Unit</u>	<u>Total</u>	<u>Amount</u>	<u>Percent</u>
Dealer Competition/Price Analysis	66	\$1,839.10	\$121,381	\$1,839.10	\$121,381	0	0.0
Cost Analysis	66	1,839.10	121,381	██████████	██████████	\$██████████	██████████

The DSCC contracting officer relied on the previous contract price without establishing the validity of the comparison and reasonableness of the prior price as required by the FAR 15.404-1, “Proposal Analysis Techniques.” Specifically, FAR 15.404-1(b)(2)(ii) explains the technique that was not used by the contracting officer:

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]

This example demonstrates the ineffectiveness of using price analysis without establishing the validity of the comparison and reasonableness of the previous price in a noncompetitive environment.

Like this report, previous DoD IG audit reports have documented the same systemic problem with price analysis used in a noncompetitive environment to determine price reasonableness. The continued use of ineffective price analysis in a noncompetitive environment is a material internal control weakness and needs to be addressed. Since acquisition reform legislation was enacted in the mid-1990s, the prevalence of price analysis of previous Government prices throughout DoD has created a price history that is not reliable to establish price reasonableness in future procurements because once an excessive price is accepted it becomes the baseline for the next price. Further, as prices that were wrongly considered fair and reasonable continue to be relied upon in more and more procurements, the difference between the negotiated price and the actual cost will continue to increase. In a noncompetitive environment, when the current price history is not reliable to establish fair and reasonable prices, the only way to re-establish a reliable baseline price is to perform cost analysis.

In response to recommendations from DoD IG Report D-2006-122, "Commercial Contract for Noncompetitive Spare Parts With Hamilton Sundstrand Corporation," September 29, 2006, the Director, Defense Procurement and Acquisition Policy issued a memorandum, dated June 8, 2007, announcing revised procedures added to the Defense Federal Acquisition Regulation Supplement (DFARS) to determine fair and reasonable prices especially for noncompetitive items.

DFARS 215.404-1, "Proposal Analysis Techniques," provides general guidance and discusses appropriate uses of price and cost analysis. Specifically, the DFARS stated:

(b) Price analysis.

(i) Price analysis should generally be performed on supplies or services that are not subject to TINA [the Truth in Negotiations Act]. Available commercial sales, published catalogs or prices, etc., can sometimes be obtained through market research and can provide a basis for determining if the proposed prices are fair and reasonable.

(ii) In some cases, commercial sales are not available and there is no other market information for determining fair and reasonable prices . . . In such cases, the contracting officer must require the offeror to submit whatever cost information is needed to determine price reasonableness.

(iii) The following procedures shall be adhered to when executing the price analysis steps at FAR 15.404-1(b)(2):

(A) When the contracting officer is relying on information obtained from sources other than the offeror, the contracting officer must obtain and document sufficient information to confirm that previous prices paid by the Government were based on a thorough price and/or cost analysis.

(c) Cost analysis.

(i) When the contracting officer cannot obtain sufficient information to perform a price analysis in accordance with the pricing steps in FAR 15.404-1(b), a cost analysis is required.

(ii) When a solicitation is not subject to TINA and a cost analysis is required, the contracting officer must clearly communicate to the offeror the cost information that will be needed to determine if the proposed price is fair and reasonable. [emphasis added]

DoD contracting officers need to perform cost analysis in a noncompetitive environment to determine price reasonableness when price analysis does not provide sufficient information and a reliable baseline price has not been established.

Appendix C, "Other Matters of Interest," provides another example of the ineffectiveness of price analysis and discusses a questionable waiver from cost or pricing data based primarily on price analysis that was issued for a long-term [REDACTED] contract with DSCC. DLA has exhibited a material internal control weakness in granting inappropriate waivers to cost or pricing data because it does not have adequate procedures to ensure that waivers are granted in compliance with guidance. DLA needs to discontinue granting inappropriate waivers from cost or pricing data based primarily on price analysis.

Determined Unreasonable. DLA contracting officers determined that prices for seven parts could not be determined fair and reasonable using price analysis. However, because all the items were noncompetitive, DLA had to purchase the items anyway to ensure that an adequate supply was available for the warfighter. DLA paid \$1.0 million (123.2 percent) more than fair and reasonable prices for the seven items.

For example, in December 2004, the DSCR contracting officer purchased 353 door handles (NSN 1680-01-102-6066) used on the H-60 Blackhawk helicopter, shown previously in Figure 2, at a unit price of \$977.37 (totaling \$345,012) from Dutch Valley Supply. Dutch Valley Supply originally proposed a unit price of \$1,012.40 for the door handle. The contracting officer attempted to negotiate the price and counteroffered at \$[REDACTED] each. In response, Dutch Valley Supply submitted a "cost" breakdown and a copy of the [REDACTED] price list of \$[REDACTED] each, both of which failed to provide insight into the actual

manufacturing costs. Dutch Valley Supply later lowered the price to \$977.37 each and the contract was awarded. DSCR had previously purchased 679 door handles in 2003 at unit prices ranging from \$485.36 to \$506.11 from [REDACTED] the single-source manufacturer. The contracting officer documented that the price, which had increased 93.1 percent in 12 months, was unreasonable. However, DSCR had to procure the door handles anyway to support the warfighter. Specifically, the contracting officer stated:

The final negotiated offer from Dutch Valley Supply cannot be determined fair and reasonable in accordance with FAR 15. Based on the current stock position and a significant number of high priority backorders, it is the determination of the contracting officer that it is in the best interest of the Government to award this requirement at a price that cannot be determined fair and reasonable. [emphasis added]

By performing cost analysis of cost data obtained during a previous audit, we determined that the negotiated price is [REDACTED] percent more than the fair and reasonable manufacturer unit price of \$[REDACTED]. Dutch Valley Supply applied a [REDACTED] percent markup to the [REDACTED] unit price, totaling \$[REDACTED] for the contract. DSCR paid \$[REDACTED] in excessive prices and profits, including pass-through charges, for the 353 door handles that were urgently needed by the warfighter. This is another example of contractors abusing their single-source status by charging the Government unreasonable prices to make excessive profits, leaving less DoD procurement money to support other urgent warfighter needs.

[REDACTED]

In DoD IG Report No. D-2006-055, "Spare Parts Procurements From TransDigm, Inc.," February 23, 2006, we recommended that DLA seek a voluntary refund for overpriced parts when the contracting officer made a reasonable attempt to obtain cost information but was denied the information. The Blackhawk helicopter door handle was one of those items identified. The Chief of Competition and Pricing Division, DSCR requested the refund from TransDigm, parent company of Adams Rite. On August 22, 2006, TransDigm, Inc., denied the request for a voluntary refund stating:

With respect to the suggested voluntary refund itself, we believe that such a refund is not warranted by the circumstances surrounding the purchase of the parts in question . . .

In our previous report, we also recommended that DoD reverse engineer items from single-source contractors who charge excessive prices and refuse to modify their business practices. DSCR contracted with the Naval Air Warfare Center - China Lake, California (China Lake), to reverse engineer the door handle and develop a Government-owned technical data package. China Lake also organically manufactured 786 door handles for \$407.13 each, which was a 58.3 percent savings from the Dutch Valley Supply unit price of \$977.37. We commend DSCR for taking appropriate action to address this issue. DLA needs

to continue initiating reverse engineering efforts for items that have unreasonable pricing from single-source offerors.

We also commend DLA for its initiative in thoroughly documenting the circumstances surrounding unreasonable prices. While every effort is made to determine the price reasonable as the FAR requires, sometimes in a noncompetitive environment it is simply not possible to determine every price fair and reasonable because single-source offerors refuse to offer reasonable prices or provide cost information when requested. Without proper documentation of the transaction circumstances, contracting officers may wrongly rely on the previous price to determine price reasonableness in future contracts.


When the contracting officer cannot get the requested cost information from the single-source manufacturer, Military Departments and Defense agencies should note the offeror's refusal to provide the requested information in the past performance system in accordance with DFARS 215.404-1(a)(i)(F). Relevant information on uncooperative contractors needs to be maintained to ensure that the information is available when future source selection decisions are made.

The Under Secretary of Defense for Acquisition, Technology, and Logistics needs to issue guidance that instructs the Military Departments and Defense agencies to track and periodically report information about contractors that refuse to provide requested information necessary to determine price reasonableness and take appropriate action to address pricing issues related to specific contractors.

Cost Analysis. DoD paid about \$362,422 (49.5 percent) more than the fair and reasonable price for four items where the contract documentation or price reasonableness code indicated cost analysis was performed. However, for three of the four items, the contracting officer had no insight into manufacturing costs and DoD paid \$ [REDACTED] ([REDACTED] percent) more than fair and reasonable prices. For the remaining item that used manufacturer cost data, DoD paid \$ [REDACTED] ([REDACTED] percent) more than the fair and reasonable price, including pass-through charges.

Dealer Cost Data. In December 2002, DSCR purchased 21 spool and sleeve assemblies (NSN 1650-01-046-2257) from Dutch Valley Supply on contract SP0460-03-M-1335 at a unit price of \$3,339.66, totaling \$70,133. Dutch Valley Supply provided a "cost" breakdown after a request from the contracting officer.

Figure 4 is the breakdown Dutch Valley Supply provided.



COST BREAKDOWN

Date: 11/21/2002
 Solicitation Number: SP046002QNX65
 NSN: 1650-01-046-2257
 Part Number: 41002798-002
 Description: Assy., Spool and Sleeve
 Vendor/Manufacturer: [REDACTED]
 DVS Reference Number: [REDACTED]

The following Information Other Than Cost or Pricing Data is provided IAW FAR 15.403-3.
 These out of production parts are being sold as aftermarket/spares items to the U.S. Government.

	UNIT COST	QUANTITY	%	TOTAL COST
Direct Material Cost	[REDACTED]	21		[REDACTED]
Higher Level Inspection				[REDACTED]
Marking/Packaging				[REDACTED]
Freight / Shipping				[REDACTED]
Other Direct Costs (e.g. DVS Labor & VAN Services)				[REDACTED]
Subtotal				[REDACTED]
General & Administrative			[REDACTED]	[REDACTED]
Total Cost				[REDACTED]
Profit			[REDACTED]	[REDACTED]
Total Price	\$3,567.54	21		\$74,918.34

Figure 4. "Cost" Breakdown for Spool and Sleeve Assembly

However, the breakdown failed to provide insight into manufacturer costs and profit, about [REDACTED] percent of the total price, because the "Direct Material Cost" line item combined this information. The direct material cost represents the price Dutch Valley Supply paid [REDACTED] the single-source manufacturer. The contracting officer's lack of insight into this information makes it impractical to determine the reasonableness of the proposed price. The contracting officer subsequently asked the DSCR Cost or Pricing Branch to help determine price reasonableness for the item. The DSCR Cost or Pricing Branch determined, based on price analysis of the last two procurements, that the [REDACTED] proposed price of \$ [REDACTED] was fair and reasonable and recommended that the award be made.

Table 6 shows the procurement history and method used by contracting officers to determine price reasonableness for the spool and sleeve assembly since 1997.

Table 6. Price Reasonableness Determinations for the Spool and Sleeve Assemblies (NSN 1650-01-046-2257)

<u>Date</u>	<u>Contractor</u>	<u>Unit Price</u>	<u>DLA Buyer Code-Definition</u>	<u>Percent Increase</u>
July 30, 1997		\$1,573.92	BI – Other Price Analysis Techniques	
March 6, 1998		1,792.58	BB – Dealer Competition	13.9
July 17, 1998		1,774.06	BB – Dealer Competition	(1.0)
May 21, 1999		1,901.62	BG - Price Analysis	7.2
July 20, 2001		2,157.45	BC – Catalog Item Sold to General Public	13.5
October 19, 2001		2,244.81	BG - Price Analysis	4.0
December 20, 2002	Dutch Valley Supply	3,339.66	BF – Cost Analysis	48.8

The previous contract prices had been determined fair and reasonable using a variety of price determination methods. However, none of the previous prices were based on cost analysis of manufacturer cost data. Further, the contract we reviewed was inaccurately coded as cost analysis even though the contract documentation shows that the Cost or Price Branch only performed price analysis with no insight into manufacturing costs.

Using cost analysis of manufacturer cost data we calculate that a fair and reasonable unit price was \$ [REDACTED] for the spool and sleeve assembly. DoD paid [REDACTED] an excessive profit of [REDACTED] percent, a total of [REDACTED] percent more than the fair and reasonable price, including Dutch Valley Supply pass-through charges. Table 7 details the cost-based price, [REDACTED] and Dutch Valley Supply sales prices, and excessive profit paid by DoD.

**Table 7. Excessive Profit for Spool and Sleeve Assembly
NSN 1650-01-046-2257**

	<u>Unit Price</u>	<u>Markup Percent</u>	<u>Excessive Profit Percent</u>
OIG cost-based price	\$ [REDACTED]		
[REDACTED] sales price	[REDACTED]		
Dutch Valley Supply contract price	3,339.66	[REDACTED]	[REDACTED]

Without insight into manufacturing costs, the contracting officer was not able to effectively negotiate a reasonable price. DLA needs to discontinue coding an analysis of dealer costs as cost analysis unless a cost analysis of manufacturing costs has also been performed.

Manufacturer Cost Data. In June 2005, the Army Aviation and Missile Life Cycle Management Command purchased 697 solenoid valves ([REDACTED]) from Dutch Valley Supply for \$2,008.61 each, totaling about \$1.4 million.

Figure 5 shows the solenoid valve used on the Blackhawk helicopter.

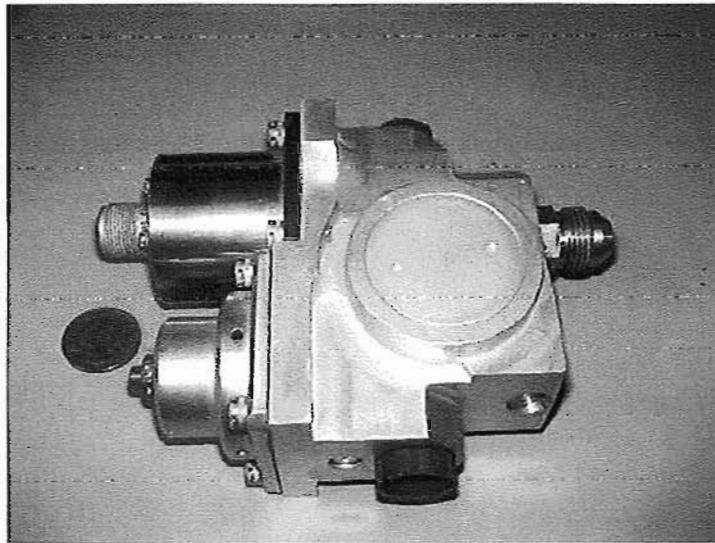


Figure 5. Solenoid Valve [REDACTED]

Dutch Valley Supply originally offered a unit price of \$3,269.94. But the contracting officer combined the base and option year quantities, which caused the total contract amount to breach the \$550,000 cost or pricing threshold, requiring the proposal to be subject to the Truth in Negotiations Act. The contracting officer relied on the Defense Contract Audit Agency (DCAA) analysis of manufacturing cost or pricing data to negotiate a lower price. Using the cost analysis, the contracting officer successfully negotiated a reduction in the proposed prime contract unit price from \$3,269.94 to \$2,008.61, yielding a total contract savings of \$879,147 (38.6 percent) price reduction. Table 8 shows the price negotiation for the solenoid valve.

Table 8. Price Negotiations for Solenoid Valve				
Proposal Cost Elements	Unit Price		Difference	
	Proposed	Negotiated	Amount	Percent
Direct Material/ [REDACTED] Price	[REDACTED]	[REDACTED]	[REDACTED]	
Marking/Packaging	[REDACTED]	[REDACTED]	[REDACTED]	
Freight/Shipping	[REDACTED]	[REDACTED]	[REDACTED]	
Subtotal	[REDACTED]	[REDACTED]	[REDACTED]	
General and administrative	[REDACTED]	[REDACTED]	[REDACTED]	
Total cost	[REDACTED]	[REDACTED]	[REDACTED]	
Profit	[REDACTED]	[REDACTED]	[REDACTED]	
Base year	\$3,269.94	\$2,008.61	(\$1,261.33)	(38.6)

By relying on manufacturer cost information, the contracting officer was able to obtain significant price reductions from Dutch Valley Supply's proposed price. This example clearly shows the importance of contracting officers obtaining

manufacturer cost or pricing data to negotiate prices and we commend the Army for taking appropriate steps to significantly reduce the price negotiated.

Performing cost analysis of more recent cost data that was not available to the Army at the time of award, we calculate the current fair and reasonable manufacturer unit price for the solenoid valve is \$ [REDACTED]. We were unable to reconcile the specific differences that existed in the two sets of cost information because the data reviewed by DCAA did not provide the same detail as the cost information obtained by the OIG. The final negotiated unit price of \$2,008.61 included Dutch Valley Supply pass-through charges of [REDACTED] percent to the manufacturer price, totaling \$ [REDACTED] for the contract.

Exclusive Distributor/Dealer Competition. DSCC used dealer competition to support price reasonableness for three of the items valued at \$436,936. Using cost analysis, we calculate fair and reasonable prices were \$191,750 or a difference of \$245,186 (127.9 percent). The ineffectiveness of this form of "competition" was previously identified in DoD IG Report No. D-2006-055. In the previous report, dealers "competed" with the single-source manufacturer for awards. In this report, Dutch Valley Supply, the exclusive distributor for numerous single-source manufacturers, "competes" with other dealers for awards.

We contacted dealers that frequently offered on solicitations with Dutch Valley Supply to determine their source for the parts. Of the 13 dealers we contacted, 10 stated Dutch Valley Supply was their single-source and that they did not stock parts for these solicitations. Of the remaining dealers, two could not recall whether Dutch Valley Supply was their source and one dealer did not respond. Since no stock is maintained, it is clear that competition will not be independent or fair because Dutch Valley Supply, as the single-source distributor, inherently controls its "competitors" costs and delivery, which gives unfair insight and a decided advantage in winning awards over its "competitors."

For example, on June 28, 2005, DSCC purchased 25 lever assemblies (NSN 3040-00-564-5377) used on the Advance Attack helicopter from Dutch Valley Supply at a unit price of \$2,723.93, totaling \$68,098 on contract SP0740-05-M-4049.

Figure 6 shows the lever assembly used on the Advance Attack helicopter.

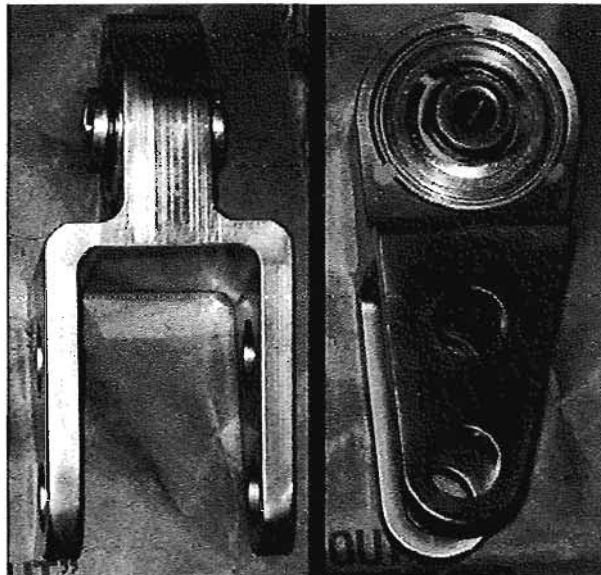


Figure 6. Lever Assembly NSN 3040-00-564-5377

The DSCC contracting officer considered offers from nine dealers who quoted the single-source manufacturer's () part. Not surprisingly, Dutch Valley Supply, who was the source of supply for the other eight dealers, had the lowest price and delivery for the lever assembly. Table 9 shows the unit price and the delivery terms from the single-source distributor and other dealers.

Table 9. Quotes for Contract SP0740-05-M-4049 (June 2005)					
Quotes	Qty	Unit Price	Delivery Days	Percent	
				Increase From Prior Price	Excessive Profit
Dutch Valley Supply (exclusive distributor)	25	\$2,723.93	155	82.6	
	25	2,832.00	195	89.8	
	25	2,839.80	183	90.3	
	25	2,860.13	180	91.7	
	25	2,861.67	185	91.8	
	25	2,899.72	240	94.4	
	25	2,914.25	169	95.3	
	25	2,996.09	195	100.8	
	25	3,000.00	420	101.1	
<u>Part Prices</u>					
Previous Dutch Valley Supply Contract (August 2004)	34	\$1,491.96			
OIG cost-based price	25				

Dutch Valley Supply's proposed price was 82.6 percent higher than the previous contract for this item awarded in August 2004, only 11 months earlier. However, the contracting officer ignored the significant price increase and wrongly justified

the price based on competition between multiple dealers. Using cost analysis, we calculate that DSCC paid [REDACTED] percent (\$ [REDACTED]) more than the fair and reasonable manufacturer unit price of \$ [REDACTED] including pass-through charges.

During our site visit, Dutch Valley Supply discussed that, as the exclusive distributor, sales for the items it oversees will go through them regardless of whether DoD buys the item directly from them or through another dealer. To illustrate the meaning of this statement, consider if Dutch Valley Supply chose not to quote this contract. The award would have most likely been made to [REDACTED] at \$2,832 each. Dutch Valley Supply still would have sold the item for \$2,723.93. Thus, [REDACTED] and Dutch Valley Supply excessive prices and profit margins remain unchanged and an additional layer of pass-through costs would be added to the price of the item.

Clearly, the use of dealer competition has not been effective at negotiating fair and reasonable prices in a noncompetitive environment and will only add more unreliable prices to the DoD procurement history.

Competition Guidance. FAR Part 15.403-1 (c)(1)(i) defines that a price is based on adequate price competition if:

two or more responsible offerors, competing independently, submit priced offers that satisfy the Government's expressed requirement.
[emphasis added]

DSCC Acquisition Guide Part 13.106-3(d)(3)(i) states competition between dealers is acceptable.

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.
[emphasis added]

Adequate competition as defined in the FAR will provide effective oversight over prices because independent sources are available to compete against one another. The dealer competition policy used by DSCC fails to ensure the independence of the offerors and has been abused to justify unreasonable prices of noncompetitive spare parts.

Previous Coverage. In our previous report, we recommended that the Director, DLA discontinue using competition between a single-source manufacturer and dealers to determine price reasonableness. The Director of Logistics Operations, DLA partially concurred with the recommendation but DLA officials would not prohibit the practice because they believe competition between manufacturers and dealers could be valid in some instances.

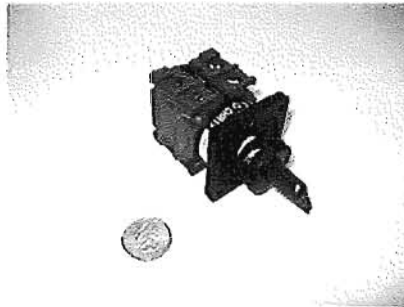
We continue to identify problems with dealer competition in a noncompetitive or single-source manufacturing environment. Further, based on both audits, our experience has shown that the dealer competition policy is predominantly being

used in an inappropriate way and unreasonable prices are being wrongly justified as fair and reasonable by contracting officers.

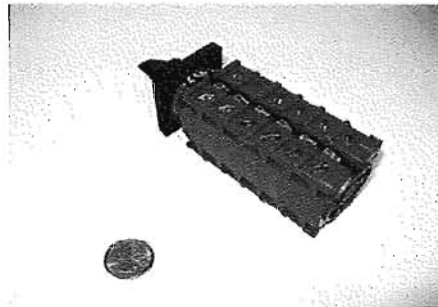
The DoD OIG and DLA Director of Logistics Operations entered mediation on this recommendation following the previous audit. On June 28, 2007, DLA issued a procurement policy letter that stated its position is that adequate price competition can exist when purchasing noncompetitive items from dealers or distributors that compete with each other or the single-source manufacturer. We do not believe that the DLA policy letter will effectively resolve this issue and stop the policy from being abused in a noncompetitive environment. See Appendix E for complete text of the DLA procurement policy letter. DLA needs to discontinue using dealer competition to determine price reasonableness in a noncompetitive environment. The Under Secretary of Defense for Acquisition, Technology, and Logistics needs to review the DLA dealer competition policies and determine whether the policies meet the FAR 15.403-1 definition of adequate competition.

No Price Reasonableness Determinations. We calculated that DSCC paid \$176,914 (42.3 percent) more than fair and reasonable prices for three parts without the contracting officer making a fair and reasonable price determination.

For example, on November 19, 2004, DSCC awarded an indefinite-delivery, indefinite-quantity contract SP0930-05-D-0007 to Dutch Valley Supply for the purchase of rotary switches (NSN 5930-01-385-1894 and NSN 5930-01-368-5160) [REDACTED]. The contracting officer failed to document a price reasonableness determination. Figures 7 and 8 show the rotary switches used on the F-16 aircraft.



**Figure 7. Rotary Switch
NSN 5930-01-368-5160**



**Figure 8. Rotary Switch
NSN 5930-01-385-1894**

The contracting officer determined that the negotiated delivery was fair and reasonable, but remained silent on the prices offered. Specifically, the contracting officer stated in the price negotiation memorandum that:

Since Dutch Valley [Supply] can deliver any quantity within 100 days, this delivery is acceptable by the Government. This delivery is considered to be fair and reasonable.

The Item Managers have verified the need for these items.

Therefore, based on the above information, recommend that award be made to Dutch Valley [Supply]... [emphasis added]

FAR 15.402, "Pricing Policy," requires contracting officers to purchase supplies and services from responsible sources at fair and reasonable prices. Further, FAR 15.406-3, "Documenting the Negotiation," requires contracting officers to document negotiation results in the contract file. Specifically, the regulation states:

(a) The contracting officer shall document in the contract file the principal elements of the negotiated agreement. The documentation (e.g., price negotiation memorandum (PNM)) shall include the following:

(11) Documentation of fair and reasonable pricing.

The contracting officer also failed to require cost or pricing data for the contract even though the expected contract amount of about \$1.6 million (base contract \$744,247 and option year \$808,993) was more than the cost or pricing threshold of \$550,000 (now \$650,000) established in FAR 15.403-4, "Requiring Cost or Pricing Data." Using cost analysis, we calculate that DSCC paid \$ [REDACTED] ([REDACTED] percent) more than fair and reasonable prices.

DLA needs to emphasize to contracting officers the importance of making price reasonableness determinations and properly documenting the contract file. DLA also needs to ensure cost or pricing data is requested as required by FAR 15.403-4.

Exclusive Distributor Model

The current exclusive distributor model used to procure items does not provide best value and is less effective than the traditional DLA supply and strategic supplier models.

Pass-Through Charges. Dutch Valley Supply, the exclusive distributor, charged an average [REDACTED] percent pass-through charge to excessive manufacturer prices, totaling \$ [REDACTED]

Table 10 shows the pass-through charges paid by DoD.

Table 10. Summary of Pass-Through Charges					
Manufacturer	Items	Total Price		Pass-Through Charges	
		Contract	Manufacturer	Amount	Percent
	2	\$ 872,695			
	3	1,087,937			
	22	3,799,416			
	6	1,146,457			
Total	33	\$6,906,504*			

*Slight rounding inconsistencies exist because auditor calculations included decimal places.

In several instances, the single-source manufacturer limited the amount of pass-through charges. Dutch Valley Supply pass-through charges were limited to keep the total contract amount below the \$550,000 (now \$650,000) threshold for the submission of cost or pricing data, distributor agreements in some cases spelled out the maximum pass-through charge, and other items were specifically marked by the single-source manufacturer. The documentation we reviewed shows that for seven items, [REDACTED] limited the pass-through charge, [REDACTED] which explains why [REDACTED] items experienced below average pass-through charges of [REDACTED]. For example, the [REDACTED] quote for the pilot valve (NSN 4810-01-246-1382) used on the Apache Helicopter stated:

[REDACTED]

In addition, the [REDACTED] distributor agreement, dated November 1, 2003, specifically limited the distributor markup on their items to [REDACTED]. However, based on our analysis of the two [REDACTED] parts, it appears that the limit in subsequent agreements has been raised to [REDACTED].

When not limited by the single-source manufacturer, Dutch Valley Supply normally charged higher pass-through charges to the manufacturer prices. Dutch Valley Supply charged greater than [REDACTED] percent markup for 9 of the 33 items reviewed, with the largest pass-through charge being [REDACTED]. The average Dutch Valley Supply pass-through charge that was not limited was [REDACTED] percent of the excessive manufacturer prices.

Lead Time. We found that the addition of Dutch Valley Supply to the procurement process has resulted in increased lead times³ for DoD. As stated previously, Dutch Valley Supply orders items from the single-source

³ Lead time, consisting of administrative and production lead time, is defined as the amount of time from the date of solicitation until the items are received by the Government. Administrative lead time represents the time to negotiate and award the contract, while production lead time represents the time for the parts to be manufactured and delivered after an order was placed.

manufacturers when the Government need becomes known. Thus, Dutch Valley Supply can only add more days to the lead times when satisfying Government orders.

We compared the DLA supply system administrative lead times from 2001 when parts were procured directly from the manufacturers with the actual administrative lead times for the Dutch Valley Supply contracts reviewed. We excluded 2 of the 27 DLA-managed items because the contracts did not have complete shipments or sufficient documentation.

To determine the administrative lead time for the Dutch Valley Supply contracts, we calculated the number of days between the contract award date and the solicitation date. To that number, we added the distributor lead time, which represents the number of days between contract award date and the purchase order date plus the number of days that Dutch Valley Supply had the material in its possession. Our analysis of the Dutch Valley Supply contracts shows that from the date of the contract solicitation to the award averaged 164 days. In addition, Dutch Valley Supply averaged an additional 15 days to issue purchase orders to the manufacturer and to ship the material to DoD, resulting in a total administrative lead time of 179 days. By comparison, we calculated that the average 2001 DLA supply system administrative lead time for the 25 items reviewed was 130 days or 49 days less when the items were procured directly from the manufacturers.

We then added the production lead times to the administrative lead time to calculate the overall lead times. We consider the production lead time to be the same whether Dutch Valley Supply or DLA procures the item from the single-source manufacturers. Based on DLA supply system data obtained in 2006, we calculated that the average DLA supply system production lead time was 248 days for the items reviewed.

Overall, we calculated that the DLA had an average lead time of 378 days (130 days administrative and 248 days production) when items were purchased directly from the manufacturers. We calculated that Dutch Valley Supply contracts averaged an overall lead time of 427 days (179 days administrative and 248 days production). Thus, the addition of Dutch Valley Supply to the procurement process has increased lead times [REDACTED] from the traditional DLA supply model of procuring items directly from the manufacturers.

Inventory. Dutch Valley Supply also does not provide value by stocking items, instead ordering items from single-source manufacturers when the Government requirement becomes known. Thus, the items ordered from the manufacturer simply "pass through" the distributor on its way to DoD, which increases lead times and associated inventory levels. As shown previously in Figure 1, adding a distributor to the DoD procurement process creates an unnecessary level of redundancy and costs. For instance, adding a distributor creates a duplicate layer of administration (purchase request, quote, order, etc.) and shipments before DoD receives the product.

Dutch Valley Supply does not invest in stocking parts because they consider DLA demand data unreliable, which may cause them to hold substantial inventory with no guarantee that DoD would purchase the parts. In November 2006, we performed a physical inventory and identified that Dutch Valley Supply had only a small amount of inventory for just 3 of the 33 parts reviewed. Further, the amount of inventory held for the 3 parts was not sufficient to satisfy normal Government requirements. Thus, the exclusive distributor model utilized by Dutch Valley Supply does not add value and will not permit DoD to reduce its inventory levels.

DLA Supply Models. DLA has been successful entering long-term strategic supplier contracts with key suppliers. For example, the DLA-Honeywell strategic supplier contract prices for noncompetitive parts are negotiated based on cost data. In addition, administrative lead times have been predominantly reduced to 10 days because parts were negotiated on a long-term contract. We calculate the strategic supplier model has an approximate lead time of about 258 days, after applying the average production lead time of 248 days. The exclusive distributor model used by Dutch Valley Supply increases lead times by 169 days (65.5 percent) from the long-term strategic supplier model. Figure 9 shows that the exclusive distributor model has the highest lead times of supply options.

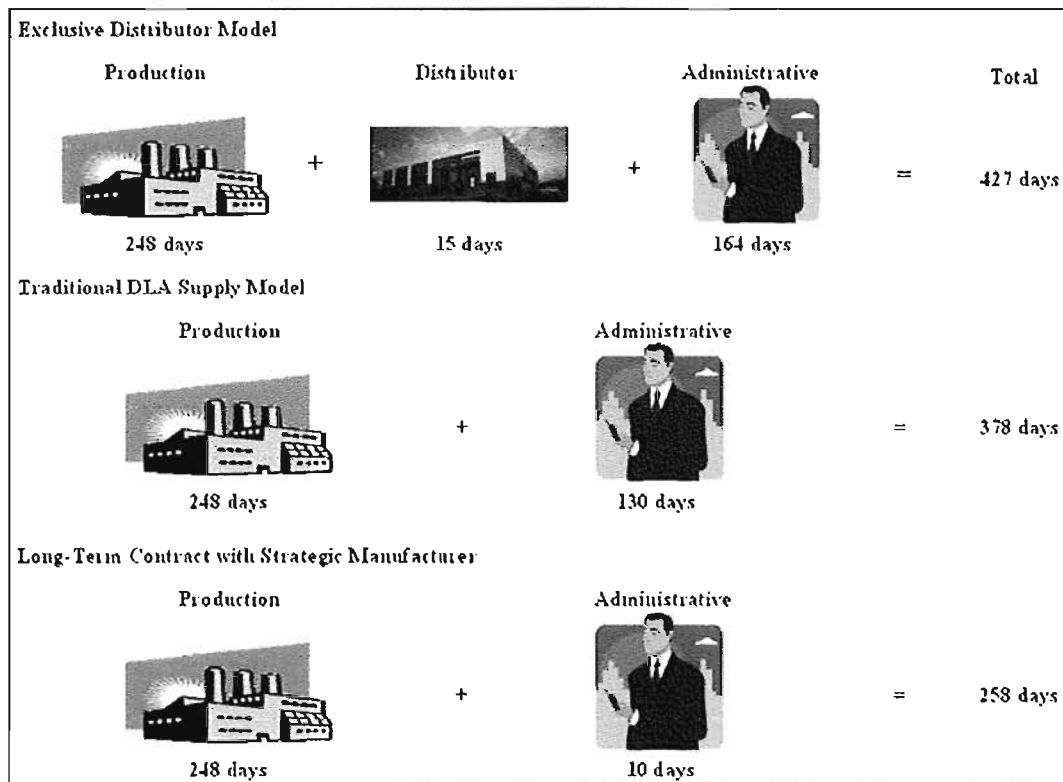


Figure 9. Comparison of Supply Model Lead Times

Clearly, the exclusive distributor model is less effective than the other supply models available and does not provide best value to DoD because increased lead

times require DoD to invest more in inventory to ensure that warfighters have sufficient stock available for their missions until the items can be re-procured and delivered.

Possible Distributor Supply Model. In order to add value to DoD, exclusive distributors, like Dutch Valley Supply, need to be able to effectively negotiate prices from single-source manufacturers. The exclusive distributors need to obtain information on actual manufacturing costs to ensure prices and profits negotiated with single-source manufacturers are reasonable.

Exclusive distributors also can add value by stocking sufficient inventory to meet DoD requirements, which would lead to reduced lead times, less DoD inventory investment, and improved parts availability. However, in order for this option to be viable, the sales price must be similar to the price that would be paid within the DoD supply system.

DLA has different cost recovery rates for stocking parts and shipping parts directly to the users (direct vendor delivery) or nonstocked parts. While the rates can vary, the stock cost recovery rate is about 32.6 percent and the nonstocked direct vendor delivery rate is about 13.2 percent. This difference in the two rates creates a delta of about 17 percent, which could represent a reasonable markup by a distributor if they were to stock the items.

For example, we calculated using cost analysis that the cost-based fair and reasonable manufacturer unit price [REDACTED] was \$262.21. If DLA were to stock the item and ship it to the end user, the sell price, including the stock cost recovery rate of 32.6 percent, would be \$347.69 each. Thus, in order to be a viable alternative, the distributor would need to stock the item and direct ship it to the end user while applying a reasonable markup of 17.1 percent that would result in a contract price of \$307.15 to DLA. DLA would then sell the item to the end user for \$347.69, after applying its cost recovery rate of 13.2 percent for direct shipments.

Figure 10 shows the comparison of the supply system to a possible direct shipment distributor model

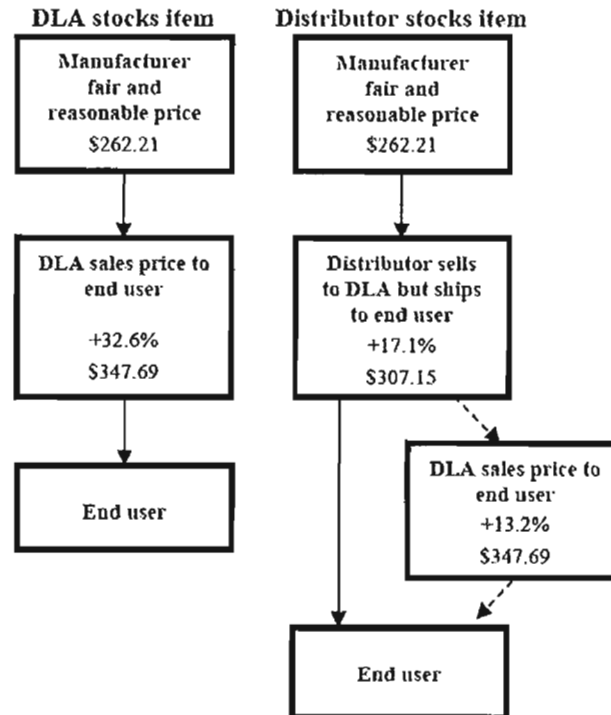


Figure 10. Traditional Supply Model Compared to Possible Distributor Model

Thus, if the distributor was able to negotiate the same price from the single-source manufacturer, stock adequate quantities of the item that could meet DoD requirements, and apply a reasonable pass-through charge that would result in the same or similar price that would be obtained through the DLA supply system, the distributor model could be viable and add sufficient value. Otherwise, we do not see how the distributor model can add sufficient value or be an effective alternative procurement option for DoD.

DoD needs to take action to discontinue using exclusive distributors unless they can develop a business model that provides sufficient added value to include increased competition, obtaining cost data to effectively negotiate prices, and reduced lead times and inventory.

Conclusion

Single-source manufacturers are refusing to quote directly on Government solicitations providing DoD contracting officers with few alternatives other than to procure the needed spare parts from exclusive distributors.

For example, in November 2003, [REDACTED] announced its agreement with Dutch Valley Supply to its customers.

[REDACTED]

[REDACTED]

Our review of contract documentation has discovered similar refusals to quote from [REDACTED]. Business practices such as these during a time of war clearly do not provide the best support to the warfighter.

Dutch Valley Supply, as an exclusive distributor, states that it provides value to DoD through reduced costs, improved readiness, and increased competition. We were unable to validate any of Dutch Valley Supply's claims and determined that no or negligible added value was provided by the exclusive distributor.

As shown by this report, DoD contracting officers [DLA, the Army Aviation and Missile Life Cycle Management Command, and the Naval Inventory Control Point, Philadelphia, Pennsylvania (NAVICP-P)] paid about \$3.0 million (75.0 percent) more than the fair and reasonable prices for 33 noncompetitive parts that cost about \$6.9 million procured through an exclusive distributor. DLA had the most difficulty negotiating fair and reasonable prices from the exclusive distributor, paying 93.0 percent more than fair and reasonable prices, totaling about \$2.7 million for 27 parts. Table 11 shows the excessive prices paid to Dutch Valley Supply, including pass-through charges.

<u>Manufacturer (Agency)</u>	<u>Items</u>	<u>Contract</u>	<u>Total Price</u>	<u>Excessive Prices</u>	
			<u>OIG Cost-Based¹</u>	<u>Amount</u>	<u>Percent</u>
[REDACTED]					
DLA	17	\$2,994,469	[REDACTED]	[REDACTED]	75.0
AMCOM ²	3	540,113	[REDACTED]	[REDACTED]	
NAVICP-P	2	264,834	[REDACTED]	[REDACTED]	
Subtotal	22	\$3,799,416	[REDACTED]	[REDACTED]	
[REDACTED]					
DLA	5	\$ 694,519	[REDACTED]	[REDACTED]	75.0
AMCOM	1	451,937	[REDACTED]	[REDACTED]	
Subtotal	6	\$1,146,457 ³	[REDACTED]	[REDACTED]	
[REDACTED] (DLA)	3	\$1,087,937	[REDACTED]	[REDACTED]	
[REDACTED] (DLA)	2	\$ 872,695	[REDACTED]	[REDACTED]	
Total	33	\$6,906,504 ³	\$3,947,016 ³	\$2,959,488	75.0

¹The OIG cost-based prices were calculated by using cost analysis of manufacturing costs and included a profit in line with DLA strategic supplier alliances.

²Army Aviation and Missile Life Cycle Management Command.

³Slight rounding inconsistencies exist because auditor calculations included decimal places.

See Appendix D for the comparison of the contract price to the cost-based manufacturer price and the buying agency for the 33 items reviewed.

The Under Secretary of Defense for Acquisition, Technology, and Logistics needs to identify and address contractors that require DoD contracting officers to procure noncompetitive items through an exclusive distributor.

Management Comments on the Finding and Audit Response

Under Secretary of Defense for Acquisition, Technology, and Logistics Comments. The Director, Defense Procurement and Acquisition Policy agreed with the report findings that DLA and DoD need to improve pricing techniques for determining fair and reasonable prices with distributors. The director also commented that a working group has been established to assess the magnitude of DoD's use of exclusive distributors, to identify pricing issues contracting officers encounter with distributors, to identify best practices for successful pricing, and to recommend actions that DoD needs to take to improve pricing techniques with distributors. Further, the director commented that guidance was clarified in the revision to Procedures, Guidance, and Information section 215.4 for when the Truth in Negotiations Act does not apply and there is no other way to determine price reasonableness except to require cost data and perform a cost analysis.

Audit Response. We consider the comments responsive and believe the changes taken will improve DoD's ability to negotiate reasonable prices from distributors.

Defense Logistics Agency Comments on Prices of Single-Source Parts. The Director, Acquisition Management concurred with the finding. The director commented that the Government does not possess the manufacturing drawings necessary to produce these parts on a competitive basis for most of the items reviewed in the report and since the items were low demand there is little incentive for other manufacturers to risk investing time and money to reverse engineer the items. The director also commented that Dutch Valley Supply or the single-source manufacturers have no incentive to present reasonable prices to the Government. Further, the Government has no bargaining power in these situations because Dutch Valley Supply and the manufacturers know the Government has no real alternative source for these single-source items. In addition, after successfully reverse engineering an item, DLA has experienced instances of price hikes by manufacturers for its other single-source items.

Audit Response. We agree that manufacturers and exclusive distributors like Dutch Valley Supply are forcing DLA and DoD to pay excessive prices for single-source items. As we recommended in the report, DoD needs to collect information on these suppliers and take appropriate action to address this issue. If single-source contractors unreasonably increase prices of their other items because DoD reverse engineered one of their items, officials at the contracting agency need to engage and work with company executives to achieve resolution

on pricing and should notify DoD acquisition leaders and oversight officials if necessary. If resolution is not achieved, DoD needs to document these actions in the past performance system and determine alternative actions.

Defense Logistics Agency on Ineffective Pricing Tools. The Director, Acquisition Management also commented that contracting officers rely on ineffective pricing tools when buying single-source items below the cost or pricing threshold (\$650,000) and there is no effective mechanism to require the supplier's compliance with requests for cost or pricing data. Further, the IG was able to obtain cost information from the single-source suppliers because of its subpoena authority. However, contracting officers do not have any ability to compel the contractor to provide the data and the report demonstrates the excessive prices that can be expected to occur in the absence of equal access by contracting officers to cost information.

Audit Response. We agree that there is little incentive for single-source suppliers to cooperate with requests for cost or pricing data that are necessary for the contracting officer to negotiate fair and reasonable prices. Over the past decade our audits have shown that single-source suppliers have been increasingly less willing to provide requested cost information to contracting officers. However, we have also seen DoD continually justify excessive prices as fair and reasonable using ineffective price analysis of previous Government prices. As stated in the report, we believe DoD needs to properly document the circumstances surrounding unreasonable prices and take appropriate action to address contractors that refuse contracting officer requests. With adequate documentation of unreasonable price negotiations, DoD will be able to quantify the full context of the problem and determine the best method for resolution.

Defense Logistics Agency Comments on Exclusive Distributor Model. The Director, Acquisition Management commented that buying directly from manufacturers will not necessarily eliminate the possibility of overpricing though it would eliminate the markup charged by the distributor. Further, DLA has little or no leverage to eliminate the use of an exclusive distributor if single-source manufacturers require DLA to procure items from them. Finally, DLA concurred with the report conclusion that distributors can occasionally be useful when they stock items and can provide quicker availability and delivery even at a higher price. However, Dutch Valley Supply, as shown by the report, does not provide value.

Audit Response. We agree that DLA was forced to procure items from exclusive distributors by single-source manufacturers. We recommend in this report that DoD identify and address contractors that require this practice. It is necessary to collect information to grasp the context of its use and determine the best approach for resolution. We agree that if distributors are able to provide reasonable pricing and can help significantly reduce DoD inventory levels and lead times, the model could be viable and provide value to DoD.

Army Comments on Solenoid Valve. The Chief of Staff, Aviation and Missile Life Cycle Management Command commented that the Army takes exception to the DoD IG using information that was not available to the Army at the time of negotiations and labeling it excessive profit in Appendix D. Further, the chief of

staff commented that using information that was not available is not an appropriate method to determine whether the appropriate steps in cost analysis were performed and the natural give and take of the market in fixed-price arrangements needs to be considered. The Army requested that the totals be adjusted for the information that the contracting officer reviewed or the item in question be removed from the DoD IG sample. Finally, the actions of the contracting officer complied with regulations and sound business practices were utilized.

Audit Response. We clearly documented in the report that the data we used in our calculations were not available to the Army during its negotiation, and we did not take exception to the small difference with the price negotiated from the manufacturer. In fact, we discussed the solenoid valve to show the importance of obtaining cost data and recognized that the Army saved \$879,147 by obtaining cost information. The report also documents that the large difference between the Army contract price and our calculated price stems from the exclusion of Dutch Valley Supply pass-through charges. However, the cost data we used represent actual costs for the performance and delivery of the contract reviewed. We believe that the use of this cost information is appropriate and correctly reflects the amount of excessive price paid under the contract. We agree that the business practice used by the Army contracting officer was appropriate and in compliance with regulations.

Army Comments on Distributors. The Chief of Staff, Aviation and Missile Life Cycle Management Command commented that contractors have the right to do business with the Government or not and in this case the Army considered the decision to use Dutch Valley Supply and its price under the circumstances reasonable. Further, some part of the distributor's effort relating to packaging and marking, freight and shipping, and general and administrative costs for oversight and logistics is necessary.

Audit Response. We agree that the Army was forced to buy the item from Dutch Valley Supply by the single-source manufacturer. We recommend in this report that DoD identify and address contractors that require this practice to determine its impact on prices and whether DoD should take action. As shown by the report, procuring items through Dutch Valley Supply has resulted in paying excessive prices without receiving sufficient value to DoD. If the distributor model could provide sufficient value by significantly reducing DoD inventory levels and lead times and provide reasonable prices, we agree that the effort should be compensated. However, if the distributor model is not a viable procurement alternative for DoD, we believe it is prudent for DoD to take action to discontinue its use.

Recommendations, Management Comments, and Audit Response

A.1. We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics:

a. Develop and issue guidance into the acquisition regulations that permits contracting officers to require consent to subcontract for fixed-price contracts from prime contractors that exhibit significant risk of charging excessive prices.

Management Comments. The Director, Defense Procurement and Acquisition Policy concurred with the intent of the recommendation. However, the director does not believe that a significant change to the regulations is warranted based on the circumstances identified in the report. The director does believe that specific guidance for pricing actions with exclusive distributors is warranted to address the issues raised in the report and referred to his response to Recommendation A.1.d. for more information.

Audit Response. We consider the comments responsive.

b. Issue guidance that requires the Military Departments and Defense agencies to track and periodically report information about problem contractors that refuse to provide requested information necessary to determine price reasonableness and take appropriate action to address pricing issues related to specific contractors.

Management Comments. The Director, Defense Procurement and Acquisition Policy concurred with the recommendation. The director commented that a policy memorandum would be issued requiring the Military Departments and Defense agencies to report any companies that refuse to provide cost or pricing data.

Audit Response. We consider the comments responsive. A policy memorandum addressing this recommendation was issued on November 7, 2007.

c. Review the Defense Logistics Agency's dealer competition policies and determine whether the policies meet the Federal Acquisition Regulation 15.403-1 definition of adequate competition.

Management Comments. The Director, Defense Procurement and Acquisition Policy concurred with the recommendation. The director commented that the DLA policy does not conflict with the FAR and believes the report findings represent implementation problems and poor use of judgment. The director commented that a memorandum would be issued to the senior procurement executive at DLA by December 14, 2007, that would request an action plan detailing how DLA will ensure proper application of FAR 15.403-1(c)(1). The memorandum would require contracting officers to obtain cost data and perform cost analysis when comparable commercial sales, adequate competition, or a prior cost analysis is unavailable and no other valid technique can be used. Further, the

memorandum would also point out the risks identified in the report when dealers are not stocking parts, rather proposing prices based on quotes from a single-source manufacturer.

Audit Response. We consider the comments responsive. On October 23, 2007, a memorandum was issued to DLA requesting an action plan. On January 7, 2008, DLA responded that its practices for determining price reasonableness in these situations need improvement so training in appropriate techniques will be provided to underscore existing regulatory guidance and instructions. DLA will also continue to review subsequent awards in other supply chains to determine the extent of the problem.

d. Identify and address contractors that require DoD contracting officers to procure noncompetitive items through an exclusive distributor.

Management Comments. The Director, Defense Procurement and Acquisition Policy concurred with the recommendation. The director commented that a memorandum would be issued to Military Departments and Defense agencies by December 14, 2007, to reiterate the requirements in FAR 15.4 and Procedures, Guidance, and Information section 215.4 and to relate the guidance to exclusive distributors. Specifically, the memorandum would require all contracting officers to obtain needed cost data, to perform a cost analysis of all costs and markup by the actual manufacturer, and to review the cost proposal analysis performed by the exclusive distributor of its price from the single-source manufacturer. Further, when companies refuse to provide the required data and an award has to be made without cost analysis, it will be reported to Defense Procurement and Acquisition Policy.

Audit Response. We consider the comments responsive. A policy memorandum addressing this recommendation was issued on November 7, 2007.

A.2. We recommend that the Commanders, Army Aviation and Missile Life Cycle Management Command and Navy Inventory Control Point, Philadelphia; and the Director, Defense Logistics Agency instruct contracting officers to:

a. Ensure prime contractors, like Dutch Valley Supply, conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices and include the results of these analyses in the price proposal as required by Federal Acquisition Regulation 15.404-3, "Subcontract Pricing Considerations."

Defense Logistics Agency Comments. The Director, Acquisition Management concurred with the intent of the recommendation. The director commented that DLA's Component Acquisition Executive would issue a memorandum addressing the need for all acquisition managers to assure compliance with policies for determining price reasonableness, including pass-through costs from subcontractors or other suppliers. The memorandum will also address the submission of contractor and subcontractor cost or pricing data when these amounts exceed the cost or pricing threshold. This action is ongoing, with an estimated completion date of April 30, 2008.

Audit Response. We consider the comments responsive.

Navy Comments. The Deputy Director of Contracts, NAVICP-P concurred with the recommendation. The deputy director commented that NAVICP-P will ensure prime contractors conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontractor prices and include the results of these analyses in the price to the Government. In addition, NAVICP-P, with DCAA, has and continues to provide extended cost and pricing training to its workforce.

Audit Response. We consider the comments responsive.

Army Comments. The Chief of Staff, Aviation and Missile Life Cycle Management Command nonconcurred with all of the recommendations. Further, the chief of staff commented that the Army contracting officers took appropriate steps and no further instruction is required.

Audit Response. The Army contract files did not contain any evidence of cost or price analysis of subcontract prices performed by Dutch Valley Supply in its price proposal as required by the FAR. The Army comments did not meet the intent of the recommendation. Therefore, the Army needs to provide additional comments to the final report that address the specific recommendation.

b. Determine the adequacy of the cost or price analyses performed by the prime contractor.

Defense Logistics Agency Comments. The Director, Acquisition Management concurred with the recommendation. The director commented that DLA is taking steps to raise contracting offices' awareness in determining the adequacy of cost and pricing data, and to formulate and implement corrective actions as appropriate. As a corrective action, the director planned to formally transmit the November 7, 2007, Defense Procurement and Acquisition Policy memorandum addressing this issue with interim implementing guidance in a DLA-wide procurement letter, by March 31, 2008. DLA will also conduct a sampling review of recent buys to determine whether the interim efforts have corrected the issue. This action is ongoing, with an estimated completion date of December 31, 2008.

Audit Response. We consider the comments responsive.

Navy Comments. The Deputy Director of Contracts, NAVICP-P concurred with the recommendation. The deputy director commented that NAVICP-P will continue to review and determine the adequacy of the cost or price analyses performed by prime contractors.

Audit Response. We consider the comments responsive.

Army Comments. The Chief of Staff, Aviation and Missile Life Cycle Management Command nonconcurred with all of the recommendations. Further, the chief of staff commented that the Army contracting officers took appropriate steps by thoroughly reviewing and analyzing cost and price information, and no further instruction was required.

Audit Response. The Army contract files did not contain any evidence of cost or price analysis of subcontract prices performed by Dutch Valley Supply in its price proposal as required by the FAR. The Army comments did not meet the intent of the recommendation. Therefore, the Army needs to provide additional comments to the final report that address the specific recommendation.

c. Review and determine the reasonableness of subcontractor prices to include obtaining cost data when necessary before awarding future contracts, if the prime contractor did not perform adequate cost or price analyses.

Defense Logistics Agency Comments. The Director, Acquisition Management concurred with the recommendation. The director commented that contracting officers do request cost data, and when provided, review and determine price reasonableness of subcontractor cost, but in most cases the data were not provided or were inadequate and were elevated to higher level management, who sought access to cost data. The director commented that substantial improvements are needed and after reporting when contractors refuse to provide cost data to Defense Procurement and Acquisition Policy, DLA will review the process results to determine if the changes have been effective and whether further emphasis is needed. This action is ongoing, with an estimated completion date of December 31, 2008.

Audit Response. We consider the comments responsive.

Navy Comments. The Deputy Director of Contracts, NAVICP-P concurred with the recommendation. The deputy director commented that NAVICP-P will review and determine the reasonableness of subcontractor prices to include obtaining cost data when necessary before awarding contracts if the prime contractor did not perform adequate cost or price analyses.

Audit Response. We consider the comments responsive.

Army Comments. The Chief of Staff, Aviation and Missile Life Cycle Management Command nonconcurred with all of the recommendations. The chief of staff commented that the report showed that steps taken by the Army Contracting Office during the review were appropriate. Specifically, the Army coordinated with DCAA, reviewed subcontractor data, and negotiated a reduction in price based on the recommendations.

Audit Response. With the exception of the solenoid valve, we do not see any evidence in Army contract files that document the Army's review of subcontractor cost data. The Army comments did not meet the intent of the recommendation. Therefore, the Army needs to provide additional comments to the final report that address the specific recommendation.

d. Perform cost analysis in a noncompetitive environment to determine price reasonableness when price analysis does not provide sufficient information and a reliable baseline price has not been established.

Defense Logistics Agency Comments. The Director, Acquisition Management concurred with the recommendation. The director commented that when adequate cost data could not be secured, contracting officers have used price analysis in some cases as a last resort to reach a conclusion regarding price reasonableness. The director also commented that the inability to obtain cost data has been elevated to higher level management, who continued to seek access to cost data. The Defense Procurement and Acquisition Policy memorandum, dated November 7, 2007, requires a report when the head of the contracting agency grants a waiver to allow an award to a distributor that refuses to provide cost data when the cost or pricing data threshold does not apply. Further, DLA will encourage the chiefs of contracting offices to seek cost data and work with suppliers to help secure necessary access. This action is ongoing, with an estimated completion date of December 31, 2008.

Audit Response. We consider the comments responsive. However, as documented in the report, the price analysis of previous Government prices is not an effective method to determine price reasonableness for single-source parts and should not be used to justify unreasonable prices.

Navy Comments. The Deputy Director of Contracts, NAVICP-P concurred with the recommendation. The deputy director commented that NAVICP-P will perform cost analysis in a noncompetitive environment to determine price reasonableness when price analysis does not provide sufficient information and a reliable baseline price has not been established.

Audit Response. We consider the comments responsive.

Army Comments. The Chief of Staff, Aviation and Missile Life Cycle Management Command nonconcurred with all of the recommendations. The chief of staff commented that appropriate rules were followed by the Army, including a cost analysis performed April 26, 2005, as required by FAR Part 15.

Audit Response. The Army comments failed to meet the intent of the recommendation. Therefore, the Army needs to provide additional comments to the final report that address the specific recommendation.

e. Take action to discontinue using exclusive distributors unless they can develop a business model that provides sufficient added value to include increased competition, obtaining cost data to effectively negotiate prices, and reduced lead times and inventory.

Defense Logistics Agency Comments. The Director, Acquisition Management concurred with the intent of the recommendation. The director commented that DLA is obliged to buy from the exclusive distributors that represent manufacturers of single-source items. The director also commented that DLA has been successful in reverse engineering some items and negotiating with one manufacturer to change its practice of not dealing directly with the Government. DLA has a long-term business strategy of maximizing efforts to build Strategic Supplier Alliances, Supply Chain Alliances, Prime Vendor, and other long-term contracts. DLA plans to continue to use these approaches and vendor fairs to emphasize the benefit of cooperative arrangements, and to tactfully seek to

discourage companies from entering into exclusive distributorships. However, DLA cannot prevent a manufacturer's use of an exclusive distributor. This action is considered complete for reporting purposes.

Audit Response. We consider the comments responsive.

Navy Comments. The Deputy Director of Contracts, NAVICP-P concurred with the recommendation. The deputy director commented NAVICP-P will review the exclusive distributor on an order-by-order basis to determine if the distributor provides value to NAVICP-P.

Audit Response. We consider the comments responsive.

Army Comments. The Chief of Staff, Aviation and Missile Life Cycle Management Command nonconcurred with all of the recommendations. The chief of staff commented that the Army cannot dictate that businesses cannot utilize distributors if they determine this business model is needed to support their products. Specifically, the Commanding General, Aviation and Missile Life Cycle Management Command has challenged the utilization of Dutch Valley by distributors for items where they were not providing the item in a timely manner or within a reasonable price. The chief of staff commented that the commanding general was proactive in challenging the prime contractor to provide direct support on the items. However, it is the Army's intent to continue to challenge the use of distributors on an individual basis when the situation warrants.

Audit Response. Even though the Army nonconcurred with the recommendation, we consider the comments and actions to be responsive in addressing this problem.

A.3. We recommend that the Director, Defense Logistics Agency:

a. Request the Defense Contract Management Agency to immediately begin a review of Dutch Valley Supply's purchasing system.

Management Comments. The Director, Acquisition Management concurred with the recommendation. The director commented that, by January 2008, the Defense Contract Management Agency would contact Dutch Valley Supply for access to commence a review of its purchasing system. This action is ongoing, with an estimated completion of June 30, 2008.

Audit Response. We consider the comments responsive.

b. Instruct the Commanders of the Defense Supply Centers to discontinue granting inappropriate waivers from cost or pricing data based primarily on price analysis.

Management Comments. The Director, Acquisition Management concurred with the recommendation. The director commented that a number of initiatives have been commenced to ensure changes to policy are understood, including the issuance of two procurement letters (on July 19, 2007, and November 7, 2007) and supply chain training. The director also commented that DLA continues to

attempt to secure cost or pricing data to avoid the use of exceptional case waivers. However, in situations where cost data cannot be obtained, contracting officers will elevate to higher level management these efforts to obtain cost data or fully comply with Public Law 107-314 and additional guidance promulgated by Defense Procurement and Acquisition Policy and DLA. This action is complete.

Audit Response. We consider the comments responsive.

c. Continue initiating reverse engineering efforts for items that have unreasonable pricing from single-source offerors.

Management Comments. The Director, Acquisition Management concurred with the recommendation. The director commented that they have been successful in some reverse engineering efforts. However, due to short time frames, limited funding, and, in some cases, a lack of economic incentive for alternative manufacturers, DLA planned to continue using correspondence, training, and a recognition of individual and group accomplishments to increase awareness about the importance of reducing or eliminating egregious overpricing by single-source distributors that add no value. This action is considered complete for reporting purposes.

Audit Response. We consider the comments responsive.

d. Discontinue coding an analysis of dealer costs as cost analysis unless a cost analysis of manufacturing costs has also been performed.

Management Comments. The Director, Acquisition Management concurred with the recommendation. The director commented that they are researching how dealer cost analysis was coded as cost analysis and what corrective actions are needed. DLA will provide the information gathered and the basis of its conclusion to the DoD IG. This action is ongoing, with an estimated completion date of April 30, 2008.

Audit Response. We consider the comments responsive.

e. Discontinue using dealer competition to determine price reasonableness in a noncompetitive environment.

Management Comments. The Director, Acquisition Management partially concurred with the recommendation. The director commented that the FAR and the Defense Logistics Acquisition Directive (DLAD) allow dealer competition to be used as the basis for price reasonableness determinations if "independence" can be established between dealers and manufacturers. DLA also updated the DLAD in Procurement Letter 07-08, dated June 28, 2007, which stated that the existence of competition is not sufficient to validate the reasonableness of an offeror's price proposal. The letter also gave two DLAD provisions that require contracting officers to verify the objective price reasonableness of all offers and provided guidance on determining when competitors can be considered independent. This action is considered complete.

Audit Response. We consider the comments responsive.

f. Emphasize to contracting officers the importance of making price reasonableness determinations, properly documenting the contract file, and ensuring cost or pricing data is requested as required by Federal Acquisition Regulation 15.403-4, "Requiring Cost or Pricing Data."

Management Comments. The Director, Acquisition Management concurred with the intent of the recommendation. The director commented that these issues are covered adequately in various Federal, DoD, and agency guidance, and local training, and will be addressed during planned procurement seminars. This action is considered complete.

Audit Response. We consider the comments responsive.

B. Cost or Pricing Data Threshold

DLA contracting officers failed to correctly calculate the threshold for requiring cost or pricing data as required by FAR 15.403-4. The threshold was not correctly calculated because DLA guidance permitted contracting officers to consider only the value of the basic contract and exercised options at the time of award versus the “final anticipated dollar value of the action, including the dollar value of all options” as the FAR requires. As a result, DLA failed to require cost or pricing data for eight items procured on three contracts valued at about \$3.5 million.

Cost or Pricing Data Guidance

Legislative Guidance. The Truth in Negotiations Act of 1962 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.

Regulatory Guidance. The FAR prescribes policy to ensure that contracting officers meet the intent of the Truth in Negotiations Act requirement for submission of cost or pricing data. Specifically, FAR 15.403-4(a)(1) requires contracting officers to obtain cost or pricing data when a pricing action exceeds \$550,000 (now \$650,000).

Determining the Threshold for Cost or Pricing Data

DLA contracting officers failed to correctly calculate the threshold for requiring cost or pricing data as required by FAR 15.403-4. DLA guidance allowed contracting officers to inaccurately measure the cost or pricing data threshold by only considering the basic contract and options exercised at the time of award. Specifically, the Defense Logistics Acquisition Directive (DLAD) 15.403-4, “Requiring Cost or Pricing Data,” stated:

(i) Pricing a contract award (other than an undefinitized contract action).

(90) In determining whether an award meets the \$550,000 Truth in Negotiations Act (TINA) threshold for requiring cost or pricing data, consider the basic contract quantity (or estimated value of an IDC base period), plus the value of either a quantity option or the estimated value of a period option that will be exercised at the time of award. [emphasis added]

The DLA cost and pricing analyst stated that the DLAD guidance was intended to prevent DLA contracting officers from dividing quantity requirements in order to avoid the requirement for obtaining cost or pricing data. Further, the analyst believed that requesting cost or pricing data for quantity option contracts and indefinite-quantity, indefinite-delivery contracts was unnecessary because there

was no guarantee that the purchases would be made and the cost or pricing threshold would be breached.

The FAR defines the contract dollar threshold as the final anticipated dollar value of the contract action to include the basic contract and all priced options. Specifically, FAR 1.108(c), "Dollar thresholds," states:

Unless otherwise specified, a specific dollar threshold for the purpose of applicability is the final anticipated dollar value of the action, including the dollar value of all options. If the action establishes a maximum quantity of supplies or services to be acquired or establishes a ceiling price or establishes the final price to be based on future events, the final anticipated dollar value must be the highest final priced alternative to the Government, including the dollar value of all options. [emphasis added]

Clearly, the DLAD guidance for calculating the cost or pricing threshold is contrary to the FAR because it only requires the consideration of the basic contract value and the value of options exercised at the time of contract award and not the value of all priced options.

Calculation of Threshold

DLA contracting officers failed to require cost or pricing data for two items purchased on two quantity option contracts and six items on an indefinite-quantity contract awarded to Dutch Valley Supply because the contracting officers' calculations of the cost or pricing data threshold did not include the value of all options. Table 12 shows that, through July 27, 2007, DLA purchased \$3.5 million on the three contracts.

Table 12. DLA Purchases Through July 27, 2007								
Quantity Option Contracts	NSN	Qty	Basic Term		Qty	Option(s)		Overall
			Unit Price	Total Price		Unit Price*	Total Price	Total
1. SP0475-04-C-1269	1650-01-222-3407	236	\$1,897.27	\$447,756	113	\$1,897.27	\$214,392	\$662,147
2. SP0480-03-C-2134	2915-01-440-6815	168	\$2,319.36	\$389,652	168	\$2,319.36	\$389,652	\$779,305
Indefinite-Quantity Contract								
3. SP0740-04-D-7875	4730-01-033-4396	-	\$ 291.00	-	191	\$ 407.58	\$ 77,847	\$ 77,847
	4810-00-492-8102	31	4,481.00	\$ 138,911	29	4,658.40	135,094	274,005
	4810-01-096-1055	-	3,370.00	-	152	3,605.69	548,064	548,064
	4810-01-194-9613	6	3,581.00	21,486	17	3,802.20	64,637	86,123
	4820-00-592-9949	109	593.00	64,637	218	629.11	137,146	201,783
	4820-01-123-7658	119	2,037.00	<u>242,403</u>	308	2,102.51	<u>647,572</u>	<u>889,975</u>
Subtotal				\$ 467,437			\$1,610,360	\$2,077,797
Total (8 Items)				\$1,304,845			\$2,214,404	\$3,519,249
*For the indefinite quantity contract, we calculated a weighted average unit price based on the quantity purchased during both option years.								

*For the indefinite quantity contract, we calculated a weighted average unit price based on the quantity purchased during both option years.

Quantity Option Contracts. DLA contracting officers divided requirements between the base and option year by waiting to exercise the option only a few days after awarding the basic contract, a practice that the DLAD was specifically intended to prevent.

For example, on April 7, 2003, DSCR awarded contract SP0480-03-C-2134 for the purchase of 168 valve assembly overhaul part kits (NSN 2915-01-440-6815) at a base year unit price of \$2,319.36, totaling \$389,652. The contract had a 100 percent quantity option, which resulted in a final anticipated contract value of \$779,305. The contracting officer then exercised the 100 percent quantity option, on April 9, 2003, which was 2 days after the contract award.

In another example, on March 25, 2004, DSCR awarded contract SP0475-04-C-1269 for the purchase of 236 housing spools (NSN 1650-01-222-3407) at a base year unit price of \$1,897.27, totaling \$447,756. The contract also had a 100 percent quantity option, which resulted in a final anticipated contract value of \$895,512. Six days after the contract award, on March 31, 2004, the contracting officer exercised part of the option for 113 units, resulting in a total contract value of \$662,147, which still exceeded the threshold for the submission of cost or pricing data.

We calculate based on annual demand that DLA paid \$ [REDACTED] ([REDACTED] percent) more than fair and reasonable prices for the two items by not obtaining sufficient data. See Appendix D for the individual part comparisons.

Clearly, the contracting officers' actions were to divide requirements between the basic contract and options in order to circumvent the DLAD guidance. We find it troubling that contracting officers appeared to take deliberate actions to circumvent guidance, which resulted in paying more than fair and reasonable prices at a time when valuable procurement dollars are urgently needed to support the warfighter.

Indefinite-Quantity Contract. A contracting officer also failed to require cost or pricing data for an indefinite-quantity contract. For example, on March 31, 2004, DSCC awarded contract SP0740-04-D-7875 for the purchase of nine items at an estimated base year amount of \$523,427, with 2 option years, totaling a final anticipated contract value of about \$1.6 million. The contracting officer evaluated option year prices, stating in the price negotiation memorandum that the option year prices were evaluated and determined to be reasonable, with an annual increase of 3 percent. Based on our review of the procurement history through July 27, 2007, total purchases on the contract exceeded the initial estimate, totaling about \$2.1 million.

Only four of the nine items (NSNs 4810-00-492-8102, solenoid valve; 4810-01-096-1055, solenoid valve; 4820-00-592-9949, check valve; and 4820-01-123-7658, calibrated flow valve) on contract were in our audit scope. We calculate based on annual demand that DLA paid \$ [REDACTED] ([REDACTED] percent) more than fair and reasonable prices for the four items reviewed. See Appendix D for the individual part comparisons.

Summary. The DLAD policy for determining the cost or pricing data threshold needs to be modified to ensure that future calculations of the threshold are consistent with the FAR. As shown in Finding A, contracting officers need to perform cost analysis when it is necessary to adequately determine price reasonableness and effectively negotiate fair and reasonable prices.

The Under Secretary of Defense for Acquisition, Technology, and Logistics needs to review and determine whether the DLA policy for determining the cost or pricing data threshold is consistent with the FAR. The Director, DLA needs to modify the DLAD to ensure that the threshold for obtaining cost or pricing data is calculated based on the "final anticipated dollar value of the action, including the dollar value of all options."

Management Comments on the Finding and Audit Response

Defense Logistics Agency Comments. The Director, Acquisition Management concurred with the finding. The director commented that the DLAD guidance was issued 18 years ago, but now has been updated to reflect the FAR "dollar threshold" convention developed substantially later.

Audit Response. We consider the comments responsive.

Recommendations, Management Comments, and Audit Response

B.1. We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics review and determine whether the Defense Logistics Agency's policy for determining the cost or pricing data threshold is consistent with the Federal Acquisition Regulation.

Management Comments. The Director, Defense Procurement and Acquisition Policy does not believe that DLA's policy is consistent with the FAR. The director commented that the issue was coordinated with DLA and DLA is revising its policy to conform to the FAR.

Audit Response. We consider the comments responsive.

B.2. We recommend that the Director, Defense Logistics Agency modify the Defense Logistics Acquisition Directive to ensure that the threshold for obtaining cost or pricing data is calculated based on the final anticipated dollar value of the action, inclusive of the dollar value of all options.

Management Comments. The Director, Acquisition Management partially concurred with the recommendation. The director updated guidance on how DLA calculates the dollar value of a contract action for the application of the cost or pricing threshold. The updated guidance was communicated in Procurement Letter 07-28, dated November 7, 2007, and now requires the calculation to

include the dollar value of all priced options. DLA calculations cannot and do not attempt to quantify or consider the value for any unpriced or undefinitized options.

Audit Response. We consider the comments responsive.

Appendix A. Scope and Methodology

We conducted this performance audit from March 2006 through July 2007 in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Overall. We visited and contacted individuals at DLA, NAVICP-P, the Army Aviation and Missile Life Cycle Management Command, Dutch Valley Supply,

[REDACTED]. During site visits to the Defense Supply Center, Philadelphia, Pennsylvania (DSCP); DSCR; DSCC; the Army Aviation and Missile Life Cycle Management Command; and NAVICP-P, we interviewed buyers and contracting officers and reviewed contract documentation relating to acquisitions and buying experiences with Dutch Valley Supply. We also reviewed contract documentation to evaluate how contract prices were determined to be fair and reasonable. Specifically, we reviewed price negotiation memorandums, simplified acquisition pricing memorandums, quotations received, evaluation of offers, negotiations, and justifications for awarding the contract. We also determined whether buyers and contracting officers followed applicable rules and regulations in awarding and negotiating contracts. In addition, we contacted 13 dealers to determine their process for bidding on Government solicitations. We reviewed cost information provided by [REDACTED] for 31 items identified in this audit. We also reviewed cost information that had been obtained in a previous audit for two items. We reviewed recent legislation and relevant guidance related to the audit scope. We reviewed contract documentation related to [REDACTED] long-term contract [REDACTED] including the contract solicitation, award, price negotiation memorandum, several price analyses, the waiver of cost or pricing data, and correspondence between DSCC and [REDACTED].

Contract Selection Process. We used the DD350 database to identify FY 2004 and FY 2005 contract actions by Dutch Valley Supply. We identified 971 contract actions totaling \$37.6 million at 24 contracting offices.

As shown in the DD350 database, DSCR, DSCC, DSCP, the Army Aviation and Missile Life Cycle Management Command, and NAVICP-P were the top five contracting offices, representing 93.2 percent of total contract actions with Dutch Valley Supply. We used Haystacks Online for Windows, the DLA Procurement Gateway, and DLA Internet Bid Board System to identify the NSNs and obtained demand and pricing information from the Defense Operations Research and Resource Analysis Office for the DLA items. We identified 585 unique DLA items with a total annual demand of \$15.0 million. Further, we identified 47 items with a total annual demand of about \$4.7 million with purchases in FY 2003 or later from Haystacks Online for Windows that were not included in the DD350 data. Combined, we identified 632 unique DLA items with annual demand of \$19.6 million. We then selected items with an annual demand of

\$50,000 or greater and identified 107 items under this criterion with an annual demand of about \$13.7 million. For the 107 items, we selected 121 contracts valued at \$25.7 million. Three DSCC contracts we requested could not be located and were removed from our scope. We added 10 additional contracts (9 at DSCR, 1 at DSCC) during our field work. Consequently, we reviewed 128 DLA contracts valued at \$26.8 million for 112 items (DSCR, 61 contracts valued at \$13.5 million; DSCC, 56 contracts valued at \$11.8 million; and DSCP, 11 contracts valued at \$1.5 million).

We reviewed Haystacks Online for Windows Procurement History to identify the NSNs and manufacturers for the Army Aviation and Missile Life Cycle Management Command and NAVICP-P DD350 contract actions. We selected 32 Army Aviation and Missile Life Cycle Management Command contracts valued at \$6.0 million that had contract value of at least \$25,000. However, one contract we requested could not be located. Therefore, we reviewed 31 Army Aviation and Missile Life Cycle Management Command contracts for 25 items valued at \$6.0 million. We also selected 16 NAVICP-P contracts valued at \$1.4 million based on high contract value or because the manufacturer was one of Dutch Valley Supply's top six manufacturers. One NAVICP-P contract we requested could not be located. Therefore, we reviewed 15 NAVICP-P contracts for 13 items valued at \$1.3 million.

Overall, for DLA, the Army Aviation and Missile Life Cycle Management Command, and NAVICP-P for the combined 150 items, we reviewed 174 contracts valued at about \$34.0 million, shown in Table A-1.

<u>Buying Agency</u>	<u>Contracts</u>	<u>Items</u>	<u>Contract Value¹</u>
DSCR	61	48	\$13,459,781
DSCC	56	53	11,791,663
DSCP	<u>11</u>	<u>11</u>	<u>1,517,940</u>
DLA Subtotal	128	112	\$26,769,384
AMCOM ²	31	25	\$5,969,387
NAVICP-P	<u>15</u>	<u>13</u>	<u>1,256,256</u>
Total	174	150	\$33,995,027

¹ Contract value represents the contract quantity multiplied by the contract unit price.

² Army Aviation and Missile Life Cycle Management Command.

Cost Data Selection. We focused our review of cost data to noncompetitive parts so competitive items were eliminated from our scope. We reviewed the six manufacturers with the highest DLA annual demand of noncompetitive parts. The six manufacturers were [REDACTED] that collectively had 73 DLA items with an annual demand of \$9.2 million. To this we added

6 additional items from the Army Aviation and Missile Life Cycle Management Command and NAVICP-P with an annual demand of about \$1.3 million. Thus, our total population consisted of 79 items that had an annual demand of \$10.5 million. From that population, we selected 43 items that had an annual demand of \$8 million (76.6 percent). We selected 37 DLA items based on highest annual demand, contract amounts that exceeded the cost or pricing threshold, and significant price increases. The remaining six items were selected based on the highest dollar value contracts from the Army Aviation and Missile Life Cycle Management Command and NAVICP-P.

We did not request cost information for the eight [REDACTED] items selected because, in February 2006, we issued a report that found instances of excessive prices. We used cost information obtained from that audit for two parts contained in the scope of this audit. We later dropped [REDACTED] because of the low number of parts that represented only about 5.4 percent of the population. Overall, we reviewed cost data for 33 parts that had an annual demand of \$6.4 million (61.2 percent) of the population (Table A-2).

Table A-2. Items Selected for Review and OIG Coverage					
<u>Buying Agency</u>	<u>Selected Population</u>		<u>OIG Reviewed</u>		<u>Percent</u>
	<u>Items</u>	<u>Annual Demand¹</u>	<u>Items</u>	<u>Annual Demand¹</u>	
DSCR	34	\$3,786,344	8	\$1,635,307	43.2
DSCC	35	4,952,185	19	3,531,655	71.3
DSCP	4	504,079	0	0	0.0
DLA Subtotal	73	\$9,242,608	27	\$5,166,962	55.9
AMCOM ²	4	\$992,050	4	\$992,050	100.0
NAVICP-P	2	264,834	2	264,834	100.0
Total	79	\$10,499,492	33	\$6,423,846	61.2

¹ DLA annual demand was calculated by multiplying the average annual demand quantity by the Mean Acquisition Unit Cost. AMCOM and NAVICP-P annual demand was calculated by multiplying the average annual demand quantity by the contract unit price.

² Army Aviation and Missile Life Cycle Management Command.

Review of Cost Data. To the costs provided by each manufacturer, we added a profit in line with DLA strategic supplier alliances to calculate a cost-based price. 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 the contractors. We applied these costs as proposed by the contractors.

We used 2007 standard costs from [REDACTED] for seven items because [REDACTED] did not have actual cost information (six items) or the data was based on an uneconomical quantity. To determine the manufacturing cost for these seven items, we de-escalated the 2007 cost standard to the year of contract award

and applied the corresponding overhead and support rates. We also eliminated unallowable costs, such as bad debts, contributions, and entertainment, from [REDACTED] cost information.

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 and contracting offices to review during the audit. We obtained Standard Automated Material Management System and Business System Modernization system data from the Defense Operations Research and Resource Analysis Office to include demand data and pricing information. We also obtained the procurement history for all items reviewed from Haystacks Online for Windows, a commercial system. The computer-processed data and 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 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 (GAO) has identified several high-risk areas in DoD. This report provides coverage of the "Defense Contract Management," "Defense Supply Chain Management," and "Defense Approach to Business Transformation" high-risk areas.

Appendix B. Prior Coverage

During the last 10 years, GAO and the DoD IG have issued 34 reports discussing the reasonableness of commercial and noncommercial prices of weapon systems and noncompetitive spare parts. Unrestricted GAO reports can be accessed over the Internet at <http://www.gao.gov>. Unrestricted DoD IG reports can be accessed at <http://www.dodig.mil/audit/reports>. Dates in parentheses indicate redacted versions.

GAO

GAO Report No. GAO-07-281, "Defense Inventory: Opportunities Exist to Improve the Management of DOD's Acquisition Lead Times for Spare Parts," March 2, 2007

GAO Report No. GAO-06-995, "DOD Contracting: Efforts Needed to Address Air Force Commercial Acquisition Risk," September 29, 2006

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-02-505, "Defense Acquisitions: Status of Defense Logistics Agency's Efforts to Address Spare Part Price Increases," April 8, 2002

GAO Report No. GAO-01-244, "Performance and Accountability Series: Major Management Challenges and Program Risks, Department of Defense," January 1, 2001

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

DoD IG

DoD IG Report No. D-2007-119, "Procurement of Propeller Blade Heaters for the C-130 Aircraft," August 27, 2007

DoD IG Report No. D-2006-122, "Commercial Contract for Noncompetitive Spare Parts With Hamilton Sundstrand Corporation," September 29, 2006

DoD IG Report No. D-2006-115, "Commercial Contracting for the Acquisition of Defense Systems," September 29, 2006

DoD IG Report No. D-2006-055, "Spare Parts Procurements From TransDigm, Inc.," February 23, 2006

DoD IG Report No. D-2004-102, "Contracting for and Performance of the C130-J Aircraft," July 23, 2004

DoD IG Report No. D-2004-064, "Acquisition of the Boeing KC-767A Tanker Aircraft," March 29, 2004

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 Air 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 26, 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 (June 12, 2000)

DoD IG Report No. D-2000-098, "Spare Parts and Logistics Support Procured on a Virtual Prime Vendor Contract" March 8, 2000 (June 14, 2000)

DoD IG Report No. 99-218, "Sole-Source Noncommercial Spare Parts Orders on a Basic Ordering Agreement," July 27, 1999 (October 12, 1999)

DoD IG Report No. 99-217, "Sole-Source Commercial Spare Parts Procured on a Requirements Type Contract," July 21, 1999 (August 16, 1999)

DoD IG Report No. 99-026, "Commercial Spare Parts Purchased on a Corporate Contract," October 30, 1998 (January 13, 1999)

DoD IG Report No. 98-088, "Sole-Source Prices for Commercial Catalog and Noncommercial Spare Parts," March 11, 1998 (October 13, 1998)

DoD IG Report No. 98-064, "Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111," February 6, 1998 (June 24, 1998)

Appendix C. Other Matters of Interest—Cost or Pricing Data Waiver

Long-Term Contract. The DSCC long-term contract with [REDACTED] further illustrates the ineffectiveness of price analysis without establishing the validity and reasonableness of the prior price. The distributor agreement between [REDACTED] and Dutch Valley Supply began to wind down in late 2006 and [REDACTED] began working on a long-term contract with DSCC.

On September 29, 2006, DSCC awarded indefinite-quantity contract [REDACTED] with 252 parts that had an estimated base year contract value of \$3.4 million to [REDACTED]. The contracting officer determined prices fair and reasonable based on price analysis of previous procurements.

For evaluation purposes, the historical price that most closely matched the current annual demand quantity while still being one of the most recent awards was selected for historical comparison. 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. In reviewing the historical data for the NSNs being considered for award, most items showed a fairly consistent price increase over the years; and for the most part, prior award prices were determined fair and reasonable based on comparison to prior price(s) determined reasonable via price analysis. [emphasis added]

On June 26, 2006, the Commander, DSCR* waived the submission of cost or pricing data because the commander believed that using price analysis of previous Government procurements was sufficient and cost data were not necessary to establish price reasonableness.

There were five items on the DSCC long-term contract that were part of our audit scope [REDACTED]

[REDACTED] Based on price analysis, the contracting officer believed the offered prices were reasonable because the prices were reduced 20.6 percent from the adjusted previous contract price.

* The parts solicited on the [REDACTED] long-term contract are managed by the Aviation Detachment at DSCC, but operates under DSCR Command. Therefore, the Commander, DSCR signed the waiver.

Table C-1 shows the [REDACTED] long-term contract price and the previous contract price (adjusted for inflation and significant quantity differences).

Table C-1. Contract Price Compared to Previous Price (Price Analysis)							
NSN	Contract Quantity	Contract Price		Previous Price		Difference	
		Unit	Total	Unit	Total	Amount	Percent
[REDACTED]	[REDACTED]	[REDACTED]	\$ 48,573	[REDACTED]	\$ 49,668	(\$ 1,096)	(2.2)
			176,026		252,022	(75,996)	(30.2)
			32,932		54,427	(21,496)	(39.5)
			61,173		78,627	(17,454)	(22.2)
			174,959		187,142	(12,184)	(6.5)
Total			\$493,662*		\$621,887*	(\$128,225)	(20.6)

*Slight rounding inconsistencies exist because auditor calculations included decimal places.

However, performing cost analysis, we determined that the long-term contract prices negotiated for the five items included excessive profit of 84.7 percent or \$226,416 based on expected contract demand, as shown in table C-2.

Table C-2. Comparison of Contract Price to Cost-Based Price (Cost Analysis)							
NSN	Contract Quantity	Contract Price		OIG Cost-Based Price ¹		Excessive Profit	
		Unit	Total	Unit	Total	Amount	Percent
[REDACTED]	[REDACTED]	[REDACTED]	\$ 48,573	[REDACTED]	\$ 25,341	\$ 23,232	91.7
			176,026		84,573	91,453	108.1
			32,932		15,071	17,861	118.5
			61,173		31,060	30,113	97.0
			174,959		111,202	63,757	57.3
Total			\$493,662 ²		\$267,247	\$226,416	84.7

¹The OIG cost-based prices were calculated by using cost analysis of actual manufacturing costs and included a profit in line with DLA strategic supplier alliances.

²Slight rounding inconsistencies exist because auditor calculations included decimal places.

Clearly, price analysis was not effective in negotiating fair and reasonable prices because the comparison prices were not a valid representation of actual costs.

DoD IG Report No. D-2006-055, "Spare Parts Procurements From TransDigm, Inc.," February 23, 2006, identified that DSCC paid [REDACTED] percent more than fair and reasonable prices because of a similar inappropriate waiver based solely on price analysis. Granting a waiver of cost or pricing data based on price analysis, especially for noncompetitive items, increases the risk that DoD will not accurately establish a fair and reasonable price and will pay excessive prices.

Congress has expressed concern to DoD over inappropriate or questionable waivers being granted. Section 817 of Public Law 107-314, "Bob Stump National Defense Authorization Act for Fiscal Year 2003," states that the Secretary of Defense must issue guidance on the circumstances where it was appropriate to issue an exceptional case exception or waiver of certified cost or pricing data and cost accounting standards. The legislation also outlines the

parameters for an exceptional case waiver. Specifically, Section 817(b) of the Act stated:

(b) DETERMINATION REQUIRED FOR EXCEPTIONAL CASE EXCEPTION OR WAIVER – The guidance shall, at a minimum, include a limitation that a grant of an exceptional case exception or waiver is appropriate with respect to a contract, subcontract, or (in the case of submission of certified cost and pricing data) modification only upon a determination that –

(1) the property or services cannot reasonably be obtained under the contract, subcontract, or modification, as the case may be, without the grant of the exception or waiver;

(2) the price can be determined to be fair and reasonable without the submission of certified cost or pricing data or the application of cost accounting standards, as the case may be; and

(3) there are demonstrated benefits to granting the exception or waiver.

On June 29, 2007, the Director, Defense Procurement and Acquisition Policy issued a memorandum to the Deputy Director for Logistics Operations, DLA to express concern that DLA continues to issue exceptional case waivers that do not meet the requirements of Section 817 of Public Law 107-314 and to obtain an action plan to correct DLA's misuse of waiver authority.

DLA needs to discontinue granting inappropriate waivers from cost or pricing data based primarily on price analysis.

Appendix D. Contract and OIG Cost-Based Manufacturer Prices

FOR OFFICIAL USE ONLY

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NSN	Buying Activity ¹	ADQ ²	Contract Price		OIG Cost-Based Manufacturer Price ³		Excessive Profit	
			Unit	Total	Unit	Total	Amount	Percent
	DSCR	58	\$3,339.66	\$ 193,700				
	DSCR	98	1,897.27	185,932				
	DSCR	88	3,233.78	284,573				
	DSCR	46	2,258.95	103,912				
	DSCC	348	411.99	143,373				
	DSCC	70	2,753.35	192,735				
	DSCR	115	2,319.36	266,726				
	DSCC	36	2,723.93	98,061				
	DSCC	66	1,839.10	121,381				
	DSCC	56	3,245.60	181,754				
	DSCC	38	5,288.25	200,954				
	DSCC	120	1,260.24	151,229				
	DSCC	44	2,968.00	130,592				
	DSCC	18	7,298.00	131,364				
	DSCC	51	4,129.35	210,597				
	DSCC	127	1,563.28	198,537				
	DSCR	181	1,099.73	199,051				
DLA Subtotal (17 items)				\$2,994,469		\$1,664,734	\$1,329,735	79.9
	AMCOM	101	\$1,888.20	\$190,708				
	AMCOM	103	2,052.91	211,450				
	AMCOM	63	2,189.76	137,955				
AMCOM Subtotal (3)				\$540,113		\$462,849	\$77,263	16.7

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

Appendix D. Contract and OIG Cost-Based Manufacturer Prices (cont'd)

NSN	Buying Activity ¹	ADQ ²	Contract Price		OIG Cost-Based Manufacturer Price ³		Excessive Profit	
			Unit	Total	Unit	Total	Amount	Percent
[REDACTED]	NAVICP-P	4	[REDACTED]	\$ 35,424	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
	NAVICP-P	136		229,410				
	NAVICP-P Subtotal (2)			\$264,834				
[REDACTED] Subtotal (22)				\$3,799,416	\$2,348,691	\$1,450,725	61.8	
[REDACTED]	DSCC	13	\$4,481.00	\$ 58,253	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
	DSCC	75	3,370.00	252,750				
	DSCC	63	2,189.23	137,921				
	DSCC	120	593.00	71,160				
	DSCC	87	2,005.00	174,435				
DLA Subtotal (5)			\$694,519	\$290,299	\$404,221	139.2		
[REDACTED]	AMCOM	225	\$2,008.61 ⁵	\$451,937	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
AMCOM Subtotal (1)			\$451,937	\$336,231	\$115,706	34.4		
PerkinElmer Subtotal (6)				\$1,146,457	\$626,530	\$519,927	83.0	
[REDACTED]	(DLA)				[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
	DSCC	5,469	\$ 51.13	\$ 279,630				
	DSCC	1,508	109.27	164,779				
	DSCC	1,396	460.98	643,528				
[REDACTED] Subtotal (3)			\$1,087,937	\$711,581	\$376,356	52.9		

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

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Appendix D. Contract and OIG Cost-Based Manufacturer Prices (cont'd)

<u>NSN</u>	<u>Buying Activity</u> ¹	<u>ADQ</u> ²	<u>Contract Price</u>		<u>OIG Cost-Based Manufacturer Price</u> ³		<u>Excessive Profit</u>	
			<u>Unit</u>	<u>Total</u>	<u>Unit</u>	<u>Total</u>	<u>Amount</u>	<u>Percent</u>
(DLA)								
	DSCR	828	\$464.96	\$384,987				
	DSCR	499	977.37	487,708				
	Subtotal (2)			\$872,695		\$260,215	\$612,480	235.4
Total (33)				\$6,906,504		\$3,947,016	\$2,959,488	75.0

¹The buying activity that awarded the contract we reviewed (AMCOM – Army Aviation and Missile Life Cycle Management Command; DSCC – Defense Supply Center Columbus; DSCR – Defense Supply Center Richmond; and NAVICP – P – Naval Inventory Control Point Philadelphia).

²Annual Demand Quantity (ADQ) for the DLA items is based on average inventory requisitions for the previous 2 years. ADQ for the Navy and Army items is based on average annual contract purchases for the previous 4 years.

³The OIG cost-based prices were calculated by using cost analysis and included a profit in line with DLA strategic supplier alliances.

⁴priced this item based on cost information with the expectation it would be asked to provide certified cost or pricing data. However, the contracting officer never requested to submit the certified cost or pricing data.

⁵Contract was negotiated using certified cost or pricing data provided to DoD.

Appendix E. DLA Guidance on Dealer Competition



DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FORT BELVOIR, VIRGINIA 22060-6221

JUN 28 2007

IN REPLY
REFER TO J-7

PROCLTR 07-08

MEMORANDUM FOR PROCLTR DISTRIBUTION LIST

SUBJECT: Price Competition for Single Manufacturing Source Items Offered by an Original Equipment Manufacturer (OEM) and Its Distributors, Dealers and/or Other Non-Manufacturing Suppliers

This PROCLTR addresses the requirements of FAR Subpart 15.4 in the context of single source procurements, defined for present purposes as procurements of items produced by only one manufacturer (OEM) because of that manufacturer's exclusive possession of proprietary information or other intellectual property rights (such as a patent).

The Defense Logistic Agency's position is that adequate price competition under the Truth In Negotiations Act (TINA) (see FAR 15.403-1(b)(1) and (c)(1)), and for making price reasonableness determinations where TINA would not apply for other reasons, can exist, even when the Government purchases single source items manufactured by an OEM, if independent dealers or distributors of the OEM's products compete with each other and/or with the OEM for Government contracts. The critical point is that there must be a reasonable basis for finding that the dealers or distributors are truly independent, both of the OEM and of each other. Thus, if the OEM exerts undue control over dealers or distributors, for instance by controlling the resale prices those dealers or distributors may charge, there would not be adequate price competition. If the dealers and distributors have access to adequate supplies of the OEM's product and may set their own prices (even if those prices, by virtue of economic exigencies, vary very little from one dealer or distributor to another), then adequate price competition may be found to exist for TINA purposes and for buys where TINA would not apply. Note that Defense Logistics Acquisition Directive (DLAD) 52.217-9002, Conditions for Evaluation and Acceptance of Part-Numbered Items, commonly referred to as the "Products Offered Clause," must be included in solicitations as appropriate. Additionally, the existence of competition is not, alone, sufficient to validate the reasonableness of an offeror's price proposal; DLAD 13.106-3(b)(90)(A)(iii) and 15.403-1(c)(1) require Contracting Officers to verify the objective price reasonableness of all offers.

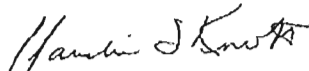
To summarize, the fact that required supplies are produced only by one OEM does not, itself, mean that adequate price competition for Government contracts to provide those supplies is impossible to achieve. Instead, when independent dealers or distributors of OEM-produced supplies compete for Government business with one another or with the OEM, the Government satisfies requirements for price reasonableness determinations, provided the proposed source offers the Government objectively fair and reasonable prices.

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This PROCLTR is effective immediately. More specific guidance in the form of DLAD coverage is forthcoming. The point of contact for this PROCLTR is [REDACTED] J-73, (703) 767-[REDACTED] DSN 427-[REDACTED] or e-mail: [REDACTED]@dla.mil.


CLAUDIA S. KNOTT
Component Acquisition Executive

Appendix F. Report Distribution

Office of the Secretary of Defense

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

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Commander, Army Materiel Command
 Commander, Army Aviation and Missile Life Cycle Management Command
Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Manpower and Reserve Affairs)
Commander, Naval Supply Systems Command
 Commander, Naval Inventory Control Point, Philadelphia, Pennsylvania
Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

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
Director, Defense Contract Audit Agency

Non-Defense Federal Organization

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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 Oversight and Government Reform
House Subcommittee on Government Management, Organization, and Procurement,
Committee on Oversight and Government Reform
House Subcommittee on National Security and Foreign Affairs,
Committee on Oversight and Government Reform

Under Secretary of Defense for Acquisition, Technology, and Logistics Comments



ACQUISITION,
TECHNOLOGY
AND LOGISTICS

OFFICE OF THE UNDER SECRETARY OF DEFENSE
3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

OCT 18 2007

DPAP/CPF

MEMORANDUM FOR TECHNICAL DIRECTOR, AUDIT FOLLOWUP & GAO
AFFAIRS, OFFICE OF THE INSPECTOR GENERAL,
DEPARTMENT OF DEFENSE

THROUGH: DIRECTOR, ACQUISITION RESOURCES AND ANALYSIS 7/8
10/23/07

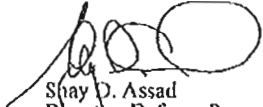
SUBJECT: Draft Report on Procuring Noncompetitive Spare Parts Through an
Exclusive Distributor (Project No. D2006-D000CH-0056.000)

Your draft report dated September 6, 2007, requested management comments on recommendations for the Under Secretary of Defense for Acquisition, Technology, and Logistics (AT&L). Comments on specific recommendations are included in the Enclosure. I agree with your findings that DLA and the Department need to improve pricing techniques for determining fair and reasonable prices with distributors.

In addition to the enclosed responses, I have taken two actions that will address the pricing issues raised in your draft report:

1. In June 2007, I established a working group to: assess the magnitude of the Department's use of exclusive distributors; identify issues contracting officers are encountering in pricing contracts with these distributors; identify best practices for successful pricing of contracts with distributors; and to recommend to me actions the Department needs to take to improve pricing techniques with these distributors.
2. In May 2007, I clarified guidance for obtaining cost data in the Procedures, Guidance and Information (PGI) revision to section 215.4 when the Truth in Negotiation Act does not apply and there is no other way to determine price reasonableness except to require cost data and perform a cost analysis.

If you have any questions regarding this memorandum, please contact my point of contact, [REDACTED] at 703-602-[REDACTED] or at [REDACTED]@osd.mil.


Shay D. Assad
Director, Defense Procurement
and Acquisition Policy

Attachments:
As stated



Enclosure

SUBJECT: Draft Report on Procuring Noncompetitive Spare Parts Through an Exclusive Distributor (Project No. D2006-D000CH-0056.000)

Recommendations:

A. 1. We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics:

Recommendation a. Develop and issue guidance into the acquisition regulations that permits contracting officers to require consent to subcontract for fixed-price contracts from prime contractors that exhibit significant risk of charging excessive prices.

Response. Concur with Intent. We do not believe that a significant change to the Defense Federal Acquisition Regulation Supplement is warranted for individual circumstances identified in the draft report; however, we do believe that specific guidance for pricing actions with exclusive distributors is warranted to address the issues raised in your report. See the DPAP response to your recommendation A.1.d. below for actions we plan to take to ensure contracting officers obtain the data they need to ensure prices from exclusive distributors are fair and reasonable.

Recommendation b. Issue guidance that requires the Military Departments and Defense agencies to track and periodically report information about problem contractors that refuse to provide requested information necessary to determine price reasonableness and take appropriate action to address pricing issues related to specific contractors.

Response. Concur. DPAP will issue a policy memorandum by December 14, 2007, requiring the Military Departments and Defense agencies to report to DPAP any companies receiving an award or contract modification beginning January 2, 2008, that refuse to provide cost data when requested by the contracting officer because performing cost analysis was the only means for a contracting officer to determine prices fair and reasonable.

Recommendation c. Review the Defense Logistics Agency's dealer competition policies and determine whether the policies meet the Federal Acquisition Regulation 15.403-1 definition of adequate competition.

Response. Concur. We assessed the Defense Logistics Agency (DLA) policy dated June 28, 2007, and the policy does not conflict with the Federal Acquisition Regulation (FAR). The policy appropriately directs contracting officers to "...ensure there is a reasonable basis for finding that dealers or distributors are truly independent..." and provides examples of undue influence where competition would not exist and

examples of potential adequate competition. The policy adds: "...Additionally, the existence of competition is not, alone, sufficient to validate the reasonableness of an offeror's proposed price...." We believe the findings in your report represent implementation problems and use of poor judgment. I plan to issue a memorandum to the Senior Procurement Executive at DLA by December 14, 2007, and request an action plan detailing how DLA will ensure proper application of FAR 15.403-1(c)(1) and that contracting officers require submission of cost data, and perform cost analysis, when comparable commercial sales, adequate competition, or a prior cost analysis is unavailable and no other valid analysis technique can be used. Our memorandum will point out the types of risks identified in your draft report when individual dealers are not stocking parts, rather are proposing prices based on quotes obtained from a single source distributor or manufacturer.

Recommendation d. Identify and address contractors that require DoD contracting officers to procure noncompetitive items through an exclusive distributor.

Response. Concur. The findings in the draft report identify issues related to determining prices to be fair and reasonable in accordance with FAR 15.4 and Procedures, Guidance and Information (PGI) 215.4. Whether a company uses an exclusive dealer or not is part of the company's business strategy and performing a data call to identify those companies would not resolve the pricing issues identified in the draft report. Although contract awards to exclusive distributors is less than .5 percent of the department's annual buys, we recognize the significance of improperly pricing the millions of dollars that are awarded to exclusive distributors. DPAP will issue a policy memorandum by December 14, 2007 to the Military Departments and Defense agencies to reiterate the requirements at FAR 15.4 and PGI 215.4, relating it to exclusive distributors/dealers. The memorandum will require all contracting officers to obtain needed cost data and perform a cost analysis for all costs, including all costs and markup comprising the price charged by the original equipment manufacturer (OEM)/actual manufacturer; and a review of the cost proposal analysis performed by the exclusive distributor/dealer of its price from the single source OEM/actual manufacturer. When companies refuse to provide the required data and/or analysis and award has to be made without the required cost analysis, it will be reported to DPAP.

Recommendation B.1. We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics review and determine whether the Defense Logistics Agency's policy for determining the cost or pricing data threshold is consistent with the Federal Acquisition Regulation.

Response. We do not believe that the policy for determining the cost or pricing data threshold is consistent with the Federal Acquisition Regulation. We have coordinated this issue with DLA and they are revising their policy to conform to FAR.

Defense Logistics Agency Comments



DEFENSE LOGISTICS AGENCY
HEADQUARTERS
6725 JOHN J. KINGMAN ROAD, SUITE 2533
FORT BELVOIR, VIRGINIA 22060-6221

IN REPLY
REFERTO J-73

JAN 7 2008

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
DEPARTMENT OF DEFENSE

SUBJECT: Procuring Noncompetitive Spare Parts Through an Exclusive Distributor
(Project No. D2006-D000CH-0056)

The Defense Logistics Agency's comments on the findings and recommendations of the subject draft report are attached.

We appreciate the opportunity to comment on the draft report. The point of contact for this report is [REDACTED] J-73, (703) 767-[REDACTED] or [REDACTED] DLA Office of Investigations and Internal Audits (OIIA), (703) 767-[REDACTED]


CLAUDIA S. KNOTT
Director, Acquisition Management

Attachment



Finding A: DOD contracting officers were unable to effectively negotiate prices or obtain best value for noncompetitive spare parts procured through Dutch Valley Supply, an exclusive distributor for numerous single-source manufacturers. Negotiations were not effective for the following reasons:

- Dutch Valley Supply did not effectively negotiate prices with single-source manufacturers (subcontractors) including obtaining cost data when necessary.
- DOD contracting officers primarily relied on ineffective tools such as price analysis, cost analysis of dealer costs, and dealer competition to support price reasonableness determinations. In several instances, price reasonableness determinations were not made.
- The current exclusive distributor model used to procure items does not provide best value and is less effective than the traditional DLA supply and strategic supplier models.

As a result, DOD paid about \$3.0 million (75.0 percent) more than the fair and reasonable prices for 33 parts that cost about \$6.9 million. Dutch Valley Supply accepted prices from manufacturers that were about \$ [REDACTED] ([REDACTED] percent) higher than fair and reasonable and then applied [REDACTED] pass-through charges of [REDACTED] percent for negligible or no added value totaling about [REDACTED]. If problems are not addressed, DOD will pay about \$17.8 million more than fair and reasonable prices for the same items over the next 6 years and this valuable procurement money will not be available to support other urgent warfighter needs. In addition, the current exclusive distributor model increased lead times and associated inventory levels by [REDACTED]. We do not believe the current exclusive distributor model is a viable procurement alternative for DOD.

DLA Comments: Concur.

Most of the parts the IG review covered in the audit were for older weapon systems with low demand for replacement parts; the Government generally does not possess the manufacturing drawings necessary to produce these parts on a competitive basis. Further, these are usually lower-valued parts presenting little or no incentive for other manufacturers to risk investing time and money in trying to reverse engineer them.

Dutch Valley Supply did not effectively negotiate prices with single-source manufacturers because there is no incentive for either Dutch Valley or the manufacturers that have chosen Dutch Valley as a sole distributor to present reasonable prices to the Government. The Government has no effective bargaining power in these situations, whether dealing directly with the manufacturers or through an exclusive distributor such as Dutch Valley. Dutch Valley and the manufacturers know the Government customers have no real alternative source for these single source items. The manufacturers know that they can charge essentially whatever price they wish, and Dutch Valley knows that it

can pass through whatever price the manufacturers set, allowing Dutch Valley to sell to the Government at that price plus its own markup on that price.

DOD contracting officers rely on ineffective pricing tools because these are the limited tools available to the Government when buying single source items at total prices below the cost or pricing data threshold (currently \$650,000), or when buying commercial items that are exempt from the Truth in Negotiations Act (TINA) requirements regardless of price. Although contracting officers can request data other than certified cost or pricing data, there is no effective mechanism in a sole source situation to require vendor compliance with these requests. It might also be noted that, even when the TINA requirements for certified cost or pricing data apply, in a sole source situation, the Government has little or no ability to require compliance if the vendor is not willing to comply voluntarily.

It was only through the IG's use of its subpoena power to access Dutch Valley's and its "subcontractors'" contract cost data that anyone in the Government was able to review and evaluate cost data from Dutch Valley and other sole parts distributors. Unlike the DODIG, contracting officers do not have the ability to compel disclosure of data, and the economics of sole source situations often give sole source suppliers little or no incentive to comply with requests for voluntary disclosure. This report demonstrates the excessive pricing that can be expected to occur in the absence of equal access by the Government to cost data necessary for negotiating sole source prices.

Finally, although the current exclusive distributor model for sole source procurements does not provide best value and is less effective than other methods of support, for the reasons stated above, buying directly from the manufacturers will not necessarily eliminate the possibility of overpricing. DLA agrees, however, that it would at least eliminate the markup charged by the exclusive distributor. If, however, the manufacturers determine that it is in their best interest to use an exclusive distributor, DLA has little or no leverage to use in eliminating this practice.

As acknowledged in this report, DLA has achieved some reverse engineering successes by teaming with Military Service organic manufacturing facilities. However, we have also experienced instances of price hikes by original equipment manufacturers (OEMs) on other sole source parts when one of their products has been reverse engineered and is now being bought competitively.

DLA concurs in the report's conclusion that distributors can occasionally be very useful as suppliers when they stock items and can provide quicker availability and delivery. When a dealer is able to fill a supply system niche by stocking and supplying customer needs for expedited supply and other improved services at reasonable increases in support costs, paying a higher price and purchasing from a sole distributor may be acceptable. This has not proven to be the case with Dutch Valley, as demonstrated by the report.

Recommendation A.2. We recommend that the Commanders, Army Aviation and Missile Life Cycle Management Command and Navy Inventory Control Point, Philadelphia; and Director, Defense Logistics Agency instruct contracting officers to:

a. Ensure prime contractors, like Dutch Valley Supply, conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices and include the results of these analyses in the price proposal as required by Federal Acquisition Regulation 15.404-3, "Subcontract Pricing Considerations."

DLA Comments: Concur with Intent.

Our Component Acquisition Executive will issue a memorandum addressing the need for all acquisition managers to assure compliance with the policies for determining reasonableness when the offered price includes a pass-through cost from a subcontractor or other supplier (Federal Acquisition Regulation (FAR) Subpart 15.4, Defense FAR Supplement (DFARS) Subpart 215.4, and DOD FAR Supplement Procedures, Guidance, and Information (DFARS PGI) Subpart 215.4). The memorandum will also address submission of contractor and subcontractor cost or pricing data when the estimated contract and subcontract amounts exceed the TINA thresholds (FAR 15.404-3(e)).

Disposition:

(X) Action is ongoing. ECD: April 30, 2008

() Action is considered complete.

b. Determine the adequacy of the cost or price analyses performed by the prime contractor.

DLA Comments: Concur.

We are taking steps to raise contracting offices' awareness and to formulate and implement corrective actions as appropriate. This matter was included in issues covered in a November 7, 2007, memorandum from the Director, Defense Procurement and Acquisition Policy (DPAP), subject: Access to Records with Exclusive Distributors/Dealers. We discussed the memorandum and discussed corrective actions during the most recent regularly scheduled teleconference with the Chiefs of our Contracting Offices (CCOs) on December 13, 2007. One such action will be the formal transmittal of the DPAP memo using a DLA-wide Procurement Letter (PROCLTR), along with additional interim implementing guidance, by March 31, 2008. Following this, DLA will conduct a sampling review of recent buys to determine whether the interim efforts have corrected the problem.

Disposition:

(X) Action is ongoing. ECD: December 31, 2008

() Action is considered complete.

c. Review and determine the reasonableness of subcontractor prices to include obtaining cost data when necessary before awarding future contracts, if the prime contractor did not perform adequate cost or price analyses.

DLA Comments: Concur.

DLA contracting officers do request and, when it is provided, review and determine the reasonableness of subcontractor cost. In most cases, however, the data is not provided or the data that is provided is inadequate. The inability to obtain cost data has been elevated to higher-level management in the past and the Supply chains will continue to seek a resolution. Substantial improvements are needed however. After the DPAP reporting requirement, providing for notification to DPAP when contractors refuse to provide cost data, has been in effect for a period, we will review the process results to determine if the changes have been effective or whether further increase in emphasis is needed.

Disposition:

(X) Action is ongoing. ECD: December 31, 2008

() Action is considered complete.

d. Perform cost analysis in a noncompetitive environment to determine price reasonableness when price analysis does not provide sufficient information and a reliable baseline price has not been established.

DLA Comments: Concur.

When unable to secure adequate cost data, contracting officers have used price analysis in some cases as a last resort to reach a conclusion regarding price reasonableness. The inability to obtain cost data has been elevated to higher-level management and we continue to seek access to such data. The DPAP Memorandum, November 7, 2007, subject: Access to Records with Exclusive Distributors/Dealers, directs contracting officers to secure cost data where needed to reach a conclusion as to price reasonableness, and requires a report to DPAP when the Head of the Contracting Activity grants a waiver to allow award to a dealer or distributor that refuses to provide cost data when TINA does not apply. We will encourage CCOs to seek this data, while pursuing a renewed teaming effort with suppliers to help secure the necessary access.

Disposition:

(X) Action is ongoing. ECD: December 31, 2008

() Action is considered complete.

e. Take action to discontinue using exclusive distributors unless they can develop a business model that provides sufficient added value to include increased competition, obtaining cost data to effectively negotiate prices, and reduced lead times and inventory.

DLA Comments: Concur with intent.

The exclusive distributors addressed in the audit, and others DLA is obliged to buy from, represent suppliers of sole or single source weapons system parts and components. As noted in this report, DLA has been successful in reverse engineering some of these items and negotiating with one OEM to change its business practice of not dealing directly with the government. DLA has a long-term business strategy of maximizing efforts to build Strategic Supplier Alliances, Supply Chain Alliances, Prime Vendor, and other long term contracts. We will use these approaches as well as vendor fairs to emphasize the mutual benefits of these cooperative arrangements, and to tactfully seek to discourage company entry into exclusive distributorships which increase our costs of sole source items. As noted previously, however, DLA cannot prevent an OEM's use of an exclusive distributor if the OEM determines to do so.

Disposition:

☐ Action is ongoing. ECD:

☒ Action is considered complete for reporting purposes.

Recommendation A.3. We recommend that the Director, Defense Logistics Agency:

a. Request the Defense Contract Management Agency (DCMA) to immediately commence a review of Dutch Valley Supply's purchasing system.

DLA Comments: Concur.

DCMA indicated it will contact Dutch Valley in January 2008 for access to commence the review.

Disposition:

☒ Action is ongoing. ECD: June 30, 2008

☐ Action is considered complete.

b. Instruct the Commanders of the Defense Supply Centers to discontinue granting inappropriate waivers from cost or pricing data based primarily on price analysis.

DLA Comments: Concur.

The DPAP memorandum, March 23, 2007, subject: Waivers Under the Truth in Negotiations Act (TINA), provided additional guidance to reiterate the exceptional case waiver requirements established by Section 817 of Public Law (PL) 107-314 (National Defense Authorization Act of 2003). Thereupon, DLA commenced a number of initiatives, including issuance of PROCLTRs 07-10 and 07-28 on July 19, 2007, and November 7, 2007, respectively. Agency-wide and individual supply chain training

sessions were also conducted to assure the changes in policy are fully understood and followed. DLA continues to attempt to secure cost or pricing data when required to avoid use of an exceptional case waiver, but there will be situations in which the cost data cannot be obtained in accordance with the revised DPARS policy. In such cases, DLA is elevating to higher-level management its efforts to secure cost data or fully comply with the three findings of Public Law 107-314 and the additional guidance promulgated by DPAP and DLA's PROCLTRs.

Disposition:

☐ Action is ongoing. ECD:

☒ Action is considered complete.

c. Continue initiating reverse engineering efforts for items that have unreasonable pricing from single-source offerors.

DLA Comments: Concur.

DLA has been successful in some reverse engineering efforts as noted in the report. However, given the protracted time-frame and limited funding we and the Military Services have available for this effort, as well as the lack of economic incentive for alternate manufacturers in some cases, we will also employ continuing correspondence through command and functional channels, training, and recognition of individual and group accomplishments and other outreach initiatives to increase awareness of the importance of reducing or eliminating instances of egregious overpricing by non-value added sole distributors.

Disposition:

☐ Action is ongoing. ECD:

☒ Action is considered complete for reporting purposes.

d. Discontinue coding an analysis of dealer costs as cost analysis unless a cost analysis of manufacturing costs has also been performed.

DLA Comments: Concur.

Research to determine the circumstance leading to the write-up was incomplete at the time of this response. We are researching why this happened and what corrective actions are needed. Following completion, we will provide the DODIG with information gathered and the basis of our conclusion.

Disposition:

☒ Action is ongoing. ECD: April 30, 2008

☐ Action is considered complete.

e. Discontinue using dealer competition to determine price reasonableness in a noncompetitive environment.

DLA Comments: Partially concur.

The Federal Acquisition Regulation and the DLA Acquisition Directive (DLAD) allow dealer competition to be used as the basis for a price reasonableness determination if "independence" can be established between the dealers and the manufacturer. Our update of the DLAD in PROCLTR 07-08, dated June 28, 2007, subject: Price Competition for Single Manufacturing Source Items Offered by an Original Equipment Manufacturer (OEM) and its Distributors, Dealers and/or Other Non-Manufacturing Suppliers, underscored that the existence of competition is not, alone, sufficient to validate the reasonableness of an offeror's price proposal. It pointed out two specific DLAD provisions that require contracting officers to verify the objective price reasonableness of all offers, and provided guidance in determining when competitors can be considered independent. Even under simplified procedures, it specifies the price reasonableness determination shall address (1) the adequacy of any price competition received, and (2) the comparability to prior prices paid for the same or similar item, if any.

Disposition:

☐ Action is ongoing. ECD:

☒ Action is considered complete.

f. Emphasize to contracting officers the importance of making price reasonableness determinations, properly documenting the contract file, and ensuring cost or pricing data is requested as required by Federal Acquisition Regulations 15.403-4, "Requiring Cost or Pricing Data."

DLA Comments: Concur with intent.

These issues are already adequately covered in various Federal, Department of Defense, Agency, and local training and are addressed during planned Procurement Seminars.

Disposition:

☐ Action is ongoing. ECD:

☒ Action is considered complete.

Finding B: DLA contracting officers failed to correctly calculate the threshold for requiring cost or pricing data as required by FAR 15.403-4. The threshold was not correctly calculated because DLA guidance permitted contracting officers to consider only the value of the basic contract and options exercised at the time of award versus the "final anticipated dollar value of the action, including the dollar value of all options" as the FAR requires. As a result, DLA failed to require cost or pricing data for eight items procured on three contracts valued at about \$3.5 million.

DLA Comments: Concur.

The DLAD guidance cited above was issued 18 years ago, but has now been updated to reflect the FAR "dollar threshold" convention developed substantially later and included at FAR 1.108(c). The DLAD coverage has now been updated to correct this oversight.

Recommendation B.2: We recommend that the Director, Defense Logistics Agency, modify the Defense Logistics Acquisition Directive to ensure that the threshold for obtaining cost or pricing data is calculated based on the final anticipated dollar value of the action, inclusive of the dollar value of all options.

DLA Comments: Partially concur.

Updated guidance on how the DLA calculates the dollar value of a contract action for application of the TINA threshold was issued in PROCLTR 07-28, November 7, 2007, and now includes the dollar value of all priced options. Our calculations cannot, and thus do not, attempt to quantify and consider a value for any unpriced options, consistent with DFARS PGI 215.403-1(c)(4)(A)(4), which explains there is no price for unpriced supplies or services. For the same reason, our calculations exclude the value for undefinitized options, if any.

Disposition:

() Action is ongoing. ECD:

(X) Action is considered complete.

Department of the Navy Comments

Final Report
Reference



DEPARTMENT OF THE NAVY
NAVAL INVENTORY CONTROL POINT
700 ROBBINS AVENUE
PHILADELPHIA PA 19111-5054
5433 CAPLISLE PIKE - PO BOX 12020
MECHANICSBURG PA 17055-0200

COM & ITS
DSN & EXT
FAX
E-MAIL REFERENCE

DEC 17 2007

Joseph Bucsko
Department of Defense
Office of Inspector General
400 Army Navy Drive, Room 801
Arlington, VA 22202-4704

Dear Mr. Bucsko,

This letter is being sent in response to your draft proposed report on Procuring Noncompetitive Spare Parts Through an Exclusive Distributor (Project No. D2006-D000CH-0056.000) dated September 6, 2007. The NAVICP-P Management comments are submitted below in response to DoD IG recommendations A.2, page 31, of the draft proposed report.

NAVICP-P concurs with the recommendation A.2.a. In accordance with FAR 15.404-3, Subcontract Pricing Considerations, NAVICP-P will ensure prime contractors conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices and include the results of these analyses in the price to the Government. NAVICP, in cooperation with DCAA, has and continues to provide extended cost and pricing training to its workforce.

Examples of training are as follows:

1. Intrinsic Value 12/13/06
2. Rates in Government Contracting 02/27/07
3. DCAA in the Acquisition Process 06/27/07
4. Price Reasonableness 10/23/07
5. CAS Procedures 12/04/07

NAVICP-P concurs with the recommendation A.2.b. Determination of price reasonableness is a Federal Acquisition Regulation requirement. NAVICP-P contracting officers will continue to review and determine the adequacy of the cost or price analyses performed by the prime contractor.

NAVICP-P concurs with the recommendation A.2.c. NAVICP-P will, where appropriate, review and determine the reasonableness of subcontractor prices to include obtaining cost data when necessary before awarding future contracts, if the prime contractor did not perform adequate cost or price analyses.

NAVICP-P concurs with the recommendation A.2.d. NAVICP-P will, where appropriate, perform cost analysis in a noncompetitive environment to determine price reasonableness when price analysis does not provide sufficient information and a reliable baseline price has not been

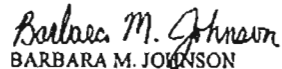
Page 35

established.

NAVICP-P concurs with the recommendation A.2.e. NAVICP-P will review the exclusive distributor on an order-by-order basis (as the order comes up) to determine if the distributor provides value to NAVICP-P.

If you have any question, please feel free to contact me at 215-697-2868.

Sincerely


BARBARA M. JOHNSON
Deputy Director of Contracts

Department of the Army Comments



REPLY TO
ATTENTION OF:

DEPARTMENT OF THE ARMY
HEADQUARTERS, U.S. ARMY MATERIEL COMMAND
9301 CHAPEK ROAD
FORT BELVOIR, VA 22060-5527

AMCIR

10 December 2007

MEMORANDUM FOR Mr. David Lawson, Chief, The Army Audit Liaison Office, U.S. Army Audit Agency, 3101 Park Center Drive, Alexandria, VA 22302-1596

SUBJECT: DODIG Draft Report, Procuring Noncompetitive Spare Parts Through an Exclusive Distributor (D2006-D000CH-0056.000) (AMC No. D0602)

1. Headquarters, U.S. Army Materiel Command (HQ AMC) has reviewed the subject draft report and the U.S. Army Aviation and Missile Command's (AMCOM) command reply (encl). HQ AMC endorses with AMCOM's nonconcurrence to the recommendations made in the report.

2. HQ AMC point of contact for this action is [REDACTED] commercial (703) 806-[REDACTED]
DSN: 656-[REDACTED] or email address [REDACTED]@us.army.mil.

FOR THE COMMANDER:

Encl

Susan C. McCoy
SUSAN C. MCCOY
Director, Internal Review and Audit
Compliance Office

Printed on Recycled Paper



DEPARTMENT OF THE ARMY
UNITED STATES ARMY AVIATION AND MISSILE COMMAND
6330 MARTIN ROAD
REDFSTONE ARSENAL AL 35899-6010

b(4)

AMSAM-IR


OCT 25 2007

MEMORANDUM FOR Department of Defense, Office of Inspector General, 400 Army Navy Drive, Arlington, VA 22202-4704

SUBJECT: Report on Procuring Noncompetitive Spare Parts Through an Exclusive Distributor (Project No. D2006-D000CH-0056.000) (AMC D0602) (AMCOM Project 20061.032D)

1. Reference e-mail, 6 Sep 07, subject, Draft Report, D2006-D000CH-0056.000, Procuring Noncompetitive Spare parts Through an Exclusive Distributor.
2. The US Army Aviation and Missile Life Cycle Management Command (AMCOM) comments to the subject report are enclosed.
3. The points of contact for this action are [redacted] Internal Review and Audit Compliance office, DSN 788- [redacted] commercial 256-876- [redacted] email [redacted]@us.army.mil, or [redacted] DSN 746- [redacted] commercial 256-876- [redacted] email [redacted]@us.army.mil.

Encl


THOMAS J. NEWMAN
COL, QM
Chief of Staff



US Army Aviation and Missile Life Cycle Management Command
Comments to DODIG Draft Report:
Audit of Procuring Noncompetitive Spare Parts
Through an Exclusive Distributor
(Project No. D2006-D000CH-0056.000)
(AMCOM Project 2006L032D)

FINDING: Procuring Noncompetitive Spare Parts through an Exclusive Distributor

"DoD contracting officers were unable to effectively negotiate prices or obtain best value for noncompetitive spare parts procured through Dutch Valley Supply, an exclusive distributor for numerous single-source manufacturers. Negotiations were not effective for the following reasons.

- Dutch Valley supply did not effectively negotiate prices with single-source manufacturers (subcontractors) including obtaining cost data when necessary.
- DoD contracting officers primarily relied on ineffective tools such as price analysis, cost analysis of dealer costs, and dealer competition to support price reasonableness determinations. In several instances price reasonableness determinations were not made.
- The current exclusive distributor model used to procure items does not provide best value and is less effective than the Traditional DLA supply and strategic supplier models.

As a result, DoD paid about \$3.0 million (75.0 percent) more than the fair and reasonable prices for 33 parts that cost about \$6.9 million. Dutch Valley Supply accepted prices from manufacturers that were about \$ [REDACTED] ([REDACTED] percent) higher than fair and reasonable and then applied [REDACTED] pass-through charges of [REDACTED] percent for negligible or no added value totaling about [REDACTED]. If problems are not addressed, DoD will pay about \$17.8 million more than fair and reasonable prices for the same items over the next 6 years and this valuable procurement money will not be available to support other urgent warfighter needs. In addition, the current exclusive distributor model increased lead times and associated inventory levels [REDACTED]. We do not believe the current exclusive distributor model is a viable procurement alternative for DoD."

ADDITIONAL COMMENTS:

These comments are provided in reference to the Solenoid Valve, NSN [REDACTED], which is discussed on pages 18, 19, & 20 of the subject draft report. On pages 19 & 20, the DODIG states that "This example clearly shows the importance of contracting officers obtaining manufacturer cost or pricing data to

negotiate prices and we commend the Army for taking appropriate steps to significantly reduce the price negotiated." This statement follows the DODIG discussion on page 19 where the contracting officer required cost or pricing data from the contractor and then requested and relied upon the DCAA audited position of the contractor's proposal in negotiating a 38.6% price reduction to the proposed price.

Based on these statements, one would assume that the Army (AMCOM Contracting Officer) did everything in accordance with FAR Parts 15.403 and 15.404. In fact, these statements are appreciated, however, the DODIG then states that "performing cost analysis of more recent cost data that was not available to the Army at the time of award, we calculate the current fair and reasonable manufacturer unit price of the solenoid valve is [REDACTED]. We were unable to reconcile the specific differences that existed in the two sets of cost information because the data reviewed by DCAA did not provide the same detail as the cost information obtained by the OFG." Further discussions by AMCOM with the DODIG verified that the data the DODIG utilized were actually recorded after contract award. The AMCOM takes exception to the DODIG utilizing information that could not have been known at the time of negotiations and then labeling it "excessive profit" at Appendix D.

As it relates to the Dutch Valley pass thru cost mentioned by the auditors, a minimum of some part of this effort is necessary in that packaging and marking is required as well as freight and shipping. In addition, as a minimum, some part of the G&A for oversight and logistics cost would be necessary, as well.

It is requested that either the totals be reviewed for what the contracting officer would have known at the time of negotiations or that this item be taken out of the DODIG sample since the cost/pricing analysis conducted by the contracting officer was in accordance with regulations and sound business principals were utilized. As it relates to Perkin Elmer Manufacturer utilizing Dutch Valley Supply as a distributor, Perkin Elmer Manufacturer has the right to do business with the Government or not do business with the Government. In this case, the Government made the decision that by utilizing Dutch Valley Supply, under the circumstances that existed at the time, the price, at the bottom-line, was considered reasonable.

Utilizing information that occurred after the fact and could not have been known at the time of negotiations is not an appropriate method to determine whether the appropriate steps in cost analysis were performed. If fixed price contracts are reviewed, "excessive profit" may be found in one area and a significant loss found in another that offsets the profit. That is the natural give and take of the market in fixed price arrangements.

It is requested that either the totals be reviewed for what the Contracting Officer would have known at the time of negotiations or that this item be taken out of the DODIG sample relative to the cost/pricing analysis conducted by the Contracting Officer. The actions by the Contracting Officer were in accordance with regulations and sound business principals were utilized.

RECOMMENDATION AND COMMAND COMMENTS:

Recommendation A-2:

"We recommend that the Commanders, Army Aviation and Missile Life Cycle Management Command and Navy Inventory Control Point, Philadelphia; and the Director, Defense Logistics Agency instruct contracting officers to:

- a. Ensure prime contractors, like Dutch Valley Supply, conduct appropriate cost or price analyses to establish the reasonableness of proposed subcontract prices and include the results of these analyses in the price proposal as required by Federal Acquisition Regulation 15.404-3, "Subcontract Pricing Considerations.
- b. Determine the adequacy of the cost or price analyses performed by the prime contractor."
- c. Review and determine the reasonableness of subcontractor prices to include obtaining cost data when necessary before awarding future contracts, if the prime contractor did not perform adequate cost or price analyses.
- d. Perform cost analysis in a noncompetitive environment to determine price reasonableness when price analysis does not provide sufficient information and a reliable baseline price has not been established.
- e. Take action to discontinue using exclusive distributors unless they can develop a business model that provides sufficient added value to include increased competition, obtaining cost data to effectively negotiate prices, and reduced lead times and inventory."

Command Comments: Nonconcur. The Army (AMCOM) Contracting Officer utilized clear guidance in the Federal Acquisition Regulations on conducting cost and price analysis to determine fair and reasonable prices. The draft report specifically discusses excessive prices paid by the Command, but it is based on actual manufacturing cost of the items procured. This is cost information that is based on "actual" and would not have been available to the Contracting Officer prior to the award of an action. In fact, in the detailed review of AMCOM's buy for the Solenoid Valve, NSN [REDACTED] primarily discussed on pages 18, 19 & 20 of the subject report, it states "This example clearly shows the importance of contracting officers obtaining manufacturer cost or pricing data to negotiate prices and we commend the Army for taking appropriate steps to significantly reduce the price negotiated." This statement follows the DODIG discussion on page 19 where the Contracting Officer required cost or pricing data from the contractor and then requested and relied upon the DCAA audited position of the contractor's proposal in negotiating a 38.6% price reduction to the proposed price. Based on these statements one would assume that the Army (AMCOM Contracting Officer) did everything in accordance with FAR Parts 15.403 and 15.404. Therefore, the Army Contracting Officers took the appropriate steps and no further instruction is required.

The steps taken by the AMCOM Contracting Officer in reviewing and analyzing cost and price information were thorough in all aspects. The fact that additional information is now available since the items have been manufactured is not an appropriate comparison of what price should be negotiated based on analysis of a proposal.

The report clearly shows the AMCOM Contracting Officer took appropriate steps during the review to determine a fair and reasonable price. They coordinated with DCAA, reviewed subcontractor data, and negotiated a reduction in price based on the recommendations. The DODIG acknowledges that the price they recommend as fair and reasonable is based on performing cost analysis of more recent cost data that was not available to the Army at the time of award. This Command attempted to reconcile the specific differences that existed in the two sets of cost information because the data reviewed by DCAA did not provide the same detail as the cost information obtained by the DODIG. Further discussions between AMCOM and the DODIG verified that the data the DODIG utilized was actual recorded after contract award.

The appropriate rules, as stated in FAR Part 15 were followed by AMCOM and a cost analysis was performed on 26 April 2005, as required by the regulations.

The Army cannot dictate to businesses that they cannot utilize distributors if they determine this is a business model required to support their products. In fact, some companies do not have a capability to meet the Army's packaging and marking requirements or have determined that a distributor allows them to effectively meet multiple customers' requirements. The AMCOM Commanding General did challenge the prime for utilization of Dutch Valley for items where they were not reflecting timely performance and support to our requirements within a reasonable price. It is our intent to continue to challenge the use of distributors on an individual basis when the situation warrants. The AMCOM Commanding General was proactive in challenging the prime contractor to provide direct support on those items.

Team Members

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

Richard B. Jolliffe
Henry F. Kleinknecht
Joseph P. Bucsko
Bradford C. Green
Marc D. Santaua
Steven L. Kohue
Jason R. Parks
Mayra G. Velazquez-Perez
Meredith H. Johnson

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Inspector General
Department of Defense

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