
April 14, 2005



Statement
of
The Honorable Joseph E. Schmitz
Inspector General
Department of Defense

before the
Airland Subcommittee
Senate Committee on Armed Services
on
"Air Force Acquisition Oversight"

Mr. Chairman and Members of the Airland Subcommittee:

Thank you for the opportunity to appear before the committee today and to address your questions regarding Air Force acquisition oversight. I will also discuss related work on commercial contracting practices for major Defense system procurements which I understand is of concern to the Committee.

Audit of the Acquisition of the Boeing KC-767A Tanker Aircraft

We conducted an audit of the Air Force's planned acquisition of Boeing KC-767A Tanker Aircraft, and – based on the audit findings I am about to explain – recommended that the Under Secretary of Defense for Acquisition, Technology, and Logistics, either:

- proceed with the sole-source acquisition of 100 or fewer tanker aircraft, but only after implementing audit recommendations to resolve contracting and acquisition issues;
- initiate a new major Defense acquisition program based on the results of the ongoing analysis of alternatives for military tanker aircraft; or
- implement a mix of the first two options.

Section 8159 of the Department of Defense Appropriations Act for FY 2002, authorized the Air Force to make payments under a multiyear pilot program to lease general purpose Boeing 767 aircraft in commercial configuration. Because of concerns over the cost to

lease 100 tanker aircraft, Congress then authorized the Air Force in Section 135 of the National Defense Authorization Act for FY 2004 to lease no more than 20 tanker aircraft and purchase no more than 80 tanker aircraft.

Using the congressional authority, the Air Force finalized negotiations with Boeing in December 2003 to lease 20 KC-767A tanker aircraft and procure 80 tanker aircraft using noncompetitive fixed-price commercial contracts. Because of revelations by The Boeing Company (Boeing) in November 2003 concerning apparent improprieties by two of the company's executives, the Deputy Secretary of Defense placed the Boeing KC-767A Tanker Program on hold until our review and two other studies were completed. On March 29, 2004, we issued Inspector General Report No. D-2004-064, "Acquisition of the Boeing KC-767A Tanker Aircraft," in which we concluded, among other findings, that at the time, the proposed Boeing KC-767A tanker contracts as negotiated and the acquisition strategy were not a good deal for the Department of Defense, or for the taxpayers.

Commercial Item Procurement Strategy Strongly encouraged by Air Force management including Ms. Druyun, the Air Force contracting officer decided to use a commercial item procurement strategy for the sole-source Boeing KC-767A Tanker Program with Boeing. However, contrary to the Air Force interpretation, we found that a military tanker aircraft is not a commercial item as defined in section 403 of title 41, United States Code. The Air Force contracting officer, in making the commercial item

determination, inappropriately determined that modifications of the Boeing 767 aircraft were of a minor type not customarily available in the commercial marketplace. The modifications made to develop the Boeing 767A tanker aircraft were not minor, were for unique military-specific purposes, and cost 65.8 percent of the base commercial aircraft price. In addition, the modifications significantly changed the aircraft's primary purpose and function from that of transporting people and cargo in a civil context to that of a military tanker. Furthermore, there is no commercial market to establish reasonable prices by the forces of supply and demand. The commercial item procurement strategy also required that the Air Force use a fixed-price type contract rather than a more appropriate mix of cost and fixed-price incentive type contracts. The commercial strategy also exempted Boeing from the requirement to submit cost or pricing data (Truth in Negotiations Act [section 2306a of title 10, United States Code]) which places the Government at high risk for paying excessive prices and profits and precludes good fiduciary stewardship and oversight of congressionally appropriated DoD funds.

The Air Force stated that Federal Acquisition Regulation (FAR) Part 16.202-2 provides that use of a firm-fixed-price contract is suitable for acquiring commercial items or for acquiring other supplies or services on the basis of reasonably definite functional or detailed specifications when the contracting officer can establish fair and reasonable prices. Price reasonableness under FAR 16.202-2 can be established by a number of different methods including reasonable price comparisons with prior purchases of the same or similar supplies or services. FAR 16.202-2 permits the use of fixed-price

contracts notwithstanding performance uncertainties as long as the performance uncertainties can be identified and reasonable estimates of their cost impact can be made, and the contractor is willing to accept a firm fixed price representing assumption of the risks involved.

We believe that by using fixed-price contracts, the Air Force created a high-risk procurement strategy for the development, modification, procurement, and logistics support of the Boeing KC-767A Tanker Program. As to the Boeing KC-767A Tanker Program, a fixed-price commercial contract may be appropriate for the basic Boeing 767-200ER aircraft, but a cost or fixed-price incentive contract would be more appropriate for the initial Boeing KC-767A tanker aircraft development, modification, and logistics support efforts.

Using the commercial item procurement strategy, the Air Force did not have sufficient data to make multi-billion dollar decisions for the Boeing KC-767A Tanker Program and could not demonstrate the level of accountability needed to conclude that the prices negotiated represent a fair expenditure of DoD funds.

Acquisition Strategy The Air Force used Section 8159 of the Department of Defense Appropriations Act for FY 2002 as its acquisition strategy for the Boeing KC-767A tanker aircraft. The focus and goal of using this informal acquisition strategy was to expeditiously lease 100 Boeing KC-767A tanker aircraft. By not treating the acquisition

of the Boeing KC-767A tanker aircraft as an acquisition program, the Air Force disregarded best business practices, prudent acquisition procedures, and compliance with statutory provisions for testing. Without a disciplined acquisition strategy, the Air Force cannot assure the warfighter that Boeing will deliver KC-767A tanker aircraft that will satisfy operational requirements.

Specifically, the operational requirements document (ORD) for the tanker did not require that the first 100 Boeing KC-767A tanker aircraft acquired meet requirements in the Mission Needs Statement for “Future Air Refueling Aircraft.” Instead, the Air Force planned to address the requirements through an evolutionary acquisition strategy in three spirals. In doing so, the negotiated contract for the first 100 tanker aircraft did not include the key performance parameter for interoperability. By not including the interoperability key performance parameter in the negotiated contract, the Air Force may not achieve the objectives of the remaining key performance parameters because of their dependency on interoperability requirements. In addition to not meeting tanker aircraft interoperability requirements, the first 100 tanker aircraft would not have met warfighter requirements for:

- refueling multiple aircraft simultaneously;
- conducting secondary missions, such as combined cargo/passenger transportation and aeromedical evacuation;
- self-protective measures (including armor protection); and
- electro-magnetic pulse protection.

Also, systems engineering requirements were not fully developed. Among the systems engineering requirements not fully developed were:

- a performance metric for verifying the satisfaction of the 40-year service life requirement while operating 750 hours per year;
- inclusion of corrosion prevention and control requirements in the system specification; and
- inclusion of ORD requirements for interoperability, combat identification, and secure communications in the system specification.

Further, Air Force plans for conducting operational and survivability testing of the Boeing KC-767A tanker aircraft did not comply with statutory requirements in sections 2366 and 2399 of title 10, United States Code. The statutes require that systems under development may not proceed beyond low-rate initial production, normally 10 percent of the total production quantity, before operational tests determine the effectiveness and suitability of the system (section 2399 of title 10) and survivability testing of the system (section 2366 of title 10) are completed. As planned, the dedicated operational and survivability testing of the Boeing 767A tanker aircraft would not occur until 3 years after the award of the contracts for the lease of 20 tanker aircraft and the procurement of 80 tanker aircraft. The Director, Operational Test and Evaluation has also taken the position that the required testing should be accomplished before the Air Force proceeds with the full-rate production decision for the 80 tanker aircraft.

Boeing KC-767A Tanker Lease Criminal Investigation

The criminal investigative component of the Office of Inspector General, known as the Defense Criminal Investigative Service (DCIS), has led the investigations of Darleen Druyun, the former Principal Deputy Assistant Secretary of the Air Force for Acquisition and Management and Michael Sears, the former Boeing Chief Financial Officer, both of whom have since pled guilty to federal crimes associated with conflicts of interest. As the result of interviews conducted with Ms. Druyun during the course of the investigation, Ms. Druyun also admitted to improperly influencing other contracts and stated she was not objective while negotiating several Department of Defense programs. These admissions implicated the C-17 Multi-Year Procurement, a NATO AWACS equitable adjustment, the Small Diameter Bomb contract, the C-130 Avionics Modernization Program, and the proposed KC-767 tanker lease. Several of these admissions were incorporated into Ms. Druyun's supplemental statement of facts and resulted in an increase of her sentence guidelines range. We continue to assist the U.S. Attorney for the Eastern District of Virginia and Department of Justice with the criminal and civil litigation aspects of this investigation.

DoD OIG has also led and continues to participate in the investigation of the theft of Lockheed Martin Corporation proprietary documents relating to the Evolved Expendable Launch Vehicle (EELV) program by persons who later went to work for Boeing and delivered the documents to Boeing managers. Three Boeing divisions were suspended

from Government contracting for a period of time by the Air Force as a result of our EELV investigation.

KC-767A Tanker Program Accountability Review

Request from the Senate Armed Services Committee. On November 19, 2004, Senate Armed Services Committee Chairman Warner; Ranking Member Levin; and Senator McCain sent a letter to the Secretary of Defense requesting that the DoD IG conduct an accountability review of all members of the DoD and the Department of the Air Force, both military and civilian, who participated in structuring and negotiating the proposed lease contract for the KC-767A tanker aircraft program, including the then-Secretary of the Air Force and the then-Assistant Secretary of the Air Force (Acquisition). Specifically, the accountability review should determine “what happened, who was accountable, and what actions must be taken to prevent this situation from happening again.”

We plan to issue our report by April 30, 2005. At that time, we will include recommendations.

DoD OIG Review of Contracts Referred by Acting Under Secretary of Defense for Acquisition, Technology and Logistics

In a February 11, 2005, memorandum, Mr. Michael Wynne, Acting Under Secretary of Defense for Acquisition, Technology and Logistics, referred eight Air Force contracts

involving actions of Ms. Darleen Druyun to DoD OIG for review. Mr. Wynne had previously referred to us two unidentified classified contracts for review. All of these contracts are Air Force contracts that were identified during the course of an internal study commissioned by the Acting Under Secretary in November 2004. A selected team led by Ms. Sallie Flavin, Deputy Director, Defense Contract Management Agency conducted the internal study. This team reviewed specific acquisition actions involving Ms. Druyun over the course of the time that she was Principal Deputy Assistant Secretary of the Air Force for Acquisition and Management. The acquisition actions identified for review were source selection decisions, Acquisition Strategy Panel (ASP) decisions, revisions to Acquisition Strategy Reports during or after ASP approvals, award fee determinations, equitable adjustments, actions involving contested payments to contractors, contract restructures, contract extensions, and contract litigation. Excluded from the study were acquisition actions already under review by another Government body.

Specifically, 407 acquisition actions were reviewed that Ms. Druyun had been involved with from 1993 through 2002. These actions included approvals of Justification and Approvals for other than full and open competition, source selection decisions, negotiation decisions, and award fee determinations. As a result of this review, eight actions were identified as requiring additional scrutiny. Specifically, these eight actions are:

- National Polar-orbiting Operational Environmental Satellite System – Conical Microwave Imager Sensor (Contract F04701-01-C-0502);
- C-5 Avionics Modernization Program - (Contract F33657-98-C-007/006);
- Financial Information Resource System (FIRST) – (Contract FA877-01-C0-0020);
- C-22 Replacement Program (C-40) – (Contract F33657-00-C-0056);
- 60 K Tunner Program;
- KC-135 Programmed Depot Maintenance (Contract F42620-98-D-0054);
- F-16 Mission Training Center (Contract F33657-99-D-2025); and
- C-40 Lease & Purchase Program (Contract F33657-02-C-0017).

We have identified an additional procurement action on the J-PATS program. We are in the process of reviewing the detailed documentation obtained by the study team on each of the contracts identified. Our auditors are currently coordinating with our investigators on the eight contracts because of the nature of the issues involved and will be assigning internal responsibility for addressing those issues. We are also reviewing additional items associated with the C-130J program.

C-130J Aircraft

In July 2004, we reported that the Air Force conditionally accepted 50 C-130J aircraft at a cost of \$2.6 billion even though none of the aircraft met commercial contract specifications or operational requirements. As a result, the Government fielded C-130J aircraft that could not perform the intended mission.

The Air Force initially contracted for two C-130J aircraft in 1995 through a modification to a 1990 contract for C-130H aircraft. The Air Force undertook to buy the C-130J as a commercial item, which limited cost oversight by the Government. Further, FAR Part 12.208 “Contract quality assurance” requires that contracts for commercial items shall rely on contractors' existing quality assurance systems as a substitute for Government inspection and testing before tender for acceptance. As of the time of our audit, the contractor had been unable to deliver a specification compliant aircraft.

The Air Force’s commercial justification included, in part, that there was a 95 percent commonality between the C-130J and the civilian commercial version of the plane and that modifications from the commercial version would be minor. The Air Force could not provide evidence supporting its claims. In fact, the Air Force acknowledged that the C-130J included features not customarily available in the commercial marketplace including aerial delivery (cargo and paratroop), defensive systems, secure voice communication, night vision imaging, and satellite communication. The Air Force also acknowledged at the time of the audit that no commercial version (L-100J) of the C-130J currently existed and no sales of the L-100J had been made to the public. A website cited by the Air Force in its comments to a draft of our report showed that the L-100 J “would be a commercial derivative” of the C-130J.

NATO AWACS Mid-Term Modernization Program "Global Solution"

In April 2004, we reported that senior level Air Force managers did not use appropriate contracting procedures as specified in the Federal Acquisition Regulation when they negotiated the NATO AWACS Global Solution with the Chief Executive Officer of Boeing Integrated Defense Systems in September 2002. The report identified those senior level managers as Darleen Druyun, who at the time was Principal Deputy Assistant Secretary of the Air Force for Acquisition and Management; the Chairman of the NATO Airborne Early Warning and Control Program Management Agency Board of Directors); and the NATO Airborne Early Warning and Control Program Management Agency General Manager. Specifically, Druyun and other managers did not determine whether the \$1.32 billion NATO AWACS negotiated price was fair and reasonable because they did not use an independent Government cost estimate, did not use (1) an integrated product team to analyze the Boeing proposed statement of work, including a technical evaluation of labor hours and labor mixes, (2) audit assistance to review direct and indirect labor rates, and (3) weighted guidelines to establish reasonable profit and share ratios.

Druyun Actions on the C-17 Program

A January 1993 DoD OIG report, "Government Actions Concerning McDonnell Douglas Corporation During 1990," identified five Air Force officials, including Ms. Druyun, as culpable for improper progress payments to McDonnell Douglas on the C-17 program. The report recommended that the Secretary of the Air Force take appropriate disciplinary

action against Ms. Druyun and the others relating to actions to implement an Air Force “plan of action to provide financial assistance to [McDonnell Douglas Corporation (MDC)] during August through December 1990.” Resulting “improper contracting actions reduced [MDC] financial risk on the C-17 program by \$1.6 billion and created the false appearance of [program] success”

The Air Force subsequently disciplined four of those officials, but exonerated Ms. Druyun. Further review by the Secretary and Deputy Secretary of Defense “concluded that punishment of Mrs. Druyun was not appropriate.” A 1993 letter from Senator Grassley to then Secretary of Defense Aspin objected to the purported Air Force exoneration and promotion of Druyun “one month after the [DoD] Inspector General recommended that she be disciplined for improper or illegal behavior,” in response to which then Under Secretary of Defense Deutch responded to Senator Grassley, “You may be assured that we would not retain Mrs. Druyun in her present position if we felt it would jeopardize the integrity of defense acquisition.”

Small Diameter Bomb

We began an audit of the Air Force source selection process for the Small Diameter Bomb (SDB) (Project No. D2004CH-0164) in June 2004 in response to a DoD OIG investigative referral.

On November 10, 2004, Lockheed Martin filed a protest with the Government Accountability Office (GAO) relating to the SDB System Development and Demonstration (SDD) contract award to Boeing (RFP No. F08635-03-R-0038).

In regard to that procurement, Lockheed Martin protests (i) the Air Force's evident intention to reinstate a particular scope of work (known as Phase II) to a Boeing contract where the scope was removed from the SDB SDD competition under [the former Principal Deputy Assistant Secretary of the Air Force for Acquisition and Management's corrupt direction], as well as, (ii) the underlying award of the SDB contract because it now appears that the work scope for the SDD competition was defined not by the Agency's legitimate needs but through [the former Principal Deputy Assistant Secretary of the Air Force for Acquisition and Management's] corrupt dealings with Boeing.

In a decision issued on February 18, 2005, GAO sustained Lockheed Martin's protest because:

the record showed that Darleen Druyun was involved in the decision-making process that culminated in changes made to evaluation factors-including deletion of specific technical requirements. The record further showed that the Air Force currently intends to amend Boeing's contract on a sole-source basis to add those previously deleted requirements. GAO recommended that, rather than making this sole-source addition to Boeing's contract, the Air Force conduct a competition for those requirements.

Related Ongoing Audits

Audit of Service Acquisition Executives Management Oversight and Procurement Authority for Acquisition Programs

The audit objective will be to determine the adequacy of each Service Acquisition Executive's management oversight procurement authority over major acquisition programs. Specifically, the audit will evaluate the program management and procurement decision process used by the Service Acquisition Executives and the Program Executive Officers.

Audit of Commercial Contracting Practices for Procuring Defense Systems

The overall audit objective will be to determine whether procurement officials are complying with Federal Acquisition Regulation Part 12, "Acquisition of Commercial Items," and part 15, "Contracting by Negotiation," when procuring defense systems or their subcomponents. Specifically, we will evaluate the justifications used to determine whether major systems or subsystems meet commercial item criteria and evaluate the adequacy of the basis for establishing price reasonableness.

Both audits have been suspended because of audit support for Base Relocation and Closure and other operational priorities.