



INSPECTOR GENERAL

U.S. Department of Defense

**Statement of
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Deputy Inspector General
for a Hearing on**

**“Price Gouging in Military Contracts: New
Inspector General Report Exposes Excess Profit
Obtained by TransDigm Group”**

**Before the
Committee on Oversight and Reform
U.S. House of Representatives
January 19, 2022**

Chairwoman Maloney, Ranking Member Comer, and members of the committee, thank you for inviting me to appear before you today to discuss the DoD Office of Inspector General (DoD OIG) report titled “Audit of the Business Model for TransDigm Group Inc. and Its Impact on Department of Defense Spare Parts Pricing.”

I am Theresa Hull, a Deputy Inspector General at the DoD OIG, and I oversaw this audit. I will discuss in my testimony today our long-standing concerns about sole-source procurements, such as those the DoD conducts with TransDigm. While these concerns are not new, the prices charged by TransDigm provide another clear demonstration of the ongoing problems that occur when contractors are not compelled to provide cost data if contracting officers request the data to negotiate contracts with sole-source contractors.

Following the issuance of our previous report involving TransDigm, the DoD OIG received a letter from this committee requesting a comprehensive review of TransDigm’s contracts with the DoD from January 2017 through June 2019 to identify whether TransDigm earned excess profits.¹ The DoD OIG also received a request from Senator Charles Grassley to provide information on TransDigm’s corporate structure, the structure of TransDigm’s contracts with the DoD, the rate of TransDigm’s company acquisitions, and TransDigm’s impact on the Defense market.

Our recent audit examined the prices that TransDigm charged the DoD for aircraft spare parts. Specifically, we examined a sample of 107 spare parts provided by TransDigm. We used 15 percent as a reasonable profit for our analysis and considered any profit over 15 percent to be excess profit. We used 15 percent because it is the highest profit percentage identified in the FAR for various contract types. On 105 of the 107 spare parts, we determined that TransDigm

¹ Report No. DODIG-2019-060, “Review of Parts Purchased From TransDigm Group, Inc.,” February 25, 2019.

earned excess profits over 15 percent, ranging from 2.8 percent to over 3,850 percent.²

We also determined that TransDigm refused to share cost data DoD contracting officers requested for 25 out of 27 contracts. Contracting officers' inability to compel TransDigm to provide such data under the current legal framework prevented them from being able to perform cost analysis and contributed to the DoD overpaying for spare parts that it must buy to meet mission requirements.

Background and Long-Standing Problems with Pricing of Sole-Source Spare Parts

The issues raised in this audit are not limited to just this company and its contracts with the DoD. Sole source contractors' unwillingness to share cost data, and DoD contracting officers' limited success in negotiating fair and reasonable prices for sole-source parts, are common findings that the DoD OIG has highlighted in our audit reports for more than 20 years.³

Often, our reports have identified the lack of cost data available to DoD contracting officers as the root cause for contractors' obtaining excessive profits on sole-source parts. Using certified or uncertified cost data to perform cost analysis are the most reliable ways DoD contracting officers can determine whether a price is fair and reasonable.

² We reviewed the fair and reasonable price determinations on all 107 spare parts on 153 contracts and performed cost analysis on 106 spare parts on 152 contracts because TransDigm only provided cost models for the 106 spare parts that had been delivered.

³ DoD OIG Report No. 98-064, "Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111," June 24, 1998; Report No. D-2006-055, "Spare Parts Procurements from TransDigm, Inc.," February 23, 2006; Report No. DODIG-2014-088, "Defense Logistics Agency Aviation Potentially Overpaid Bell Helicopter for Sole-Source Commercial Spare Parts," July 3, 2014; Report No. DODIG-2015-120, "Defense Logistics Agency Did Not Obtain Fair and Reasonable Prices From Meggitt Aircraft Braking Systems for Sole-Source Commercial Spare Parts," May 8, 2015; Report No. DODIG-2015-137, "Improvements Needed on DoD Procurements from Robertson Fuel Systems," June 25, 2015; Report No. DODIG-2016-023, "Improvements Needed in the Defense Logistics Agency's Evaluation of Fair and Reasonable Prices for C-130 Aircraft Spare Parts," November 16, 2015; Report No. DODIG-2016-047, "Defense Logistics Agency Did Not Appropriately Determine Fair and Reasonable Price for F108 Engine Sole-Source Commercial Parts," February 16, 2016; Report No. DODIG-2017-053, "The Air Force Did Not Adequately Determine or Document Fair and Reasonable Prices for Lot 7 Sole-Source Initial Spare Parts for the C-5 Aircraft," February 7, 2017; Report No. DODIG-2019-060, "Review of Parts Purchased From TransDigm Group, Inc.," February 25, 2019.

Certified cost data is cost or pricing data that contractors provide to the contracting officer, and they are required to certify as accurate, complete, and current at the end of negotiations in accordance with the Federal Acquisition Regulation (FAR). Data other-than-certified cost or pricing data includes pricing data, cost data, and other information that is also provided by the contractor but is not certified, though it is often necessary for the contracting officer to determine a fair and reasonable price.

The FAR states that certified cost data is required for contracting officers to award contracts above a certain dollar threshold, which is established by the Truth in Negotiations Act (TINA). The 2018 National Defense Authorization Act raised the threshold from \$750,000 to \$2 million.

Although the intent of raising the threshold was to streamline the acquisition process, the increase in the threshold resulted in contracting officers having less information to use during their negotiations with contractors to determine a fair and reasonable price. This had a particularly large impact on negotiations for sole source items. Moreover, if the contract is for the acquisition of commercial items, the FAR does not require certified cost or pricing data, even if the acquisition is above the TINA threshold.

In addition, current statutory and regulatory requirements discourage contracting officers from requesting uncertified cost data from contractors. The FAR states that for all acquisitions contracted by negotiation, the contracting officers must obtain other-than-certified cost or pricing data from the contractor when it is the only means available to determine whether the price is fair and reasonable. The FAR lists six other options that contracting officers should consider, including the use of historical prices, before using uncertified cost data. Also, the Defense Federal Acquisition Regulation Supplement (DFARS) lists cost data as a last option for determining price reasonableness. For contracts awarded under simplified acquisition

procedures, the FAR does not list obtaining cost data as an option for the contracting officer.

TransDigm's Products and Business Model

TransDigm and its operating units design, produce, and supply specialized parts for aircraft, including the C-17 Globemaster III, the AH-64 Apache, the F-16 Fighting Falcon, and the CH-47 Chinook. From January 1, 2017, through June 30, 2019, the DoD awarded 5,113 contracts, valued at \$569 million, to TransDigm or to its operating units. For FY 2020, more than three-quarters of TransDigm's net sales came from products for which TransDigm believes it is the sole-source provider. TransDigm identified that it was the sole manufacturer for 94 of the 107 spare parts we reviewed in our audit.

The DoD generally purchases spare parts from the TransDigm operating units in small quantities, resulting in lower-dollar-value contracts. Contractors are required to provide certified cost or pricing data only for contracts valued at or above the TINA threshold. From January 2017 to June 2019, more than 95 percent of the contracts that the DoD awarded to TransDigm, valued at \$268.2 million, were below the TINA threshold. TransDigm also practices what it calls "market-based pricing." According to TransDigm, market-based pricing is a strategy in which a company sets prices of items that it sells based on what commercial or Government entities are willing to pay for the item as opposed to basing prices on the cost to make the spare parts. This means that if the DoD has only one source for the part and if that part is needed to operate a weapon system, such as an aircraft, then the value of that part to the DoD is very high even if the cost to manufacture the part could be very low.

Sole-source parts are, by their nature, difficult to price on a fair and reasonable basis because the normal market structure and dynamics do not always exist for sole-source parts. Often with sole-source parts, without competitive market forces, the price charged by contractors becomes what the contractor is willing to negotiate and what the DoD is willing to pay for a part

to keep an essential weapon system operational.

According to TransDigm's FY 2020 Annual Report, most of its products generate significant aftermarket revenue from spare parts used over the total product life cycle, which is estimated to be approximately 45 to 60 years for spare parts on some aircraft. TransDigm officials estimate that approximately 49 percent of TransDigm's net sales in FY 2020 were generated from aftermarket sales that came from commercial and military aftermarkets.

According to TransDigm officials, TransDigm operating units generally do not track specific sales to the U.S. Government. Unless TransDigm sold the spare parts directly to the U.S. Government, TransDigm could not track where the spare parts were being sold because the operating units used distributors to manage sales of spare parts to third parties or sales to other contractors. When TransDigm's operating units used distributors, TransDigm could not identify the end customer.

TransDigm officials also stated that sole-source spare parts in the aerospace industry are the result of multiple companies competing to manufacture spare parts during the development of an aircraft. The company that won the competitive award during development often became the only provider for any spare parts going forward. For example, when the Original Equipment Manufacturer (OEM) for a weapon system initially designs a system, it requests bids from multiple companies for the spare parts. This competition results in less profit for TransDigm and the companies competing to win the award from the OEM designing the weapon system. As the OEM finalizes the design of the weapon system and moves into production, it selects one company to provide the spare parts. Once production of the weapon system ends, the OEM-selected company begins selling the spare parts as aftermarket and can earn higher profits because competition has been reduced or eliminated.

TransDigm seeks out and competes for the acquisition of aerospace companies that

design, manufacture, and sell specialized sole-source products that have stable demand and profit margins. TransDigm grows its sales and business by acquiring operating units that independently focus on designing and developing new proprietary products that will lead to high-margin, repeatable sales in the OEM market and the aftermarket. Another outcome of TransDigm's company acquisitions is that spare parts sold to the Government by the acquired company are often for older aircraft, which are part of the aftermarket.

TransDigm mergers and acquisitions have resulted in it recognizing significant goodwill on its financial statements. Goodwill occurs when TransDigm purchases a company for more than the recorded value of that company's assets. Generally accepted accounting principles and Securities and Exchange Commission guidelines require that amounts paid in excess of the recorded value of a company's assets, as well as the debts carried by that company, be recorded as goodwill. Specifically, as of September 30, 2020, TransDigm disclosed in its FY 2020 Annual Report that goodwill represented about 43 percent, or \$7.9 billion, of its total assets.

TransDigm finances the purchase of some operating units that it buys at a premium with loans and debt, creating an additional expense for interest on the loans, which is paid by TransDigm's customers. Interest is a cost that is unallowable by the FAR when cost analysis is performed to determine a fair and reasonable price, but it was included as a cost of the spare parts in the uncertified cost data provided by TransDigm to the DoD OIG. According to Defense Pricing and Contracting officials, TransDigm's debt-to-asset ratio was over 100 percent, the highest of any of the top 10 U.S. Defense companies, ranked by revenue, on the Defense News' Top 100 for 2019.

TransDigm's acquisition of some operating units has resulted in an increase in spare parts prices. We examined the historical prices for all 107 spare parts reviewed in this audit. However, only 46 of the 107 spare parts had procurement history data within 5 years both

before and after TransDigm acquired the operating unit. The remaining 61 spare parts did not have enough procurement history data for us to analyze.

We identified that 44 of the 46 spare parts (96 percent) immediately increased in price, and 2 spare parts immediately decreased in price after TransDigm acquired the operating unit. For 31 of the 44 spare parts that immediately increased in price (70 percent), the annual average price increase percentage was larger than the annual average price increase percentage before TransDigm's acquisition of the operating unit. For 14 of the 31 spare parts with an immediate price increase, the annual average price increase was more than 25 percent larger than the annual average price increase of the spare part before TransDigm acquired the operating unit.

DoD OIG Audit Findings

For our audit, we reviewed a sample of 107 spare parts that TransDigm operating units sold to the DoD from January 1, 2017, through June 30, 2019, on 153 contracts, with a total value of \$38.3 million.⁴ Of those 107 spare parts, we found only two instances in which TransDigm received a profit of 15 percent or less when compared to TransDigm's provided costs for the spare parts. For the remaining 105 spare parts that we reviewed, TransDigm earned excess profits over 15 percent, ranging from 2.8 percent to over 3,850 percent. We used the percentage of cost calculation, in which profit is divided by cost to make the part, to calculate the profit percentages. We did this to stay consistent with the February 2019 DoD OIG report on TransDigm and to allow for comparisons over time. In addition, FAR and DFARS guidance provides procedures for contracting officers to calculate the negotiated profit for a contract based on costs when certified cost or pricing data is provided by the contractor.⁵

⁴ We reviewed the fair and reasonable price determinations on all 107 spare parts on 153 contracts and performed cost analysis on 106 spare parts on 152 contracts because TransDigm only provided cost models for the 106 spare parts that had been delivered.

⁵ FAR 15.404, "Proposal Analysis," and DFARS 215.404, "Proposal Analysis."

Another calculation that could be used would be the percentage of revenue calculation, where profit is divided by selling price. Unlike the percentage of cost method, by using the percentage of revenue, the profit percent would never exceed 100 percent. For the spare parts we reviewed, the percentages of excess profit ranged from 2.4 to 97.1 using the percentage of revenue calculation. However, the dollar amount of the profit was the same for either calculation.

According to TransDigm officials, aerospace industry contractors that use market-based pricing generally earned profits ranging from 8 percent to 22 percent. In addition, TransDigm officials claimed that from 2016 through 2020, the company's net profit margin varied between 10 percent and 24 percent, with an average of 15.9 percent. Using 15 percent as our benchmark for the purposes of our audit, we determined that for these 107 spare parts, which cost the DoD \$38.3 million, TransDigm earned \$20.8 million in excess profit on 105 spare parts.

In some instances, DoD contracting officers attempted to obtain the cost of making a part to determine whether the price TransDigm wanted to charge for the part was reasonable. For example, on 27 occasions, DoD contracting officers requested cost data from TransDigm. However, TransDigm was not obligated by law to provide that data, and it refused to do so in response to all but two requests. In the instances when TransDigm did provide the requested cost information, the data provided to the contracting officer did not include the same level of detail as the data TransDigm provided the DoD OIG.

For the remaining 25 contracts for which TransDigm refused to provide cost data, the contracting officers had to rely on other FAR methods to determine a fair and reasonable price. However, because most of the spare parts (94 of the 107 according to TransDigm) were manufactured solely by TransDigm, the DoD contracting officer bought the part at a price that resulted in large profit percentages for TransDigm (up to 3,850 percent).

It is clear that the more insight contracting officers have into the cost of a part, the better their chances to negotiate a fair and reasonable price. However, the contracting officers had limited options once TransDigm refused to provide the requested cost data: either buy the spare parts without receiving cost data from TransDigm, or do not purchase the spare parts needed to meet mission requirements, which at times were urgent.

For example, contracting officers determined that 22 spare part contracts were fair and reasonable based on the best attainable price or other reasonable basis methods. Contracting officers justified using these methods because they had exhausted other methods of determining price reasonableness. In addition, 12 contracting officers for 15 contracts stated that the need for the spare part was urgent enough that they had to buy the part at the price offered by TransDigm. In these instances, the contracting officers had to choose between not meeting mission requirements or potentially paying excessive prices for the spare parts to meet mission requirements.

I also want to note that our findings are consistent with a 2018 DoD review of the negotiated prices for spare parts from one TransDigm operating unit. The independent review team was led by the Air Force and consisted of representatives from the Air Force, the Defense Contract Audit Agency, and the Defense Contract Management Agency. The independent review team determined, consistent with our findings, that TransDigm's spare parts were overpriced and that TransDigm took advantage of its sole-source position and refused to provide cost data when requested by contracting officers.

Previous DoD OIG Audits

Our previous audits have repeatedly found problems with determining a fair and reasonable price for sole-source parts. For example, in 1998, we reported that Sundstrand Aerospace, a manufacturer of aerospace products, refused to negotiate catalog prices for

commercial items based on price analysis of previous cost-based prices; refused to provide Defense Logistics Agency (DLA) contracting officers with “uncertified” cost or pricing data for commercial catalog items; and terminated Government access to the company cost history system.⁶

In another example, Report No. DODIG-2015-137, “Improvements Needed on DoD Procurements from Robertson Fuel Systems,” June 25, 2015, stated that Robertson refused to provide uncertified cost data to support fair and reasonable price determinations. Additionally, Report No. DODIG-2014-088, “Defense Logistics Agency Aviation Potentially Overpaid Bell Helicopter for Sole-Source Commercial Spare Parts,” July 3, 2014, stated that DLA Acquisition explained that Bell consistently refused to provide uncertified cost data for commercial spare parts when requested, and, as a result, the DLA did not believe that it had the ability to obtain uncertified cost data.

Furthermore, Report No. DODIG-2015-120, “Defense Logistics Agency Did Not Obtain Fair and Reasonable Prices from Meggitt Aircraft Braking Systems for Sole-Source Commercial Spare Parts,” May 8, 2015, stated that contracting officers stopped elevating Meggitt’s refusal to provide uncertified cost data because Meggitt did not provide uncertified cost data even after the contracting officers elevated the refusal to the Head of the Contracting Activity as required by the FAR. The DoD OIG also determined that a DLA contracting officer did not obtain fair and reasonable prices for 51 of 54 sole-source, commercial spare parts procured from the Meggitt Aircraft Braking Systems Corporation companies, and the contracting officer relied on previous over-inflated prices to determine current contract prices.⁷

⁶ DoD OIG Report No. 98-064, “Audit Report on Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111,” February 6, 1998.

⁷ DoD OIG Report No. DODIG-2015-120, “Defense Logistics Agency Did Not Obtain Fair and Reasonable Prices From Meggitt Aircraft Braking Systems for Sole-Source Commercial Spare Parts,” May 8, 2015.

We first audited the DoD's contracts with TransDigm in 2006 and those findings were similar to what we found in our most recent audits of TransDigm. In our 2006 audit, we concluded that the DoD could not effectively negotiate prices for spare parts procured from TransDigm operating units. Using cost analysis, we calculated that the DLA had paid approximately \$5.3 million more than the fair and reasonable price for 77 spare parts.⁸

In Report No. DODIG-2019-060, "Review of Parts Purchased from TransDigm Group, Inc.," February 25, 2019, the DoD OIG determined that TransDigm earned excess profit on 46 of 47 parts purchased by the DLA and the Army, even though contracting officers followed FAR and DFARS procedures when they determined that prices were fair and reasonable for the 47 parts at the time of contract award. When the DoD OIG compared the awarded prices for the 47 parts on 113 contracts to TransDigm's other-than-certified cost data, the analysis determined that only one part purchased under one contract was awarded with a reasonable profit of 11 percent. The remaining 112 contracts resulted in total profit percentages ranging from 17 percent to 4,451 percent for 46 parts. The DoD OIG determined profit percentages of 15 percent or below to be reasonable.

The DoD took action in response to our recommendations in all these reports. DoD officials issued and reiterated policy on fair and reasonable pricing of spare parts, provided additional training to contracting officers, and met with contractors to discuss pricing. The DoD also established the Reverse Engineering Technical Data Initiative and the Strategic Supplier Alliance Initiative, submitted legislative proposals such as the two listed in our report related to commercial item determinations and obtaining uncertified cost data when requested, required contracting officers to verify price reasonableness of prior contractor prices, and elevated and

⁸ DoD OIG Report No. D-2006-055, "Spare Parts Procurements From TransDigm, Inc.," February 23, 2006.

reported contractor denials of cost data to the head of the contracting activity. However, more than 20 years after first identifying the problem, we are still identifying the same issues, as reflected in this most recent audit of TransDigm.

Regulatory Reform Needed for Sole-Source Offerors

Our body of work in spare parts pricing demonstrates that change is necessary to address the high prices charged by, and excessive profits obtained by, contractors like TransDigm that sell sole-source spare parts to the DoD. Because the United States Code and Federal and DoD policies do not compel contractors to provide uncertified cost data for contracts below the TINA threshold when requested, contracting officers are not always able to use cost analysis to determine fair and reasonable prices for sole-source spare parts that were bought in small quantities at low dollar values. For instance, at least nine DoD OIG reports over the past 23 years have identified uncertified cost data not being provided when requested.

To correct the deficiencies detailed in our recent TransDigm report, we recommended several administrative actions that the DoD could pursue. First, the DoD should seek voluntary refunds from TransDigm for the \$20.8 million in excess profit that we identified. Second, we recommended that the DoD update the DFARS and DFARS Procedures, Guidance, and Information to identify and require when cost analysis should be performed in sole-source situations. Finally, we recommended that Defense Pricing and Contracting and the DLA work together to identify alternative contracting strategies that could be used with companies, such as TransDigm, to obtain more reasonable prices.

However, these administrative efforts will likely have minimal impact without fundamental regulatory and statutory changes. As discussed earlier, current statutes, such as TINA, as well as simplified and commercial acquisitions process, streamlined administrative processes and limited the documentation necessary to support certain acquisitions. In

addition, current statutes do not compel companies to provide sufficient information to ensure that contracting officers can determine whether fair and reasonable prices are paid for spare parts.

Specifically, TransDigm seeks out aerospace companies that sell specialized sole-source products. The contracts are often in quantities under the TINA threshold or through commercial contracts, which have minimal cost information available to substantiate price reasonableness. As a result, the DoD has paid TransDigm prices that result in excess profits.

Without legislative changes, the DoD will continue to be unable to perform adequate price reasonableness determinations because contractors are not compelled to provide uncertified cost data under the TINA threshold, and the other price analysis methods are not always effective in identifying excessive prices. However, we did not make additional recommendations to address this policy problem because recommendations that specifically addressed the potential need for legislative changes from the February 2019 DoD OIG TransDigm report remain open.

Therefore, we support the legislative reforms proposed by Defense Pricing and Contracting in response to the recommendations made in the February 2019 TransDigm report. The first would be to amend existing acquisition statutes to allow for contracting officers to have the ability to obtain, at a minimum, uncertified cost data before awarding a contract to a sole-source offeror for the procurement of spare parts, including those determined to be commercial items, regardless of the contract dollar value. Certified cost or pricing data would be required for contracts that exceed the TINA threshold. The second would be legislation to consider waiving the requirement to provide the cost data if:

- the contracting officer receives documentation verifying that the offeror submitted cost or pricing data to a contracting officer before the award of a previous contract

for the same or similar spare parts within the last year and that contracting officer relied on this data to make a fair and reasonable price determination, or

- the part is a commercially available off-the-shelf item sold in substantial quantities in the commercial marketplace and offered to the Government without modification; and
- any price increase over the previous contract price does not exceed a reasonable adjustment for inflation.

We believe that, with these new statutory provisions, contracting officers would be better able to obtain crucial information necessary to level the playing field and award contracts for spare parts with these sole-source manufacturers that do not result in profits like those obtained by TransDigm and others. Without these steps, we believe that the DoD may continue to pay excessive prices for spare parts that it needs, as we found in over 20 years of audit work.

Thank you for the opportunity to testify this morning, and I look forward to answering your questions.