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DEFENSE ISSUES

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Recent allegations of defense industry price gouging have focused attention on DoD's acquisition practices. Here's what happened and how DoD plans to prevent similar incidents in the future.

Volume 13 Number 30

Acquisition Reforms Effective Despite Recent Problems

Press briefing by Jacques S. Gansler, undersecretary of defense for acquisition and technology, Washington, March 19, 1998.

What I thought I would do is to just very briefly give you a perception of how we see the commercial pricing issue and then open it to questions.

Given all the attention that's been paid to this as a result of yesterday's hearing, which I took part in before the Senate Armed Services Committee, we just thought it would be a good idea to try to meet with you, explain the complexities[,] as we see them[,] of the issues, and then to give you a better understanding of what's involved in the contract procedures and then go on to take the questions.

Let me mention that at the risk of appearing to play down what I think is a very significant set of errors that took place, if you put the criticism of these two Department of Defense contract awards in perspective, I think it shouldn't detract from the overall success of the department's current purchasing efforts. And that's the thing I really wanted to put in perspective.

The important question then, is are these special cases or are they sort of typical cases? And we obviously believe these to be special cases. In fact, the inspector general audit showed two incidents which occurred in the 1994-1996 time period, two to four years ago, and both of which were brought to the inspector general's attention via the Waste, Fraud And Abuse Hotline by government employees.

Essentially, that's what we want to happen. That's why that hot line was set up, for government employees to notify the DoD. And as the DoD Inspector General said, we responded immediately and took corrective action.

The IG identified these as errors, by the way. They were not illegal actions in any respect, according to the IG, and we agree with that. These errors were made in dealing with two commercial suppliers as the Department of Defense moved in this mid-90s time period toward greater use of commercial practices and commercial items.

The first case, we paid more for a sole source commercial item purchased from the company's catalog than we had paid for the same items when we obtained them in a detailed cost analysis from the company 10 years or so ago. The buyers should have observed this difference and failed to do so.

We also made repeated purchases at that time without leveraging our buying power to get substantial discounts, which we should have been able to do, off the catalog price. When this was found out, we worked with the department's inspector general to investigate the problem, come up with solutions, and now we're providing much more guidance to our buyers and training them in how to do commercial buying and how to obtain fair and reasonable prices for these commercial items.

In the case of one of these, we've negotiated a single contract for these parts and based on all those department's requirements so that any buyer can, in fact, go to that single agreement. And we got a substantial discount off the company's catalog prices, a very substantial discount.

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In the second case, we had negotiated a contract for direct delivery on an as-needed basis. In other words, you don't have to maintain an inventory. You get the part when you need it and you get it delivered immediately, like the airlines would do when they have a problem with one of their spare parts.

This contract eliminated the need for us to do forecasting, warehousing and maintenance on these parts. The company guaranteed delivery of the parts at a specified location with an agreed-upon timeframe. The problem was that the buyer mistakenly issued orders against the contract not for ones and twos, but for large quantities of these to be delivered to our warehouse. It was an error.

The price we paid was too high because the contract was based on delivery of small quantities for direct delivery to the specific locations, essentially flight lines. Some of these parts were also mistakenly coded as sole source when they should have been coded as competitive.

As a result, the Defense Logistics Agency has been working with its hardware centers to ensure that this contract is used as it is intended to be used -- in other words, if you need one quickly, then you pay an extra price for it, including the Fed Ex cost or whatever delivery system you were using -- and also, to make the additional training available not just to those individuals who are involved in this program, but across the board.

We want to make sure that the detailed policy guidance in determining fair and reasonable prices for commercial items is available to all of our contracting officers. These improvements, obviously, will help us to correct the problems that we've identified and any future problems that we anticipate.

The mistakes we made in these isolated cases were based on a number of factors. We failed to take advantage of our buying power. We failed to understand what we were buying in the case of rapid delivery vs. buying for inventory, and we failed to fully understand what was included in prices that we were paying -- in other words, the benefits that should have been accrued at the higher prices.

As soon as these were found out -- and, as I said, they were found out because of the system that we had set up with a government employee notifying us, and then we responded immediately to these mistakes -- we then went back and fixed those.

The training is a major step in that because over the last few years now, we have basically tried to change dramatically the way in which we do business. Our marketplace has changed, our practices have changed and we have to have the updated training to match those -- and the tools, by the way, for the procurement people to be able to look back at prior prices and be able to make comparisons.

The inspector general, Eleanor Hill, made this clear in her testimony before the Senate Armed Services Committee yesterday. Ms. Hill acknowledged, ... I'm quoting here: "The Office of the Under Secretary of Defense for Acquisition and Technology recognized the importance of our findings right away and took appropriate action."

What is important to emphasize here, I think, is that these were rare cases. In the overwhelming majority of cases using commercial practices and buying commercial items has clearly paid huge dividends in savings, responsiveness and quality for the Department of Defense.

As you know, the DoD managed more than 7.8 million contracts in 1997 valued at more than \$120 billion. The vast majority of these purchases were handled efficiently using best commercial practices, best business practices and, in fact, most of these were competitive.

In the Defense Logistics Agency alone, which handles more than 1.5 million purchasing contracts -- and most of these are for small items each year -- the use of commercial buying practices and the use of commercial parts has resulted in significant savings.

In a recent sample that I had them go back and do in DLA, just for comparison, to determine whether this was a special case or an aggregate case, what they found in the sample that they did was that you

made savings in the range of 20 [percent] to 22 percent depending on the product area; that they had order-to-receipt times reduced by 50 [percent] to 95 percent, again depending upon which way they were doing it; and their total inventory was reduced by \$720 million, which is about a 30 percent reduction in those areas where they're using commercial buying practices and commercial parts.

So, overall, we think it's a very significant direction and we want to continue to move in that direction.

Obviously, the defense acquisition system is one of the largest in the world. As I noted in my testimony before the Senate Armed Services Committee, when we begin what amounts to a very complete restructuring in the way we do business, in other words shifting to more efficient and effective commercial practices, purchasing high-quality commercial items when they meet our needs, we're bound to make a few mistakes. That's very regrettable and that shouldn't happen.

Overall, however, the department is managing its acquisition mission as a result of these changes far more efficiently and at greatly reduced cost to the American taxpayer, and that's our objective. Thank you.

[Excerpts of selected questions and responses follow.]

Q. How long have you been monitoring the relations between the Pentagon and the defense industry?

A. Me personally? I guess I could say I've been monitoring them for -- let's see, I started working in the defense industry in summer jobs in the 1950s. My first full-time job in the defense industry was in 1957. So I guess over 40 years.

Q. Well, wouldn't you say that this is more of what we've seen over the past 25 years?

A. No.

Q. Incurring rip-offs by major defense contractors of the Pentagon?

A. Well, I don't think that we have seen -- I mean, the problem is that you are bound to get one or two mistakes no matter when you take a sample.

What we've done, if you look back at the history, is we have actually been making significant changes. We will still find one or two errors. I think there's a dramatic difference between the way we're doing business today and the way we were doing business even 10 years ago.

Q. When you checked, you asked the people responsible to do a bore sample. The people who do the actual buying and administrating the program say they're directed by their superiors not to push these companies, to go ahead and pay the price, not to get tough with them; it could endanger their relationships.

So it's the overwhelming number of people I've talked to about this say they're told to go ahead and pay these high prices.

A. I specifically asked that question because it seemed to me that it's important to understand what they are being told, and that's what these training courses that I've told you about are really focused on.

We are a major buyer. There's no question we are a very large buyer with a lot of monopsony [sole customer] buying power, if we exercise it. In fact, in the case of DLA, over 90 percent of the cases are in competitive marketplace. When you're using competitive market forces, you have a lot of choices. You can compare their prices. You don't have to negotiate under those conditions unless there's a really big volume difference, and then maybe you still might want to negotiate, or if the terms and conditions are significantly different, then you still might want to negotiate.

Where the negotiation comes in is on a sole source case, where we're the only buyer and they're the only

supplier. Then you have a monopsony and a monopoly trying to negotiate. Under those conditions, it really does pay to exercise your buying power and to try to really negotiate hard.

In one of these two cases specifically, where the buyer chose not to really press and negotiate much, the buyer still got a small discount. I think it was like a 20 percent discount. After going back and actually negotiating in detail, the buyer got something like a 71 percent discount as a result of our buying power.

So it really does make a difference, and what we have been training the people to do is to use more judgment in those cases. Pick the case when it does make a difference and actually go back and exercise that power. They did it in that case.

Q. In your mind, is there any responsibility or culpability on behalf of the companies that obviously knew they were getting quite a deal on some of these things?

A. It's a commercial world. You expect that some companies will attempt to get what they can get, and that's why this negotiating is such an important thing on sole-source conditions.

In both these cases when we went back afterwards and negotiated, essentially, we were satisfied that they were not really trying to rip us off totally. But it's very clear that the buyers have to be smarter under these conditions.

It places more of a burden on the buyer to make smart judgments in the same way that you and I do in the commercial marketplace. We make judgments as we go out and look at different products. We don't just take the price off of the catalog and say, "We'll buy that" without looking at other ones.

Q. But do the companies take any action against the managers that oversee these certain parts, parts lines? Did they take any actions against these managers? They clearly knew they were raking it in.

A. Well, I don't know honestly whether they took any action at all. We felt that our employees made some mistakes and we're training them to do it better. We want them to exercise their buying power and that's what we're training them to do.

It was not a case of any illegal action on either party's side, and so I don't know that we pursued trying to get any punishment out of it from either side.

Q. You described a case a minute ago where the department overpaid by 70 percent, and you all didn't consider that an attempt to rip you all off?

A. Well, I'm not saying it wasn't an attempt. I'm not making a value judgment on what their approach was.

The problem is they use a commercial catalog which lists the commercial price. That's what they charge for catalog items for a normal person when you come in off the street. It's not that they arbitrarily pick some high price. This was their catalog price.

What we had been telling our buyers is, "We're going to use commercial practices." You can buy at commercial prices and, if they're competitive, you should be getting a decent price. What happened is, on a sole-source case, they went to the catalog, looked at the catalog price and bought it. It wasn't like the company doubled their price.

Q. Well, I understand that. But if I went to the store and bought something this week and then next week I discovered I could have bought it for 70 percent less, I'd be howling. I suspect you would be, too.

A. Well, in fact -- the real case here was that they went back 10 years later and got a much higher price and didn't bother to look back and say this doesn't make sense. It's a much higher price. I shouldn't be paying that.

Now the fact that we've negotiated them down by 70 percent makes them look bad, I guess, but that's about all you can say in terms of the effect on them. We're not trying to judge their motives. We're trying to make sure we get a good price for the government.

Q. But you're making it sound -- the Pentagon sound -- like it's fallen off the back of a watermelon truck. ... The Pentagon is the biggest buyer of this equipment. These defense companies would die without Pentagon contracts. They can't victimize these people and get away with it so easily. If you were to name the three companies -- do you know the three companies that ripped off in this incidence?

A. Well, there were two, not three.

Q. Two. Boeing, Allied Technical and Sundstrand, I'm told. These are major companies. They get billions of dollars in contracts, and here they're ripping off people because of catalog prices and doing mirrors. I mean, how do they get away with that? Why don't you pursue them for fraud and criminal activity?

A. I think what you have to recognize is that, at the corporate level, if I were sitting talking to the president of one of these corporations, I'm sure we wouldn't have this problem.

What is happening down in the system, someone is buying a spring or a small piece and someone down in their system is selling that piece from a catalog at a catalog price. And at that level, there was an error made.

Now, is this something that you send someone to jail for? Clearly, no. Is it something that you necessarily want to raise to their corporate management's attention? I might mention it sometime casually at dinner. But most of the discussions you're having with the corporate level are on the multimillions or hundreds of millions of dollars worth of programs, billion-dollar weapons systems and things like that.

This is down in the very low parts level within the system. It happens that some of these corporations have such flow-through down to the low levels that they're involved with the Defense Department at essentially all levels.

Q. Then you're familiar with a C-5A. ... That was a major project. They doubled the price of that through engineering incompetence, and no one went to jail for that one either. I mean, when do you blow the whistle on these guys?

A. Well, what we're trying to do now is actually to use price as a much more important consideration in all of our weapons procurements. That's really a big driver today as contrasted to -- and that's part of the acquisition reform initiative -- as contrasted to the historic approach of mostly focusing on performance.

Essentially, it's another commercial practice in the sense that when you and I go out to buy, we're interested, and say we're going to buy a television set. We don't typically say, "What's the decibel level from Philadelphia in the third stage of the amplifier?" We say, "I want a television set for a certain price. That looks like a good television set." We're now trying to use much more performance specifications and price as the criteria for our selection.

In the case of these particular examples of errors, the people didn't place enough emphasis, I think, on the price that they were paying relative to the historic price that they had paid. And that was generally the accepted error, and so for those two examples -- in the case of DLA, 1.5 million procurement actions -- we have to correct it.

Q. Can you tell us about the specific resolutions in these two cases when ... these were brought to your attention? What has happened? Have they given refunds? Can you just describe that?

A. In one of the two, we went back and established a corporate-negotiated package so that all of our various buyers could then go to this overall package and select off of it prices that were, in fact, as I said,

70 percent less than their normal catalog prices.

In the other case, the company said [they used] normal catalog prices [and preferred not to discount them].. But on the other hand, what they said was that we will let you give back any parts you want to and we'll give you the full price for those parts.

What we decided in that case is, since they weren't willing to lower their price, we're going to simply compete it and we'll force the market to get the lower price, which is an easy way of getting it done.

Q. That was the sole-source case?

A. I don't want to identify which of the two contractors that was, but that was the sole source.

Q. Does the catalog really list a screw for \$75? Doesn't the buyer take a second look and say, "Wait a minute"?

A. The way the buyer sees it, by the way, is some long part number and it will say, "Screw." It's hard for them to identify what it is and what it's worth. This is somebody who is dealing with thousands of them. The reality is they made a mistake. If you look in hindsight back and say, "Would I pay \$75 for that item?" No. On the other hand, that's what we're trying to train them to do for the future.

Q. Did you return those screws?

A. I don't know whether they have returned any or not. Some of these were purchased some time ago.

Q. Can I follow up? Were these like stainless steel or platinum or titanium? Seriously.

A. I honestly don't know. I mean, as I say, I found out about this yesterday. I haven't personally gone back and looked at any of the parts or anything like that.

We're going to have people go back and look at that to see if there's a story there that we should learn even more from. We learned a lot when we were told about it, when the IG highlighted it to us. We viewed it much more as a question of how do we prevent this from occurring again? Because we have so many purchases, millions of them, we want to make sure that our people understand what they're doing and how to really use marketing pricing the way we do it.

Comparative pricing, look at historic prices, other ways in which you can determine what [is] the right price you should pay. How do you get good value for it? And that's what we focused on when we did the corrective action then, in fact, including going back and negotiating with them. That was the focus we took.

It was very clear that we're paying too much for that item. Once you look at it, I mean, any rational person would say that's paying more than what probably you should pay for it.

And so now the question is, well, why do we do it and what corrective actions can we take so that in the future this doesn't occur? The fact that it was only a couple of cases, that it was pointed out by our system that we had set up for the government to alert people to it, we think there aren't a lot more out there of that type. And that's what we're trying to make sure of.

Q. What makes you think that?

A. Well, just the example that I just gave you. First of all, because we are doing sampling to try to determine it. Secondly, because the way this came about was somebody in the government saying, "This doesn't look right."

And where we've only gotten those two examples, the IG's impression was that this was not a large, big problem. It was our impression it's not a large, big problem. I can't stand here today and guarantee there's

not one more out there either out of 7 million.

Q. Well, you don't know really. Isn't that the truth?

A. No, because the vast majority of these are competed. Over 90 percent of them are competed. In that case, I have total confidence that the market is establishing the right prices. **Q.** General Motors has a purchasing agent who gets a good salary, but if that guy saves a couple of million dollars for General Motors, he's rewarded one way or another. Have you thought about an incentive program like that for people who buy things for the Pentagon, buy far more than the General Motors purchasing agent?

A. We've actually looked at it. Of course, we've looked at it much more though at the high-dollar value, I have to admit, in other words people who are buying a \$2 billion item rather than a \$2 item, in terms of the incentives that we might consider.

We've got some tests and some evaluations under way now to look at what forms of incentives we might be able to introduce. The acquisition work force ... is really doing a very good job of making this transition in an environment in which we've been shrinking the work force significantly ... from '89 until '97. The overall acquisition work force, as part of the consolidation and downsizing that we've been going through in the Defense Department, has shrunk about 42 percent. Now, that's part of the DoD trying to, essentially, do what U.S. world-class corporations have been doing -- downsizing, streamlining and so forth.

So you have two things going on at once. You have this downsizing and streamlining, and then you have the cultural change ... switching from government buying practices into commercial buying practices. We're actually trying to introduce more commercial firms at the same time. We want to take advantage of world-class commercial firms out there that can supply to us, broaden our industrial base, get cheaper stuff, get better stuff and more reliable equipment.

Q.: When you say world class, you mean outside the United States?

A. No. I was thinking of firms such as, well, Hewlett Packard, for example, who hasn't been doing R&D [research and development] business with the Department of Defense because of our cost accounting systems. They don't want to set up a special accounting system.

Well, we're saying if they're a commercial supplier, we have to figure out ways in order to be able to do business with them on more of a commercial basis, because they clearly are a world class company that we want to draw on.

So we want to broaden the defense industrial base. We want to bring in world-class, high-quality -- maybe another way of saying it is commercial suppliers -- take advantage of their price delivery. ...

I should emphasize here that price is not the only big benefit that we gain from this. We gain a huge benefit in delivery time. On these DLA parts that I did this little sample on recently, not only did they save 20 [percent] to 25 percent on the cost, but they had a huge improvement in the delivery time. In other words, the order-to-receipt time averaged 50 percent in one category and about 95 percent in a couple of other categories. And so if you think about that in terms of inventory, we're making a dramatic reduction in inventory. Even if you paid a little more for it to get that faster response, it's worth it just to cut down dramatically on the inventory.

Q. On the measures that you're going to be taking for the future, you've talked about training for your buyers and things of that sort. I'm just curious if there's -- as long as you're going to commercial -- more commercial practices, if it's not likely to be at least some balance to the old idea of buyer beware and get some seller beware in there, as well.

A. Well, that's the point that was made about using your market power in the sense of we won't buy from you if you're not a good supplier.

Q. If I go somewhere and get ripped off, I'm not necessarily going to file lawsuits and have somebody thrown in jail, but I'm not going to go back there again.

A. And in fact, historically, using the old buying practices, essentially we were prohibited from not allowing anyone to bid unless they were in jail. That was kind of the law, and we're trying to shift from the sort of old philosophy of anybody can bid -- open the envelope and the low bidder wins -- to try to have best-value purchases. One of the criteria for best-value purchases is prior performance.

So we are placing much more emphasis now in our procurement practices. Particularly this comes out in the larger programs, but we're also doing it in the smaller ones in spare parts and things like that. We had a program that we instituted where you give 10 percent credit for prior performance on a price comparison.

That's the sort of thing you're talking about, and it makes a lot of sense to be able to evaluate prior performance. It's just like you said. You wouldn't go back to someone who hadn't given you a good product. You wouldn't go back, unless you had to, to somebody who didn't give you a good deal.

Q. Prior performance would apply in the case of somebody who managed to get something past a buyer?

A. Somebody who had given us a price that was not fair or reasonable or someone who gave us a bad product. ... In many cases of these small parts and things like that, I'm much more concerned about getting a poor-quality product. The majority of the scandals that used to take place in the spare parts and that sort of thing were really for low-quality stuff, where somebody would buy a bad bolt or something that was holding an airplane together. ...

So what we need to do is to get good quality at lower cost, and that's what the market forces will provide. And that's why we think that if you can go to best-value, prior-performance, counting for it, go to high-quality commercial suppliers and defense suppliers and use our market power with these people, that's the direction that we're trying to move. And we're trying to do that on the big weapons systems on down to the spare parts.

Now, you're doing that on over \$100 billion a year worth of stuff and millions of procurements every day and lots of people in that system, and a few of them are going to make a mistake, particularly when you first introduce them. I mean, these errors occurred in the '94-'96 time period. DLA at that time had started using some of these buying practices on medicine, on food, on clothing and textiles, where they were getting really significant savings and much, much better response.

So they said, OK, now we'll start shifting and start trying these practices to eliminate all the paperwork, eliminate all the practices. You go back and audit the cost, not the price ... , in the old way and get lots of reports and so forth, almost negotiate item by item single items. They said let's go to more of these commercial practices, negotiate packages with the companies and so forth, on a commercial basis and start to move out on the spare parts types of stuff.

Well, that was about 1995, and these two examples occurred right at that time period. We think that today our people are better trained and that sort of thing isn't going to happen. You might still find one. It wouldn't surprise me. ...

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DEFENSE ISSUES

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