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United States Government Accountability Office
Washington, DC 20548

June 19, 2006

The Honorable John Warner
Chairman
The Honorable Carl Levin
Ranking Minority Member
Committee on Armed Services
United State Senate

The Honorable Duncan L. Hunter
Chairman
The Honorable Ike Skelton
Ranking Minority Member
Committee on Armed Services
House of Representatives

Subject: Defense Management: Attention Is Needed to Improve Oversight of DLA Prime Vendor Program

In fiscal year 2005, prime vendor sales accounted for approximately \$9 billion of the Defense Logistics Agency's (DLA)¹ total sales and service of \$32 billion. Under the prime vendor concept, the Department of Defense (DOD) relies on a distributor of a commercial product line, who provides that product line and incidental services to customers in an assigned region or area of responsibility. Products or services are to be delivered within a specified period of time after order placement. Since 1991, we have identified the use of prime vendors as a best commercial practice for inventory management.² Nonetheless, media reports in October 2005, and a hearing before the House Armed Services Committee on November 9, 2005, raised concerns about the use of the prime vendor concept and the prices that DLA was paying for items acquired through a prime vendor.

The use of prime vendor contracts is governed by the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplement. DLA manages

¹DLA is DOD's largest combat support agency, providing worldwide logistics support in both peacetime and wartime to the military services as well as several civilian agencies and foreign countries.

²GAO, *Defense Inventory: Opportunities Exist to Expand the Use of Defense Logistics Agency Best Practices*, GAO/NSIAD-00-30 (Washington, D.C.: Jan. 26, 2000). A best commercial inventory practice is defined in The National Defense Authorization for Fiscal Year 1998 as a practice that enables the agency to reduce inventory levels and holding costs while improving the responsiveness of the supply system to user needs.

the program and the Director of DLA reports to the Under Secretary of Defense for Acquisition, Technology and Logistics through the Deputy Under Secretary of Defense for Logistics and Materiel Readiness. The Defense Supply Center Philadelphia (DSCP), a field activity of DLA, is the lead center for managing four major commodities: medical materiel; subsistence/garrison feeding; construction and equipment; and clothing and textiles. It is also responsible for managing DOD's prime vendor contracts within those commodities.

In 1992, we identified DOD's contract management as one of our high-risk areas, and it remains so today.³ One of the key reasons the area is high risk is because DOD does not provide adequate oversight over defense contracts. One aspect of oversight is to ensure that the government is obtaining fair and reasonable contract prices through such means as conducting price reviews. In addition, management oversight can also assure that steps are taken to determine that prices agreed to at contract award are fair and reasonable. For the purposes of this report, we are defining a pricing review as either a determination of price reasonableness for items added after the initial contract award, or a postaward verification that any invoiced price is not in excess of the price stipulated in the contract.

Under the authority of the Comptroller General, we initiated a review of DOD's prime vendor concept to determine (1) the extent to which DLA has conducted pricing reviews for items purchased through a prime vendor, and (2) the extent to which DLA has addressed the pricing issues identified at the November 2005 hearing. To accomplish the objectives, we reviewed policies and procedures governing the use of prime vendors and DLA's adherence to those policies and procedures. In addition, we reviewed internal and external assessments of DSCP's procurement management, and prior GAO reports, and we analyzed 16 prime vendor contracts to determine the requirements for conducting pricing reviews. We also analyzed two contracts with a manufacturer and four delivery orders to prime vendors to document the price increase for an aircraft refrigerator. Further, we interviewed DLA and DSCP officials, prime vendors, customers, and a manufacturer. We conducted our review from December 2005 through April 2006 in accordance with generally accepted government auditing standards. Our scope and methodology are discussed in further detail at the end of this report.

Results in Brief

Personnel at the Defense Supply Center Philadelphia did not always conduct pricing reviews for all commodities. The medical materiel and food subsistence commodities' contracting personnel reviewed pricing on a regular basis. However, required price reviews were not being conducted for the food service equipment and construction and equipment commodities. For example, the contracts for food service equipment required verification of price increases, but officials from the supply center were unable to provide documentation on why the price of an aircraft refrigerator increased from \$13,825 in March 2002 to \$32,642 in September 2004. Both logistics agency and supply center officials acknowledged that these problems occurred because management at the agency and supply center level were not providing

³GAO, *Defense Contract Pricing*, GAO/HR-93-8 (Washington, D.C.: Dec. 1, 1992), *High-Risk Series: An Update*, GAO/05-207 (Washington, D.C.: January 2005).

adequate oversight to ensure that contracting personnel were monitoring prices. The lack of pricing reviews on certain commodities has been a continual problem cited in the logistics agency's internal reviews since 2002. Internal reviews of the prime vendor programs conducted in 2002 and 2003 showed that supply center contracting personnel responsible for the food service equipment and construction and equipment commodities failed at times to properly perform price reviews to determine whether the prices charged by the prime vendors were reasonable. The internal reviews found that contracting personnel either did not have knowledge of, or were disregarding contracting rules and regulations with regard to price reviews. As a result, the internal reviews recommended stronger contract management and oversight to ensure that price reviews were conducted. Management at the supply center agreed to take corrective actions to address the 2002 and 2003 reviews. However, issues with the lack of pricing oversight were identified again in a 2005 internal review.

The Defense Logistics Agency has developed corrective actions and has begun to develop a prime vendor contracting policy to address the most recent pricing problems identified in 2005. The agency's recent actions include increasing the number of audits to ensure that the government was not overcharged, revoking some contracting officers' warrants, and establishing additional training for all contracting officers and managers. Some of these corrective actions have resulted in delays in order approval and slowed delivery to some customers. The logistics agency is also in the process of developing a policy to implement regulatory guidance on prime vendor contracting. However, policies and procedures for pricing reviews were in place prior to November 2005, and corrective actions were identified in prior internal reviews. Problems still occurred because of a lack of management oversight by logistics agency and supply center officials to ensure that the policies and procedures were followed and that the corrective actions were implemented. Standards for internal controls in the federal government call for assessing the quality of performance over time and to ensure that the findings of audits and other reviews are promptly resolved.⁴

We are recommending that the Secretary of Defense ensure that the Director of the Defense Logistics Agency provide continual management oversight of the corrective actions to address pricing problems in the agency's prime vendor program. In commenting on a draft of our report, DOD concurred with our recommendation. We discuss DOD's comments and our evaluation of them later in this correspondence.

Background

DOD operates a worldwide supply system, with the vast majority of the items being managed by DLA. A DLA prime vendor arrangement is one in which a distributor of a commercial product line provides those products and related services to all of DLA's customers in an assigned region within a specified period of time after order placement. The prime vendor either provides the product at the cost to the prime vendor to obtain it, or at a price agreed upon in advance with DLA.

⁴GAO, *Standards for Internal Control in the Federal Government*, AIMD-00-21.3.1 (Washington, D.C.: Nov. 1999).

The process for using a prime vendor described below is generic, and different commodities may vary from this process. Under the prime vendor process, a single vendor buys items from a variety of manufacturers and the inventory is stored in commercial warehouses. A customer orders the items from the prime vendor using electronic ordering systems. For some commodities prices are pre-negotiated by DLA as part of the contract award process. The negotiated price includes the prime vendor's handling fee. The prime vendor (or the customer) sends a copy of the order to DSCP. Depending on the commodity, DSCP may need to approve the order before the prime vendor can process it further. Once DSCP approves the order, the prime vendor fills, ships, and tracks the order through final acceptance. The prime vendor then submits an invoice to DSCP, which matches it with the order and receipt from the customer and authorizes the Defense Financial Accounting Service to make payment. DSCP then bills the customer for the cost of the order plus DSCP's cost recovery fee.

DOD awarded its first prime vendor contract in 1993 for pharmaceutical items, such as aspirin and antibiotics. This was followed by a contract for medical supplies, such as syringes and surgical gloves. In 1994, DOD expanded the use of the prime vendor concept to include providing food for military dining facilities. DOD subsequently expanded the use of the prime vendor concept to include construction and equipment as well as clothing and textiles. Since the first contracts were awarded, DLA has refined its use of the prime vendor concept and incorporated changes into successive generations of contracts.

DSCP is responsible for managing prime vendor programs for medical materiel, subsistence, and construction and equipment. Medical materiel includes pharmaceutical and medical/surgical items. Subsistence includes food for troop feeding and food service equipment (products associated with the receipt and storage of food, serving, presentation and preservation of food, and clean up or maintenance). Construction and equipment includes several commodities such as maintenance, repair and operations (MRO),⁵ lumber, and metals. There are no prime vendor contracts for the clothing and textile commodity.

According to DLA, the benefits of prime vendor contracts include improved access to a wide range of high-quality commercial products, rapid and predictable delivery from a single vendor at the time and in the manner most conducive to the customer's needs, and reduced overhead charges. Other benefits of prime vendor contracts include significant reductions in the manpower needed to manage these items at DLA, elimination of any DLA inventory investment, reduction of the infrastructure and related costs associated with warehousing that inventory, and reduced transportation costs via multiple-item prime vendor deliveries to the customer rather than transportation from vendors to the military depots for subsequent transportation to the ultimate customer. In addition, prime vendor contracts provide for surge and broader mobilization capabilities, and worldwide customer support.

⁵The MRO category is further broken out between supplies and services, with separate prime vendor contracts for each.

We have previously identified the use of prime vendors as a best commercial practice for inventory management.⁶ In a series of reports, we reported on the benefits of using a prime vendor for medical and food inventories.⁷

In October 2005, media reports raised concerns that DLA had been overcharged for certain food service equipment items such as ice cube trays, refrigerators, and coffee-makers. The reports resulted in a congressional hearing on November 9, 2005 to discuss DLA's prime vendor program.⁸

Pricing Reviews of Prime Vendor Commodities Were Not Always Conducted

DSCP personnel did not always conduct pricing reviews for all commodities. The medical materiel and food subsistence commodities' contracting personnel reviewed prices on a regular basis. Prices for food service equipment and construction and equipment commodities were not being reviewed for price reasonableness before orders were approved for new items. This lack of oversight was identified by internal DLA reviews, known as procurement management reviews, as early as 2002 and 2003. These reviews found that some prime vendor contracts were not being executed and managed properly and made recommendations that required an increase in management oversight and in some cases, additional training. Even though DSCP management concurred with the recommendations, the problems recurred in the next reviews conducted in 2005.

Some Prime Vendor Programs Review Prices

During the course of our review, we found that contracting officials responsible for medical materiel and food subsistence commodities were routinely reviewing prices. These officials used information systems to track pricing and to flag price increases. For example, the prices for medical materiel and food subsistence items are generally set by national pricing agreements.⁹ Customers order from pre-priced catalogs and the vendor only gets paid the current catalog price. In addition, DSCP uses automated tools to match the prime vendor's sales data with pricing data for pharmaceutical items. For food subsistence items, the contracting officer and customer liaison specialists monitor price changes and audit orders. The electronic ordering system for food subsistence also flags price changes that are more than 10 percent.

Pricing Reviews Were Lacking for Some Commodities

Pricing reviews were lacking for some commodities. In addition to price review concerns, a Defense Contract Management Agency (DCMA) review, conducted

⁶GAO, NSIAD-00-30.

⁷*DOD Medical Inventory: Reductions Can Be Made Through the Use of Commercial Practices* GAO/NSIAD-92-58 (Washington, D.C.: Dec. 5, 1991); *DOD Food Inventory: Using Private Sector Practices Can Reduce Costs and Eliminate Problems*, GAO/NSIAD-93-110 (Washington, D.C.: June 4, 1993).

⁸*House Armed Services Committee Hearing on Prime Vendor Program of Defense Logistics Agency* (Nov. 9, 2005).

⁹A pricing agreement is a manufacturer's or distributor's agreement with DSCP to provide products at a specified price or discount.

between December 2005 to January 2006, found concerns with the evaluation of prices at contract award for food service equipment.¹⁰ Based on our discussions with DLA officials, the first food service equipment vendor contracts awarded in June 1999 used a market basket evaluation tool to help evaluate contract prices before contracts were awarded. A market basket evaluation is a tool used during proposal evaluation that samples a percentage of items anticipated to be purchased in a given commodity to use as a measure of all prices for items offered under contract. The prices of items obtained for the market basket became the baseline price for those items. However, according to the DCMA report and senior DLA officials, DSCP was not sampling a high enough percentage of food service equipment items to make sure that fair and reasonable prices were being paid.¹¹ On average only 18 percent of the first generation food service equipment items were being sampled; for the second generation contracts awarded in June 2005, the average rose to 24 percent. While the sample size for the recompeted food service equipment prime vendor contracts was larger, the DCMA report noted that it was still small compared to the total number of items under the food service equipment contract.

In addition, while the contracting officers were required to document price increases in the contract files for food service equipment, we found that this was not being done. For example, we reviewed contract prices DSCP paid for an aircraft refrigerator and determined that the contract price had increased from \$13,825 in March 2002 to \$32,642 in September 2004. DSCP officials were unable to explain why the price of the aircraft refrigerator had more than doubled during the time period. These officials also stated that there was no documentation in the contract file to support the increase as required. Additionally, the officials could not explain why two different prices were paid for the same aircraft refrigerator on the same date. Specifically, on September 24, 2005, two different orders were awarded with prices of \$32,642 and \$29,975. Senior officials from DLA and DSCP acknowledged that these particular problems resulted from contracting personnel not doing their jobs and from a lack of management oversight.

Since 2002 DLA Internal Reviews Cited Lack of Pricing Reviews

DLA's periodic reviews of its contracting activities identified weaknesses in contract management and execution of some prime vendor contracts that are managed by DSCP. DLA periodically conducts reviews of its contracting activities to improve the operational efficiency and effectiveness of contracting operations and evaluate the integrity of the procurement process.¹² In 2002, DLA conducted an internal review for the Subsistence Directorate, and in 2003, a review of the Construction and Equipment Directorate. These reviews identified weaknesses in contract management and execution as some prime vendor contracts were not being managed properly and

¹⁰Department of Defense Procurement Management, December 12, 2005 – January 25, 2006, Defense Contract Management Agency.

¹¹Items and quantities selected for inclusion in a market basket have not been consistent among the various commodities, according to DLA officials. For example, in subsistence (food and food service equipment), the samples have ranged from a low of 18 percent of the items to be purchased to a high of 75 percent. DLA is currently developing policy that will require that market baskets must represent 75 percent of the anticipated dollar value of the planned acquisition.

¹²These reviews considered whether contracting officials met all requirements of law, executive orders, regulations, and other procedures when contracting for supplies and services for the government.

there was no evidence in the contract file that prices had been reviewed for price reasonableness. These reviews found that the integrity of the procurement process needed to be strengthened in the Subsistence and the Construction and Equipment Directorates.

The 2002 internal review found that oversight of the Subsistence Directorate contract actions needed to be enhanced to better manage the risk associated with subsistence contracting. For example, DLA's review found that the Subsistence Directorate needed to improve its methodology for verifying the prices for food service equipment by expanding the number of pricing reviews being conducted. Specifically, the Directorate allowed food service equipment prime vendors to add new items to the contracts without an up-front price review, relying instead on postaward delivery order price reviews performed by contracting personnel in the buying section. However, DLA's 2002 internal review found that the postaward delivery order price reviews occurred infrequently. For example, in fiscal year 2001, 4,487 orders were issued, of which only 25 to 50 were reviewed. In fiscal year 2002, 4,401 orders were issued. At the time of the 2002 assessment, no price reviews had taken place.

The 2003 internal review of the Construction and Equipment Directorate reported that many of the deficiencies identified revolved around a failure to comply with fundamental contracting requirements that are designed to preserve the integrity of the procurement process. In addition, the review team found pricing problems where purchases were made at unreasonably high prices or contracting personnel failed to perform any price reviews to determine price reasonableness. For example, a sample of 30 items reviewed found that 14 items were priced at least 25 percent over the estimated fair market price and none of the items in the sample had a price reasonableness determination completed at the time of purchase. The report stated, "It appears that these deficiencies stem from the fact that many contracting personnel and several supervisors . . . have not gained the basic skills to execute government contracts or have blatantly disregarded procurement policy and procedures. The situation presents high risks to the Agency and calls for more rigid enforcement of review and oversight."

The 2002 and 2003 reviews made recommendations requiring an increase in price verification reviews, management oversight, and in some cases, additional training. Although DSCP management concurred with the findings and agreed to take the recommended actions, some of the problems recurred in the next DLA review conducted in January and May 2005. For example, this review found that postaward pricing reviews for the food service equipment prime vendor contracts were not being conducted as required. In addition, the 2005 review noted that increased management attention and procurement oversight was needed to eliminate the shortcomings regarding contracting rules and regulations. Specifically, the review found significant deficiencies in the application of fundamental contracting rules in the Construction and Equipment Directorate. The findings related to, among other things, the proper use and exercise of options in that most contract files did not indicate that options had been properly justified prior to the government exercising

them;¹³ compliance with requirements for best value source selection; compliance with requirements for negotiated acquisitions; and compliance with procurement oversight policies and procedures. The review noted that the findings related to the basic principles of contracting and were not symptoms of the complexity of prime vendor contracting.

We found that another factor that could be influencing the lack of pricing reviews in these commodities is the emphasis DLA management has traditionally placed on increasing sales to customers rather than on the prices the prime vendors charge for items. Both the DCMA review and a DLA internal review noted the undue emphasis placed on sales data. DLA senior officials also acknowledged that this could be an issue. As noted in the following section, DLA is changing the metrics it reviews to include pricing as well as sales data.

DLA Is Instituting Corrective Actions and Developing Policy Guidance for Prime Vendor Contracting

DLA has developed corrective actions and has begun to implement some of these corrective actions such as increasing the number of audits and establishing additional training requirements for contracting officers and managers. However, some of the corrective actions DLA is taking have delayed order approval and delivery times for customers. In addition to the corrective actions it is implementing, DLA is also developing a policy to implement regulatory guidance for prime vendor contracting.

DLA Has Initiated Corrective Actions

Senior DLA officials acknowledged that weaknesses in oversight led to the pricing problems highlighted in the media reports and at the congressional hearing and stated that they are instituting corrective actions. DLA has since conducted internal reviews and requested an external review by the Defense Contract Management Agency, which has been completed.¹⁴ In addition, DLA has requested the Defense Contract Audit Agency to perform audits under the food service equipment prime vendor program, which are expected to be completed by June 2006. As a result of the completed reviews, since December 2005 DLA has initiated several actions aimed at strengthening oversight, such as modifying contracts to change the price verification process and establishing additional training for contracting officers and managers. Because DLA is still in the process of implementing these actions, we did not evaluate them at this time.

We summarized the main findings of the reviews and DLA actions to address these findings in table 1.

¹³FAR 17.207(c) requires that the contracting officer exercise options only after determining that (1) funds are available; (2) the requirement covered by the option fulfills an existing government need; (3) the exercise of the option is the most advantageous method of fulfilling that need, price, and other factors considered; and (4) that the option was synopsisized in accordance with FAR Part 5 or properly exempted.

¹⁴*Department of Defense Procurement Management Review*, December 12, 2005 – January 25, 2006, Defense Contract Management Agency.

Table 1: Summary of Main DLA and DCMA Findings and DLA Actions

Finding/observation	DLA actions
Lack of management oversight.	- Monthly briefings to DSCP Command on pricing reviews and audits. - Annual procurement management reviews on prime vendor contracts. - All prime vendor contracts will be approved by DLA headquarters. - Reorganizing the Procurement Directorate to provide more independent oversight of the supply chains.
Inadequate pricing reviews being conducted.	- Ensuring prime vendor contracts comply with an established prime vendor pricing model. - Contracting officers documenting fair and reasonableness price determinations for orders over certain thresholds. - Increasing the number of audits to ensure the government was not overcharged. - Modifying contracts to change the price verification process. - Requesting a price audit by DCAA.
Lack of knowledge or skills of contracting personnel, or a disregard for the contracting rules and regulations.	- Establishing additional training for contracting officers and managers. - Reorganizing the Subsistence Directorate and revoking some contracting officers' warrants.
Management metrics may be too narrowly focused on sales, fill rates and customer satisfaction.	Acquisition management metrics developed with a Monthly Command review. Now look at price as well as sales.
Prime vendor concept may not be suitable for all commodities.	Adjusting acquisition strategies to reassign programs to best procurement approach.^a

Source: GAO analysis of DLA and DCMA data.

^aFor example, DLA has evaluated the acquisition of food service equipment and has determined not to continue acquiring food service equipment through a prime vendor. A new acquisition strategy is under development that will require the development of a contractual relationship primarily with manufacturers or their representatives for equipment and incidental services.

Based on the Standards for Internal Controls in the Federal Government, a key internal control element is the monitoring of the quality and performance over time and ensuring that the findings of audits and other reviews are promptly resolved.¹⁵ Internal control should generally be designed to assure that ongoing monitoring occurs in the course of normal operations, is performed continually, and is ingrained in the agency's operations. It includes regular management and supervisory activities, comparisons, reconciliations, and other actions people take in performing their duties. However, DLA officials have acknowledged that a lack of management oversight led to the pricing problems noted in 2002, 2003, and again in 2005.

¹⁵GAO/AIMD-00-21.3.1.

DLA's Corrective Actions Have Resulted in Delays for Some Customers

The requirements for additional price verification and approval implemented by DSCP have resulted in delays in order approval and slowed delivery to some customers and resulted in additional resource requirements for DSCP. The delays and additional requirements have already led to some refinements being made in the verification requirements. For example, in January 2006, the maintenance, repair and operations (MRO)-Supplies commodity within the Construction and Equipment Directorate was initially required to perform a fair and reasonable price determination on all orders over \$2,500 before the prime vendor could process the order. The average number of orders with a value of more than \$2,500 received each month for this commodity is about 40,000, and each order contains, on average, 5 line items. Thus, the average number of lines that required price determinations was approximately 200,000 per month. All orders under \$2,500 were to be reviewed by a statistical sample on a post-order basis. To assist in fulfilling this requirement, 12 staff have been added since January 2006. In spite of the additional staff, the turnaround time to complete an order has risen from around 2 days to about 10, as approximately 8 days are required to perform the price determination. According to a manager in the Construction and Equipment Directorate, some customers are pulling back from using the prime vendor because of the delay. Some prime vendors have also reported a decrease in sales.

Because of the delay and increase in resource requirements, the criteria for performing the fair and reasonable price determination were refined in February 2006. MRO-Supplies management changed its policy of reviewing every order of \$2,500 or more for a fair and reasonable price determination prior to the prime vendor processing the order to reviewing 30 percent of the orders with a value of \$2,500 to \$24,999 on a pre-order basis and the remaining 70 percent done post-order.¹⁶ However, MRO-Supplies is still reviewing all orders with a value greater than \$25,000 prior to the order being processed. In addition, a statistical sample of orders with a value of less than \$2,500 will still be reviewed for a fair and reasonable price, some pre-order and some post-order, whereas previously, the entire sample was reviewed post-order.

DLA is Developing New Policy Guidance for Prime Vendor Contracting

In addition to the corrective actions being carried out, DLA is also developing a policy to implement regulatory guidance for prime vendor contracting. According to a DLA acquisition official, the policy will also establish the basis for lessons learned from the reviews of prime vendor programs. Key points of the policy include: specific requirements for management oversight such as pricing and compliance audits; requiring all prime vendor contracts to comply with an established prime vendor pricing model; annual procurement management reviews for all prime vendor contracts; and requiring advance approval by headquarters for all prime vendor contracts, regardless of dollar value. Because this policy was still in draft form at the time of our review, we did not evaluate it.

¹⁶We note that the FAR generally requires a price determination on orders over \$2,500 – FAR 2.101, FAR 13.106-3 and FAR 16.505(b)(3).

Conclusions

The prime vendor concept can be a useful approach to acquiring commercial goods and services, reducing delivery times, and decreasing the need for and costs of maintaining government inventory, but until DOD's prime vendor program receives the level of oversight it has been lacking, it remains vulnerable to the systemic pricing problems that have plagued it in the past. DLA's 2002 and 2003 internal reviews recommended corrective actions and DLA officials agreed to implement changes to better oversee prices. However, these changes, which included policies and procedures for pricing reviews, failed to prevent the problems highlighted in October and November 2005 because of a lack of management oversight by both logistics agency and supply center officials. Therefore, the new actions DLA is taking may not be effective until DLA provides the continual oversight which has been lacking.

Recommendation

We recommend that the Secretary of Defense direct the Undersecretary of Defense, Acquisition, Technology and Logistics to ensure that the Director of the Defense Logistics Agency provide continual management oversight of the corrective actions to address pricing problems in the prime vendor program.

Agency Comments and Our Evaluation

In written comments on a draft of this report, the Deputy Under Secretary of Defense for Logistics and Materiel Readiness, which is responsible for DLA oversight, concurred with our recommendation and identified corrective actions already being taken by DLA. DOD noted that DLA is committed to implementing the corrective actions and has assigned additional resources to oversee prime vendor contracts. In addition, the department stated that DLA will continue to monitor prime vendor programs to ensure the actions taken will produce the intended results. We noted that DOD's comments did not address what actions the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics would take to ensure that DLA will provide continual management oversight and contacted the office to clarify its role in overseeing DLA's corrective actions. We were told by a senior official from the Under Secretary's office that the office of the Deputy Under Secretary of Defense for Logistics and Materiel Readiness will review the implementation of the corrective actions in its regular management meetings with DLA. The written comments from the Deputy Under Secretary of Defense for Logistics and Materiel Readiness are included in enclosure 1 of this correspondence.

Scope and Methodology

To determine the extent of pricing reviews conducted by DLA for items purchased through a prime vendor, we analyzed 16 prime vendor contracts (10 food service, 1 subsistence, and 5 maintenance, repair and operation), two contracts with the manufacturer of an aircraft refrigerator and four delivery orders to prime vendors for the same refrigerator to determine pricing control and audit requirements, and reviewed internal and external assessments of DLA's procurement management. In addition, we reviewed policies and procedures governing the use of prime vendors

and prior GAO reports on the subject. Further, we discussed the mechanisms used to monitor price with DLA and DSCP officials; prime vendors located in Columbia and Lexington, South Carolina; customers located at Fort Jackson, South Carolina, and Fort Stewart, Georgia; a Naval Sea Systems Command official in Philadelphia, Pennsylvania; and a manufacturer located in Philadelphia, Pennsylvania.

To determine the extent to which DLA has addressed the pricing issues identified at the November 2005 hearing we discussed with DSCP and DLA officials their ongoing and planned actions to rectify the management oversight weaknesses identified within the DSCP prime vendor programs and the changes and adjustments made to prime vendor contracts since they were first awarded. We also discussed with DCMA and DCAA the prime vendor contract and pricing reviews those agencies were conducting at DLA's request. Finally, we discussed the impacts of DLA's corrective actions with DSCP officials and with prime vendors located in Columbia and Lexington, South Carolina.

We conducted our review from December 2005 through April 2006 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Undersecretary of Defense, Acquisition, Technology and Logistics; the Deputy Undersecretary of Defense for Logistics and Materiel Readiness; the Director, Defense Logistics Agency; and interested congressional committees. We will also make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

Please contact me at (202) 512-8365 or solisw@gao.gov if you or your staff have any questions concerning this report. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report were Marilyn Wasleski, Assistant Director; Vijay J. Barnabas; John Clary; Susan Ditto; Aaron Kaminsky; and Kenneth Patton.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'W. Solis', with a large, stylized loop at the end.

William M. Solis, Director
Defense Capabilities and Management

Enclosure

Enclosure

Comments from the Department of Defense



DEPUTY UNDER SECRETARY OF DEFENSE FOR
LOGISTICS AND MATERIEL READINESS
3500 DEFENSE PENTAGON
WASHINGTON, DC 20301-3500

June 5, 2006

Mr. William Solis
Director, Defense Capabilities and Management
U.S. Government Accountability Office
Washington, DC 20548

Dear Mr. Solis:

This is the Department of Defense (DoD) response to the GAO draft report GAO-06-739R, "DEFENSE MANAGEMENT: Attention is Needed to Improve Oversight of DLA Prime Vendor Program," dated May 24, 2006 (GAO Code 350789). The GAO draft report acknowledges that the DLA is developing corrective actions to address the prime vendor pricing problems identified in November 2005 testimony but recommends that continual management oversight of the corrective actions is needed to ensure the problems do not continue. The DoD concurs with the recommendation and identifies actions already being taken by DLA.

Detailed comments on the draft report recommendation are included in the enclosure. The DoD appreciates the opportunity to comment on the draft report.


Jack Bell

Enclosure:
As stated



**GAO DRAFT REPORT - DATED MAY 24, 2006
GAO CODE 350789/GAO-06-739R**

“DEFENSE MANAGEMENT: Attention Is Needed to Improve Oversight of DLA Prime Vendor Program”

**DEPARTMENT OF DEFENSE COMMENTS
TO THE RECOMMENDATIONS**

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense direct the Under Secretary of Defense for Acquisition, Technology, and Logistics to ensure that the Director of the Defense Logistics Agency (DLA) provide continual management oversight of the corrective actions to address pricing problems in the prime vendor program. (Page 16/GAO Draft Report)

DOD RESPONSE: Concur. After a November 2005, House Armed Services Committee hearing regarding pricing inconsistencies in DLA’s food service equipment prime vendor program, DLA initiated an extensive internal review of the prime vendor process. DLA also engaged the Defense Contract Management Agency and Defense Contract Audit Agency to conduct additional reviews of the prime vendor program. Although the reviews indicate that a vast majority of prime vendor program expenditures are supporting the war fighter as intended, some vulnerabilities in business practices were identified and immediate corrective actions were taken. Processes are in place and have been reinforced to provide proper planning, execution, and aggressive oversight for all DLA prime vendor contracts. Improvements include assigning additional resources and increased emphasis on post award administration of these contracts. To ensure only fair and reasonable prices are paid, DLA has established agency standards for prime vendor pricing methodologies, a thorough review regime, and recurring audit procedures.

All DLA acquisition and logistics personnel clearly understand priorities of customer support through appropriate acquisition strategies. In some cases, acquisition strategies have been adjusted to reassign programs to the best procurement approach. In addition, individual actions were taken to assign accountability for the issues raised with the food service equipment prime vendor program. DLA will continue to monitor prime vendor programs to ensure actions taken to date produce the intended results. Additional adjustments to prime vendor practices and procedures may be made as required to ensure the integrity of the programs. DLA is committed to ensuring that the prime vendor program continues to be a best business practice supporting the warfighter and will provide continual management oversight as recommended.

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