June 20, 2002

Supply Inventory Management

Industrial Prime Vendor Program at the Air Force Air Logistics Centers
(D-2002-112)

This special version of the Report has been revised to omit data considered "Science Applications International Corporation Proprietary."

Department of Defense
Office of the Inspector General

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Acronyms

ALC	Air Logistics Center
DLA	Defense Logistics Agency
DSCP	Defense Supply Center Philadelphia
DVD	Direct Vendor Delivery
FSC	Federal Supply Class
IPV	Industrial Prime Vendor
NSN	National Stock Number
SAIC	Science Applications International Corporation
SUP	Standard Unit Price

INSPECTOR GENERAL
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June 20, 2002

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Report on the Industrial Prime Vendor Program at the Air Force Air Logistics Centers (Report No. D-2002-112)

We are providing this report for information and use. This report is one in a series involving commercial and noncommercial pricing of spare parts and other logistics support initiatives. We considered management comments on a draft of this report when preparing the final report.

Management comments on the draft report conform to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Henry F. Kleinknecht at (703) 604-9324 (DSN 664-9324) or Mr. Patrick J. Nix at (703) 604-9332 (DSN 664-9332). A version of this report without protected information is being prepared for release outside the Government. See Appendix E for the report distribution. The team members are listed inside the back cover.

David K. Steensma

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Acting Assistant Inspector General
for Auditing

Office of the Inspector General of the Department of Defense

Report No. D-2002-112 **June 20, 2002**
(Project No. D2001CF-0091.000)

Industrial Prime Vendor Program at the Air Force Air Logistics Centers

Executive Summary

Who Should Read This Report and Why? The report should be of particular interest to senior acquisition, logistics, and supply managers of defense inventory because it concerns a new logistics support initiative for bench-stock material.

Background. This report is one in a series involving the pricing of commercial and noncommercial spare parts and other logistics support initiatives. This report addresses bench-stock material (screws, bolts, rivets, etc.) and logistics support procured from Science Applications International Corporation (SAIC) under the Industrial Prime Vendor (IPV) Program to support Air Force air logistics centers.

The Defense Supply Center Philadelphia initiated the IPV Program in July 1998 as a test or demonstration program to explore innovative logistics solutions for providing spare parts used in maintenance, repair, and overhaul facilities. The IPV Program is a customer-oriented, supply-chain management initiative that transfers complete responsibility for bench-stock material to a third-party vendor. The primary customers covered under the demonstration program are Navy depots and Air Force air logistics centers. FY 2002 budget figures show overall bench-stock sales of about $296.5 million, which includes the IPV stock sales of about $42 million. The Defense Supply Center Philadelphia awarded the IPV contract (SP0500-00-D-BP02) to SAIC on January 24, 2000, to support Air Force air logistics centers. The contract was valued at about $40 million annually, with approximately $34 million in material costs and $6 million in annual distribution (infrastructure) costs. SAIC is responsible for purchasing bench stock and maintaining the stock bins. [redacted]

Results. The Defense Supply Center Philadelphia IPV contract with SAIC has provided structure and improved availability of bench-stock material at the Air Force air logistics centers; however, the increased costs associated with these improved services and other problems with the existing program need to be addressed. Problems include not placing sufficient bench-stock material on contract economically to offset additional personnel costs and not using existing depot inventories. As a result, the IPV Program uses 55 additional personnel to manage bench-stock material at a cost of $4.6 million and will not make use of almost $9 million of available inventory in Defense depots to satisfy program requirements over the next 3 years. In addition, the current IPV Program was not designed to address problems with the supply

infrastructure, contracting methods, administrative lead times, inventory investment, and cost recovery rates associated with most of DoD bench-stock material business. The Defense Supply Center Philadelphia is working to revise its concept for the IPV Program (finding A).

The Defense Supply Center Philadelphia did not validate the accuracy of pricing data prior to authorizing spot buy procurements. As a result, SAIC erroneously charged the air logistics centers $79,698 on spot buy invoices. Similar conditions were reported at Naval Aviation Depot, North Island in Inspector General of the Department of Defense Report No. D-2001-072, and Naval Aviation Depot, Cherry Point in Inspector General of the Department of Defense, Report No. D-2001-171 (finding B).

Management Comments and Audit Response. The Defense Logistics Agency agreed to reengineer its market basket pricing process and supply items from the "best value" source, to include from existing Defense Logistics Agency inventory. The Agency also plans to remove items already priced and on contract where the savings derived by using existing inventory to fill demand exceeds the costs to delete the items. The Agency agreed to establish an integrated process team and develop a reengineered approach to the IPV Program that will address the issues identified such as pricing, inventory investment, competition, contract bundling, and other contracting issues. The Agency agreed to refund air logistics centers an appropriate amount of overcharges and implement procedures to prevent erroneous billings on future spot buy invoices.

The Air Force commented that the IPV Program was a test and included several features that would be inappropriate in a permanent program. The Air Force stated the intent of the program was to improve customer support by using commercial sources for supplying depot repair material. The Air Force considers the IPV test program a success and stated that the IPV contractor had improved parts availability and made progress towards using commercial sources for supplying depot repair material at a very modest additional cost.

The audit recognized that the IPV Program was a test initiated to explore a new and innovative logistics solution for providing consumable items; however, the success of the program has yet to be determined. The majority of the items supplied under the contract were from the Defense Logistics Agency depot system and only 53 percent of the items on contract had been priced. In addition, only about half of the priced items on contract had been purchased and supplied by the IPV contractor. See the Management Comments section for the complete text of the management comments.

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Background

Spare Parts Audits. This report is one in a series involving prices paid for commercial and noncommercial spare parts. The report addresses bench-stock material and logistics support procured from Science Applications International Corporation (SAIC) under the Industrial Prime Vendor (IPV) Program. Table 1 shows items included in bench-stock material and their Federal supply classes (FSCs).

Table 1. Bench-Stock Material and Federal Supply Classes

Material	FSCs
Gaskets and packing	5330, 5331
Nuts and washers	5310
Screws, bolts, and studs	5305, 5306, 5307
Nails, pins, and rivets	5315, 5320, 5325

Defense Logistics Agency Overview. The Defense Logistics Agency (DLA) provides supply support and technical and logistics services to DoD, Federal civilian agencies, and selected foreign governments. This support begins with joint planning for parts and support for new weapons systems, extends through production, and concludes with the disposal of material that is obsolete or no longer needed. DLA is headquartered in Ft. Belvoir, Virginia, with field activities worldwide. DLA buys and manages a vast number and variety of items used by all the military Services and Federal civilian agencies, including hardware and electronic items used in the maintenance and repair of equipment and weapons systems. Customers determine their requirements, and one of five DLA supply centers consolidate the requirements and procure supplies in sufficient quantities to meet customers' projected needs. Many procured items are delivered directly from a commercial vendor; other items are stored and distributed through a complex of nationwide depots. This report addresses only the Defense Supply Center Philadelphia (DSCP), which is a troop and general supply inventory control point.

Section 912 Report. Section 912(c) of the FY 1998 National Defense Authorization Act directed the Secretary of Defense to submit to Congress an implementation plan to streamline acquisition organizations, workforce, and infrastructure. In response, the Secretary of Defense prepared a report to Congress, "Actions to Accelerate the Movement to the New Workforce Vision," April 1, 1998. The report included a section that addressed prime vendor contracts.

> **Greatly Expanded Prime Vendor and Virtual Prime Vendor.** As a result of the revolutions in the marketplace - in terms of transportation, manufacturing, and technology - it is no longer necessary for DoD to manage supplies. What DoD needs to do is manage suppliers through programs such as Prime Vendor; and where

> Prime Vendor is not a commercial practice in a particular sector, create a Virtual Prime Vendor which accomplishes the same outcome through the use of technology. This initiative will reduce the number of personnel and the amount of infrastructure we need to support our warfighters. It will also improve delivery of products and services, but will require the acquisition of new skills by our existing workforce.

Demonstration Program. DSCP initiated the IPV Program in July 1998 as a test program to explore innovative logistics solutions for providing maintenance, repair, and overhaul facilities with spare parts. The conceptual goal of the IPV Program was to improve logistics support to service depot maintenance facilities at lower costs by streamlining the logistics pipeline, thus, providing valuable benefits for DoD and warfighters. DSCP approved a justification for other than full and open competition and awarded a limited number of site-specific contracts to evaluate the concept. The program was designed for a 5-year test period. During the 2-year contract base period, material management responsibility was expected to migrate from the Government to the contractor. Total responsibility transfers to the contractor in year three. As performance progressed on initial contracts, metrics would be established to assess the impact on total logistics costs and readiness posture at specific sites.

The DLA maintains its conventional logistics support system concurrently with the new system. Once the new logistics system has been fully tested and determined successful, performance metrics will be refined, and the program will be converted to a fully competitive acquisition environment, targeting consolidated requirements based on common missions and/or weapon systems. At that time, the concurrent system will become redundant and require functional adjustments. DSCP awarded a number of IPV contracts to various contractors to support Defense depots throughout the world. This report addresses only the IPV contract with SAIC for the Air Force Air Logistics Centers (ALCs) at Robins Air Force Base, Georgia; Tinker Air Force Base, Oklahoma; and Hill Air Force Base, Utah. FY 2002 budget figures show overall bench stock sales of about $296.5 million, which includes the IPV bench stock sales of about $42 million.

DSCP awarded the ALC IPV contract (SP0500-00-D-BP02) to SAIC on January 24, 2000. The contract was valued at about $40 million annually, with approximately $34 million in material costs and $6 million in annual distribution (infrastructure) costs. SAIC purchased bench stock to maintain stock bins at or near where depot maintenance was performed. [redacted] In the event that SAIC could not economically purchase an item, contract clauses authorized SAIC to supply the material from DLA stock. SAIC would not earn profit on materials obtained from DLA stock.

Table 2 shows the intended IPV Program benefits.

Table 2. Intended IPV Program Benefits

Reduced	Increased
Logistics response time	Readiness
Customer material costs	Financial accountability
Transactions	Rapid response
Inventory investment	Material availability
Storage, handling, and transportation costs	Opportunities for infrastructure streamlining

Objective

The primary audit objective was to determine whether the DLA IPV Program is being effectively implemented and provides the best value for the Air Force. See Appendix A for a discussion of the scope and methodology, and Appendix B for prior coverage related to the objectives.

A. Industrial Prime Vendor Program

The DSCP IPV contract with SAIC has provided structure and improved availability of bench-stock material at the Air Force ALCs and has permitted DLA to make progress towards shifting to a commercial source for bench stock. Those accomplishments were achieved because SAIC provided additional dedicated resources at the ALCs and negotiated a long-term subcontract [redacted] The subcontract provides direct vendor delivery for 11,434 items with routine delivery within 3 days and requires a 98 percent fill rate[1]. However, there are increased costs associated with these improved services and other problems with the existing IPV Program that need to be addressed. The IPV Program uses [redacted] additional personnel to manage bench-stock material at a cost of $4.6 million annually and will not make use of almost $9 million of available inventory in Defense depots over the next 3 years. In addition, the current IPV Program was not designed to address problems with the supply infrastructure, contracting methods, administrative lead times, inventory investment, and cost recovery rates associated with the majority of the DoD bench-stock material business. DSCP is working to revise its concept for the IPV Program; however, we remain concerned whether the revised concept will correct the program deficiencies.

IPV Program Concept

Streamlining the Logistics Pipeline. DSCP has promoted the IPV Program as a model for DoD procurement and logistics support. DSCP designed the IPV Program to streamline the logistics pipeline by transferring procurement and logistics support requirements for bench-stock material from DSCP to SAIC (see Figure 1). SAIC is responsible for ordering, purchasing, receiving, stocking, and billing for bench-stock material. The SAIC purchasing department and SAIC on-site employees at the ALCs accomplish these contract requirements. The IPV concept calls for SAIC to serve as an integrator and establish contracts with manufacturers that would ship the bench-stock parts directly to the ALCs (direct vendor delivery). DSCP believed that SAIC could supply parts better, cheaper, and faster by taking advantage of the commercial supply chain instead of the DLA supply system.

[1]A fill rate of 98 percent is attained if the part is physically in the bin 98 percent of the time when the mechanic requests the part. In addition, if the part is not in the bin at the time of the mechanic request, the IPV contractor is allowed 24 hours to obtain the needed part from another bin or receive additional parts.

Figure 1 shows the DSCP purchasing model for the IPV Program.

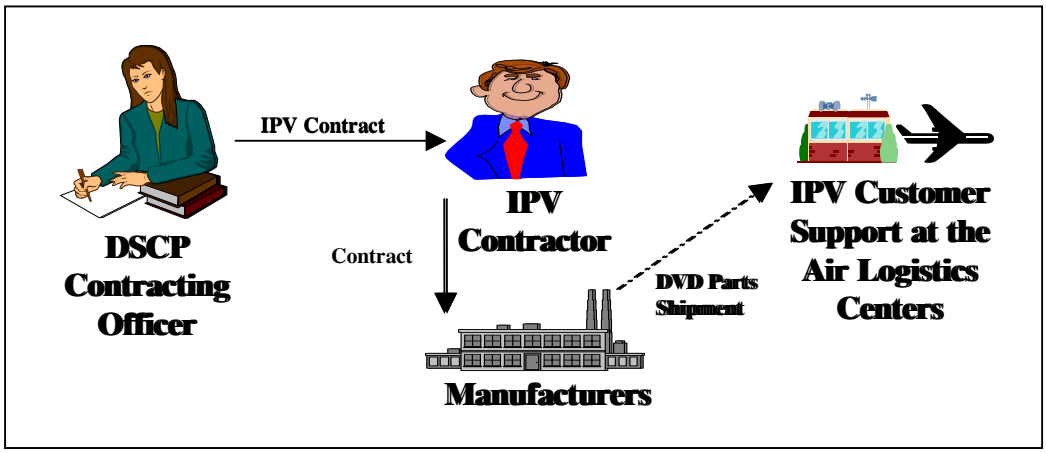

Figure 1. DSCP Model for the IPV Program

Placing Material on the IPV Contract at Economical Prices. The basic concept for placing material on the IPV contract at economical prices was that SAIC unit prices for bench-stock parts supplied through the commercial supply chain could not exceed 80 percent of the DLA standard unit price (SUP). The SUP is the price DLA charged its customers. The SUP was derived from the mean acquisition unit cost (the actual price DLA paid for items) and included the cost recovery rate charged by the supply center responsible for managing the item. The cost recovery rate recouped supply center operations costs, depot costs, corporate costs and other miscellaneous costs. For example, if DSCP purchased an item for $100 and its cost recovery rate was 50 percent, the DLA customer paid $150 (the SUP).

Reasonable Cost Goal. SAIC needed to obtain the item for no more than 80 percent of the SUP for an item to be included on the IPV contract within a reasonable cost goal. For example, if the DLA SUP for an item was $150, SAIC would have to provide the items for $120 ($150 x 80 percent) or less to be included on the contract. [redacted] DSCP then added a 5.7 percent special cost recovery rate for the IPV Program. In theory, if sufficient items had been included on the IPV contract, SAIC profit and infrastructure and the DSCP surcharge would have been offset by the 20 percent difference in material from the DLA SUP. Items included on the IPV contract at prices higher than 80 percent of the SUP would cost the Government more than if the items were provided from the DLA supply system.

Bench-Stock Material for the ALCs

The DSCP industrial prime vendor contract with SAIC has provided structure and improved availability of bench-stock material at the Air Force ALCs and

made progress transitioning to a commercial source for bench stock. Those accomplishments were achieved because SAIC employed dedicated staff at the centers, implemented an innovative bench-stock management process, and negotiated a long-term direct vendor delivery subcontract with a single commercial supplier. In fact, the subcontract supports 11,434 items and requires a 98 percent fill rate with routine delivery within 3 days.

Improved Parts Availability. Although comparable data on parts availability prior to the IPV Program is not available, evidence indicates that the IPV Program at the ALCs has increased parts availability. Again, although difficult to measure, increased parts availability can only have a positive impact on repair work performed at the ALCs. SAIC provided dedicated staff at each ALC and implemented an innovative process that significantly changed how bench-stock items were managed. SAIC uses pre-expended bins[2] to manage ALC bench stock, and SAIC employees check bin stock levels daily. When a bin is half full or less, a SAIC employee scans a bar code on the bin, which places an order for the part immediately. Bench-stock shipments are received by SAIC at a central staging area and are reconciled against the shipping documents. The material is also randomly compared to material requisitions and checked for quality. The parts are then scanned into the SAIC material management system as "received" and placed into a bin for delivery. Trucks make parts deliveries to the ALCs twice a day. All parts are warranted for 1 year, once the part is placed in the bench stock bin.

Bin fill rates are calculated by multiplying the total number of bins supported by the number of days in the month and then subtracting the cumulative total number of bins found empty each day for the month. The result of that calculation is then divided by the total number of bins supported multiplied by the number of days in the month. Table 3 shows bin fill rates by each ALC for April 2001.

Table 3. ALC Bin Fill Rates (April 2001)

ALC	Total Bins Supported	Cumulative Empty Bin Count	Fill Rate Percent
Warner Robins	51,681	19,323	98.8
Ogden	20,889	1,004	99.8
Oklahoma City	32,056	3,265	99.7
Total	**104,626**	**23,592**	**99.2**

[2]Pre-expended bins, also called bench stock, consist of spare parts and industrial hardware stored near or at the point of use, which mechanics employ in the maintenance, overhaul, and repair of aviation and related weapons systems.

Transitioning to Commercial Supply Source. DSCP made progress using the IPV contract to shift to using a commercial source to supply the ALCs bench stock. [redacted] As of April 2001, SAIC used its commercial sources to fill 47 percent of the total IPV transactions (line items) and the DLA supply system for the remaining 53 percent. Total SAIC-supplied sales, including spot buys, amounted to 41 percent ($8,549,470) of the total IPV dollars, while DLA sales were 59 percent ($12,117,787). Figure 2 (transactions) and Figure 3 (dollars) show that from February 2000 through April 2001, the IPV Program progressed toward use of a commercial source of supply for ALC bench-stock supplies.

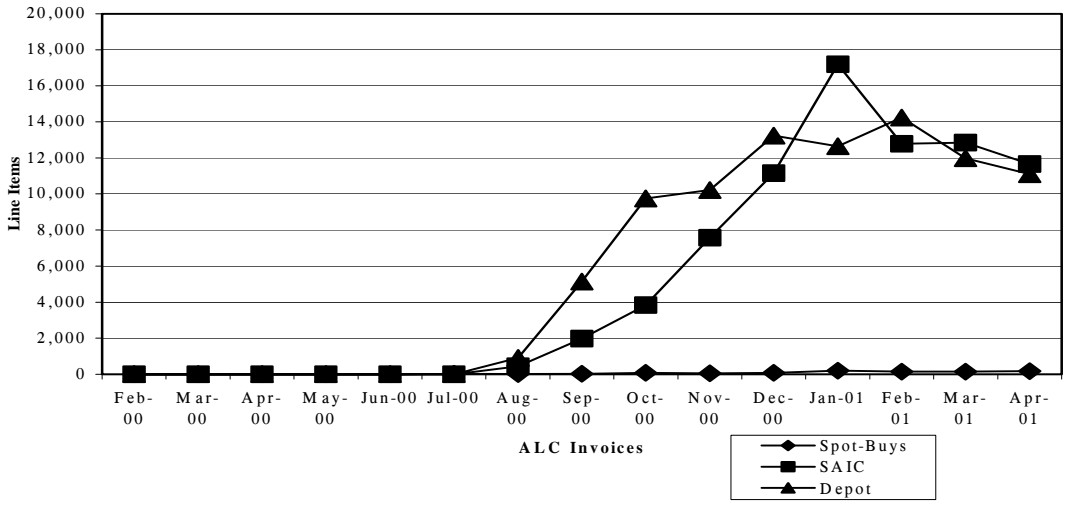

Figure 2. Comparison of IPV and Depot Transactions

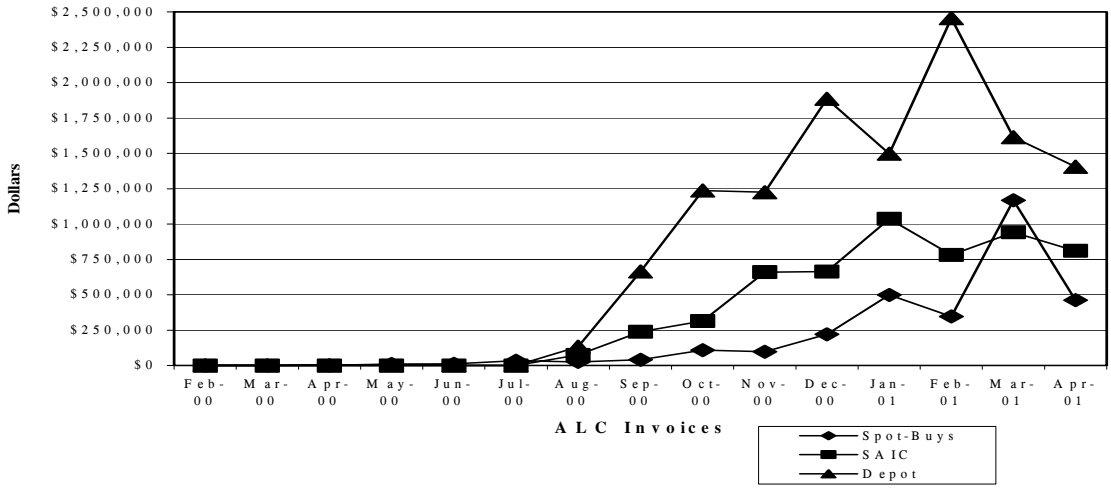

Figure 3. Comparison of IPV and Depot Dollars

IPV Program Costs and Problems

There are increased costs associated with these improved services and other problems associated with the existing IPV Program that need to be addressed. These include increased service costs, placing sufficient bench-stock material on contract at cost-effective prices, and not making use of existing depot inventory.

SAIC Services Costs. The cost of managing bench stock at the ALCs has increased under the IPV Program. DSCP now spends $6.4 million annually for SAIC to supply bench stock to the ALCs versus the $1.8 million it spent prior to implementation of the program (amounts included the cost of fully burdened material handlers, inventory holding costs, equipment, and supervision). Consequently, the improvements that DSCP has achieved in bin management and parts availability are costing DoD an additional $4.6 million. Prior to the IPV contract, the ALCs employed 45 staff to work bench stock. Under the IPV Program, the number of staff working bench stock has increased to 100. See Appendix C for a detailed breakdown of program costs before and after DSCP implemented the IPV Program at the ALCs.

Placing Material on Contract Economically. DSCP has had problems placing material on the IPV contract within established cost goals. As of May 2001, 10,755 of the 20,122 (or 53 percent) items covered by the contract had been priced and placed on contract. The median value[3] of the 10,755 priced items[4]

[3]The median value is the middle percentage of the entire population.

[4]Actual calculations were based on either 10,666 or 10,706 items because data was not available for all items.

was 144.1 percent of the mean unit acquisition cost and 87.9 percent of the FY 01 SUP. Approximately half of the priced items had been purchased (5,328) from SAIC by the end of April 2001. The median value of purchased items[5] was 143.3 percent of the mean unit acquisition cost and 86.3 percent of the FY 2001 SUP.

Market Baskets. DSCP used market baskets or groups of items to place material on the IPV contract. The use of this market basket approach meant that some items could be higher than 80 percent of the SUP while others were lower; but cumulatively, the total cost of the baskets could not exceed 80 percent of the SUP. SAIC submitted groups of items (with expected demand quantities) to DSCP for approval. DSCP added items to the contract without regard to individual unit prices if the market baskets met the 80 percent criteria. SAIC used the DLA supply system (without earning a profit) for those items that were not procurable within the 80 percent SUP threshold or were never placed on contract because they caused the market baskets to exceed 80 percent of the SUP.

Problems with the Market Basket Approach. Contract prices overall appeared to be within the contract cost goal of 80 percent of SUP. However, the DSCP market baskets used inaccurate 2-year demand estimates based on significantly different quantities for the market basket comparisons for a number of bench-stock items that were placed on the contract. For example, the market basket that added turnlock fastener receptacles (national stock number [NSN] 5325-00-326-5341) compared the SUPs resulting from procurements to satisfy two vastly different estimates of demand. In August 1995, DLA purchased 50 turnlock fastener receptacles for $42.74 each. The DLA SUP resulting from that procurement was $74.75. When the receptacles were added to the IPV contract, the market basket compared that SUP to a $6.75 per each receptacle price (11 times lower than the last DLA SUP) that resulted from a SAIC procurement to meet a 2-year estimated demand of 36,000 for the ALCs. DLA has never purchased more than 2,500 receptacles in a year. In fact, to date, not a single receptacle has been purchased under the IPV contract. For market basket comparison purposes, the total IPV contract price was $243,000 (36,000 x $6.75) versus a DLA SUP total price of $2,691,000 (36,000 x $74.75) or a positive market basket variance for the IPV Program of $2,448,000.

In another example, the market basket that added screw caps (NSN 5305-00-724-7218) to the contract compared the SUPs that resulted from procurements to satisfy two vastly different estimates of demand. In the first part of 2001, DSCP purchased 11,963 screws caps for $0.18 each. The DLA SUP resulting from that procurement was $0.23. The market basket that added the machine screws to the IPV contract compared that SUP to a $8.32 per each cap price (41 times higher than the last DLA SUP) that resulted from a SAIC procurement to meet a 2-year estimated ALC demand of 34. DLA has never purchased less than 1,200 caps in a year. In fact, to date, no caps have been purchased under the IPV contract. For market basket comparison purposes, the total IPV

[5]Actual calculations were based on either 5,284 or 5,309 items because data was not available for all items.

contract price was $282.88 (34 x $8.32) versus a DLA SUP total price of $6.80 (34 x $0.23) or a negative IPV Program market basket variance of $275.06. Figure 4 shows the range for all of the items purchased under the IPV Program and the number of items that fall within the contract cost objective of 80 percent of SUP. Variations have been capped at 200 percent.

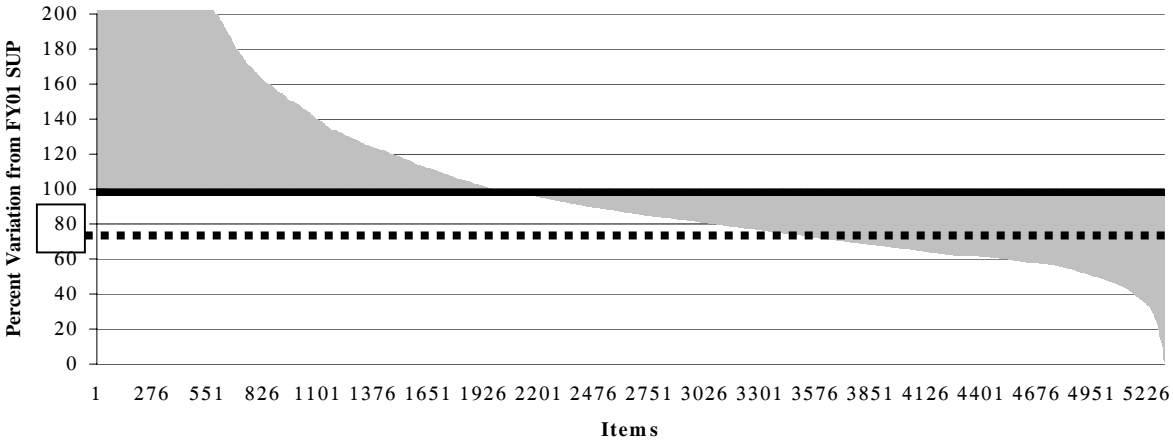

Figure 4. IPV Contract Prices Compared to the FY 01 DLA SUP

The use of unsuitable data, like that described in the previous examples, has caused the SUP comparison for a number of bench-stock items to inappropriately favor the use of the DLA or SAIC supply chains for providing the material to the ALCs. Further, the use of the unsuitable data invalidates the DSCP approach for placing bench-stock material on the contract, as it may have caused a market basket to be incorrectly accepted or rejected. For these reasons, we believe that the market basket approach is not appropriate to determine which parts should be placed on the IPV contract.

DSCP should discontinue use of the market basket approach to determine which parts are placed on the IPV contract. Instead, DSCP should adopt an approach that evaluates each item separately and uses the most cost-effective source of supply to satisfy the ALCs bench-stock requirements. Further, because unsuitable data have been used for placing bench-stock items on contract in the past, DSCP should reevaluate all of the existing IPV items using the new approach.

Using Existing Inventory. The IPV Program at the ALCs did not use existing depot inventory. DSCP added items to the IPV contract without regard to previous depot inventories. As of the 3rd quarter of FY 2001, 4,031 items supported by the IPV contractor have depot inventories in excess of 3 years. For example, close tolerance screws (NSN 5305-01-346-3748) have an annual demand of 2,131. The Defense depots have 47,869 screws on hand, which equates to a 22.5-year supply. DSCP did not need to place the screws on the

IPV contract. In addition, the depots are maintaining inventory for another 602 IPV contract items for which DLA reports no demand. Figure 5 shows that depot inventories could be used to fill IPV demand.

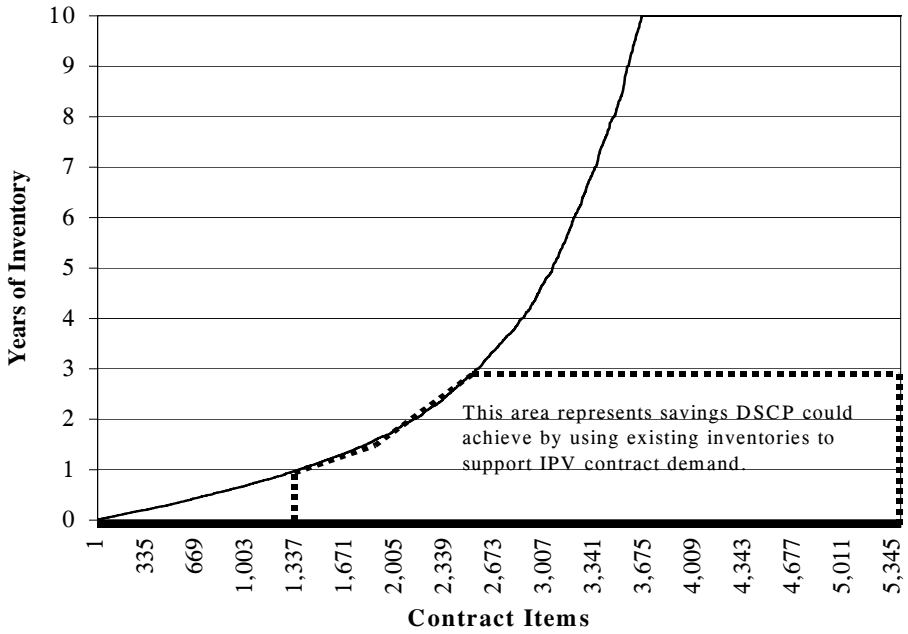

Figure 5. Depot Inventory for Contract Items[6]

DSCP could save $8,966,149 by using existing depot inventories to fill IPV demand for the remainder of the contract. DSCP should review inventory levels and discontinue placing items on the IPV contract with more than 3 years of inventory. DSCP should also take appropriate action in accordance with contract terms to remove items with more than 3 years of inventory and start using existing depot inventories as the first choice to fill contract demand.

Bench-Stock Material Outside the IPV Program

The current IPV Program was not designed to address problems existing with the supply infrastructure, contracting methods, administrative lead times, inventory investment, and cost recovery rates associated with the majority of DoD bench-stock material business.

[6] We removed 2 years of DLA customer demand before calculating the number of years existing inventories would support IPV demand. Further, for presentation purposes, we capped the number of years at 10.

Defense Supply System Infrastructure. The IPV Program has expanded the DLA infrastructure because DSCP, in addition to procuring items on the IPV contract, has to procure the same items for stock to support other non-IPV customers. While the DSCP demonstration program addressed the need for concurrent systems until the proof of the success of direct reliance on industry, the ability of industry to effectively provide bench-stock material to all DLA customers may not be cost-effective. Further, while the ALCs are receiving improved bench stock support, the majority of DLA customers are not supported under the current program.

Figure 6 shows the effect of the IPV Program on the DLA infrastructure, a sharp contrast to the DSCP purchasing model for the IPV Program shown in Figure 1.

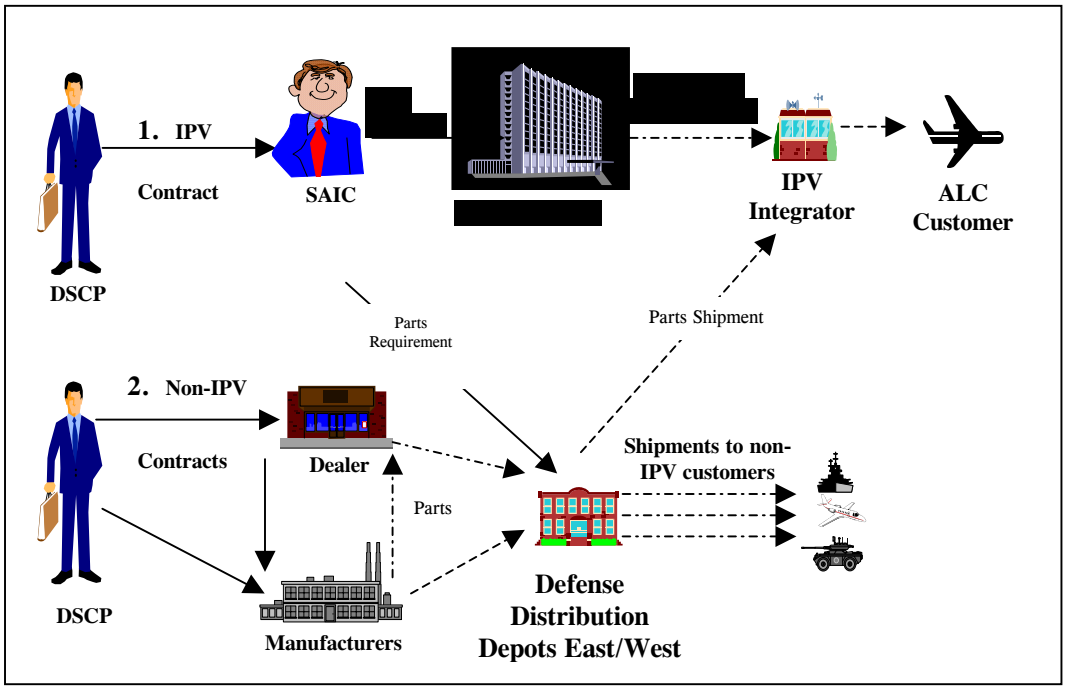

Figure 6. Bench Stock—Managed in Both the IPV and Traditional Programs

Non-IPV Program Contracting Methods. DSCP does not use long-term direct vendor delivery (DVD) contracts [redacted] to provide bench-stock material to non-IPV Program customers. Instead, DSCP issues individual purchase/delivery order contracts and obtains larger quantities of material for stock as needed to support the non-IPV customers through the depots. This approach requires DSCP to perform many more contracting actions, negotiating the price and contract terms order-by-order, which significantly increases the administrative lead times needed for delivery, and thus, the amount of material needed in inventory to cover customer demand. Further, a much larger infrastructure is needed to manage bench stock in this manner.

DSCP attempted to use long-term DVD contracts to provide bench stock in the past. We identified two such contracts that DSCP awarded in 1995, one to Wesco Aircraft and the other to Honeywell HPG. The Wesco Aircraft contract provided for 7-day DVD support for 65 items worth $3.3 million over a 2-year period. The indefinite quantity contract had a 2-year base period with an option to extend the term for an additional 3 years. By having the material shipped directly to the customers, DSCP lowered its depot operations and transaction costs, and thus, the total cost to the customer for those items. However, DSCP did not exercise the 3-year option claiming that Wesco was unable to handle the volume of transactions and was experiencing delivery problems. Although we were unable to obtain a copy of the Honeywell HPG contract, DSCP cited similar problems with it. [redacted]

Administrative Lead Times. As mentioned previously, DSCP still has to perform the same number of contracting actions as it did before the implementation of the IPV Program. In calendar year 2001, DLA awarded contracts for 4,403 of the 10,755 IPV items. DLA awarded the 4,403 contracts to 528 different sources (manufacturers or dealers) with 3,788 or 86.0 percent awarded to small businesses; 323 or 7.3 percent awarded to large businesses; 255 or 5.8 percent awarded to either small disadvantaged, women-owned small disadvantaged, or women-owned businesses; and the remaining 37 or 0.9 percent awarded to other sources. The IPV Program does not address inefficiencies in the administrative process used by DSCP to satisfy the non-IPV customers' bench-stock material requirements. Table 4 shows administrative lead times for non-IPV customers.

Table 4. Administrative Lead Time for DSCP Non-IPV Bench Stock Procurements

FY	Quarter	Items*	Total ALT days	Average ALT	Percent Change
1999	1st	10,591	838,709	79.2	
2000	1st	10,580	786,546	74.3	-6.2
2001	1st	10,573	1,235,712	116.9	47.3
2001	3rd	10,566	1,230,802	116.5	46.7

* Items were excluded because no data were available.

Defense Inventory Investment. The IPV Program has had no effect on reducing defense inventory for bench-stock material. To the contrary, DSCP invests more now in inventory than it did before the IPV Program was

implemented. Figure 7 shows that the investment in inventory held at the depots to meet non-IPV customer demand has steadily increased, from $66.7 million in FY 1999 to $75.7 million in FY 2001, for the 10,755 items on the IPV contract.

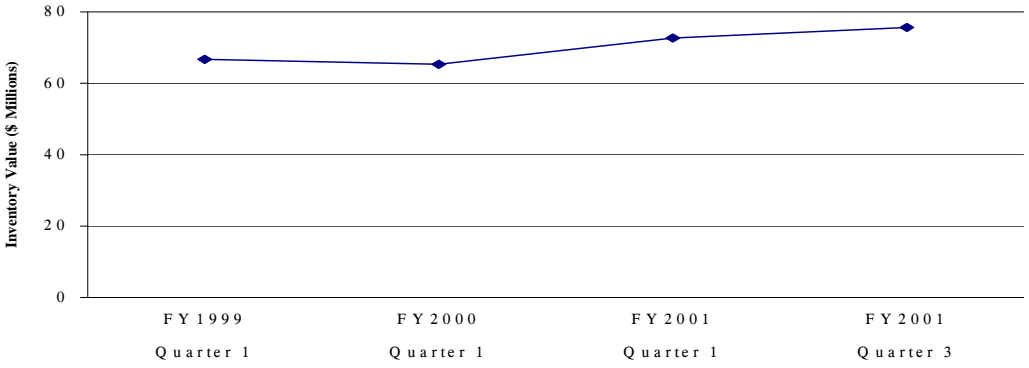

Figure 7. DLA Bench-Stock Material Inventory is Trending Up

Conventional Bench Stock Cost Recovery Rates. The IPV Program has increased the cost recovery rate non-IPV customers pay on bench stock. As stated previously, the amount DLA charges customers for bench stock is derived from the cost of material plus a cost recovery rate which helps recoup the costs incurred to maintain the defense supply infrastructure. As DSCP transfers its best customers' sales to the IPV Program, the conventional bench stock cost recovery rate has increased. Thus the (now smaller) non-IPV Program customer base absorbs the costs associated with managing two systems concurrently.

In FY 2000, DSCP established a separate cost recovery rate for bench-stock items. The new rate of 57.2 percent was significantly higher than the DSCP overall cost recovery rate of 39.8 percent. In FY 2001, DSCP again hiked the cost recovery rate for bench stock to 74.9 percent. The overall cost recovery rate grew to 40.5 percent. In FY 2002, DSCP pulled general hardware and paperless ordering procurement system stocked items out of its cost recovery rate for bench stock. If those were put back into the cost recovery rate for bench stock, the FY 2002 rate would be 64.5 percent, versus 34.2 percent for the overall DSCP cost recovery rate. DSCP officials stated the FY 2002 cost recovery rate is artificially high because the projected budgeted sales were lower than actual sales. DSCP officials believe the actual rate is closer to the FY 2000 cost recovery rate. The use of the artificially high FY 2002 cost recovery rate for market basket comparisons causes items to be placed on the IPV contract at uneconomical prices.

We reviewed the various cost elements of the bench stock cost recovery rates for FYs 2000 through 2002 and determined that the rates did not accurately reflect the costs associated with DSCP managing bench-stock material. Table 5 shows that if costs not directly associated with bench-stock material were removed, and the IPV Program was discontinued, the cost recovery rates for bench-stock material would be 45.3 percent for FY 2000, 49.4 percent for

FY 2001, and 56.2 percent for FY 2002. Table 5 also shows IPV Program sales at $42.1 million—about 14.2 percent of overall bench stock sales of about $296.5 million.

Table 5. DSCP Sales, Cost of Operations, and Cost Recovery Rates ($ millions)

	Overall	Bench Stock*	IPV	Adjusted Bench Stock*	Adjusted Bench stock and IPV
FY 2000					
Sales	$776.6	$250.9	$20.0	$250.9	$270.9
Cost of Operations	$309.0	$143.5	$1.2	$115.6	$122.6
Cost Recovery Rates	39.8%	57.2%	5.7%	46.1%	45.3%
FY 2001					
Sales	$923.0	$245.8	$38.0	$245.8	$283.8
Cost of Operations	$373.6	$184.2	$2.2	$135.4	$140.3
Cost Recovery Rates	40.5%	74.9%	5.7%	55.1%	49.4%
FY 2002					
Sales	$966.6	$85.9	$42.1	$254.4	$296.5
Cost of Operations	$330.7	$55.4	$2.4	$164.1	$166.5
Cost Recovery Rates	34.2%	64.5%	5.7%	64.5%	56.2%

*FY 2000 and 2001 figures include Depot operations, Defense Reutilization and Marketing Service, and other non-bench stock adjustments. FY 2002 figures are artificially high because projected budgeted sales were lower than actual sales figures.

As conventional bench stock sales are transitioned to the IPV Program without corresponding infrastructure cost reductions, the DSCP cost recovery rate for traditional bench stock support increases. For example, if DSCP has bench stock sales of $150 million and costs of $100 million, the bench stock cost recovery rate would be 66.7 percent. If $50 million of sales were transferred to the IPV Program without an infrastructure or cost reduction, non-IPV customers (sales of $100 million) would face a cost recovery rate of 100 percent. Increases in the DSCP cost recovery rates make it difficult to measure the cost effectiveness of the IPV Program. The cost effectiveness of the IPV Program is based on a comparison with conventional prices for bench-stock material. Unfortunately, the comparison with conventional support changes dramatically from year to year with changes in the DSCP cost recovery rate. For example, if DSCP purchases a bench stock item for $1.50, the SUP in FY 2000 would be $2.35 ($1.50 x 1.572[7]), in FY 2001 the SUP would be $2.62 ($1.50 x 1.749), and in FY 2002 the SUP would be $2.47 ($1.50 x 1.645 percent). If the IPV contract price for the item is $1.95, it would exceed 80 percent of the SUP

[7]Cost recovery rate of 57.2 percent plus the cost of the item at 100 percent = 157.2 percent or 1.572 factor.

($2.35 x 80 percent = $1.88) in FY 2000. However, in FYs 2001 and 2002 as the DSCP cost recovery rates increase, the item's contract cost ($1.95) would not exceed 80 percent of the SUP, $2.10 ($2.62 x 80 percent) and $1.98 ($2.47 x 80 percent) respectively. Consequently, as the DSCP cost recovery rate for bench-stock material increases and DSCP becomes less efficient in managing conventional bench-stock material, the IPV Program gives the false appearance of being more cost-effective.

IPV Generation II Program

DSCP is working to change its bench stock management concept for the IPV Program. Under its IPV Generation II Program, DSCP plans to use a best value approach to placing items on contract and consolidate customer requirements beyond its original concept of single sites towards customer groupings. The IPV Generation II prime vendor will manage the various sources of supply (commercial, DLA inventory, strategic sources) to achieve the most cost-effective support for the customer and DLA. For example, where the customer segment is the primary user, the prime vendor procures worldwide demand for all customers. This allows the prime vendor to establish supplier agreements and meet the delivery requirements of the contract, while incurring minimal investment in inventory, therefore passing the cost of the most efficient alternative on to the Government. Additionally, the integrator will have access to DLA arrangements with suppliers for direct supply of items to the integrator/site.

At the IPV sites, the contractor is responsible for full supply chain management (100 percent fill rate) for all of the items covered under the contract, regardless of the source of the item. Where the contractor achieves effective commercial pricing for an item, the contractor is responsible for IPV site requirements and additionally responsible for the acquisition of the item to support worldwide demand. In this scenario, the contractor is not responsible for distribution, only acquisition of the parts. Distribution to the non-IPV customers will be performed through the DLA distribution system. The IPV Generation II Program has not yet been officially approved by DLA headquarters.

We remain concerned about the prime vendor's ability to supply parts as cost effectively as DLA and part manufacturers. In addition, DSCP would pay a premium price to the prime vendor for sending the majority of parts DVD to Defense depots to support other customers. Further, the Generation II IPV concept needs to address depleting existing depot inventory before adding items to the contract or the competition and the bundling of requirements problems that should be resolved before the end of the test period.

Reengineer Bench Stock Management Approach

The IPV Program has successfully demonstrated the advantages of structured bench stock support and long-term DVD contracts. Department goals to reduce administrative lead time and inventory can be accomplished using DVD contracts. However, the IPV Program was never intended to address competition or the bundling of requirements and the IPV Program as implemented at the ALCs is not consistent with the competition statute and regulations. The Competition in Contracting Act of 1984, section 2304, title 10 of the United States Code, establishes the absolute preference for competition by requiring Federal agencies to use competitive procedures for procuring goods or services unless a statutory exception exists. In addition, although not an issue when DSCP awarded the IPV contract to support ALCs, effective July 26, 2000, the Federal Acquisition Regulation prohibits the consolidation of requirements for supplies or services previously performed under separate smaller contracts into a single contract that is likely unsuitable for award to small business concerns (contract bundling) unless measurable substantial benefits can be derived. DSCP received a justification and approval for other than full and open competition granted by the DLA senior Procurement Executive so it could evaluate the IPV concept with a limited number of site-specific contracts over a 5-year test period. Once the program is fully tested and determined successful, the program will be converted to a fully competitive acquisition environment targeting consolidated requirements based on common missions and/or weapon systems.

[redacted] This arrangement denies all other businesses the opportunity to supply bench stock to the ALCs, and could eventually reduce the size of the Defense industrial base. DSCP needs to explain how the IPV Program will satisfy competition requirements and restrictions on contract bundling.

DSCP should develop an approach to managing bench stock that maximizes the use of long-term DVD contracts—a proven commercial practice—with manufacturers and other businesses that will lower administrative lead times and inventory levels. DSCP also needs to use long-term contracts with manufacturers for inventory when it is advantageous to do so. In addition, DSCP needs to ensure compliance with all pertinent acquisition laws and regulations; therefore all bench stock requirements need to be competed and unbundled. Also, DSCP needs to ensure all bench stock customers will benefit from the new approach, not just big business. We believe there could be a more limited role for the IPV integrators focusing mainly on bin management. For example, IPV integrators would be responsible for filling bins with material and re-ordering parts when necessary. In addition, the IPV integrators would be responsible for obtaining spot-buy material. However, the IPV integrators should not be contracting for bench-stock material. We believe DLA should be

solely responsible for the contracting function to ensure fully leveraged buying, adequate support for each item, and compliance with all acquisition guidance. Figure 8 shows how DSCP might support bench stock customers in the future.

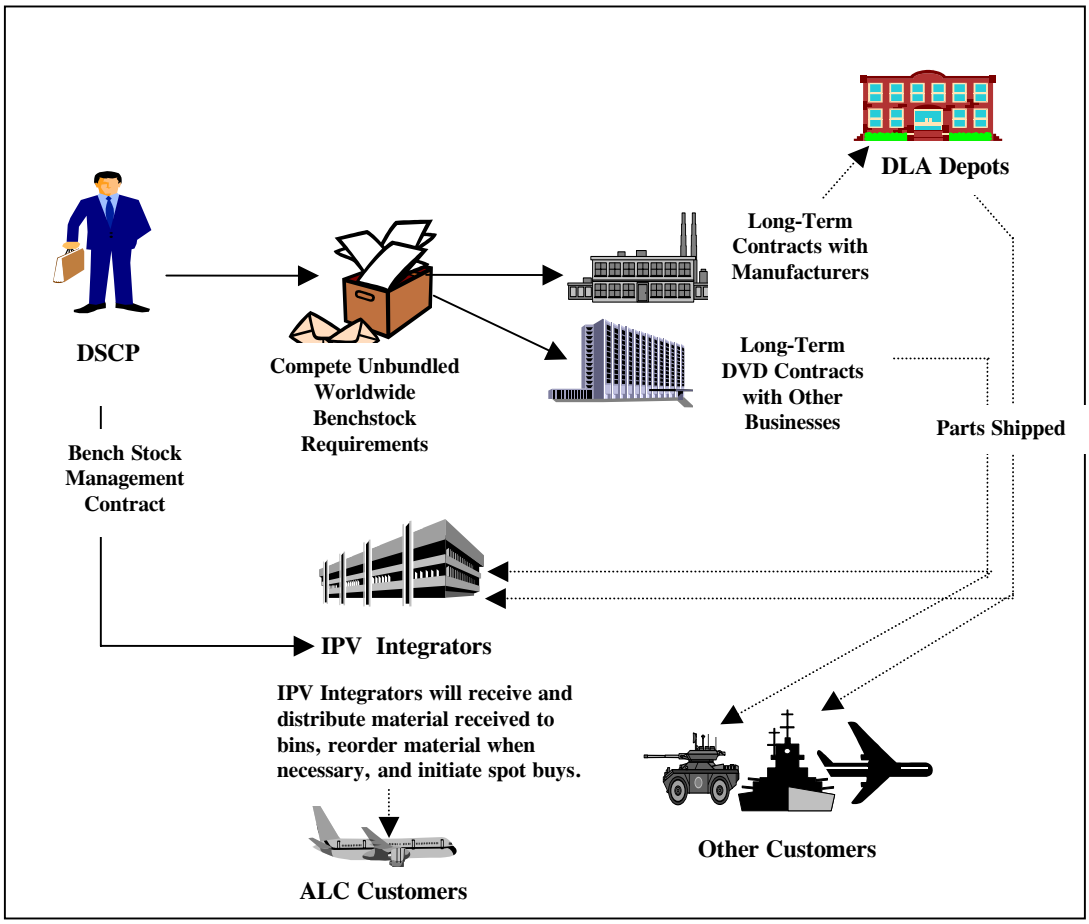

Figure 8. Future of DSCP Bench Stock Management

DLA needs to convene a performance improvement team composed of representatives from all relevant stakeholders, including appropriate oversight agencies, to plan and execute a reengineered best value approach to managing bench-stock material for all customers that addresses competition and restrictions on contract bundling.

Summary

DSCP has promoted the IPV Program for the ALCs as a best commercial business practice–an improved way for DLA to manage suppliers and not supplies. We remain concerned about the DLA overarching goal to shift business practices from managing supplies to managing supplier relationships.

We believe the Defense supply system would be better served if the DLA overarching goal was to become a world class, competitive procurement and logistics support organization in order to provide better, faster, and cheaper support for the warfighter around the world, around the clock.

Management Comments on the Finding and Audit Response

Summaries of management comments on the finding and our audit response are found in Appendix D.

Recommendations, Management Comments, and Audit Response

A.1. We recommend that the Commander, Defense Supply Center Philadelphia require Industrial Prime Vendor Program officials to:

a. Discontinue the use of the market basket approach to determine which bench-stock items are placed on the industrial prime vendor contract. Instead, evaluate each item separately and select the most economical source to supply material.

Management Comments. The Defense Logistics Agency partially concurred with the recommendation, stating that the pricing process—using the market basket approach—had been reengineered. The new process scrutinizes forecasted parts usage in greater detail and employs a pricing algorithm that compares item prices to historical prices. All items whose prices fall outside acceptable limits are rejected and reviewed manually. The new pricing process also will include a sourcing model that will identify and remove items from further commercial pricing actions. Support of those items will be provided from other sources, to include: existing inventory, strategic source alliances, and direct vendor delivery.

Audit Response. Although the Defense Logistics Agency partially concurred, we consider the comments responsive. The modifications the Defense Supply Center Philadelphia made to its pricing process meets the intent of the recommendation. Thus, no additional comments are required.

b. Review inventory levels and discontinue placing items on the industrial prime vendor contract with more than 3 years of inventory.

Management Comments. The Defense Logistics Agency partially concurred and stated that its new pricing process will include a sourcing model that will identify and cause items to be supplied by the "best value" source, including from existing Defense Logistics Agency inventory.

Audit Response. The Defense Logistics Agency comments were responsive. The modifications the Defense Supply Center Philadelphia made to its pricing process meets the intent of the recommendation.

c. Take appropriate action in accordance with contract terms to remove items with more than 3 years of inventory and start using existing depot inventories as the first choice to fill contract demand.

Management Comments. The Defense Logistics Agency partially concurred and stated that the successful performance by the Industrial Prime Vendor Program contractor and a favorable cost study resulted in the Air Force approving full implementation of the Industrial Prime Vendor Program at the air logistics centers. Further, a plan was being developed to deplete existing inventory and remove items already priced and on contract where the savings exceeded the costs incurred to delete the items.

Audit Response. We consider the Defense Logistics Agency comments responsive. Additional comments are not required.

A.2. We recommend that the Director, Defense Logistics Agency convene a performance improvement team composed of representatives from all relevant stakeholders, including appropriate oversight agencies, to plan and execute a reengineered best value approach to managing bench-stock material for all customers that addresses competition and restriction on contract bundling.

Management Comments. The Defense Logistics Agency concurred and stated that it had established an integrated process team consisting of representatives from Headquarters Defense Logistics Agency, Defense Supply Center Philadelphia, Defense Supply Center Richmond, and Defense Supply Center Columbus, to develop a reengineered the approach used by the Industrial Prime Vendor Program to manage bench-stock material. The Defense Logistics Agency also stated it will collaborate the execution of its reengineered program with the Inspector General of the Department of Defense.

B. Verification of Spot Buy Pricing

DSCP did not validate the accuracy of pricing data prior to authorizing material to be filled through spot buy procurements. This condition occurred because DSCP procedures for authorizing spot buy material procurements were inadequate. As a result, SAIC erroneously charged the ALCs $79,698 on spot buy invoices from July 2000 through April 2001.

Spot Buys Procurements

SAIC is responsible for purchasing bench stock to maintain stock bins at or near where depot maintenance is performed. [redacted] At the time items are added to the contract, a delivery date is set. The delivery date establishes when SAIC is responsible for supplying the material from its supply chain. After that date, if SAIC is unable to provide the item from its sources, it could request the item be provided by the DLA supply system; however, the price charged has to be the lower of the contract price or the DLA SUP. If neither the SAIC nor the DLA supply chains are able to fill the material requisition by the time the item is needed, SAIC, with DSCP authorization, can purchase the item through a spot buy procurement from a non-SAIC supplier. But again, SAIC cannot charge the ALCs more than the price set at the time the item was added to the IPV contract. As of May 2001, the ALCs and DSCP authorized SAIC to obtain material for 937 line items costing $3 million through spot buy procurements.

Verification of Spot Buy Pricing Data

DSCP did not validate the accuracy of the pricing data contained on the spot buy form prepared by SAIC and approved by the ALCs to request urgent procurements. Specifically, DSCP did not determine whether the material identified on the spot buy forms had been priced, placed on the IPV contract, and had a delivery date that was in effect prior to authorizing spot buy procurements. Consequently, material that was priced and placed on contract by DSCP was erroneously procured as spot buys by SAIC. Further, DSCP has no assurance that material that had been placed on contract was billed and paid for in accordance with the terms of the contract.

Erroneous Payments

Our review of the July 2000 through April 2001 spot buy invoices identified 68 questionable charges. Those charges were for material that SAIC had procured as spot buys after DSCP had placed the items on contract. The items

had effective delivery dates on the contract and SAIC's spot buy unit prices were higher than the contract prices. Table 6 summarizes the erroneous charges approved and paid by DSCP.

Table 6. Summary of Erroneous Charges

ALC	Lines	Billed	Corrected	Overcharges
Ogden	18	$ 51,624.55	$20,001.80	$31,622.75
Warner Robins*	29	68,090.70	36,549.49	31,541.21
Oklahoma City	21	26,972.94	14,736.68	12,236.26
Sub-Total	**68**	**$146,688.19**	**$71,287.97**	**$75,400.22**
DLA Surcharge (5.7 percent)				$ 4,297.81
Total				**$79,698.03**

* Four items were excluded because contract prices were based on questionable quantities significantly less than the spot buy quantities purchased.

DSCP needs to implement procedures to ensure that future spot buy material procurements are priced and paid for in accordance with the terms of the contract. DSCP also should obtain a full refund from SAIC for erroneous charges and take steps to reimburse the ALCs for the full amount of erroneous charges.

Recommendations, Management Comments, and Audit Response

B. We recommend that the Commander, Defense Supply Center Philadelphia:

1. Implement procedures to ensure that future spot buy material procurements are priced and paid for in accordance with the terms of the contract.

2. Obtain a full refund from the Science Application International Corporation for erroneous charges, including lost interest, and take appropriate steps to reimburse the air logistics centers for the full amount of the contract overcharges.

Management Comments. The Defense Logistics Agency agreed to refund the air logistics centers the full amount of the erroneous charges and to implement procedures to prevent erroneous billings on future spot buy invoices.

Appendix A. Scope and Methodology

Scope

Work Performed. We reviewed DSCP procedures and support documentation for the IPV contract SPO500-00-D-BP02. Specifically, we reviewed contract invoices from contract inception, January 24, 2000, through April 2001. We reviewed a total of 169,674 line items for bench-stock items valued at $29,138,274. Additionally, we determined whether the IPV Program reduced system infrastructure. We reviewed DLA cost recovery rates for FYs 2000 through 2002, spot buy procedures, administrative lead times, and inventory managed by DSCP, and the IPV Generation II concept [redacted] Our review focused on whether the IPV Program, when fully operational, is beneficial to the Air Force ALCs and DoD as a whole.

Limitations to Scope. The adequacy of the DLA management control program was addressed in Inspector General of the Department of Defense Report No. 98-088, "Sole-Source Prices for Commercial Catalog and Noncommercial Spare Parts," therefore, we did not review it further.

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the Defense Inventory Management and Contract Management areas.

Methodology

Use of Computer-Processed Data. We relied on computer-processed data from the DSCP and SAIC to determine the audit scope. The computer-processed data were determined reliable based upon the significant number of contract items we reviewed and compared to the data output from DSCP. Although we did not perform a formal reliability assessment of the computer-processed data, we determined that the bin locations, quantities, order dates, and amounts generally agreed with the information in the computer-processed data. We did not find errors that would preclude use of the computer-processed data to meet the audit objectives or that would change the conclusions in the report.

Audit Dates and Standards. We performed this audit from April 2001 through December 2001, in accordance with generally accepted government auditing standards.

Contacts During the Audit. We visited or contacted individuals within the DoD, SAIC, and Honeywell. Further details are available on request.

Appendix B. Prior Coverage

During the last 5 years, the General Accounting Office has issued four audit reports, and the Inspector General of the Department of Defense has issued nine audit reports discussing either logistics response time or prices for spare parts in the Acquisition Reform environment.

General Accounting Office

General Accounting Office, Report No. GAO-01-22 (OSD Case No. 2080), "Defense Acquisitions: Price Trends for the Defense Logistics Agency's Weapon Systems Parts," November 2000

General Accounting Office, Report No. NSIAD-00-30 (OSD Case No. 1920), "Opportunities Exist to Expand the Use of Defense Logistics Agency Best Practices," January 2000

General Accounting Office, Report No. NSIAD-00-21 (OSD Case No. 1868), "Management of Repair Parts Common to More than one Military Service can be Improved," October 1999

General Accounting Office, Report No. NSIAD-99-90 (OSD Case No. 1808), "DoD Pricing of Commercial Items Needs Continued Emphasis," June 1999

Inspector General of the Department of Defense (IG DoD)

IG DoD Report No. D-2001-171, "Industrial Prime Vendor Program at the Naval Aviation Depot - Cherry Point," August 6, 2001

IG DoD Report No. D-2001-072, "Industrial Prime Vendor Program at the Naval Aviation Depot - North Island," March 5, 2001

IG DoD Report No. D-2000-099, "Procurement of the Propeller Blade Heaters for the C-130 and P-3 Aircraft," March 8, 2000

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

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

IG DoD Report No. 99-101, "Logistics Response Time for the Direct Vendor Delivery Process, Defense Supply Center, Columbus," March 4, 1999

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

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

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

Appendix C. Bench Stock Support Program Costs

Table C-1. Bench Stock Support Costs Prior to the Implementation of the IPV Program

Location	Government Staff Number	Government Staff Amount
Oklahoma City		
Support	8	$ 342,479
Oversight	3	30,448
Other Costs[8]		105,854
Subtotal	**11**	**$ 478,781**
Ogden		
Support	8	$ 316,436
Oversight	3	30,654
Other Costs		66,434
Subtotal	**11**	**$ 413,524**
Warner Robins		
Support	14	$ 606,047
Oversight	9	44,027
Other Costs		240,934
Subtotal	**23**	**$ 891,008**
Total	**45**	**$1,783,313**

[8] Other costs includes the costs for inventory holding and equipment.

Table C-2. Bench Stock Support Costs under the IPV Program						
	[redacted]		Government Staff		Total	
Location	[redacted]	[redacted]	Number	Amount	Number	Amount
Oklahoma City						
Support	[redacted]	[redacted]			41	[redacted]
Oversight			7	$253,250	7	253,250
Other Costs		[redacted]		103,257		103,257
Subtotal	[redacted]	[redacted]	**7**	**$356,507**	**48**	[redacted]
Ogden						
Support	[redacted]	[redacted]			9	[redacted]
Oversight			9	$334,444	9	334,444
Other Costs		[redacted]		66,434		66,434
Subtotal	[redacted]	[redacted]	**9**	**$400,878**	**18**	[redacted]
Warner Robins						
Support	[redacted]	[redacted]			17	[redacted]
Oversight			17	$469,916	17	469,916
Other Costs		[redacted]		220,538		220,538
Subtotal	[redacted]	[redacted]	**17**	**$690,454**	**34**	[redacted]
Total	[redacted]		**33**		**100**	[redacted]

Appendix D. Management Comments on the Finding and Audit Response

Defense Logistics Agency Comments

DLA Comments on Sufficient Time to Test Innovative Logistics Solution. DLA stated that the report does not fully appreciate that the IPV Program was a test initiated to explore a new and innovative logistics solution for providing consumable items and that sufficient performance must occur to properly assess the effectiveness of the program.

Audit Response. The report discusses the IPV Program as a test; however, sufficient performance had occurred to identify deficiencies with the design and implementation of the program.

DLA Comments on Qualitative and Quantitative Analysis of IPV Program Benefits. DLA stated that the report does not provide sufficient quantitative or qualitative analysis relating to program benefits such as improved fill rates and readiness support.

Audit Response. The report clearly states that parts availability had improved and recognizes that improved availability can only have a positive impact on readiness support. The report also recognizes the reasons for improved availability such as dedicated bench stock support at the ALCs and the use of spot buy procedures. In addition, the report shows that the majority of the bench stock material supplied under the IPV Program came from DLA depots (53 percent of the line items and 59 percent of the dollars). Therefore, the DLA supply system played a vital role in the improvements claimed by the IPV Program.

DLA Comments on Air Force Determination of IPV Program Success. DLA stated that the Air Force formally declared the IPV test program a success based on successful performance by the contractor and favorable results from their own cost study.

Audit Response. As previously explained to both the Air Force and DLA, we have reservations with the Air Force, "As Is Cost Assessment Study," and believe it inappropriate for use to support the IPV Program. The study claims cost avoidances result because under the IPV Program the Air Force avoids paying the DLA depot transaction and storage charges for retail level stock stored at the local DLA wholesale depot. However, if the wholesale material purchased by the Air Force for retail stock is already stocked at the local DLA depot the purchased material is not subject to the receipt charge. Receipt charges represented the largest cost avoidance claimed in the Air Force study. We believe the Air Force study does not represent an accurate depiction of cost avoidance and is inappropriate for use to support the IPV Program. Consequently, we did not include the results of the study in our report.

DLA Comments on Supply System Infrastructure. DLA stated that references to problems with the Defense Supply System infrastructure attributable to the IPV Program's test parameters were unjustified. The IPV Program is a test to explore innovative logistics solutions for providing bench-stock and the present DLA logistics support systems will be prudently maintained concurrently with the IPV initiative. The intention is to assess performance and determine industry's ability to support bench stock primarily using a commercial supply chain through the test period. Meanwhile, the follow-on acquisition plans are being developed, incorporating program enhancements, for converting to a fully competitive environment targeting consolidated requirements. Upon award, the concurrent systems will become redundant.

Audit Response. The IPV contractor and DLA supply system are redundant systems managing the same items and the current IPV Program had no strategy for resolving this issue. Questions exist regarding the contractor's ability to meet total IPV Program requirements cost effectively using a commercial supply chain. Further, the fact that the follow-on acquisition plans are still being developed, incorporating program enhancements that we believe are questionable, clearly shows that DLA still does not know how to resolve issues relating to the redundant systems, competition, and contract bundling.

DLA Comments on Long-Term Agreements. DLA stated that comments about DSCP non-IPV contracting methods were inaccurate and about 50 percent of DSCP General and Industrial Directorate's annual contract obligations are through long-term agreements.

Audit Response. Although DSCP may be obtaining 50 percent of its contract obligations through long-term agreements, the audit clearly shows that DSCP did not use DVD contracts for bench stock requirements outside the IPV Program. Meanwhile, the IPV contractor provided 11,434 items (nearly all the requirement) using a single long-term DVD contract.

DLA Comments on Administrative Lead Times and Defense Inventory Investment. DLA stated that the IPV Program was not designed to effect administrative lead time or depot inventory for non-IPV items.

Audit Response. We agree that the current IPV Program was not designed to reduce administrative lead time or depot inventory levels for the identical items being managed outside the program by DLA. We believe that not developing an effective strategy to address these critical supply issues was a major deficiency with the current program. Further, as stated in the, "Reengineer Bench Stock Management Approach," section of Finding A, DLA needs to address these issues in any follow-on acquisition plan incorporating program enhancements.

DLA Comments on Bench Stock Cost Recovery Rates. DLA stated that the IPV Program has had an insignificant impact on non-IPV cost recovery rates.

Audit Response. The IPV Program had a 5.7 percent and 8.3 percent impact on cost recovery rates for non-IPV items for FYs 2001 and 2002, respectively. These increases to non-IPV customers are not insignificant.

DLA Comments on Single Process Owner and Integrator Capabilities. DLA stated that without a single process owner, such as the current IPV integrator (SAIC), it would not have been possible to achieve the 98 percent fill rate specified in the contract. DLA also stated that integrators would not be interested in limited business opportunities such as managing bins, and that its IPV integrator had extensive modeling and simulation, logistics, system engineering, and information technology capabilities.

Audit Response. As previously stated, the majority of the material supplied under the IPV Program came from the DLA depot supply system. As to the extensive information technology capabilities, the IPV integrator uses only one contractor to supply more than 11,000 parts and requires the supplier to meet the 98 percent fill rate. Consequently, we do not agree that the use of an IPV integrator was solely responsible and is the only solution for achieving improved fill rates.

DLA Comments on Unique Forecasting Program. DLA stated that the IPV integrator independently developed a unique forecasting program based on actual demand patterns and future known requirements that will reduce excess inventory costs.

Audit Response. We believe that the IPV contractor's forecasting model is not unique because the DLA material management system also provides excellent information on actual demand patterns and DLA item managers include future known requirements in procurement decisions.

DLA Comments on Other IPV Program. DLA stated that the IPV Program approach is recognized as providing cost-effective support to DoD maintenance activities as shown by the Navy and Marine Corps independently awarding IPV type contracts.

Audit Response. IPV contracts reviewed to date have shown significant problems relating to obtaining competition, contract bundling, and placing sufficient material on contract at cost-effective prices.

DLA Comments on IPV Generation II. DLA stated that the IPV Generation II approach will allow the prime vendor to establish supplier agreements to achieve the most efficient price, meet delivery requirements, and incur minimal investment in inventory.

Audit Response. We have reviewed the IPV Generation II approach and previous Generation II approaches and remain concerned about issues relating to competition, bundling, cost-effectiveness, existing depot inventory reduction, and excessive layering of suppliers.

DLA Comments on Incomplete Program Assessment. DLA stated that the report does not quantify the impact of the improved fill rates and that an independent study had been commissioned to evaluate the IPV Program from a total logistics perspective.

Audit Response. Improving supply of bench-stock material will have a positive impact on weapon system readiness, but many other factors also impact readiness. The study evaluating the IPV Program from "a total logistics costs perspective" should examine the cost-effectiveness of the current program in supplying bench-stock material and the costs associated with adding additional material to the contract.

DLA Comments on DLA Vision. DLA stated that an overarching goal to shift business practices from managing supplies to managing supplier relationships was consistent with guidance from the General Accounting Office and the Under Secretary of Defense for Acquisition, Technology, and Logistics relating to performance-based initiatives.

Audit Response. We believe that the cost-effectiveness of a performance-based initiative where DLA manages the integrator (SAIC), who manages the supplier (Honeywell HPG), who manages the actual suppliers (manufacturers/dealers) of the parts, remains to be demonstrated. The value provided by DLA is uncertain because of the layers in the process.

Air Force Comments

Air Force Comments on Test Program. The Air Force stated that the test contract (IPV contract) did not use DLA stocks because the intent of the program was for the contractor to demonstrate its ability to support Air Force customers without DLA support. Although there may be some unnecessary expenditure, relying on a large portion of DLA stock would invalidate the test. Because a high level of contractor performance has been demonstrated, altering the program to draw down DLA stock is now appropriate. The Air Force also commented that there was some duplication of manpower because only a small number of shops were affected by the test.

Audit Response. The majority of inventory supplied under the IPV Program was from the DLA depot system. This was primarily due to the difficulty in placing material on the IPV contract at cost-effective prices. We do agree that altering the program to draw down DLA stock levels is appropriate and that as more shops are added to the program, the contractor's manpower efficiency should increase.

Air Force Comments on Manpower Duplication. The Air Force stated that the contractor provided a substantially better result than the previous method of bench-stock management, and that a higher level of organic staff would have been required to achieve the same results. The Air Force also commented that there should be significant manpower savings at the wholesale level because support issues become the responsibility of the contractor.

Audit Response. We agree that the increased staff levels managing bench stock improved results and also agree that there should be manpower savings at the wholesale level if total support responsibility is transferred to a contractor. However, we do not believe the cost-effectiveness of this transfer of total support responsibility from DLA to a contractor has been sufficiently demonstrated.

Air Force Comments on Improved Performance. The Air Force stated that the report gave little attention to improved availability of parts to the Air Force customer and stated that specific criticisms about the increase in total inventory is also viewed as a success by the customer. Further, support has improved dramatically in the shops where the test program has been implemented.

Audit Response. The report states that performance had improved and gave specific reasons for the improved performance such as increased staff levels managing bench stock material. Although the customer does benefit in terms of improved availability when redundant systems are used, we believe that maintaining redundant systems and excessive wholesale inventory to improve availability is not in the best interest of the DoD.

Air Force Comments on Market Basket Approach and Competition. The Air Force stated that "substantial benefits" accrued from bundling this contract. The Air Force also commented that establishing market basket groups prevented the contractor from choosing only the easy items to supply and that if the alternative was to buy the same group of parts at the same or even higher total cost with more stock shortages, it was time to work through the problems.

Audit Response. Bundling requirements is an issue that DLA needs to resolve on any follow-on IPV Program. We identified significant deficiencies with the DSCP market basket approach on this and previous IPV Program audits relating to placing items on contract at cost-effective prices. At the time of our review, only 53 percent of the items on the IPV contract had been priced because of problems obtaining fair and reasonable prices.

Air Force Conclusion. The Air Force stated that the IPV Program has provided an impressive improvement in customer support at a very modest additional cost, if any. The Air Force cannot afford to pass up this opportunity.

Audit Response. The additional cost associated with the IPV Program has yet to be determined because the majority of the items supplied under the contract were from the DLA depot system and only 53 percent of the items on contract had been priced. In addition, only about half of the priced items on contract had been purchased/supplied by the IPV contractor.

Appendix E. Report Distribution

Office of the Secretary of Defense

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- Deputy Under Secretary of Defense (Logistics)
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Under Secretary of Defense (Comptroller)
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House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform
House Subcommittee on Technology and Procurement Policy, Committee on Government Reform

Defense Logistics Agency Comments

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

IN REPLY
REFER TO J-33

MAY 14 2002

Mr. Garold E. Stephenson
Director, Contract Management Directorate
Department of Defense Inspector General
400 Army Navy Drive
Arlington, VA 22202-4704

Dear Mr. Stephenson:

This is the Defense Logistics Agency's (DLA) response to the DoD IG Draft Audit Report, "Industrial Prime Vendor Program at the Air Force Air Logistics Centers (Project No. D2001CF-0091.000)" dated February 6, 2002. In addition to responding to the recommendations cited in the report, comments regarding specific issues are provided. Also, comments received from the Headquarters, Air Force Materiel Command and the contractor supporting the Air Logistics Centers, Science Applications International Corporation, are incorporated by attachment.

The report does not provide a complete or appropriately balanced appraisal of the IPV program. The report does not fully appreciate that IPV was initiated as a test to explore a new and innovative logistics solution for providing consumable items. As such, sufficient performance must occur to properly assess the program and, with any cutting edge initiative, there will be lessons learned and adjustments required. Also, the report does not provide adequate qualitative or quantitative analysis of the IPV program's total logistics costs or program benefits, such as improved fill rates and readiness support. Although some of the report's assessments can be disputed, it is agreed there are deficiencies with the design parameters. Current IPV program processes will be reengineered to improve cost effective customer support and the next generation of the IPV program is being revised to remedy initial design deficiencies and incorporate lessons learned.

Although DLA disagrees with some of the draft report's assessments of the IPV program, there are areas where DLA and DoD IG can collaborate to ensure future improvements. The IPV program office will be contacting your audit staff soon to address those opportunities for future discussions.

Sincerely,

HAWTHORNE L. PROCTOR
Major General, USA
Director
Logistics Operations

Federal Recycling Program Printed on Recycled Paper

Attachment

This is the Defense Logistics Agency (DLA) response to the DoD IG Draft Audit Report, "Industrial Prime Vendor Program at the Air Force Air Logistics Centers (Project No. D2001CF-0091.000)" dated February 6, 2002. In addition to responding to the recommendations cited in the report, comments regarding specific issues are provided. Also, comments received from the Headquarters, Air Force Materiel Command (HQ AFMC) and the contractor supporting the Air Logistics Centers, Science Applications International Corporation (SAIC) are incorporated by enclosure.

General comments:

Issue - Audit Report Objective

Comment: The report states, "The primary audit objective was to determine whether the Defense Logistics Agency's Industrial Prime Vendor Program is being effectively implemented and provide the best value for the Air Force". The IPV program is meeting the expectations of the original test plan. More importantly, the customer has determined the IPV program is being effectively implemented and provides the best value. In December 2001, the Air Force formally declared the IPV test program a success. The Air Force has decided to support full implementation of the IPV program to maximize support of ALC consumable hardware item requirements based on successful performance by the contractor and favorable results from their (IPV versus organic "As-Is" support) cost study. All three depots concurred with exercising of remaining IPV contract extension and expansion options by the DSCP (Defense Supply Center Philadelphia). The proposed IPV shop additions have been identified and depot civilian personnel impacts have been quantified. The Air Force Material Command has completed negotiations with the American Federation of Government Employees (AFGE) union and an official IPV program expansion Memorandum of Agreement (MOA) has been established. All 17 additional expansion affected civilian employees will be reassigned without negative impact. Finally, DSCP has processed the contract option for coverage through January 2005.

Issue – Bench Stock Material Outside the IPV Program.

Comments: It is inappropriate for the report to recognize the current IPV program as a test, yet criticize it for not accomplishing objectives not contained in the initial test design. The following discussion is provided regarding subsections in the "Bench Stock Material Outside the IPV Program" section of the report:

- Defense Supply System Infrastructure: References to addressing problems with the Defense Supply System infrastructure attributable to the IPV program's test parameters are unjustified. The IPV program was designed as a 5-

year test program to explore innovative logistics solutions for providing spare parts used in maintenance, repair and overhaul facilities. The present DLA logistics support system for bench stock items will be prudently maintained concurrently with the IPV initiative. Premature reductions in DLA infrastructure risks DoD readiness support. The intention is to assess performance and determine industry's ability to support bench stock primarily using a commercial supply chain through the test period. Meanwhile, the follow on acquisition plans are being developed, incorporating program enhancements, for converting to a fully competitive environment targeting consolidated (i.e worldwide) requirements based on common customer missions and/or weapon system complements. Upon award, the concurrent systems will become redundant and require adjustment in the scope of function.

- Non-IPV Program Contracting Methods: Comments regarding DSCP non-IPV program contracting methods are inaccurate. Approximately 50% of DSCP's General & Industrial Directorate's annual contract obligations are through long-term agreements.

- Administrative Lead Times: IPV was not designed to effect nor can the increase in ALT for non-IPV acquisitions be attributable to the IPV program.

- Defense Inventory Investment: The suggestion that IPV has been responsible for an increase in depot inventory is inappropriate. IPV program customers are not the only activities requisitioning these items. Support to other non-IPV customers is key in establishing inventory levels for these items.

- Conventional Bench Stock Cost Recovery Rates. Cost Recovery Rates are developed annually in accordance with established regulations, guidelines and customary procedures using the Activity Based Costing (ABC) accounting technique. Accordingly, the IPV program has had an insignificant impact on non-IPV cost recovery rates.

Issue - Reengineer Bench Stock Management Approach

Comment: This report suggests an alternate approach to managing bench stock that "maximizes the use of long-term DVD contracts" with integrators serving a more limited role by "focusing mainly on bin management". Concerns with this approach include:

- Without a single process owner, this approach does not provide a sufficient business arrangement, with opportunities and incentives, to achieve current IPV program objectives. The current IPV approach, with the contractor as the single process owner, clearly demonstrates material management performance exceeding contract requirement of 98% fill rate. By comparison, traditional supply availability rates are significantly lower these types of commodities.

These results could only have been achieved by the dedication and persistence of an integrator committed to meeting their customers needs versus the volume of parts delivered.

- Integrators that have the capability to address a wide range of process and technical issues would not be interested in a business opportunity limited to managing bins. For example, SAIC has extensive modeling and simulation, logistics, system engineering and information technology capabilities. Those specialties were brought to bear on the IPV program to provide enhanced demand forecasting associated with an advanced supply chain management system. Very few integrators and no parts suppliers have developed such end-to-end systems. Most parts supplier systems are unable to integrate their processes with their customer's data systems. There is no value in even paying a parts supplier to link their systems to government systems if there is no requirement to actively apply (i.e. plan, forecast, apply, etc.) the data. In the proposed approach, support is simply responding to customer generated requirements. Lastly, SAIC was able to quickly implement automated enhancements including: EDI solutions, legacy interface data feeds, web status displays, and data reports.

- This approach eliminates any incentive of the integrator to invest in process improvements beyond filling bins. For example, under the current approach, SAIC has independently developed a unique forecasting program. This program, which draws significantly on actual demand patterns, tempered by future known requirements, will reduce costs (e.g. excess inventory) and improve the pricing process. Other improvements to operations made by SAIC include:

  - Tail of the aircraft (TOA) bins. This action put parts in bins in close proximity to maintenance technicians thus reducing mechanic down time.

  - Replaced manned with unmanned bins locations. This action resulted in significant savings in manpower over time, and allowed maintenance technicians much more access to the bench stocks. This also reduces the downtime associated with having a mechanic wait for a part.

  - Building kits on site from existing bench stocks or in off-base locations to speed up the repair process and eliminate waste. This process is more cost effective than traditional (i.e. stand alone) kits with parts obtained from independent supply sources. Unused kit parts already purchased are often excess. Under IPV, unused kit parts are returned to inventory for use.

  - Bench stock re-use. SAIC resolved the problem complying with contract ISO 9000 quality requirements while at the same time allowing reclaiming removed, but unused, bench stock. This reduces excess inven-

tory.

- Identification and validation of bench stock parts in bins. SAIC inventoried and identified all items in the bench stock bins to be supported, and took action to either recommend continued support or removal of the item(s) from the bins. This reduced on-hand inventory and prevents investment in inactive inventory. A parts supplier would only be interested in supporting as many items as could be found in the bins. The emphasis would not necessarily be on removing unused items.

- The existing IPV program approach, despite test plan limitations, is recognized as providing cost effective support to DoD maintenance, repair and overhaul activities. For example, the PSNY (Puget Sound Naval Shipyard) and former IPV program activities at the Marine Corps Logistics Bases at Albany, GA and Barstow, CA have independently awarded IPV-type contracts.

- The IPV Generation II approach provides the optimal integrated supply chain solution. Under IPV generation II, the prime vendor manages the various sources of supply (i.e. commercial, DLA inventory, strategic sources) to achieve the most cost effective support for the customer and DLA. Where the customer group is the majority user, the prime vendor may acquire worldwide demand for the item. This allows the prime vendor to establish supplier agreements to achieve the most efficient price and meet the delivery requirements of the contract while incurring minimal investment in inventory. Additionally, the integrator will have access to DLA arrangements with suppliers for direct supply of items to the integrator/site.

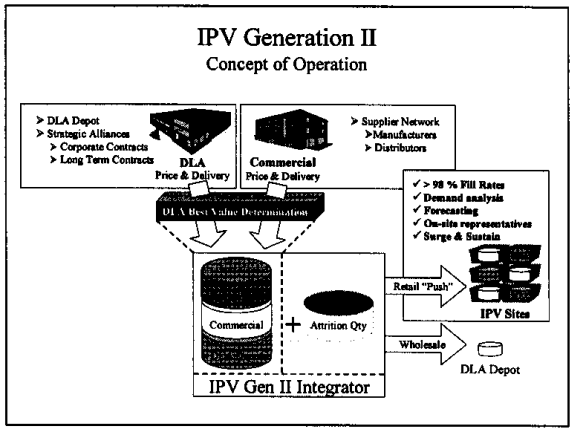

Figure – IPV Approach: IPV Generation II Concept of Operation

Issue – Incomplete Program Assessment

Comment: IPV at the three ALC's has provided parts availability and support improvements resulting in a greater than 99% fill rate. Although the report acknowledges the increased parts availability has a positive impact on repair work performed at the ALC's and readiness of weapon systems, it does not attempt to quantify the impact. The report does, however, focus on the costs associated with material management services, item prices and existing depot inventory. Accordingly, a total logistics cost assessment of the IPV program has not been provided. A complete program assessment requires an analysis of the entire supply chain and associated resources along with a valuation of related benefits including: operational efficiencies, fewer down hours, and reduced repair time. A independent study has been commissioned to evaluate the IPV Program from a total logistics costs perspective.

Issue – DoD IG's Vision for the DLA

Comment: The report expresses concern about the DLA's overarching goal to shift business practices from managing supplies to managing supplier relationships. This position is disturbing because it is counter to numerous General Accounting Office recommendations, as well as, the explicit goals of the Under Secretary of Defense for Acquisition, Technology and Logistics and the DLA. The IPV program is a performance-based initiative providing improved support to the Warfighter consistent with the DoD and the DLA goals.

Comments to recommendations:

A.1. We recommend that the Commander Defense Supply Center Philadelphia require Industrial Prime Vendor officials to:

a. Discontinue use of market basket approach to determine which benchstock items are placed on the prime vendor contract. Instead, evaluate each item separately and select the most economical source to supply material.

Comment: Concur with exception. A market basket type approach to pricing items provides an optimal means to evaluate the large number item price requirements. The pricing problem, however, is mostly attributable to the demand data and the variability in the usage of these items, not the approach. The accuracy of the data necessary to develop consumption quantities for these items is marginal because of the limited accountability

of the customer's tracking system. This level of accountability for bench stock material is typical of DoD industrial activities. In particular, after two years of operation at the ALCs, the consumption data for 2,079 of the 15,000 items is within +/- 25% of the Government forecasted quantities. This equates to less than 14% of all items being within 25% accuracy tolerance. The consumption data for all other items is outside of the +/-25% band. This situation will continue to improve along with the full transition of supply chain management responsibility to the contractor.

Regardless, the pricing process, using the market basket approach, has been reengineered. In addition to greater scrutiny of forecasted requirements, a price evaluation algorithm that compares item prices to historical government prices has been developed. Individual items, where prices are outside acceptable limits, are rejected for manual review. As part of the current IPV program reengineering efforts, a sourcing model is being developed. This sourcing model will be used to screen candidate item lists to remove items from further commercial pricing actions. Support for these items will be provided from other sources including, DLA wholesale inventory, customer retail inventory, strategic source alliances, DVD's, etc. Once commercial prices are obtained for the remaining items, the sourcing model will be used in determining the "best value" source. DSCP intends to collaborate with the DoD IG's in developing this sourcing model.

Scheduled completion date: Not applicable

b. Review inventory levels and discontinue placing items on the industrial prime vendor contract with more than 3 years of inventory.

Comment: Concur with exception. An automated sourcing model capable of evaluating individual items for IPV support and determining the "best value" source (i.e. commercial, DLA inventory and DLA Strategic Sources) is being developed by a consultant services provider. This sourcing model considers various factors, including inventory levels, to determine the "best value" source.

Scheduled completion date: June 2002

c. Take appropriate actions in accordance with contract terms to remove items more than 3 years of inventory and start using existing depot inventories as the first choice to fill contract demand.

Comment: Concur with exception. See A.1.b. above. Successful performance by the IPV contractor and a favorable cost study resulted in the Air Force deciding to approve full implementation of the program to max-

imize support of ALC consumable hardware item requirements. With this determination, a plan to deplete existing inventory is being developed. It must be understood, however, that actions to remove items already priced and on contract may adversely impact the Contractor's business model. Accordingly, consideration (i.e. termination costs) which are paid by the government will be factored into these decisions.

Scheduled completion date: On-going

A.2. We recommend that the Director, Defense Logistics Agency, convene a performance improvement team composed of representatives from all relevant stakeholders, including appropriate oversight agencies, to plan and execute a reengineered best value approach to managing bench-stock material for all customers that address competition and restriction on contract bundling.

Comment: Completed. An Integrated Process Team (IPT), consisting of HQ DLA, Defense Supply Center Philadelphia, Defense Supply Center Richmond and Defense Supply Center Columbus representatives, has been established to develop a reengineered approach to IPV. This new approach is called IPV Generation II. Current program weaknesses and revisions, including recommendations from this and previous DoD IG reports, are being incorporated into IPV Generation II. Also, market research consisting of customer, stakeholder and industry input and findings from an independent IPV program assessment being conducted will be used to reengineer IPV. Regardless, implementing IPV Generation II will require approval from DLA's Acquisition Planning Executive Committee, Supply Chain Management Council and Business Review Board. In so doing, competition and bundling, along with many other contracting and business issues, will be addressed. Finally, execution of IPV generation II will use a sourcing model (see A.1.b.) and reengineered process that will be collaborated with the DoDIG.

Scheduled completion date: Not applicable

B.1. We recommend the Commander Defense Supply Center Philadelphia:

a. Implement procedures to ensure that future spot buy material procurements are priced and paid for in accordance with the terms of the contract.

Comment: Completed. Internal controls have been established. Subsequent spot buy procurements are being priced and paid for in accordance with contract terms.

Scheduled completion date: Not applicable

b. Obtain a full refund from SAIC for erroneous charges, including lost interest, and take appropriate steps to reimburse the ALC's for the full amount of the contract overcharges.

Comment: Concur. The refund amount is being determined based upon full analysis and reconciliation of invoice documentation.

Scheduled completion date: June 2002

Science Applications International Corporation
An Employee-Owned Company

9 April 2002

Mr. Neil Kovnat/DSCP-IBC
Defense Supply Center Philadelphia
700 Robbins Ave
Philadelphia, PA 19111-5098

Subject: **Industrial Prime Vendor Inspector General Draft Audit**

Reference: Contract No. SP0500-00-D-BP02

Enclosure: Redacted copy of the Draft DOD IG Audit Report

Dear Mr. Kovnat:

SAIC appreciates the opportunity to review and provide our response to the IPV Program Air Force Air Logistics Centers draft audit report prepared by the Office of the Inspector General. SAIC has four major concerns with the draft audit report:

1. SAIC Proprietary Information that was provided to the IG auditors at their request is included in the report. This proprietary information was clearly marked by SAIC with the applicable Restrictive Legends prior to providing to the auditors.
2. The report alleges that SAIC has received "erroneous payments" under the Spot Buy provision of the contract.
3. The primary audit objective to determine whether the IPV Program is being effectively implemented and provides the best value for the Air Force should not be based on incomplete financial data that includes only 15 months of a 5-year program. In addition a best value analysis for the Air Force must attempt to quantify the impact of the substantial increase in fill rates and improvement in benchstock bin management that allows the depot maintenance facilities to improve their performance at an overall lower cost.
4. The draft reports claim that DSCP should make use of long-term DVD contracts and limit the role of IPV integrators.

This letter will provide SAIC's position regarding each of these concerns as well as comments for your consideration in preparing your response to draft audit report.

Proprietary Information

In support of the review of the IPV Program, SAIC provided extensive proprietary information to the DoD IG in documents that are clearly marked with an SAIC proprietary legend. We are requesting that the IG Audit report <u>not</u> be released in its present form, as it contains sensitive SAIC proprietary information.

1710 Goodridge Drive, P.O. Box 1303, McLean, Virginia 22102 (703) 821-4300
Other SAIC Offices: Albuquerque, Colorado Springs, Dayton, Falls Church, Huntsville, Las Vegas, Los Altos, Los Angeles, McLean, Oak Ridge, Orlando, San Diego, Seattle, Tucson

The SAIC proprietary information provided to the DOD IG included, but was not limited to, SAIC's Subcontract with Honeywell International Inc., Hardware Products Group, which contains confidential and proprietary information critical to our overall Government and Commercial businesses. This very sensitive information relates to our initial business model (single vendor sub contractor), and includes information such as subcontractor delivery timeframes for both expedited and routine shipments, overall distribution costs and costs per ALC, actual vendors used, SAIC staffing, SAIC material stocking policies, profit margins, and other proprietary information. If this information were disclosed to our competitors, SAIC would suffer substantial and irreparable damage to our competitive position and our ability to compete for future business opportunities. It is therefore critical that Government protect the Proprietary Information that SAIC provided during the Inspector General audit of the Industrial Prime Vendor Program.

Since IG Audit reports of this nature become public information when signed and released, the report must be revised to delete all SAIC proprietary information indicated by Privileged, Confidential, and/or Proprietary legends.

SAIC wants to emphasize that federal law prohibits the unauthorized disclosure of a contractor's proprietary information. Specifically, failure to delete SAIC's Proprietary Information from the IG Audit could violate the Trade Secrets Act, 18 U.S.C. §1905, which imposes penalties on for:

> publishing, divulging, disclosing, or making known in any manner or to any extent not authorized by law any information coming to him in the course of his employment or official duties or by reason of any examination or investigation ..., which information concerns or relates to the trade secrets, processes, operations, style of work, or apparatus, or to the identity, confidential statistical data, amount or source of any income, profits, losses, or expenditures or any person, firm, partnership, corporation, or association; . . . shall be fined under this title, or imprisoned not more than one year, or both; and shall be removed from office or employment.

SAIC shares the Government's commitment to comply with all applicable laws and would be pleased to assist in the proper redacting of the DOD IG report if requested. To facilitate this process, we are attaching a redacted copy of the DOD IG report that SAIC would be comfortable releasing.

Erroneous Payments for Spot Buys

During start up of the Industrial Prime Vendor program when new weapon systems were being transitioned from the government, SAIC made every effort to replenish all bins for which we were responsible. We replenished bins supporting the Air Force maintenance organization whether an item was included on our contract list, as an un-priced item or priced item, or waiting to be added to the contract. To meet the Air Force maintenance requirements and the fill rate metrics established in the contract we used each of the

mechanisms contemplated by the IPV contract whether by contract or spot buy authorization. We obtained parts from our commercial vendor under a subcontract specifically to meet the requirements of the IPV program, obtained parts from DLA inventory under the DoDACC clause of the contract, and used the Spot Buy Procedures clause.

The spot buy procedure was used as a last resort. If an item was not immediately available through SAIC's commercial supply chain established for the IPV program, SAIC would first attempt to requisition the item from DLA inventory. If DLA did not have the item and it wasn't available from Air Force retail stock, only then would the Spot Buy procedures be implemented to support the maintenance organization and prevent a work stoppage. The objective of the Spot Buy procedure included in the IPV contract is to allow the Government to obtain items for which there are an immediate and urgent maintenance requirement. In each of the cases referenced in the IG audit the Air Force customer determined that the requirement was critical and urgent enough to warrant the use of the spot buy procedure by explicitly approving each of these spot buys. SAIC would then make a good faith effort to ensure that the customer was supported in the most effective and efficient way

By all accounts, the spot buy procedure is an essential part of an overall strategy to provide parts to the Air Force when they are needed. SAIC's commitment to the IPV program has resulted in an overall fill rate of 99.5% and contributed to substantial efficiencies in the maintenance and repair of aircraft and Air Force readiness.

Best Value for the Air Force Air Logistics Centers

At the time of the DoD IG audit the IPV program for the Air Force Air Logistics Centers had been under contract for approximately 15 months of a 5-year program. As cited on page 2 of the draft audit report, this contract was designed to migrate material management responsibility from the Government to the contractor during the 2-year base period and total responsibility would transfer to the contractor in year 3. The Implementation Phase of this program provided a 12 month transition of weapon systems to the IPV Program to mitigate risk and avoid any disruption in service to the maintenance depots. In April 2001 some weapon systems had been supported for only a few months while the longest a weapon system had been supported by this contract for only 9 months. SAIC believes it is inappropriate to attempt to draw conclusions on the cost effectiveness of this program or make recommendations based on this limited timeframe that was, by design, intended to provide a gradual transition from DLA to contractor support to mitigate any risk for the ALC's.

In addition, as briefly mentioned in the draft audit report, the IPV Program has achieved substantial improvements in fill rates and bin management of bench-stock material that has increased the effectiveness and efficiency of the depot maintenance facilities. These improvements must be quantified to achieve the audit objective of determining whether the IPV Program provides best value for the Air Force. A best value analysis of the IPV Program, ***a customer-oriented, supply-chain management initiative,*** must evaluate and

quantify the impact of this program throughout the entire life cycle of bench stock material; from the procurement of the material through delivery to the war fighter maintaining and repairing the weapon systems. The timing and scope of this audit did not allow the auditors to achieve their primary objective.

Using long-term DVD contracts and reducing the role of IPV integrators

SAIC believes the current IPV program has clearly demonstrated the critical role the IPV integrator has in achieving all of the program objectives established by DLA and the Air Force. The challenges and issues that were, and continue to be, addressed and resolved by SAIC under this program while still exceeding the fill rate goals of this contract that are far above the performance results prior to implementing this contract, could only have been achieved by the dedication and persistence of an integrator committed to meeting their customers needs versus the volume of parts they sell from their excess inventory. Summarized below are just some of the benefits and issues that have been resolved by SAIC's overall logistics support to the ALC's under the IPV Program.

SAIC's initial approach for this program of entering into a partnership with one primary supplier, which significantly reduced the risk of program failure during the implementation phase since:

1. Initial IPV consumption data from the Government could be categorized as "poor" and "untimely" at best.
2. There were significant delays in receiving "accurate" consumption data. For example, data to be provided at contract award (or shortly thereafter) was not provided until five to nine months later.
3. After two years of operation the consumption data for 2079 of 15,000 NSNs are within +/- 25% of the Government forecasted quantities (which equates to less than 14% of all NSNs are within 25% accuracy tolerance). The consumption data for all other items is outside of the +/-25% ban.
4. Long-term commitments with a primary supplier provided a capability to negotiate acceptable terms and conditions that allowed for some latitude in parts acquisition and pricing. A supplier is more willing to take a loss on some parts if they understand that, in the aggregate, they will be able to make a reasonable profit for the parts they provide. Since the Government's requirements were impossible to accurately compute at the beginning of the program with reliable accuracy, having a large supplier with pricing flexibility and significant inventory was a very significant risk mitigation strategy.
5. The SAIC model has matured as the experience has grown which has resulted in:
    a. The capturing of consumption rates and patterns since the first weapon system implementation in August 2000. We have explicit insight into the number of demands, pipeline times, applications, and customer's requirements at a discrete level never before possessed by the Air Force or DLA.
    b. We have recommended adjustments to inventory levels based on our experience. To assist us in this task, we use the SAIC-developed

requirements forecasting capability of our SCOPTIMA® system. This capability is unique in that it draws significantly on actual demand *patterns*, tempered by future known requirements.

c. Understanding "real" requirements has allowed SAIC to expand its vendor base. We now have subcontracts with five companies for bench stock parts, and we have a vendor pool of 5,000 companies for potential spot buy and hard-to-get, low demand bench stock items. Using a broader support base would not have been possible without more defined requirements developed from detailed consumption data and patterns.

An integrator is "process" or "customer" focused as opposed to being strictly "parts" focused. Integrator success is not just based on providing parts to a bin. The primary characteristic of an integrator is the ability to provide the right parts at the right time in the right place. Understanding the bench stock "drivers," eliminating excess property (or never used property), and anticipating customer requirements (in the form of properly developed AQ) are much more important than just ordering and supplying parts. A responsible integrator will want to ensure that critical funds are being expended in the most efficient way possible. Cost reduction and cost avoidance (not having excessive inventory in a customer's bin) are critical measures of success. In addition:

1. Integrators have the capability to address a wide range of process and technical issues. SAIC has extensive modeling and simulation, logistics, system engineering and information technology capabilities. Those specialties were brought to bear on the IPV program to provide enhanced demand forecasting associated with an advanced supply chain management system. Very few integrators and no parts suppliers have developed such end-to-end systems. Most parts supplier systems are unable to integrate their processes with their customer's data systems. SAIC's engineers were able to quickly implement EDI solutions, legacy interface data feeds, web status displays, varied data reports, and the like.
2. Integrators are much more likely to use alternate supply sources if valid requirements are known or can be developed with some degree of certainty. This is the trend with SAIC and the current IPV program. Over time, because of a significantly higher confidence in accurate demand information, SAIC has been able to determine where the "best deals" can be found. At this stage of program maturity, dealing with one principal supplier is, in many ways, counter-productive.
3. Integrators are more likely to develop innovative ideas for operations since their livelihood does not necessarily depend on buying and selling parts.
4. The following improvements to USAF bin stock operations have been made by SAIC to improve support to the customer maintenance operations:
   a. Tail of the aircraft (TOA) bins. This action put parts in bins in close proximity to maintenance technicians thus reducing mechanic down time.
   b. Replaced manned with unmanned bins locations. This action resulted in significant savings in manpower over time, and allowed maintenance technicians much more access to the bench stocks.
   c. Building kits on site from existing bench stocks or in off-base locations to speed up the repair process and eliminate waste.

d. Bench stock re-use. SAIC resolved the problem of how to comply with ISO 9000 quality requirements of the contract while at the same time allowing re-claiming of removed but unused bench stock.
e. Identification and validation of bench stock parts in bins. SAIC inventoried and identified all items in the bench stock bins to be supported, and took action to either recommend continued support or removal of the item(s) from the bins. A parts supplier would only be interested in supporting as many items as could be found in the bins. The emphasis would not necessarily be on removing unused items.

In summary, SAIC believes that some of the conclusions and recommendations in the draft audit report are based on pre-mature and incomplete data and that any evaluation of best value for the Air Force cannot be made based on 15 months of a 5-year contract. Also, the continued success of these programs requires a systems integrator with supply chain management experience that has as their primary focus the current and future needs of their customers.

If you have any questions on any of our concerns with the draft audit report or would like additional information or clarification on our comments, please contact Vincent D. Crabb at 858-826-9312 to discuss further.

Sincerely,

SCIENCE APPLICATIONS
INTERNATIONAL CORPORATION

John W. Duchesne, Jr.
Corporate Vice President for Administration
Sector Director of Contracts,
Engineering, Logistics & Strategic Solutions Sector

Copy to:

Mr. Henry F Kleinknecht
Inspector General, Department of Defense
400 Army Navy Drive (Room 801)
Arlington, VA 22202-4704

Department of the Air Force Comments

DEPARTMENT OF THE AIR FORCE
OFFICE OF THE CHIEF OF STAFF
WASHINGTON, DC

02 MAY 2002

MEMORANDUM FOR DIRECTOR OF AUDIT FOLLOWUP, OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

FROM: AF/IL

SUBJECT: DoD(IG) Draft Audit Report, "Industrial Prime Vendor Program at the Air Force Air Logistics Centers," 6 February 2002 (Project # D2001CF-0091.000)

As the major customer affected in this audit, the Air Force has a direct interest in the Defense Logistics Agency Industrial Prime Vendor program at the Air Logistics Centers. Therefore, we are providing the following comments.

This program was a test and included several features as a test that would not be appropriate in a permanent program. Some of the "problems" identified by the audit were temporary duplications of manning or inventory caused by test conditions only. The audit report gave very little attention to the success that this program has had in improving availability of parts to the Air Force customer. Rejecting the market basket approach would prevent holding the contractor responsible for overall performance in maintaining bench-stock. Detailed comments are provided as an attachment.

Thank you for considering our comments,

Susan A O'Neal

SUSAN A. O'NEAL
Asst DCS/Installations & Logistics

Attachment:
Detailed Comments

cc:
SAF/FMPF
HQ AFMC/LG

Detailed Air Force Comments for DoD(IG) Draft Audit Report, "Industrial Prime Vendor Program at the Air Force Air Logistics Centers," 6 February 2002 (Project # D2001CF-0091.000)

Recommendation A.1. We recommend that the Commander, Defense Supply Center Philadelphia, require Industrial Prime Vendor Program officials to:

a. Discontinue the use of the market basket approach to determine which bench-stock items are placed on the industrial prime vendor contract. Instead, evaluate each item separately and select the most economical source of supply material.

b. Review inventory levels and discontinue placing items on the industrial prime vendor contract with more than 3 years of inventory.

c. Take appropriate action in accordance with contract terms to remove items with more than 3 years of inventory and start using existing depot inventories as the first choice to fill contract demand.

Recommendation A.2. We recommend that the Director, Defense Logistics Agency, convene a performance improvement team composed of representatives from all relevant stake holders, including appropriate oversight agencies, to plan and execute a reengineered best value approach to managing bench-stock material for all customers that addresses competition and restriction on contract bundling.

Recommendation B.1. We recommend that the Commander, Defense Supply Center Philadelphia:

a. Implement procedures to ensure that future spot buy material procurements are priced and paid for in accordance with the terms of the contract.

b. Obtain a full refund from SAIC for erroneous charges, including lost interest, and take appropriate steps to reimburse the ALCs for the full amount of the contract overcharges.

1. **TEST PROGRAM.** This program was a test and included several features as a test that would not be appropriate in a permanent program. The problems identified in Recommendation B.1 are being addressed by DSCP.

Some of the "problems" identified by the audit were temporary duplications of manning or inventory caused by test conditions only. For example, the test contract did not use DLA stocks because the intent of the program was that the contractor would demonstrate the ability to support the Air Force customer without DLA support. While it may be that some unnecessary expenditure occurred, encouraging the contractor to rely on DLA for a large portion of their stock would invalidate the test. Since the initial test demonstrated a high level of successful performance by the contractor, altering the program to draw down DLA stocks is now appropriate. (Recommendations A.1.b and A.1.c.)

Another example of how the test program differs from a permanent program is the issue of additional contractor manpower to manage bench stock. In the test program, it was inevitable that there would be some duplication of manpower since only a small number of shops were affected by the test and the majority of the depot retail supply operation was not changed. As

more shops are added to the program, the Air Force expects that the contractor's manpower efficiency to increase.

2. MANPOWER DUPLICATION. The Air Force also disputes some of the statements made in the report regarding manpower duplication. The contractor provided a substantially better result than the previous method of bench-stock management. Therefore, it would be more appropriate to ask what level of manning would have been required for the organic staff to accomplish the same result. Also, the audit only looked at manpower at the retail supply site. In the long run, this program has the potential for significant manpower savings at the wholesale level since many of the support issues become the responsibility of the contractor instead of the DLA wholesale item management team. Finally, when citing that manpower increased from 45 to 100 under the industrial prime vendor program, the contractor numbers include part-time on-call personnel.

3. IMPROVED PERFORMANCE. The audit report gave very little attention to the success that this program has had improving availability of parts to the Air Force customer. Some of the specific criticisms in the audit, increased total inventory for example, are viewed by the customer as a success story. The contractor is successfully identifying materials that are needed and putting them in the bench-stock prior to need. This resulted in fewer work stoppages, reducing overall depot maintenance costs with a modest increase in bench-stock inventory. Support has improved dramatically in the shops where this test program has been implemented. As a result, Air Force Material Command has asked to expand the test program (HQ AFMC/LG memo, 18 Jan 2002).

4. MARKET BASKET APPROACH AND COMPETITION. While understating the benefits of this program, the audit report overemphasizes potential advantages of going back to individual item procurement. The purpose of giving the contractor responsibility both to manage the bench-stock at the customer location and obtain the material from other contractors is to create a performance oriented contract where the contractor can be held accountable. Otherwise, the contractor could claim that the reason he does not have the bench-stock item is because a third party has failed to provide it to him. This is one of the "substantial benefits" accrued from bundling this contract. Since the contractor providing the IPV service is not the manufacturer of the inventory, this arrangement does not benefit only large manufacturers. Establishing market basket groups also prevents contractors from choosing only the easy to supply items, leaving DLA to try to supply the most difficult ones outside the IPV agreement. The Air Force agrees that determining reasonable prices is more difficult under the market basket approach. However, if the alternative is to buy the same group of parts at the same or even higher total cost with more stock shortages, it is time to work through those problems.

5. CONCLUSION. The Industrial Prime Vendor for the Air Logistics Centers program has provided an impressive improvement in customer support. Allowing for some duplication and inefficiencies during the limited test program, it appears that this improvement is being achieved at a very modest additional cost, if any. The Air Force cannot afford to pass up this opportunity.

Point of Contact: Bob Buckles, HQ USAF/ILGP, DSN 225-9798, 27 Apr 2002

MEMORANDUM FOR HQ USAF/ILSP
1030 AIR FORCE PENTAGON
WASHINGTON, D.C. 20330-1030

25 MAR 2002

FROM: HQ AFMC/LG
4375 Chidlaw Road, Room A135
Wright-Patterson AFB OH 45433-5006

SUBJECT: Department of Defense (DOD) Inspector General (IG) Audit (Project No. D2001CF-0091.000), Industrial Prime Vendor (IPV) Program at the Air Logistics Centers (ALCs), Draft Report

1. HQ AFMC/LGPP has reviewed the subject draft DOD IG audit report in accordance with your request, and submits the following comments for your consideration:

a. We concur with the DOD IG audit conclusion that the Defense Supply Center Philadelphia (DSCP) IPV contract with SAIC has provided structure and has improved availability of bench stock material at the Air Force ALCs, and has made progress towards shifting to commercial sources for supplying required depot repair material. We believe the audit report understates the improved bench stock logistics support progress being made at our Air Force depots under the IPV contract. For example, over 20,000 bench stock authorized quantity (AQ) bin levels have been substantially increased during the test to support real world Air Force depot maintenance shop production requirements that had not been supported at those levels. This is directly attributable to increased contractor oversight. Many of these changes reflect bin level increases in the magnitude of 700, 800, 900, and in some cases, 1000 percent over previous levels. The IPV contractor has also exceeded the required 98 percent fill rate contract performance metric in all of our Air Force depot maintenance test shops for the last 8 months. As a result, senior executive HQ AFMC/LG and ALC management personnel declared the IPV test program a success, and requested DSCP not only extend current contract coverage for existing test shops, but deploy the program to all remaining Air Force depot maintenance shops. We have requested that DSCP award all remaining IPV contract award options that will extend direct delivery parts support coverage through Jan 05.

b. We do not concur with the DOD IG auditor's conclusion that the IPV contract will not make use of available depot bench stock inventory to satisfy depot requirements over the next 3 years. As the remaining contract options are awarded and IPV deployment expands to our remaining depot maintenance shops, the current HQ AFMC/ALC/DSCP plan is to include a contract provision that will allow the draw down of all remaining existing Air Force depot supply IPV unique retail stock to a zero balance. SAIC, the IPV contractor, has agreed to pick up and utilize unique IPV government excess retail stock (placing the material in the bins) prior to initiating any additional parts

procurements from their commercial parts suppliers. The DOD IG auditor's conclusion is therefore not valid.

c. We do not concur with the DOD IG auditor's statement on page 17 implying that "only Big Business" is benefiting from the IPV program. There are literally scores of subcontractors across the nation that are involved as suppliers under the IPV contract, and additional competition (involving more optional suppliers) will be incorporated by DSCP under the IPV expansion contract option effort.

d. Additionally, we do not agree with the DOD IG auditor's statement on pages 17-18 that "DLA should be solely responsible for the contracting function" and should create a separate IPV parts delivery integrator contract function separate from direct vendor delivery parts contractors. This DOD IG audit proposal would not only drive additional contract costs for our ALC depot maintenance customers, it would require that our IPV contract 98 percent fill rate parts performance delivery metric requirement with our IPV contractor SAIC be waived. Under such a scenario, the IPV contractor could no longer be held accountable for timely delivery of bench stock parts into the Air Force depot maintenance customer bins based on real world depot mechanic demands. That responsibility would now shift to an "IPV integrator" under the DOD IG auditor's concept. This would create an additional integration management burden on our Air Force depot supply managers who currently oversee IPV contractor parts delivery performance as DSCP's on site Contract Officer Representatives. This would unnecessarily fragment our new and successful IPV bench stock support process. There would be no inherent incentive for the direct vendor delivery parts suppliers (i.e. SAIC) to interface directly with the proposed DOD IG "IPV integrator" contractor. Our ALC depot IPV maintenance customers do not concur with implementation of such a proposal.

e. The DOD IG auditors also stated on page 15 that the IPV program used 55 additional personnel to manage bench stock material at the ALCs. It is not accurate to compare the previous number of organic Air Force depot bench stock management personnel who previously performed depot bench stock support requirements with assigned IPV SAIC support personnel and reach a valid conclusion. The DOD IG auditor comparison did not recognize that the IPV contractor was selected to supply complete supply chain management cradle to grave parts support services to our Air Force depot maintenance customers in the designated test shops. In order to ensure an accurate comparison, the DOD IG auditor's report would require modification to also include counting the Defense Logistics Agency (DLA) personnel that currently provide distribution and transportation support for bench stock at the three depots as well as addressing the total amount of program management, item management, and procurement staff that would have been required by DSCP to support the IPV test shop items under the old support system. The additional required organic DLA supply, item management, and procurement personnel under the old system are not adequately covered or addressed in the DOD IG auditor's report. Finally, some of the 55 SAIC personnel are part time only employees that are are used to satisfy weekend emergencies. These SAIC contractor employees are used exclusively in the manned depot maintenance production shops at OC-ALC during those weekend time periods. OC-ALC is the only remaining depot that utilizes an IPV contractor manned bench stock parts maintenance approach.

2. Our point of contact is Mr. John D. Anderson, HQ AFMC/LGPP, DSN 674-0150.

Thomas W. Batterman

THOMAS W. BATTERMAN
Deputy Director for Depot Maintenance
Directorate of Logistics

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

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