Audit Report

OFFICE OF THE INSPECTOR GENERAL

HOTLINE ALLEGATIONS CONCERNING THE NAVY'S PURCHASE OF M-65 SUBSYSTEMS

Report No. 95-042 November 25, 1994

Department of Defense

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Acronyms

MICOM	Missile Command
NAWC	Naval Air Warfare Center
NTS	Night Targeting System
TOW	Tube-Launched, Optically Tracked, Wire-Guided

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
DIRECTOR, DEFENSE LOGISTICS AGENCY
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Hotline Allegations Concerning the Navy's Purchase of M-65 Subsystems (Project No. 4AL-8017)

Introduction

We are providing this memorandum report for your information and use. The audit was performed in response to allegations made to the Inspector General, DoD, relating to the Navy's purchase of M-65 subsystems for the Tube-Launched, Optically Tracked, Wire-Guided (TOW) System on AH-1 Cobra helicopters. The complainant alleged that the Navy purchased M-65 subsystems from the Hughes Aircraft Company (Hughes) without coordinating the purchase with the National Inventory Control Point, the Army's Missile Command (MICOM). The complainant further alleged that the Navy could have saved $6.1 million by acquiring the subsystems from MICOM.

Audit Results

The allegation concerning the Navy's coordination with MICOM was partially valid. The Navy discussed its requirements with MICOM before contracting with Hughes for the M-65 subsystems needed for the Marine Corps' Night Targeting System (NTS). The allegation that the Navy could save $6.1 million by acquiring the subsystems from MICOM was valid; however, the amount of savings was understated. As a result of our audit, the Navy agreed to terminate its contract with Hughes and buy the M-65 subsystems from MICOM. The Navy's action will result in the DoD realizing $14.3 million in savings ($16.5 million less $2.2 million in termination costs). The Navy will realize $8.8 million in savings by buying the M-65 subsystems from MICOM. Finally, MICOM will receive about $5.5 million from selling the subsystems to the Navy. We reviewed the officials' efforts and plans and are convinced that the efforts will satisfactorily correct the deficiencies identified during the audit.

Objective

The audit's overall objective was to determine the validity of allegations concerning the Navy's purchase of M-65 subsystems for the TOW System on AH-1 Cobra helicopters.

Scope and Methodology

To satisfy the audit objectives, we reviewed MICOM's inventory positions for M-65 subsystems to determine their availability. We also identified existing contracts for the M-65 subsystems and reviewed the contracts to determine the feasibility of terminating the contracts and using the M-65 subsystems from the Army's inventory. The contracts identified are shown in Table 1.

Table 1. Contracts for M-65 Subsystems

Military Department	Contract/Order	Amount (millions)
Navy	N00163-94-C-0095	$16.5
Army	DAAH01-92-C-0302	61.9
Army	DAAH01-92-G-0001/0007	2.5
Navy	N00383-91-G-B501/0093	10.6

We did not recommend terminating three of the four contracts because Hughes had either started deliveries or was to begin deliveries in October 1994. On contract N00163-94-C-0095, Hughes was not scheduled to begin deliveries until June 1995. We visited the Defense Plant Representative Office at Hughes to determine the status of contract N00163-94-C-0095 with Hughes and whether it would be economical for the Navy to terminate the contract. To do so, we obtained cost and schedule data from the Defense Plant Representative Office. Also, we met with officials from MICOM and the Navy to determine the Navy's reasons for acquiring the M-65 subsystems from Hughes. Finally, we arranged for the officials to meet and decide whether it would be in the DoD's best interest to terminate contract N00163-94-C-0095 and acquire M-65 subsystems from MICOM.

We did not determine the reliability of the computer-generated data that we used to determine the availability of subsystems at MICOM and to terminate the contract with Hughes. Therefore, errors in the data could directly effect our conclusions. Although we did not determine the reliability of the data at MICOM, we asked MICOM's inventory managers to confirm the availability of the M-65 subsystems to the Navy. Similarly, in deciding whether or not it would be economical for the Navy to terminate the contract with Hughes, we obtained cost and schedule data on two separate occasions. Also, we encouraged the Navy to determine whether it would be cost beneficial to terminate the contract.

This program audit was made from July 1994 through August 1994, in accordance with the auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. The organizations visited and contacted during the audit are listed in Enclosure 4.

Internal Controls

We did not assess internal controls because the audit was limited to the allegations in the Hotline complaint.

Prior Audits and Other Reviews

No prior audits or reviews had been made on the Navy's purchase of M-65 subsystems from Hughes by the General Accounting Office; the Office of the Inspector General, DoD; or the Audit Agencies of the Military Departments.

Background

The M-65 system provides the AH-1 Cobra helicopter with a fire control system for the TOW. The M-65 system consists of a Telescopic Sight Unit, Stabilization Control Amplifier, Missile Command Amplifier, Electronic Power Supply, four Guided Missile Launchers, and the Sight Hand Control.

Hughes has provided the M-65 subsystems to MICOM since the mid-1970s. MICOM is the designated inventory control point and is responsible for acquiring and managing the M-65 subsystems. MICOM acquires the subsystems based on records of reported inventory, historical use, repair rates, and approved force-level requirements.

The Navy needed the M-65 subsystems to provide the Marine Corps and certain foreign customers with a Night Targeting System (NTS) for their AH-1 Cobra helicopters. The NTS enables the AH-1 Cobra helicopter to engage the enemy during the day or night under adverse weather conditions with any of its weapons.

Discussion

The allegation that the Navy did not coordinate the purchase of the M-65 subsystems with the inventory control point was not entirely valid. The Navy informed MICOM that it was considering contracting with Hughes through the Naval Air Warfare Center (NAWC) for the M-65 subsystems. The Navy also discussed with MICOM its requirements for the M-65 subsystems. On March 30, 1994, the NAWC, at the request of the Navy, awarded contract N00163-94-C-0095 with a not-to-exceed price of $16.5 million to Hughes. The contract called for 25 sets of M-65 subsystems: 12 sets for the Marine Corps and 13 sets for Foreign Military Sales customers.

The allegation that the Navy could save money by acquiring the subsystems from MICOM was valid. The DoD could put to better use $14.3 million if the Navy would acquire the subsystems from MICOM rather than Hughes.

Navy's Reasons for Acquiring M-65 Subsystems From Hughes. The Navy officials said they had several reasons for awarding contract N00163-94-C-0095 directly to Hughes.

o The Navy was required to provide the Foreign Military Sales customers for the NTS with new, not refurbished, M-65 subsystems.

o The Navy did not believe that MICOM could satisfy its requirements for the M-65 subsystems. In addition, MICOM could not provide the individual parts from the Telescopic Sight Unit and Stabilization Control Amplifier that the Navy uses in the NTS.

o The Navy maintained that MICOM's refurbished M-65 subsystems were not suitable to provide as Government-Furnished Equipment and would void the contractor's warranty on the NTS.

On March 21, 1994, the Navy notified MICOM that the Marine Corps was interested in obtaining refurbished M-65 subsystems in order to reduce the cost of the NTS. The Navy believed that it could obtain at no cost an excess supply of M-65 subsystems from MICOM. The correspondence noted that MICOM had been closely involved in providing new and refurbished M-65 subsystems to the Marine Corps for the NTS.

Availability of M-65 Subsystems From MICOM. MICOM responded to the Navy's inquires and stated that the M-65 subsystems were not in an excess supply position. However, MICOM offered to sell the M-65 subsystems to the Navy for a total of $12.3 million or $4.2 million less than Hughes' prices. MICOM stated that when the items become excess, it would offer the M-65 subsystems as reduced-cost items or for disposal.

During the audit, MICOM reviewed its inventory positions and determined that it had sufficient M-65 subsystems to satisfy the Navy's requirements. MICOM also determined that the Telescopic Sight Units and the Guided Missile Launcher qualified as reduced-cost items. The Army reduced the price of the Telescopic Sight Unit from $277,946 to $58,230 and the price of the Guided Missile Launcher from $17,170 to $3,597.

With the reductions on the sights and launchers, MICOM's prices on four of the five subsystems were substantially less than Hughes' undefinitized prices for contract N00163-94-C-0095 as shown in Table 2.

Table 2. Comparison of Unit Prices for M-65 Subsystems

Item	Unit Prices		
	Hughes	Army	Delta
Telescopic Sight Unit	$237,600	$58,230	$179,370
Stabilization Control Amplifier	137,900	35,431	102,469
Missile Command Amplifier	71,700	12,828	58,872
Electronic Power Supply	105,500	99,036	6,464
Guided Missile Launcher	26,500	3,597	22,903

Benefits in Terminating the Contract With Hughes

We reviewed the potential for the Navy to terminate contract N00163-94-C-0095 with Hughes. We estimated that the Navy would incur approximately $2.2 million in termination costs (Enclosure 1). Hughes may be able to offset the $2.2 million in estimated termination costs by using the $1.6 million in materials on other Government contracts for M-65 subsystems. Specifically, Hughes has 41 Telescopic Sight Units and 39 sets of M-65 subsystems to manufacture and deliver between October 1994 and July 1995.

The 39 sets of M-65 subsystems was an option that MICOM exercised on contract DAAH01-92-C-0302. Of the 39 M-65 subsystems, 22 were designated for the Marine Corps and 17 for a Foreign Military Sales customer. The Navy could use the M-65 subsystems from contract DAAH01-92-C-0302 to satisfy the Foreign Military Sales customers on contract N00163-94-C-0095 who wanted new items. We recommended that the Navy transfer 13 of the Marine Corps' 22 M-65 subsystems to the Foreign Military Sales customers on contract N00163-94-C-0095. That transfer would allow the Navy to terminate all 25 M-65 subsystems on contract N00163-94-C-0095. The Navy could then replace the 13 M-65 subsystems transferred to the Foreign Military Sales customers with items obtained from MICOM.

We concluded that it would be in the DoD's best interest for the Navy to completely terminate contract N00163-94-C-0095 with Hughes. The Navy could put to better use $8.8 million by buying the M-65 subsystems from MICOM (Enclosure 2). MICOM would also benefit from the termination of contract N00163-94-C-0095 by selling the Navy unneeded M-65 subsystems. MICOM would receive about $5.5 million from the sale of the 25 sets of M-65 subsystems to the Navy. In addition, MICOM would avoid costs associated with maintaining the M-65 subsystems in its inventory.

Actions Taken by Management

During the audit, we arranged for officials of the Army and the Navy to meet and decide whether the subsystems should be acquired from MICOM or Hughes. MICOM confirmed for the Navy the availability of the M-65 subsystems and the revised prices. As a result of that meeting and supplemental evaluations, the Navy agreed to terminate contract N00163-94-C-0095 and have MICOM provide the M-65 subsystems. On October 5, 1994, the NAWC notified Hughes that contract N00163-94-C-0095 was terminated. The Navy also requested that we include a chronology of the discussions between MICOM and the Navy concerning the procurement of the M-65 subsystems from Hughes. The chronology is in Enclosure 3. We considered the actions taken by the Navy and the Army responsive to the conditions that we noted.

Management Comments

A draft of this report was provided to officials within the Army, the Navy, and the Defense Logistics Agency. Since this report contains no recommendation, written comments on our conclusions were not required. Management elected not to respond. However, we request that the Army and the Navy provide comments concerning the net monetary impact of the actions taken by management on matters addressed in this report. Your comments should be provided by January 27, 1995.

The courtesies extended to the audit staff are appreciated. If you have questions on this audit, please contact Mr. Rayburn H. Stricklin, Program Director, at (703) 604-9051 (DSN 664-9051) or Mr. J. Steven Hughes, Project Manager, at (703) 604-9045 (DSN 664-9045). Enclosure 5 lists the distribution of this report.

Robert J. Lieberman

Robert J. Lieberman
Assistant Inspector General
for Auditing

Enclosures

Estimated Termination Costs

Termination Costs for Contract N00163-94-C-0095

Description	Contract Costs ($ in millions)
Materials[1]	$1.60
Labor	0.21
Other Direct Costs	0.01
Contract Overhead	0.07
General and Administrative	0.02
Cost of Money[2]	0.02
Profit[3]	0.29
Estimated Cost to Terminate	$2.22

[1]The $1.6 million in material costs consisted of $1.4 million in material commitments with the remainder being materials charged directly to contract N00163-94-C-0095. The actual cost of the work performed on the material commitments was not known.

[2]The cost of money was calculated using the labor cost multiplied by an 11 percent rate for cost of money.

[3]Profit was calculated using 15 percent of the $1.93 million in cost incurred.

Summary of Potential Savings

Analysis of Savings	Savings (in millions)	
Cost of Contract N00163-94-C-0095	$16.5	
Less Estimated Termination Costs	2.2	
Total Savings to DoD[1]		$14.3
Navy's Cost to Procure Army M-65 Subsystems:		
Telescopic Sight Unit	$1.5	
Stabilization Control Amplifier	0.9	
Missile Command Amplifier	0.3	
Electronic Power Supply	2.4	
Guided Missile Launcher	0.4	
Cost of Army's M-65 Subsystems[2]		5.5
Net Savings to the Navy[3]		$ 8.8

[1]We estimated that the potential savings to DoD is the $14.3 million that the Navy could avoid paying to Hughes by terminating contract N00163-94-C-0095 and buying the M-65 subsystems from MICOM.

[2]The $14.3 million in potential savings would result in MICOM receiving $5.5 million from the Navy for M-65 subsystems that the Army no longer needed.

[3]The net savings to the Navy is the total cost of contract N00163-94-C-0095 ($16.5 million) less the estimated termination cost of ($2.2 million) and less the cost of buying the items from MICOM ($5.5 million).

Chronology of Navy's Purchase of M-65 Subsystems

April 20, 1993. The NAWC notified MICOM that the Navy had requested NAWC "to solicit, award, and administer the fiscal year 1994 contracts for the United States Marine Corps, National Guard and Reserve Equipment, and Foreign Military Sales M65 Subsystem requirements." NAWC also requested information from MICOM on the past procurements of the M-65 subsystems.

July 1, 1993. In response to the NAWC memorandum, MICOM stated that it was the manager for the M-65 subsystems. MICOM also informed NAWC that the Navy's buying of the items on its own rather than going through the established logistics system at MICOM could result in the Government incurring unnecessary costs.

August 12, 1993. The Navy then informed MICOM that the most cost-effective way to procure the M-65 subsystems for the Night Targeting System is competitively through NAWC.

August 24, 1993. NAWC synopsized the purchase of the 25 M-65 subsystems in the Commerce Business Daily as a sole-source procurement with the Hughes Aircraft Company.

February 28, 1994. The Hughes Aircraft Company submitted a $16.7 million proposal to NAWC for the 25 M-65 subsystems.

March 21, 1994. The Navy notified MICOM of its interest in buying excess M-65 subsystems. The Navy believed that 72 Telescopic Sight Units were excess to the Army's needs and would have to be sent to property disposal.

March 30, 1994. NAWC awarded Hughes Aircraft Company a sole-source contract with a not-to-exceed price of $16.5 million.

April 8, 1994. MICOM informed Hughes that the NAWC contract for the M-65 subsystems should be accepted. MICOM noted that the contract was in direct violation of DoD policy and that this contract was a one-time exception to those policies. MICOM granted the exception because a delay "would only penalize the Marines of the Fleet Marine Force and these are the very persons we must make every effort to support."

April 18, 1994. In response to the Navy's March 21, 1994, memorandum, MICOM notified the Navy that the M-65 subsystems were not in excess supply and could not be sold at reduced prices. The items were available for sale to the Navy at the standard prices. MICOM added that if the M-65 subsystems become excess to the Army's requirements, the items will be offered as reduced-cost items or to disposal.

May 2, 1994. MICOM requested that the Navy reconsider the purchase of the 25 M-65 subsystems from Hughes. MICOM emphasized that the Navy could procure the M-65 subsystems from MICOM at a substantial cost savings and that the items were available for immediate delivery.

July 7, 1994. Our audit was initiated in response to the allegation made to the Inspector General, DoD.

August 4, 1994. At our request, representatives of the Army and the Navy met to decide whether the M-65 subsystems should be acquired from MICOM or Hughes. MICOM confirmed to the Navy the availability of the M-65 subsystems and the revised prices.

August 12, 1994. NAWC issued a stop-work order to Hughes on contract N00163-94-C-0095.

September 21, 1994. The Navy requested that NAWC terminate contract N00163-94-C-0095.

October 5, 1994. The NAWC terminated contract N00163-94-C-0095.

Organizations Visited or Contacted

Department of the Army

Deputy Chief of Staff for Logistics, Washington, DC
Missile Command, Redstone Arsenal, AL

Department of the Navy

Naval Air Systems Command, Washington, DC
Navy Aviation Supply Office, Philadelphia, PA
Naval Air Warfare Center, Aircraft Division, Indianapolis, IN

Defense Agencies

Defense Contract Audit Agency, Los Angeles, CA
Defense Logistics Agency, Alexandria, VA
- Defense Contract Management District West, Los Angeles, CA
  - Defense Plant Representative Office, Hughes Aircraft Company, Los Angeles, CA

Contractor

Hughes Aircraft Company, Los Angeles, CA

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