Audit Report

PURCHASING RESTRICTIONS AND STATE TAXATION
ON DISTILLED SPIRITS

Report Number 99-025 October 29, 1998

Office of the Inspector General
Department of Defense

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Acronyms

AAFES	Army and Air Force Exchange Service
AFB	Air Force Base
ASD(FMP)	Assistant Secretary of Defense (Force Management Policy)
MWR	Morale, Welfare, and Recreation
NAF	Nonappropriated Fund
NEXCOM	Navy Exchange Service Command
PFRD	Personnel and Family Readiness Division

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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ARLINGTON, VIRGINIA 22202

October 29, 1998

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (FORCE MANAGEMENT POLICY)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Audit Report on Purchasing Restrictions and State Taxation on Distilled Spirits (Report No 99-025)

We are providing this report for your information and use. We performed the audit in response to a request by the Executive Director, Morale, Welfare, and Recreation and Resale Activities. This is the second of two audit reports responding to the Executive Director's request. Inspector General, DoD, Report No 98-126, "Economic Distribution of Distilled Spirits Within DoD," April 30, 1998, discussed the most economical method of distributing distilled spirits within DoD.

Comments from the Executive Director for Morale, Welfare, Recreation, and Resale Activities on a draft of this report were considered in preparing this final report. In response to management comments, we revised Recommendation A.1. The Executive Director's comments conformed to the requirements of DoD Directive 7650.3; therefore, additional comments are not required.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr Michael A. Joseph (mjoseph@dodig osd.mil) or Mr Timothy J. Tonkovic (ttonkovic@dodig.osd mil) at (757) 766-2703. See Appendix B for the report distribution. The audit team members are listed inside the back cover

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Report No. 99-025 **October 29, 1998**
(Project No. 7LF-5020.01)

Purchasing Restrictions and State Taxation on Distilled Spirits

Executive Summary

Introduction. Defense Appropriation Acts from FY 1986 through FY 1996 required nonappropriated fund instrumentalities to purchase distilled spirits only from in-state sources in Alaska and Hawaii. Although the purchasing provision in Alaska and Hawaii expired at the end of FY 1996, nonappropriated fund instrumentalities continued to comply with the provision in FYs 1997 and 1998. Additionally, Washington requires that distilled spirits purchased for resale on DoD installations in the state be purchased from the Washington State Liquor Control Board. Nonappropriated fund instrumentalities include the Army and Air Force Exchange Service (AAFES), the Navy Exchange Service Command (NEXCOM), and the Marine Corps Personnel and Family Readiness Division (formerly the Morale, Welfare, and Recreation Support Activity). Distilled spirit sales by AAFES, NEXCOM, and the Marine Corps Personnel and Family Readiness Division totaled $17.5 million in Alaska, Hawaii, and Washington in 1996.

The audit was requested by the Executive Director, Morale, Welfare, and Recreation and Resale Activities in the Office of the Assistant Secretary of Defense (Force Management Policy). This is the second audit report in response to the request. Inspector General, DoD, Report No. 98-126, "Economic Distribution of Distilled Spirits Within DoD," April 30, 1998, discussed the most economical method of distributing distilled spirits within DoD.

Objectives. The primary objective was to determine whether the military exchange systems provided the most economical method of distribution of distilled spirits within DoD. A second objective was to determine whether the use of commercial distributors rather than the AAFES and NEXCOM network for distribution of distilled spirits resulted in taxation to nonappropriated fund instrumentalities. This report discusses the second objective and purchasing restrictions in Alaska, Hawaii, and Washington.

Results. Nonappropriated fund instrumentalities were restricted from purchasing distilled spirits in the most economical manner in Alaska, Hawaii, and Washington. As a result, for items surveyed, distilled-spirit prices ranged, on average, from $5 to $28 more per case in

1996 than if the distilled spirits had been purchased from commercial distillers and distributed through the AAFES and NEXCOM distribution networks (Finding A).

AAFES and NEXCOM may be precluded from distributing distilled spirits in the most economical manner when distilled-spirit case costs include taxes. As a result, nonappropriated fund instrumentalities could be prevented from making best value purchasing decisions, thereby reducing profits for morale, welfare, and recreation programs (Finding B).

Summary of Recommendations. We recommend that the Assistant Secretary of Defense (Force Management Policy) direct nonappropriated fund instrumentalities to use best value purchasing decisions, to include consideration of Title 10, United States Code, Section 2488 (c)(2), when purchasing distilled spirits for military stores in Alaska, Hawaii, and Washington. We also recommend that the Assistant Secretary direct AAFES to terminate its distilled-spirit purchasing contract with the Washington State Liquor Control Board. We also recommend that the Assistant Secretary determine the potential legal impact on military store patrons if distilled spirits are purchased from sources other than the Washington State Liquor Control Board. Finally, we recommend that the Assistant Secretary propose a legislative change to Title 10, United States Code, Section 2488 (c)(2), to delete the paragraph requiring nonappropriated fund instrumentalities be considered the most economical source for procuring distilled spirits, if other sources include taxes.

Management Comments. The Executive Director, Morale, Welfare, and Recreation and Resale Activities, Office of the Assistant Secretary of Defense (Force Management Policy), nonconcurred with the draft report recommendation to use best value purchasing decisions because the recommendation did not require consideration of Title 10, United States Code, Section 2488 (c)(2). The Executive Director concurred with the recommendation to terminate the distilled-spirit purchasing contract with the Washington State Liquor Control Board and to determine the potential legal impact on military store patrons if distilled spirits are purchased from sources other than the Washington State Liquor Control Board. The Executive Director also concurred with the recommendation to propose a deletion of the paragraph in Title 10, United States Code, Section 2488, that requires nonappropriated fund instrumentalities to be considered the most economical source for procuring distilled spirits, if other sources include taxes. The complete text of management comments is on page 26.

Audit Response. Comments from the Executive Director are fully responsive. We agree that AAFES and NEXCOM should comply with the requirements of Title 10, United States Code, Section 2488 (c)(2) (until the paragraph is repealed), when making best value purchasing decisions. We revised the recommendation accordingly and no further comments are required.

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Background

The audit was requested by the Executive Director, Morale, Welfare, and Recreation and Resale Activities, Office of the Assistant Secretary of Defense (Force Management Policy) (ASD[FMP]). The request was based on the National Defense Authorization Act for FY 1996 that required the Secretary of Defense to use the Inspector General, DoD, to make determinations whether nonappropriated fund (NAF) instrumentalities provided the most economical method of distilled-spirit distribution and if distilled spirits were subjected to taxation. This is the second audit in response to the Executive Director's request. Inspector General, DoD, Report No. 98-126, "Economic Distribution of Distilled Spirits Within DoD," April 30, 1998, discussed the most economical method of distributing distilled spirits within DoD.

This report discusses distilled-spirit sales at military stores in Alaska, Hawaii, and Washington. It also discusses taxation of distilled spirits purchased from commercial distributors in the United States. The 1996 Army and Air Force Exchange Service (AAFES) distilled-spirit retail sales in Alaska were $1.4 million. Combined sales for AAFES, the Naval Exchange Service Command (NEXCOM), and the Marine Corps Personnel and Family Readiness Division (PFRD) in Hawaii were $4.8 million. In Washington, AAFES and NEXCOM sales were $11.3 million. The NEXCOM retail sales include wine because NEXCOM did not distinguish between distilled-spirit and wine sales at NEXCOM military stores.

NAF instrumentalities use three sources to purchase distilled spirits: commercial distillers, commercial distributors, and state alcoholic beverage control boards.

Commercial Distillers. Distillers, such as Jim Beam Brands Co.; Heublein, Inc.; and Joseph E. Seagram and Sons, Inc., sell in bulk and normally do not distribute their products to individual retail outlets. Commercial distributors, AAFES, NEXCOM, and state alcoholic beverage control boards purchase distilled spirits from distillers, and distribute the products to retail outlets through their own established distribution networks.

Commercial Distributors. Distributors purchase, warehouse, and distribute distilled spirits to retail outlets in the state where they are located. The prices charged by in-state distributors include delivery, handling, and storage of distilled spirits. In addition, distributors' prices may include state taxes. Those expenses are added to the base cost of distilled spirits and result in a delivered case cost

price that is paid by the retail outlet. Distributors normally have exclusive rights to distribute specific commercial brands in their geographic areas. In addition to distilled spirits, distributors also distribute beer and wine.

State Alcoholic Beverage Control Boards. AAFES, NEXCOM, and the Marine Corps PFRD also purchase distilled spirits from state alcoholic beverage control boards. In alcoholic beverage control board states, a state agency is responsible for procuring, warehousing, and distributing distilled spirits to retail outlets. Alcoholic beverage or liquor control boards govern 18 states and 1 county. In North Carolina, AAFES and NEXCOM voluntarily negotiated an agreement to purchase all distilled spirits from the North Carolina Alcoholic Beverage Control Commission. In Washington, AAFES and NEXCOM agreed to a state mandate to purchase all distilled spirits from the Washington State Liquor Control Board (the Board). In the other 16 states and 1 county, the military stores have the option of purchasing distilled spirits from state alcoholic beverage control boards.

Distribution Centers. AAFES and NEXCOM operate 10 distribution centers that distribute general merchandise to their military stores in the continental United States and overseas. Distilled spirits is one category of merchandise that is stored and distributed from the distribution centers. The AAFES distribution center in Oakland, California, and the NEXCOM distribution center in Chino, California, provide general merchandise and other products (except for distilled spirits) to the distribution centers in Hawaii and military stores in Alaska and Washington. The AAFES military store at Elmendorf Air Force Base (AFB), Alaska, maintains a storeroom that is used to store limited quantities of distilled spirits purchased from in-state Alaskan distributors. The Marine Corps PFRD does not operate distribution centers in the continental United States or overseas. The Marine Corps PFRD obtains distilled spirits from AAFES and NEXCOM distribution centers, local commercial distributors, and state alcoholic beverage control boards.

Military Stores. Throughout this report, we use the phrase *military stores* to refer to AAFES class VI retail alcoholic beverage stores and NEXCOM and Marine Corps PFRD retail package stores, which sell distilled spirits. Also included in the phrase are shoppettes and other retail stores that sell alcoholic beverages, including distilled spirits, for consumption off the premises.

Distilled Spirits. Distilled spirits include alcoholic beverages obtained by distillation, such as brandy, gin, rum, and whiskey. Distilled spirits normally contain more than 21 percent of alcohol by volume.

Business Year. AAFES, NEXCOM, and the Marine Corps PFRD operate on a business year that starts on February 1st and ends on January 31st. Unless

otherwise noted, all references to 1996 in the report are for the AAFES, NEXCOM, and Marine Corps PFRD 1996 business year that began on February 1, 1996, and ended on January 31, 1997.

Nonappropriated Fund Instrumentalities. NAF instrumentalities provide DoD Components various morale, welfare, and recreational (MWR) programs for military personnel and authorized civilians. For purposes of this report, our discussion of NAF instrumentalities includes only AAFES, NEXCOM, and the Marine Corps PFRD. Those organizations purchase distilled spirits directly from commercial distillers, distributors, or state alcoholic beverage control boards for their military stores.

Objectives

The audit objectives were to determine whether the military exchange systems provided the most economical method of distribution of distilled spirits within DoD. The audit also evaluated whether the use of commercial distributors in certain states, rather than AAFES and NEXCOM distribution networks, resulted in taxation to NAF instrumentalities. The first objective was discussed in Inspector General, DoD, Report No. 98-126, "Economic Distribution of Distilled Spirits Within DoD," April 30, 1998. This report discusses distilled spirit distribution practices in Alaska, Hawaii, and Washington. It also discusses the implication of taxes on distilled spirits that alcohol beverage control boards and commercial distributors sold to AAFES, NEXCOM, and the Marine Corps PFRD. See Appendix A for a discussion of the audit scope and methodology and a summary of prior audit coverage.

A. Purchasing Restrictions in Alaska, Hawaii, and Washington

NAF instrumentalities were restricted from purchasing distilled spirits in the most economical manner in Alaska, Hawaii, and Washington. The condition occurred because Defense Appropriation Acts from FY 1986 through FY 1996 required NAF instrumentalities to purchase distilled spirits only from commercial distributors in Alaska and Hawaii. Additionally, AAFES and NEXCOM agreed to a Washington mandate to purchase distilled spirits only from the Board. As a result, for the distilled spirits surveyed, cases purchased from in-state sources in Alaska, Hawaii, and Washington ranged, on average, from $5 to $28 more per case in 1996 than if distilled spirits had been purchased from commercial distillers and distributed through the AAFES and NEXCOM distribution networks. Purchasing distilled spirits from in-state sources in Alaska, Hawaii, and Washington may also reduce profits for MWR programs.

Criteria

Defense Appropriation Acts (the Acts) from FY 1986 through FY 1996 contained provisions requiring NAF instrumentalities to purchase distilled spirits only from in-state sources in Alaska and Hawaii. Specifically, the Acts state:

> ...that local procurement requirements for malt beverages and wine shall apply to all alcoholic beverages for military installations in States which are not contiguous with another State.

Local procurement requirements for malt beverages and wine are defined by the Acts as purchasing from sources in the same state in which the military installation is located. Alaska and Hawaii are the only two states that are not contiguous with another state. After 1996, the Acts did not contain the requirement to purchase distilled spirits from in-state sources in Alaska and Hawaii; however, AAFES and NEXCOM continued to comply with the requirements of prior Acts.

After passage of the FY 1996 Act, Title 10, United States Code, Section 2488 (10 U.S.C. 2488), "Nonappropriated Fund Instrumentalities," was amended to require procurement of alcoholic beverages from the most competitive source.

The amendment also contained new guidance for determining whether NAF instrumentalities or commercial distributors were the most economical method of distributing alcoholic beverages to military stores.

Alaska and Hawaii

Prior to 1997, NAF instrumentalities were restricted from purchasing distilled spirits in the most economical manner in Alaska and Hawaii because the Acts required them to purchase distilled spirits for their military stores only from in-state commercial distributors. As a result, for items surveyed, AAFES paid, on average, about $28 more per case in Alaska during 1996, and AAFES and NEXCOM paid, on average, $26 and $24 more per case, respectively, in Hawaii during 1996, than if distilled spirits had been purchased from a commercial distiller and distributed through AAFES and NEXCOM distribution networks to their military stores. Our determination was based on the per-case price differences of distilled spirits and not on an average cost weighted by the volume of distilled-spirit cases that were issued. We computed overseas shipping and handling costs as if AAFES and NEXCOM were purchasing distilled spirits from distillers and shipping them from distribution centers in California to overseas distribution centers and military stores in Alaska and Hawaii.

In Hawaii, the Marine Corps PFRD was also required to purchase distilled spirits from commercial distributors for its Hawaiian military stores. Marine Corps PFRD savings would have been in the range of the AAFES and NEXCOM savings, less any local delivery charge, if they had been allowed to purchase distilled spirits from AAFES or NEXCOM distribution centers in Hawaii.

Restricted Competition in Alaska. We surveyed 201 distilled-spirit line items that AAFES purchased from Alaskan commercial distributors in 1996 and compared the distributor price to the AAFES distribution center price. See Appendix A for an explanation of the survey methodology. For the 201 distilled-spirit line items, the commercial distributor price averaged $27.59 more per case than the AAFES price. Of the 201 line items, 8 were less expensive from Alaskan commercial distributors. For the remaining 193 (96 percent), the cost per case from commercial distributors ranged from $.92 to $102 48 more than the AAFES price. Table 1 shows specific examples of commercial distributor and AAFES price differences in Alaska.

Table 1. Alaska Distilled-Spirit Case Cost Comparison

Brand	Size	AAFES Delivered Per-Case Price[1]	Alaskan Distributor Delivered Per-Case Price
Bacardi Limon	750[2]	$ 84.28	$120.97
Hiram Walker Coffee Brandy	750	66.29	85.00
Jim Beam	1.75[3]	77.74	87.25
Chivas Regal	375[4]	209.50	275.69
Gordon's Vodka	1.75	57.04	55.00
Tanqueray Gin	1.75	123.49	143.75

[1]The AAFES delivered per-case price is to the Elmendorf AFB storeroom and does not include inventory carrying costs in Alaska.
[2]750 milliliter bottle.
[3]1.75 liter bottle.
[4]375 milliliter bottle.

Cost to Provide Distilled Spirits to Elmendorf AFB from the AAFES Oakland Distribution Center. The AAFES prices shown in Table 1 include the case cost of the distilled spirits and a shipping and handling cost of $9.04 per case. For example, the AAFES price of $77.74 for Jim Beam includes the per-case distiller cost of $68.70 and $9.04 for shipping and handling. The $9.04 shipping and handling cost for 1996 to the AAFES Elmendorf AFB military store through the Oakland Distribution Center covers inland transportation costs to the Oakland Distribution Center from the distiller of $4.34 and overseas shipping and handling costs of $4.70 per case. The Oakland Distribution Center warehousing and distribution costs are included in the overseas shipping and handling cost. A discussion of the Oakland Distribution Center operating costs included in the per-case overseas shipping and handling cost is in Appendix A.

The shipping and handling costs to Alaska did not include inventory carrying costs at Elmendorf AFB. Specially discounted distilled spirits that commercial distributors delivered were held in the Elmendorf AFB storeroom only when there was insufficient space to display the product in the military store sales area. Additionally, the distilled spirits were not separately inventoried to the storeroom

but were included in the military store operating inventories. As a result, average storeroom inventories, necessary for computing inventory carrying costs, were unavailable.

Results of Restricted Competition in Hawaii. We surveyed 116 distilled-spirit line items that AAFES purchased from commercial distributors in Hawaii during 1996 and compared distributor prices to the AAFES distribution center prices. See Appendix A for an explanation of the survey methodology. Of the 116 line items, none were less expensive from commercial distributors than from AAFES. For the 116 line items, the cost per case ranged from $1.04 to $97.87 more than the AAFES price, and averaged $26.01 more than the AAFES price.

Similarly, for the 103 NEXCOM line items surveyed, NEXCOM paid an average of $24.18 more per case in Hawaii. Of the 103 line items, only 3 were less expensive from Hawaiian commercial distributors. The remaining 100 (97 percent), ranged from $.26 to $95.06 more per case than the NEXCOM price. Our determination for AAFES and NEXCOM was based on price differences per case of distilled spirits and not on the average cost weighted by the volume of distilled-spirit cases that were issued.

Table 2 shows specific examples of commercial distributor, AAFES, and NEXCOM price differences in Hawaii.

Table 2. Hawaii Distilled-Spirit Case Cost Comparison

Brand	Size	AAFES Delivered Per-Case Price	NEXCOM Delivered Per-Case Price	Hawaiian Distributor Delivered Per-Case Price
Bacardi Limon	750[1]	$ 88.82	$ 91.63	$108.50
Kahlua Coffee Liquor	375[2]	141.43	144.24	203.00
Jim Beam	1.75[3]	82.28	85.09	89.50
Chivas Regal	1.75	219.03	221.84	298.95
Tanqueray Gin	750	121.98	124.79	137.70

[1]750 milliliter bottle.
[2]375 milliliter bottle.
[3]1.75 liter bottle.

Cost to Provide Distilled Spirits to Hawaii through the AAFES Oakland Distribution Center. The AAFES prices in Table 2 include the case cost of the distilled spirits and a shipping and handling cost of $13.58 per case. For example, the AAFES price of $141.43 for Kahlua Coffee Liquor includes the per-case distiller cost of $127.85 and $13.58 for shipping and handling.

To determine the 1996 AAFES delivered per-case shipping and handling cost, we divided the total operating costs for the Hawaiian Distribution Center by the number of cases shipped. Hawaiian Distribution Center operating costs include depreciation, general operating costs, inventory carrying costs, personnel, and transportation. After determining the AAFES distilled-spirit shipping and handling cost of $6.26 per case, we added the Oakland Distribution Center inland transportation costs of $4.34 and $2.98 for overseas shipping and handling.

Cost to Provide Distilled Spirits to Hawaii through the NEXCOM Chino Distribution Center. The NEXCOM prices in Table 2 include the case cost of the distilled spirits and a shipping and handling cost of $16.39 per case. For example, the NEXCOM price of $144.24 for Kahlua Coffee Liquor includes the per-case distiller cost of $127.85 and $16.39 for shipping and handling. To

determine the NEXCOM per-case shipping and handling cost, we obtained NEXCOM financial statements for the Pearl Harbor Distribution Center. NEXCOM financial statements include expenses for depreciation, general operations, personnel, and transportation. We allocated operating costs based on the proportion of the dollar value of distilled spirits issued to the total dollar value of all issues. We also calculated the inventory carrying costs for distilled spirits. (See Appendix A for an explanation of how shipping and handling costs were calculated.) The resulting operating expenses and inventory carrying costs attributable to distilled spirits were then divided by the number of cases of distilled spirits issued to determine a per-case shipping and handling cost. After determining that distilled-spirit shipping and handling cost for the Pearl Harbor Distribution Center was $9.06 per case, we added the Chino Distribution Center inland transportation costs of $4.67 and $2.66 for overseas shipping and handling.

The AAFES and NEXCOM overseas shipping and handling costs include a portion of the distribution center operating cost. See Appendix A for details of costs included in overseas shipping and handling costs.

Washington

AAFES and NEXCOM did not purchase distilled spirits in the most economical manner in Washington. During 1996, Washington charged AAFES an average of $10.52 more per case and NEXCOM an average of $5.41 more per case than what the distilled spirits would have cost had they been purchased and distributed through the Oakland and Chino Distribution Centers. This occurred because AAFES and NEXCOM agreed to a Washington mandate to purchase distilled spirits only from the Board. We computed shipping and handling costs to Washington as if AAFES and NEXCOM were purchasing distilled spirits from distillers and shipping them to military stores in Washington from distribution centers in California.

In 1987, AAFES agreed to a contract with the Board that required all distilled-spirit purchases to be made from state-owned and -operated warehouses. NEXCOM subsequently agreed to comply with the contract. According to AAFES and NEXCOM personnel, AAFES and NEXCOM agreed to purchase distilled spirits from the Board because state officials indicated they would prevent authorized military store patrons from transporting distilled spirits off military installations if the distilled spirits were not purchased from the Board.

Washington State Title 66, "Alcoholic Beverage Control," chapter 66.44.160, states that any person who has, keeps, or transports alcoholic beverages other than

those purchased from the Board, a state liquor store, or some person authorized by the Board to sell them, shall be guilty of a violation of Title 66. Title 66 also states that any person buying alcoholic beverages from any person other than the Board, a state liquor store, or some person authorized by the Board to sell them, shall be guilty of a misdemeanor.

The contract to purchase distilled spirits in Washington is renewable annually, and it stipulates that all distilled spirits sold by AAFES in the state will be purchased from the Board. It also states that military stores purchasing distilled spirits from the Board are considered "authorized" sources under state law. As a result, distilled spirits purchased from the Board and sold by military stores may be legally transported off the military installation where purchased.

Washington State Title 66, chapter 66.12.120, also states that once a month, a person who is 21 years of age or older may bring into the state of Washington *from another state,* for personal or household use, up to 2 liters of spirits or wine or 288 ounces of beer, free of tax and markup.

DoD installations in Washington include bases, camps, posts, and stations that are located on territory within the state that has been ceded to the United States. Areas over which the United States exercises exclusive or partial jurisdiction are considered to be Federal enclaves. Federal-state relations respecting enclaves differ according to the issue involved and whether the enclave is viewed as part of the State in which it is located. The view that enclaves are *States within States* and therefore unreachable by State regulation is applied to a narrow range of issues. It continues to apply with full force to the regulation of alcoholic beverages destined for military installations. Therefore, we believe that AAFES- and NEXCOM-authorized patrons could legally transport up to 2 liters of distilled spirits per month off DoD installations even if the military stores did not purchase the distilled spirits from the Board.

The ASD(FMP) should evaluate the potential legal impact on military store patrons who purchase distilled spirits at military stores and transport them off military installations, if the agreement with Washington is canceled.

Results of Purchasing Restrictions in Washington. Distilled-spirit prices at Board retail outlets consist of the case cost from the distiller, Federal taxes, freight and merchandising costs, a 39.2 percent markup, state sales taxes, and a per liter excise tax. The Board gives AAFES and NEXCOM a 20-percent discount from the retail price and does not charge state sales taxes or the per liter excise tax.

We surveyed 229 distilled-spirit line items that AAFES purchased from the Board. For the 229 distilled-spirit line items, the Board price averaged $10.52 more per case than the AAFES distributed price. Of the 229 line items, 43 were less expensive from the Board than the AAFES price. For the remaining 186 (81 percent), the cost per case ranged from $.11 to $57.15 more than the AAFES distribution center price. Our determination was based on per-case price differences for distilled spirit line items and not on an average cost weighted by the volume of distilled-spirit cases that were issued.

Similarly, for the 229 NEXCOM line items that we surveyed, NEXCOM paid an average of $5.41 more per case than it would have if it had obtained and distributed the distilled spirits through its Chino Distribution Center. Of the 229 line items, 75 of the line items were less expensive from the Board than the NEXCOM price. For the remaining 154 (67 percent) line items, the excess cost per case ranged from $.08 to $52.04 more than the NEXCOM price.

Table 3 shows specific examples of commercial distributor, AAFES, and NEXCOM price differences in Washington.

Table 3. Washington Distilled-Spirit Case Cost Comparison

Brand	Size	AAFES Delivered Per-Case Price to Washington	NEXCOM Delivered Per-Case Price to Washington	Washington State Liquor Control Board Price
E&J Brandy	750[1]	$ 59.77	$ 64.88	$ 76.56
Smirnoff Vodka 80	375[2]	70.06	75.17	84.00
Beefeater Gin	1.75[3]	116.88	121.99	132.42
Canadian Club	1.75	87.30	92.41	92.52
Tanqueray Gin	750	112.46	117.57	136.68

[1]750 milliliter bottle.
[2]375 milliliter bottle.
[3]1.75 liter bottle.

Cost to Provide Distilled Spirits to Washington from the AAFES Oakland Distribution Center. The AAFES prices in Table 3 include the case cost of the distilled spirits and a shipping and handling cost of $4.06 per case. For example, the AAFES price of $112.46 for Tanqueray Gin includes the per-case distiller cost of $108.40 and $4.06 for shipping and handling. We computed the AAFES Oakland Distribution Center 1996 per-case shipping and handling costs by dividing the total distribution center operating costs by the number of cases shipped.

Cost to Provide Distilled Spirits to Washington from the NEXCOM Chino Distribution Center. The NEXCOM prices in Table 3 include the case cost of the distilled spirits and a shipping and handling cost of $9.17 per case. For example, the NEXCOM price of $117.57 for Tanqueray Gin includes the per-case distiller cost of $108.40 and $9.17 for shipping and handling. For NEXCOM, we allocated operating costs based on the proportion of the dollar value of distilled spirits issued to the total dollar value of all merchandise issued. We also calculated the inventory carrying costs for distilled spirits. We then divided the operating expenses and inventory carrying costs by the number of cases of distilled spirits issued to determine a per-case shipping and handling cost. The methodology may overstate the shipping and handling cost because the average case cost for distilled spirits is higher than for most other commodity groups in the distribution center. Additionally, NEXCOM completed a move to the new Chino Distribution Center in 1996. The move and start-up costs for the new facility could have affected the case shipping and handling costs for distilled spirits.

For the Oakland and Chino Distribution centers, shipping and handling costs consist of depreciation, inventory carrying costs, operational costs, personnel, transportation from the distiller, and transportation to the Washington military stores.

Marine Corps PFRD. The Marine Corps PFRD does not operate distribution centers in the continental United States or overseas. Marine Corps military stores can purchase distilled spirits from AAFES, commercial distillers and distributors, NEXCOM, or state alcoholic beverage control boards. We did not compare commercial distributor or alcoholic beverage control board case costs in Alaska, Hawaii, and Washington to Marine Corps PFRD case costs. Marine Corps PFRD purchasing authorities are subject to the same purchasing restrictions as AAFES and NEXCOM. If the Marine Corps PFRD were allowed to obtain distilled spirits from AAFES or NEXCOM distribution centers for Marine Corps military stores in those states, we believe that they would realize savings similar to those potentially available to AAFES and NEXCOM, less any delivery charges.

Best Values

DoD acquisition reform goals include buying better products, obtaining the products in less time, and obtaining products at less cost. In Alaska, Hawaii, and Washington, NAF instrumentalities have been paying higher per-case costs because of restricted competition caused by complying with the Acts from 1986 through 1996 and the Washington mandate. Since 1997, the Acts have not included the restriction to purchase distilled spirits only from in-state sources in Alaska and Hawaii; therefore, we believe DoD now has the authority to make best value purchasing decisions. In our opinion, AAFES and NEXCOM distribution centers offer best value purchasing for the majority of distilled spirits, and those centers should be allowed to fairly compete with per-case prices offered by commercial distributors and state liquor control boards.

Our intent in recommending best value purchasing for distilled spirits is not to reduce the retail prices in the military stores, but to increase the profits that may be available for MWR programs. When NAF instrumentalities can realize advantages in price by purchasing distilled spirits from commercial distillers and distributing them through their distribution networks, they should be able to do so. Those best value purchasing decisions allow AAFES, NEXCOM, and the Marine Corps PFRD to earn a higher profit, thereby increasing the benefits to active-duty MWR programs.

Recommended Management Action, Management Comments, and Audit Response

Revised Recommendation. As a result of management comments, we revised draft Recommendation A.1. to clarify our intent that 10 U.S.C. 2488 (c)(2) be included in any best value purchasing determination until it is repealed.

A. We recommend that the Assistant Secretary of Defense (Force Management Policy):

1. Direct the Army and Air Force Exchange Service, the Navy Exchange Service Command, and the Marine Corps Personnel and Family Readiness Division to use best value purchasing decisions when purchasing distilled spirits for military stores in Alaska, Hawaii, and Washington. The best value purchasing decision should comply with Title 10, United States Code, Section 2488 (c)(2), until it is repealed, and should be based on a comparison of the total Army and Air Force Exchange Service and Navy

Exchange Service Command delivered case price to the lowest delivered case price offered by a commercial distributor or state alcoholic beverage control board.

Management Comments. The Executive Director, Morale, Welfare, Recreation and Resale Activities nonconcurred stating the recommendation requires AAFES and NEXCOM to use best value purchasing decisions but does not require consideration of 10 U.S.C. 2488 (c)(2). The Executive Director suggested that the recommendation be made in deference to 10 U.S.C. 2488 (c)(2) and that the word "delivered" be inserted in front of "case price offered by a commercial distributor."

Audit Response. We agree that AAFES and NEXCOM should include the requirements of 10 U.S.C. 2488 (c)(2) until it is repealed (see Recommendation B) when making best value purchasing determinations. Therefore, we revised the recommendation.

2. Direct the Army and Air Force Exchange Service to terminate the distilled-spirit purchasing contract with the Washington State Liquor Control Board.

Management Comments. The Executive Director, Morale, Welfare, Recreation and Resale Activities concurred with the recommendation.

3. Determine for the state of Washington, the potential legal impact on military store patrons that may occur from transporting distilled spirits from military installations, if distilled spirits are purchased from sources other than the Washington State Liquor Control Board. This determination should be made before Recommendations 1. and 2. are implemented.

Management Comments. The Executive Director, Morale, Welfare, Recreation and Resale Activities concurred with determining the legal impact on patrons who transport distilled spirits from military installations. He did not agree that management action on Recommendations 1. and 2. should be contingent on the legal determination, stating that no provision of 10 U.S.C. 2488 (c)(2) allows DoD to consider state law when purchasing distilled spirits.

Audit Response. We consider comments from the Executive Director fully responsive to the recommendation.

B. Taxation on Distilled Spirits Distributed by Nonappropriated Fund Instrumentalities

AAFES and NEXCOM may have been precluded from distributing distilled spirits in the most economical manner. The condition occurred because 10 U.S.C. 2488 (c)(2) considers AAFES and NEXCOM to be the most economical source for purchasing distilled spirits, if distilled-spirit prices from private distributors include taxes. As a result, NAF instrumentalities could have been prevented from making best value purchasing decisions, thereby reducing profits for MWR programs.

Criteria

Section 2488 of 10 U.S.C. states:

> (a) the Secretary of Defense shall provide that:
>
> 1) Covered alcoholic beverage purchases made for resale on a military installation located in the United States shall be made from the most competitive source, and distributed in the most economical manner, price and other factors considered...

Section 2488 also states:

> (c)(2) If the use of a private distributor would subject covered alcoholic beverage purchases of distilled spirits to direct or indirect State taxation, a nonappropriated fund instrumentality shall be considered to be the most economical method of distribution regardless of the results of the determination made under paragraph (1).

Taxation

AAFES and NEXCOM may have been unable to distribute distilled spirits from the most competitive source or in the most economical manner when distilled-spirit case costs include taxes. This occurred because legislation imposed purchasing restrictions by not allowing consideration of prices that include direct or indirect taxes.

Direct Taxation. Direct taxation occurs when the legal incidence of a tax falls directly on the United States as the buyer of goods or consumer services. Direct taxes include state excise taxes, and state sales and use taxes that generally can be identified to the goods or services purchased. It is a general principle that, absent express authorization of Congress, the United States and its instrumentalities are immune from direct taxation by state and local governments.

All NAF instrumentalities are required to pay Federal excise taxes on distilled spirits, unless the distilled spirits are purchased for immediate export from the United States. We did not identify any cities, counties, or states that directly tax NAF instrumentalities on distilled spirits.

Indirect Taxation. The legal incidence of an indirect tax does not fall on the Federal Government but generally falls directly on a manufacturer, importer, or wholesaler. Indirect taxes generally cannot be identified to the specific goods or services that are purchased at the retail level. For example, indirect taxes include administrative fees, licensing fees, markups, and specific taxes. Specific taxes may include bottle; gallonage; licensing; purchasing; or surcharge taxes, depending on the state.

The amounts of indirect tax passed on through a distributor's markup on distilled spirits could not be identified within the scope of this evaluation because those amounts are included in the delivered per-case cost charged by the distributor. For example, distributors pay state licensing fees and other administrative fees that are not specifically identified to distilled spirits but are passed on indirectly as a cost of doing business.

Purchasing Considerations

NAF instrumentalities could have been prevented from making best value purchasing decisions, thereby reducing profits for MWR programs. 10 U.S.C. 2488 requires NAF instrumentalities to purchase alcoholic beverages from the most competitive source. However, paragraph (c)(2) of Section 2488 states that NAF instrumentalities shall be considered the most economical method of distribution if the use of a private distributor subjects alcoholic beverage purchases to direct or indirect state taxation.

Taxation should not be a determining factor in best value purchasing decisions. In those instances when taxes are included in a distilled-spirit case cost, the

decision on the most economical source for obtaining the distilled spirits should be based on the best value, to include shipping and handling, without consideration of whether the cost includes taxes.

In states that do not exempt NAF instrumentalities from indirect taxation, there may be a cost advantage to supplying military stores directly from AAFES and NEXCOM distribution centers. However, purchases from commercial distributors and state alcoholic beverage control boards could be more cost-effective, even though taxes are included in the distilled-spirit cost.

AAFES and NEXCOM distributed case prices consisted of the cost of the distilled spirits and a per-case shipping and handling charge. In some cases, distributors may be able to provide a specific brand of distilled spirits to the military store at a lower cost than an AAFES or NEXCOM distribution center. AAFES and NEXCOM made best value purchasing decisions in the two examples discussed below.

North Carolina. North Carolina is an alcoholic beverage control board state. AAFES and the Marine Corps PFRD have agreed to purchase distilled spirits from the North Carolina Alcoholic Beverage Control Commission (the Commission) for resale to military stores in North Carolina. In 1996, distilled-spirit sales by military stores were $9.7 million. In North Carolina, civilian market distilled-spirit prices consist of the case cost from the distiller, bailment fees[1], bailment surcharges[2], excise taxes, Federal taxes, freight costs, markup, and state sales taxes. North Carolina charges NAF instrumentalities the case cost from the distiller, including shipping and handling, plus $1.74. The $1.74 covers the bailment fee, bailment surcharge, and administrative fee. Although the $1.74 could be considered an indirect tax, purchasing distilled spirits from the Commission is more economical than from the AAFES or NEXCOM distribution centers.

We surveyed 236 distilled-spirit line items that the Commission sold to AAFES and the Marine Corps PFRD during 1996. For the 236 distilled-spirit line items, the Commission price averaged $3.08 less per case than the AAFES distribution center price. Our determination was based on per-case price differences for distilled spirit line items and not on an average cost weighted by the volume of distilled-spirit cases that were issued to military stores in the state.

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[1] Bailment fee - a fee paid by the military consignee to cover the operating expenses of the North Carolina Alcoholic Beverage Control Commission warehouse.

[2] Bailment surcharge - a fee paid by the military consignee to cover the operating expenses of the North Carolina Alcoholic Beverage Control Commission.

To comply with 10 U.S.C. 2488, paragraph (c)(2), if the $1.74 fee is considered to be an indirect tax, AAFES and the Marine Corps PFRD would be required to deem themselves the most economical method for distributing distilled spirits and would not be able to purchase distilled spirits from the Commission.

Specialty Items. AAFES and NEXCOM distribution centers typically do not carry specialty items. Specialty items include regional distilled spirits such as Virginia Gentleman bourbon, imports such as Amadeus Liquor, low-demand items, seasonal decanters, and special order items. Specialty items are procured from either a commercial distributor or a state alcoholic beverage control board or shipped directly to the store from a commercial distiller. According to AAFES and NEXCOM personnel, they do not distribute those items because in-state distributors are usually able to provide the products at a cost lower than the AAFES or NEXCOM distribution center cost.

Distilled spirits purchased from commercial distributors may cost less than those obtained from an AAFES or NEXCOM distribution center. When NAF instrumentalities can purchase distilled spirits from distributors offering advantages in value, they should be able to do so, regardless of any indirect taxes included in the price. Best value purchasing decisions allow NAF instrumentalities to earn a higher profit, thereby increasing benefits to active-duty MWR programs.

Recommended Management Action and Management Comments

B. We recommend that the Assistant Secretary of Defense (Force Management Policy) propose a legislative change to delete paragraph (c)(2) of Title 10, United States Code, Section 2488, that specifies nonappropriated fund instrumentalities shall be considered the most economical method of distribution if distilled spirits purchased from commercial distributors include direct or indirect state taxation.

Management Comments. The Executive Director, Morale, Welfare, Recreation and Resale Activities concurred with the recommendation. He stated that deletion of the paragraph would permit AAFES and NEXCOM to make best value purchase decisions from sources that may impose direct or indirect taxes.

Appendix A. Audit Process

Scope

Work Performed. We examined 1996 information relating to the purchase, storage, and distribution of distilled spirits. We obtained financial statements, distilled spirit inventory, product ordering, and other information from AAFES and NEXCOM that related to their headquarters, distribution centers, and military store operations. We also obtained distilled spirit marketing and pricing information from state governments and civilian distributors and obtained AAFES and NEXCOM distilled-spirit prices for items purchased directly from distillers and commercial distributors.

To determine whether NAF instrumentalities were purchasing distilled-spirit products in the most economical manner in Alaska, Hawaii, and Washington, we compared commercial distributor and alcoholic beverage control board prices to AAFES and NEXCOM prices. The AAFES and NEXCOM price included the cost of distilled spirits obtained from distillers and shipping and handling costs. Although, AAFES and NEXCOM did not ship distilled spirits to Alaska, Hawaii, or Washington, we computed the 1996 per-case shipping and handling costs as if they did. The Marine Corps PFRD obtains distilled spirits and other general merchandise from AAFES and NEXCOM distribution centers and local commercial distributors.

We also analyzed per-case prices in 1996 for various distilled spirit line items stocked in AAFES and NEXCOM distribution centers in California. The items represented various brands, manufacturers, and sizes of distilled spirits. The commercial distributor and the Board case costs used in the report were amounts charged to AAFES and NEXCOM during 1996.

Limitations to Audit Scope. The comparison of AAFES and NEXCOM distribution center prices to commercial distributor prices required us to obtain prices from commercial distributors in Alaska and Hawaii and from the Board. Those prices were obtained for the 1996 business year and were not based on a statistical sample. We did not attempt to validate the case costs provided by the distributors. The survey costs provided a point of comparison for a given time and should not be used for future purchasing decisions.

Direct taxes are normally identifiable if they are passed on to the end user. For example, sales taxes or Federal excise taxes are identifiable to a specific product. Indirect taxes are not always identifiable and are normally passed on by a commercial distributor as a cost of doing business. The amount of tax passed on through distributor markup could not be identified within the scope of this evaluation.

DoD Functional Area Reform Goals. Most major DoD functional areas have established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objective and goal.

> **Logistics Functional Area. Objective.** Streamline logistics infrastructure. **Goal:** Implement most successful business practices (resulting in reductions of minimally required inventory levels). **(LOG-3.1)**

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 Infrastructure high risk area.

Audit Type, Dates, and Standards. This economy and efficiency audit was performed from September 1997 through April 1998 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. The audit did not include a review of the management control program because it addresses only policy and legal issues. The audit did not rely on statistical sampling.

Methodology

Use of Computer-Processed Data. We relied on computer-processed data contained in AAFES and NEXCOM databases. We relied on cost information from AAFES automated financial systems to determine the actual cost of distributing a case of distilled spirits for 1996. We also relied on automated cost information from NEXCOM distribution centers to determine the extent of their distilled-spirit purchases and the related shipping and handling costs. We did not verify the accuracy of the computer-processed data for the automated systems. We worked closely with AAFES and NEXCOM personnel in analyzing the data and nothing came to our attention during the audit that caused us to doubt the reliability of the computer-processed data.

Distilled-Spirit Overseas Shipping and Handling Costs From the Oakland and Chino Distribution Centers. We computed overseas shipping and handling costs as if AAFES and NEXCOM were purchasing distilled spirits from distillers and distributing them to overseas distribution centers and military stores in Alaska and Hawaii from the Oakland and Chino Distribution Centers. For our computation, we determined that distilled spirits would not be co-mingled with other distribution center inventories, but would be staged for immediate loading into containerized seavans. When loaded into the containerized seavans, the distilled spirits would be hauled to a port of embarkation, placed on a ship, and delivered to the Alaskan or Hawaiian port of debarkation. Overseas shipping and handling costs to Alaska and Hawaii are composed of labor costs to stage, load, and unload the distilled spirits, the costs to rent the containerized seavans, and charges to ship overseas.

The overseas shipping and handling costs from the Oakland Distribution Center to the storeroom at the Elmendorf AFB military store do not include inventory carrying costs. The distilled spirits were not separately inventoried to the storeroom but were included in the military store operating inventories. As a result, average storeroom inventories, necessary for computing inventory carrying costs, were unavailable.

Washington Distilled-Spirit Shipping and Handling Costs from the Oakland and Chino Distribution Centers. To determine AAFES and NEXCOM distilled-spirit per-case shipping and handling costs for Washington, we obtained 1996 financial reports for the Oakland and Chino Distribution Centers that service Washington military stores. We allocated a portion of the total cost of operating the distribution centers to distilled-spirit distribution operations. For the AAFES Oakland Distribution Center, we proportionally allocated total operating costs to the cases of distilled spirits issued. To the case cost, we added inventory carrying costs using the average monthly ending inventory for 1996 multiplied by the AAFES short-term borrowing rate.

NEXCOM tracks the dollar amounts of issues and not the number of cases issued. We allocated operating costs based on the proportion of the dollar value of distilled spirits issued to the total dollar value of all issues. Because NEXCOM did not record the total number of cases issued per year by the Chino Distribution Center, we obtained the number of distilled-spirit cases issued from NEXCOM merchandising reports. We then divided the costs attributable to distilled spirits by the cases of distilled spirits that we determined were issued by the Chino Distribution Center. To this case cost, we added inventory carrying costs using the average monthly ending inventory for 1996 multiplied by the NEXCOM short-term borrowing rate. This methodology may overstate the shipping and

handling costs attributable to distilled spirits because the average case cost for distilled spirits is higher than the average cost for all commodity groups in the distribution center

Commercial Distributor Price Surveys. To determine the most economical source for distilled spirits in Alaska and Hawaii, we obtained a list of distilled-spirit line items in the Oakland and Chino distribution centers. During 1996, the Oakland Distribution Center had 444 distilled spirit line items and the Chino Distribution Center had 424 distilled spirit and wine line items. We were able to match 201 line items in the Oakland Distribution Center to items that AAFES purchased from commercial distributors in Alaska. We were also able to match 116 line items that AAFES purchased in Hawaii. Similarly, we matched 103 line items in the Chino Distribution Center that NEXCOM purchased from distributors in Hawaii. In Washington, we matched 229 distilled-spirit line items that AAFES and NEXCOM purchased from the state liquor control board. The AAFES and NEXCOM prices included commercial distiller prices and shipping and handling costs.

We determined that distilled-spirit case prices from commercial distributors ranged, on average, from $5 to $28 more than the AAFES and NEXCOM price. Our determination was based on per-case price differences for distilled-spirit line items and not on a weighted average for the volume of distilled-spirit cases issued.

Contacts During the Audit. We visited or contacted organizations within DoD, commercial companies, and state governments relating to the distribution of distilled spirits. Further details are available on request.

Summary of Prior Coverage

The Inspector General, DoD, issued one report related to the distribution of distilled spirits in 1998. The General Accounting Office (GAO) issued a report in 1991 that addressed the management of package stores. In addition, the exchange systems contracted with the accounting firm Deloitte & Touche LLP to review distilled-spirit distribution by AAFES, NEXCOM, and the Marine Corps PFRD. The Deloitte & Touche LLP reports were not audits and the reviews were limited to specific distribution centers.

General Accounting Office

General Accounting Office Report No. NSIAD-91-77 (OSD Case No. 8653), "Military Exchanges: Exchange Service Management of Army and Air Force Package Stores," February 26, 1991.

Inspector General

Inspector General, DoD, Report No. 98-126, "Economic Distribution of Distilled Spirits Within DoD," April 30, 1998.

Deloitte & Touche LLP

"Army & Air Force Exchange Service Review of Standards and Benchmark Costs For Distilled Spirits Distribution," March 3, 1995.

"Navy Exchange Service Command Distilled Spirits Procurement Process Review," March 3, 1995.

"US Marine Corps Distilled Spirits Procurement Process Review," March 3, 1995.

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)
Assistant Secretary of Defense (Force Management Policy)
  Executive Director, Morale, Welfare, and Recreation and Resale Activities
Assistant Secretary of Defense (Public Affairs)
Director, Defense Logistics Studies Information Exchange

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy
Superintendent, Naval Post Graduate School
Commander, Navy Exchange Service Command
Director, Marine Corps Personnel and Family Readiness Division

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, National Security Agency
  Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency
Commander, Army and Air Force Exchange Service

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
General Accounting Office
  National Security and International Affairs Division
    Technical Information Center
  Health, Education, and Human Services

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

  Senate Committee on Appropriations
  Senate Subcommittee on Defense, Committee on Appropriations
  Senate Committee on Armed Services
  Senate Committee on Governmental Affairs
  House Committee on Appropriations
  House Subcommittee on National Security, Committee on Appropriations
  House Committee on Government Reform and Oversight
  House Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform and Oversight
  House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
  House Committee on National Security

Final Report Reference

Office of the Assistant Secretary of Defense (Force Management Policy) Comments

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
4000 DEFENSE PENTAGON
WASHINGTON, DC 20301-4000

SEP 29 1998

FORCE MANAGEMENT POLICY

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT: Draft Audit Report on the Economic Distribution of Distilled Spirits Within DoD (Project No. 7LF-5020.01 dated June 26, 1998)

This responds to your request for views and comments on subject report. The draft report and the research behind it clearly complement the DoD acquisition reform goal of obtaining products at a lower cost. As shown in your report, restricted competition in Alaska, Hawaii, and Washington precluded AAFES and NEXCOM distribution centers from fairly competing with commercial distributors and state liquor control board. Your report clearly identified instances where DoD could have the opportunity to increase the benefits to active-duty MWR programs in the future. In that regard, we endorse strategies that will result in the lowest cost procurement and distribution of distilled spirits.

My specific comments on the recommendations contained in the report follow:

Finding A

Revised

Recommendation 1. Direct the Army and Air Force Exchange Service and the Navy Exchange Service Command, and the Marine Corps Personnel and Family Readiness Division to use best value purchasing decisions when purchasing distilled spirits for military stores in Alaska, Hawaii and Washington. The best value purchasing decisions should be based on a comparison of the total Army and Air Force Exchange Service and Navy Exchange Service Command delivered case price to the lowest case price offered by a commercial distributor or state alcoholic beverage control board.

Response: Non-concur. Recommendation 1 as written requires this office to direct the exchange services to use best value purchasing decisions. However, the recommended practice does not also require consideration of 10 U.S.C. 2488 (c)(2). If the recommendation is made in deference to 10 U.S.C. 2488(c)(2), I also recommend the final sentence be changed to read "... to the lowest *delivered* case price offered by a commercial distributor or state alcoholic beverage control board."

Recommendation 2. Direct the Army and Air Force Exchange Service to terminate the distilled spirit purchasing contract with the Washington State Liquor Control Board.

Response: Concur.

Recommendation 3. Determine for the state of Washington, the potential legal impact on military store patrons that may occur from transporting distilled spirits from military installations, if distilled spirits are purchased from sources other than the Washington State Liquor Control Board. This determination should be made before Recommendations 1 and 2 are implemented because action taken on those recommendations is dependent on the results of the determination.

Response: Concur with determining the potential legal impact. However, action on Recommendations 1 and 2 should not be contingent on the determination. As noted in your report, 10 U.S.C., subsection 2488 requires that alcoholic beverages purchased for resale be purchased from the most competitive source. Further, subparagraph (c)(2) of that section, until it may be repealed pursuant to recommendation B below, prohibits purchases resulting in direct or indirect state taxation. No provision in this statute allows the Department to consider state law when purchasing distilled spirits.

Finding B

Recommendation: That the Assistant Secretary of Defense (Force Management Policy) propose a legislative change to delete subparagraph (c)(2) of Title 10, United States Code, Section 2488, that specifies nonappropriated fund instrumentalities shall be considered the most economical method of distribution if distilled spirits purchased from commercial distributors include direct or indirect state taxation.

Response: Concur. Deletion of the paragraph in concert with other law and policy will permit the military exchanges to purchase from sources that impose a state tax burden when those sources are the best value purchasing decisions.

We appreciate your assistance in reviewing this difficult matter.

Stephen O Rossetti, Jr
Executive Director, MWR and Resale Activities

Audit Team Members

The Readiness and Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report.

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