Audit Report

PILOT PROGRAM ON SALES OF MANUFACTURED ARTICLES AND SERVICES OF ARMY INDUSTRIAL FACILITIES

Report No. D-2001-069 March 1, 2001

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Department of Defense

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March 1, 2001

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION, TECHNOLOGY, AND LOGISTICS
UNDER SECRETARY OF DEFENSE (COMPTROLLER)

SUBJECT: Audit Report on the Pilot Program on Sales of Manufactured Articles and Services of Army Industrial Facilities (Report No. D-2001-069)

We are providing this report for review and comment. This is the third of three reports on our audit of the Pilot Program on Sales of Manufactured Articles and Services of Army Industrial Facilities. We conducted the audit in response to section 115 of the FY 2000 Defense Authorization Act. The Under Secretary of Defense for Acquisition, Technology, and Logistics did not respond to a draft of this report; however, we considered comments from the Under Secretary of Defense (Comptroller) when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Under Secretary of Defense (Comptroller) comments were not responsive. We request that the Under Secretary of Defense (Comptroller) provide additional comments on Recommendation 1. and the Under Secretary of Defense for Acquisition, Technology, and Logistics provide comments on Recommendation 2. by May 1, 2001.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Garold E. Stephenson at (703) 604-9332 (DSN 664-9332) (gstephenson@dodig.osd.mil) or Mr. Eugene E. Kissner at (703) 604-9323 (DSN 664-9323) (ekissner@dodig.osd.mil). See Appendix C for the report distribution. Audit team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report No. D-2001-069 **March 1, 2001**
(Project No. D2000CH-0239)

Pilot Program on Sales of Manufactured Articles and Services of Army Industrial Facilities

Executive Summary

Introduction. This is the third of three reports on our audit of the pilot program on sales of manufactured articles and services of Army industrial facilities. This report discusses our assessment of the pilot program to sell manufactured articles and services of three industrial facilities to commercial contractors providing weapon systems to DoD. Section 141 of the FY 1998 Defense Authorization Act authorized the pilot program because of congressional concern that the industrial facilities were operating inefficiently because work was not available with reduced defense budgets. According to Army officials, in December 2000, 80 percent of Rock Island Arsenal industrial capacity and 85 percent of Watervliet Arsenal industrial capacity was unused, compared to less than 20 percent of unused capacity in 1988. The unused industrial capacity at McAlester Army Ammunition Plant was 86 percent at the end of 2000. Section 115 of the FY 2000 Defense Authorization Act extended the pilot program through FY 2001. The pilot program provides the opportunity for Rock Island Arsenal, Watervliet Arsenal, and the McAlester Army Ammunition Plant, to increase their workloads by participating in contracts and teaming arrangements with United States manufacturers, assemblers, developers, and other concerns under DoD weapon system programs without determining whether the articles and services are available from United States commercial sources. The DoD budget indicates that DoD anticipates spending about $48 billion in FY 2001 to procure new weapon systems and upgrade existing systems.

Objective. The primary audit objective was to determine the results of the pilot program. Specifically, we determined whether the waiver of 10 U.S.C. 4543(a)(5) enhanced opportunities for United States manufacturers, assemblers, developers, or other concerns; Army industrial facilities; and small businesses to enter into or participate in contracts and teaming arrangements under DoD weapon systems programs.

Results. The pilot program has been only minimally successful in increasing the use of the capabilities of the participating Army industrial facilities. From the June 1998 Army implementation of the pilot program to January 2001, the three participating industrial facilities obtained only 12 contracts valued at $6.0 million, including a 5-year contract valued at $5.2 million for demilitarization of conventional ammunition awarded to the McAlester Army Ammunition Plant in August 2000. Consequently, the pilot program has had little effect on increasing the opportunities for United States commercial firms and the Army industrial facilities to participate in contracts and teaming arrangements under DoD weapon system programs. Provisions in the FY 2001 Defense Authorization Act and recent Army initiatives have eliminated or mitigated some of the impediments to the industrial facilities obtaining work under the pilot program, but have not been in effect long enough to create a measurable

difference. Eliminating the remaining impediments will further increase the opportunities for commercial firms, small businesses, and the Army industrial facilities to enter into contracts or teaming arrangements under DoD weapon system programs and increase the use of the industrial facilities' capabilities. For details of the audit results, see the Finding section of the report.

We believe that the pilot program should be extended. Overall the pilot program is beneficial to DoD and the military industrial base. The DoD benefits because the pilot program eliminates an impediment to obtaining work for the Army industrial facilities. The military industrial base benefits because it can contract or partner directly with an Army industrial facility for needed articles and services. The pilot program eliminates the need for the Army to certify that the products or services required by commercial firms desiring to contract or partner with an industrial facility are not available from United States commercial sources. The pilot program, as well as the recently established arsenal and armament support program initiatives, also benefit commercial firms because the programs provide private contractors and small businesses additional accessibility to the Army industrial facilities and their unique capabilities. Any increase in the volume of work resulting from the pilot program and the arsenal and armaments support program initiatives provided in the FY 2001 Defense Authorization Act would use idle plant capacity, reduce overhead costs, and result in lower prices to all customers of the industrial facilities. More importantly, the added work would aid the retention of critical manufacturing skills that are being lost because of the lack of work at the industrial facilities.

Summary of Recommendations. We recommend that the Under Secretary of Defense (Comptroller) waive the requirement to charge full costs contained in Volume 11B, DoD Regulation 7000.14R,"Financial Management Regulation," and initiate action to amend Volume 11B as permitted by 10 U.S.C. 4543(b)(3)(A). The cited statute authorizes industrial facilities that manufacture large caliber cannons, gun mounts, or recoil mechanisms, or components thereof, to charge their buyers, at a minimum, the variable costs associated with the articles or services provided.

We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics request Congress to waive, for the pilot program, the requirement in 10 U.S.C. 4543(b)(2) that the industrial facilities obtain advance payment from purchasers of their articles and services.

Management Comments. The Assistant Deputy Comptroller (Program/Budget) stated he applauds the intent of the recommendation which would have the arsenals find other sources of work, specifically work for or in partnership with the private sector. This would increase utilization and reduce the overall cost of infrastructure. However, the revolving fund form of financial management is based on the principle of full cost recovery. Full cost recovery requires that for any work performed, all direct costs plus an applicable share of overhead expenses must be recovered from the customer. The Assistant Deputy Comptroller stated that allowing the Arsenals to charge private contractors less than their DoD customers, in an era of scarce resources, is counterproductive to sound financial management. Further, the concept of full cost recovery is a basic principle that must be followed. The Under Secretary of Defense for Acquisition, Technology, and Logistics did not respond to the draft report. A discussion of management comments is in the Finding section of the report and the complete text is in the Management Comments section.

Audit Response. The Assistant Deputy Comptroller comments show he understands the issues. However, the comments do not include any flexibility to address the underlying problem of excess idle capacity that raises the rates charged and results in no new work because of higher rates. We support the concept of recovering all costs. However, this is a pilot program that is allowed to try different things in order to help preserve the industrial base. Army industrial facilities are not required to charge their customers full costs. The DoD Financial Management Regulation policy that requires the Army industrial facilities to charge full costs is more restrictive than 10 U.S.C. 4543, which provides the option to charge only variable costs. The intent of 10 U.S.C. 4543 is to give Army industrial facilities relief from statutes and regulations that require that the prices offered to potential customers include costs that are unrelated to the actual manufacture of the products or services. To facilitate the pilot program, the regulation should be modified to permit the Army industrial facilities to charge, at a minimum, only variable costs. The modification could include a time limit. We request that the Under Secretary of Defense (Comptroller) reconsider its position on charging full costs and provide comments on the final report. We request that Under Secretary of Defense for Acquisition, Technology, and Logistics and the Under Secretary of Defense (Comptroller) provide comments on the final report by May 1, 2001.

Table of Contents

Executive Summary i

Introduction

Background 1
Objective 4

Finding

Pilot Program Progress 5

Appendixes

A. Audit Process
Scope and Methodology 13
Prior Coverage 14
B. Summary of Contracts Obtained Under the Pilot Program 15
C. Report Distribution 16

Management Comments

Under Secretary of Defense (Comptroller) 19

Background

FY 2000 Defense Authorization Act. We conducted the audit in response to a tasking in Public Law 106-65, "National Defense Authorization Act for FY 2000." Section 115 of the FY 2000 Defense Authorization Act extends the Army pilot program through FY 2001. The program allows Army industrial facilities to sell manufactured articles and services to persons outside DoD without determining availability from U.S. commercial sources as required by section 4543(a)(5), title 10, United States Code (10 U.S.C. 4543[a][5]). The waiver of 10 U.S.C. 4543(a)(5) applies to the sale of articles and services to be used in the manufacture of weapon systems for which solicitations of offers are issued during FYs 1998 through 2001. Before the waiver, the Army was allowed to sell manufactured articles or services to persons outside the DoD only when the Secretary of the Army determined that the articles and services were not available from commercial sources located in the United States. The FY 2000 Defense Authorization Act requires the Inspector General, DoD, to audit and submit an updated report on the results of the pilot program not later than March 1, 2001.

Congressional Concerns. The Senate Committee on Armed Services expressed concern in Report No. 105-29 accompanying the FY 1998 Defense Authorization Act that with the end of the Cold War, and the beginning of reduced Defense budgets, DoD military industrial facilities were operating inefficiently because work was not available. The committee believed these facilities should be allowed to provide commercial contractors with articles and services for inclusion in weapon systems that would ultimately be procured by the DoD. The committee believed that using this excess capacity would reduce facility operating costs, provide private industry with quality service, and maintain a critical work force. Therefore, the committee recommended a provision that would authorize Army industrial facilities to sell articles and services to commercial entities that would ultimately be incorporated into weapon systems procured by DoD.

Three Army Industrial Facilities Participating in the Pilot Program

Rock Island Arsenal, Illinois. Rock Island Arsenal, which is located on the Mississippi River near Rock Island, and Moline, Illinois, and Davenport, and Bettendorf, Iowa, began manufacturing operations in 1862. Rock Island manufactures weapon components such as artillery gun mounts, recoil mechanisms, and aircraft weapon subsystems. A $220 million modernization project completed in the late 1980s greatly enhanced Rock Island's physical plant and machine tool inventory. Every phase of manufacturing is available from prototype development to production of major items, spare parts, and repair items. Capabilities include design work; foundry work; forging; machining; finishing; soft materials fabrication; tool, die and gauge manufacturing; spare and repair parts production; and prototype fabrication. Recent products include the M198 155mm Towed Howitzer, the M119 Towed

Howitzer, and the gun mount for the M1A1 Abrams tank. Rock Island is collocated with Headquarters, U.S. Army Operations Support Command, which is responsible for managing Army depots, arsenals, and ammunition plants worldwide.

Watervliet Arsenal, New York. Watervliet Arsenal, which is located on the banks of Hudson River, northeast of Albany, New York, began manufacturing operations in 1813 and is the nation's oldest, continuously-active arsenal. Watervliet is a world-class facility that produces large bore gun barrels and breech mechanisms for artillery, armor, and shipboard weapon systems, as well as ship propeller shafts and other large, cylindrical, shaft items. Watervliet is collocated with the U.S. Army Benet Laboratory, whose mission includes the research and development of military ordinance items and manufacturing technologies. A $350 million modernization project completed in 1992 more than doubled the production capability of Watervliet. Watervliet is equipped with a variety of modern computer-numerical-control machining centers, mills, profilers, and lathes. Also, Watervliet has capabilities that include precision machining; tool and die making; metal fabrication; welding; specialized machining; forging; heat treatment; electroplating/surface coating; painting; and packaging. In addition, Watervliet conducts precision inspections and testing of a variety of parts and assembly configurations. Recently, Watervliet installed a demonstration system to recycle highly toxic chemicals that were used to clean and prepare military gun components for chrome plating.

McAlester Army Ammunition Plant, Oklahoma. The McAlester Army Ammunition Plant, which is located in McAlester, Oklahoma, began manufacturing operations in 1943 as a Naval Ammunition Depot. McAlester is the premier DoD facility for loading, assembling, and packing high explosive and inert aerial bombs. McAlester's other functions include maintenance and renovation of bombs, rockets, projectiles and propelling charges, distributing war reserve ammunition critical to the first 30 days of a military conflict, and conventional ammunition demilitarization. The installation covers about 70 square miles (45,000 acres) in southeastern Oklahoma and has 6 manufacturing facilities and more than 2,200 earth-covered ammunition storage magazines and 162 inert storage warehouses. The storage capacity is used for war reserve stocks of ammunition. McAlester is collocated with the U.S. Army Defense Ammunition Center, which performs munitions training, logistics engineering, explosive safety, demilitarization research and development, and career management functions.

Guidance Addressing Sales of Articles and Services Outside DoD

Pilot Program Requirement. Section 141 of the FY 1998 Defense Authorization Act requires the Army to carry out a pilot program to test the efficacy and appropriateness of selling manufactured articles and services of Army industrial facilities under 10 U.S.C. 4543 without regard to the availability of the articles and services from United States commercial sources. In carrying out the pilot program, the FY 1998 Defense Authorization Act

permits the Secretary of the Army to sell articles manufactured at, and services provided by, ". . . not more than three Army industrial facilities."

Temporary Waiver of Requirement to Determine Availability from Domestic Source. The FY 1998 Defense Authorization Act waives the requirement in 10 U.S.C. 4543(a)(5) for the Army to determine whether an article or service is available from a commercial source located in the United States. The waiver applied to the following types of sales for which a solicitation of offers was issued during FYs 1998 and 1999:

- articles that were incorporated into a weapon system procured by DoD, and

- services that were used in the manufacture of a weapon system procured by DoD.

Pilot Program Review Requirement. The FY 2000 Defense Authorization Act extends the pilot program through FY 2001, and requires the Inspector General, DoD, to review the pilot program and report the results of the review to Congress by March 1, 2001. The report should assess the extent to which the temporary waiver of 10 U.S.C. 4543(a)(5):

- enhances the opportunity for United States manufacturers, assemblers, developers, and other concerns to enter into or participate in contracts and teaming arrangements with Army industrial facilities under DoD weapon system programs,

- enhances the opportunity for Army industrial facilities to enter into or participate in contracts and teaming arrangements with United States manufacturers, assemblers, developers, and other concerns under DoD weapon system programs, or

- affects the ability of small businesses to compete for the sale of manufactured articles or services in the United States in competitions to enter into or participate in contracts and teaming arrangements under DoD weapon system programs.

The report may also include examples and recommendations that the Inspector General considers appropriate regarding continuation or modification of the policy as set forth in 10 U.S.C. 4543(a)(5). In response to a tasking in the FY 1998 Defense Authorization Act, the Inspector General, DoD, previously provided two audit reports on the pilot program, Report No. 99-121, "Pilot Program on Sales of Manufactured Articles and Services of Army Industrial Facilities," April 2, 1999, and Report No. 99-203, "Status of Implementation of the Pilot Program on Sales of Manufactured Articles and Services of Army Industrial Facilities," July 8, 1999. The two reports contained recommendations to improve the chances for the pilot program to succeed in providing additional work at the industrial facilities.

Objective

The audit objective was to determine the results of the pilot program. Specifically, the audit was to determine whether the waiver of 10 U.S.C. 4543(a)(5) enhanced opportunities for United States manufacturers, assemblers, developers, or other concerns; Army industrial facilities; and small businesses to enter into or participate in contracts and teaming arrangements under DoD weapon system programs. See Appendix A for a discussion of the audit scope and methodology and prior coverage related to the audit objective.

Pilot Program Progress

The pilot program has minimally increased the use of the capabilities of Army industrial facilities as of January 2001. Marketing of the pilot program by the three participating industrial facilities has resulted in only 12 contracts valued at $6.0 million, including a 5-year contract valued at $5.2 million for demilitarization of conventional ammunition, awarded in August 2000 to the McAlester Army Ammunition Plant. See Appendix B for a summary of contracts obtained under the pilot program. Factors such as DoD guidance requiring industrial facilities to charge customers full costs, which resulted in losing 38 contracts valued at $152,893,949, and the other impediments previously identified in Inspector General, DoD, audit reports 99-121 and 99-203, prevented the pilot program initiative from generating significant additional work for the industrial facilities. Consequently, the pilot program minimally increased opportunities for United States commercial firms, and Army industrial facilities participation in contracts and teaming arrangements under DoD weapon system programs. Provisions in the FY 2001 Defense Authorization Act, and recent Army initiatives, have eliminated or mitigated some of the impediments, but have not been in effect long enough to create a measurable difference. Eliminating the remaining impediments will increase the opportunities for commercial contractors, small businesses, and Army industrial facilities to enter into contracts and teaming arrangements under DoD weapon system programs and increase the use of the industrial facilities' capabilities.

Impediments Eliminated or Mitigated

Delayed Implementation of Pilot Program. This impediment was previously identified in Inspector General, DoD, Report No. 99-121. The Army pilot program was scheduled to expire on September 30, 1999. Because the Army did not implement the program until June 1998, not enough time remained to gain sufficient experience under the pilot program to assess the impact of the program.

Section 115 of the FY 2000 Defense Authorization Act extended the pilot program until September 30, 2001.

Charging Customers for Plant-Capacity Costs. This impediment was previously identified in Inspector General, DoD, Report No. 99-203. Because the industrial facilities were not being allocated the budgeted amounts for unutilized and underutilized plant-capacity costs, prices for their products and services were increased. The three industrial facilities budgeted $41,392,200 for unutilized and underutilized plant-capacity costs in FY 1998, but were allocated only $16,209,900. The $25,182,300 difference was included in prices offered by the industrial facilities to both Government and private sector customers. In FY 2000, the difference between budgeted unutilized and underutilized plant-capacity costs and the allocation received was $18,384,000.

Section 342 of the FY 2001 Defense Authorization Act requires that funds appropriated for unutilized and underutilized plant-capacity costs be used only for such costs. Section 342 also requires that when an Army arsenal is serving as a subcontractor to a private sector entity with respect to goods or services to be provided to a Government agency, the price charged by the arsenal shall not include unutilized and underutilized plant-capacity costs that are funded by a direct appropriation. Additionally, Volumes 2A and 2B of the DoD Financial Management Regulation were revised in June 2000 to show that unutilized and underutilized plant-capacity costs will be reimbursed from appropriated funds and excluded from the prices of products and services provided to customers.

Pilot Program Legislation Requiring Sales for DoD Weapon Systems. This impediment was previously identified in Inspector General, DoD, Report No. 99-203. Section 141 of the FY 1998 Defense Authorization Act permits that articles and services provided under the pilot program be sold to prime contractors for incorporation into weapon systems being procured by DoD. The requirement that the articles and services be incorporated in DoD weapon systems prevents the industrial facilities from selling articles and services to contractors for incorporation into items being procured by other Government agencies, friendly foreign governments, and commercial customers unless a determination is made that the articles or services are not available from United States commercial sources.

Section 343 of the FY 2001 Defense Authorization Act contains an arsenal support program initiative. The initiative requires the Army to carry out a demonstration program during FYs 2001 and 2002 at Rock Island and Watervliet Arsenals to increase the use by commercial firms of the skilled workforce, equipment, and facilities at the arsenals. The initiative encourages use of the unutilized capacity at the arsenals and includes a loan guarantee program to assist commercial firms in establishing commercial activities at the arsenals. Similar provisions covering the McAlester Army Ammunition Plant are included in the armament retooling and manufacturing support initiative established in 10 U.S.C. 4553. Although the arsenal and armament support program initiatives did not remove the requirement that articles and services provided under the pilot program be incorporated into DoD weapon systems, they did create additional opportunities for increased use of the industrial facilities' capabilities.

Uncertainty About the Future of the Army Arsenals. This impediment was previously identified in Inspector General, DoD, Report No. 99-203. Officials at Rock Island and Watervliet Arsenals expressed concern that the Office of Management and Budget Circular A-76 studies announced in August 1998 to determine whether operation of the arsenals should be contracted out or retained in-house and rumors circulating that the Army wanted to close the Arsenals were creating uncertainty in the minds of potential customers desiring long-term supplier relationships. The officials believed that potential customers were not awarding contracts to the arsenals because the customers were not certain that the high quality of work would continue after operations were contracted out, or that the arsenals would remain open.

The Army Materiel Command canceled the Office of Management and Budget Circular A-76 cost studies of the manufacturing functions at the arsenals because unpredictable workloads prevented identification of the scope of work. The base operations functions continue to be studied under the Circular. Additionally, the arsenal support program initiative established in section 343 of the FY 2001 Defense Authorization Act should assure potential customers that the Arsenals will remain open.

Impediments Requiring Action

Requirement to Charge Customers Full Costs. This impediment was previously identified in Inspector General, DoD, Report No. 99-203. Guidance in the DoD Financial Management Regulation that requires Army industrial facilities to include full costs in their proposed prices has placed the industrial facilities at a disadvantage when competing with commercial sources that include in their proposed prices only the costs that are attributable to the article or services to be provided. Of the 30 offers by Rock Island Arsenal under the pilot program, 27 were rejected because the prices were too high. Rock Island Arsenal officials stated that the prices were too high because they included full costs rather than specific costs related to producing the item or service. The total amount of the 27 rejected offers was $152,047,200. The three offers that resulted in contracts were valued at $66,003. Watervliet Arsenal had eight offers valued at $600,716, and McAlester Army Ammunition Plant had three offers valued at $246,033, rejected because prices were too high. Officials at the industrial facilities stated that the requirement to include full costs in prices made it difficult to compete with the private sector. The officials noted that factors, in addition to unutilized and underutilized plant-capacity costs that were driving industrial facility costs upward, included various base operations costs and headquarters-directed surcharges that are not directly related to products or services provided to customers.

The Army Materiel Command issued instructions that directs the industrial facilities to submit two alternative price packages with their FY 2003 through FY 2007 Program Objective Memorandum submissions. Either alternative would eliminate many of the costs and surcharges from customer prices that are not directly related to products or services provided to customers. However, the pricing guidance in the DoD Financial Management Regulation needs to be amended to permit the industrial facilities to charge customers only the costs directly related to the products or services provided.

DoD 7000.14R, Volume 11B, Chapter 64, "Army Industrial Activities Sale of Manufactured Articles or Services Outside of the Department of Defense," requires that, in the case of a sale of commercial articles or commercial services, an industrial facility that manufactures large caliber cannons, gun mounts, or recoil mechanisms, or components thereof, charge the buyer the full costs (fixed and variable) that are associated with the articles or services sold.

The requirement to charge full costs is more restrictive than 10 U.S.C. 4543(b)(3)(A), which authorizes the industrial facilities:

> "(A) to charge the buyer, at a minimum, the variable costs that are associated with the commercial articles or services; . . . ."

The intent of 10 U.S.C. 4543 is to permit industrial facilities relief from regulations that require that the price offered to a potential customer include costs that are unrelated to the actual manufacture of the product or the service required by that customer. To allow industrial facilities to charge only the variable costs associated with the articles or services provided, the Under Secretary of Defense (Comptroller) should waive the requirement to charge full costs contained in Volume 11B of the DoD Financial Management Regulation. The Under Secretary should initiate an amendment to Volume 11B as permitted by 10 U.S.C. 4543(b)(3)(A), which authorizes industrial facilities that manufacture large caliber cannons, gun mounts, or recoil mechanisms, or components thereof, to charge their buyers, at a minimum, the variable costs associated with the articles or services provided. The Under Secretary nonconcurred with a similar recommendation in Report No. 99-203. In light of the additional emphasis on obtaining work for the Army industrial facilities contained in the FY 2001 Defense Authorization Act, we believe that the Under Secretary should reconsider its prior position when responding to Recommendation 1.

Sales Legislation Requiring Advance Payments. This impediment was previously identified in Inspector General, DoD, Report No. 99-203. Sales under 10 U.S.C. 4543 require that Army working-capital funded industrial facilities obtain payment in advance of performance. DoD implemented the requirement in Volume 11B, Chapter 64, of the DoD Financial Management Regulation. The advance payment may be in full or by incremental payments. Officials at Rock Island Arsenal, Watervliet Arsenal, and the McAlester Army Ammunition Plant stated that the requirement to obtain advance payment is a barrier to obtaining work under the pilot program because contractors generally are not willing to pay for articles and service in advance of receipt. The common business practice in private industry is to pay for articles and services after acceptance, often 60 to 90 days. To allow the three industrial facilities participating in the pilot program to use private industry billing practices, the Under Secretary of Defense for Acquisition, Technology, and Logistics should request that Congress waive, for the pilot program, the requirement in 10 U.S.C. 4543(b)(2) that the industrial facilities obtain advance payment from purchasers of their articles and services. The Under Secretary nonconcurred with a similar recommendation in Report No. 99-203. We believe that adoption of this commercial billing practice is in consonance with Under Secretary of Defense for Acquisition, Technology, and Logistics initiatives in other areas for DoD to adopt commercial practices. As such, we request that the Under Secretary provide consideration to Recommendation 2.

Assessment of the Army Pilot Program

To date, the pilot program has minimally increased the use of the capabilities of the Army industrial facilities. Army implementation of the pilot program from June 1998 to January 2001, at the three participating industrial facilities, has resulted in only 12 contracts valued at $6.0 million. The pilot program has not generated significant additional work primarily because DoD guidance, 10 U.S.C. 4543, and the pilot program statute contain provisions that impeded efforts by the industrial facilities to obtain additional work. We identified the various impediments to the industrial facilities' efforts to obtain additional work. Provisions in the FY 2001 Defense Authorization Act and recent Army initiatives have eliminated or mitigated some of those impediments, but have not been in effect long enough to create a measurable difference. Actions to eliminate remaining impediments will further increase the opportunities for commercial contractors, small businesses, and the Army industrial facilities to enter into contracts or teaming arrangements under DoD weapon system programs and increase the use of the industrial facilities' capabilities.

We believe that the pilot program should be extended. Overall, the pilot program is beneficial to DoD and the military industrial base. The DoD benefits because the pilot program eliminates an impediment to obtaining work for the Army industrial facilities. The military industrial base benefits because it can contract or partner directly with an Army industrial facility for needed articles and services. The pilot program eliminates the need for the Army to certify that the products or services required by commercial firms desiring to contract or partner with an industrial facility are not available from United States commercial sources. The pilot program, as well as the recently established arsenal and armament support program initiatives, also benefit commercial firms because the programs provide private contractors and small businesses additional accessibility to the Army industrial facilities and their unique capabilities. Any increase in the volume of work resulting from the pilot program and the arsenal and armaments support program initiatives would use idle plant capacity, reduce overhead costs, and result in lower prices to all customers of the industrial facilities. More importantly, the added work would aid the retention of critical manufacturing skills that are being lost due to the lack of work at the industrial facilities.

Related Matter That May Impact Work-Loading of Army Ammunition Plants

Officials responsible for the pilot program at McAlester Army Ammunition Plant expressed concern that the Army was contracting out demilitarization work while the demilitarization capacity at Army ammunition plants is underused. On May 12, 1999, the Army Operations Support Command awarded a 5-year indefinite delivery indefinite-quantity contract to General Dynamics Ordnance Systems and Parsons Brinkerhoff Nordic Ammunition Company for demilitarization of 37 million rounds of 144 different types of ammunition. In FY 1999, two delivery orders totaling about $60.7 million were

issued under the contract. General Dynamics was awarded a delivery order valued at about $34.8 million. Parsons Brinkderhoff Nordic was awarded the other delivery order, valued at about $25.9 million. In October 1999, Parsons Brinkerhoff Nordic awarded a $5.2 million subcontract to the McAlester Army Ammunition Plant for demilitarization of 750 pound bombs. Parsons Brinkerhoff Nordic also awarded subcontracts, valued at $3.4 million, to the Army ammunition facilities at Crane, Indiana, and Toole, Utah, for a portion of the work under its $25.9 million delivery order. The indefinite delivery indefinite-quantity contract was of particular concern to McAlester Army Ammunition Plant officials because some of the demilitarization work required shipping of ammunition stored at Army ammunition plants in the United States (including McAlester) to contractor designated locations in Germany, Norway, and Sweden. Officials at the Army Operations Support Command told us that in FY 2000, about $7.9 million was obligated for transportation. The FY 2000 budget for demilitarization of conventional ammunition was about $85.1 million.

In February 1996, the Army Materiel Command directed the Army Operations Support Command to split the demilitarization workload between the organic base and private industry. An official at the Army Materiel Command told us that legislation or regulation did not direct the split, but that there was Army and congressional interest in moving toward R3 (Resource, Recovery, and Recycling) techniques for demilitarizing ammunition. The move towards R3 was desired because of the environmental impact of open burning and open detonation techniques used by the organic ammunition plants. The indefinite delivery indefinite-quantity contract awarded to General Dynamics and Parsons Brinkerhoff Nordic requires the contractors to use incineration or R3 techniques.

We did not evaluate the impact of the indefinite delivery indefinite-quantity contract or the Army's demilitarization program on the workload at the Army ammunition plants. Such an evaluation was outside the scope of our review of the pilot program. Additionally, the General Accounting Office is performing a review of DoD demilitarization and disposal of excess ammunition under job code 709541, which includes a discussion of the indefinite delivery indefinite-quantity contract. The General Accounting Office anticipates that it will issue the report of its review in April 2001.

Recommendations, Management Comments, and Audit Response

1. We recommend that the Under Secretary of Defense (Comptroller):

a. Waive the requirement to charge full costs contained in Volume 11B of the DoD Financial Management Regulation and allow the industrial facilities to charge variable costs for articles or services provided until Volume 11B can be amended.

b. Amend Volume 11B of the DoD Financial Management Regulation as permitted by 10 U.S.C. 4543(b)(3)(A), which authorizes industrial facilities that manufacture large caliber cannons, gun mounts, or recoil mechanisms, or components thereof, to charge their buyers, at a minimum, the variable costs associated with the articles or services provided.

Under Secretary of Defense (Comptroller) Comments. The Assistant Deputy Comptroller (Program/Budget) stated he applauds the intent of the audit recommendations which would have the arsenals find other sources of work, specifically work for or in partnership with the private sector. This would increase utilization and help reduce the overall cost of infrastructure. Core arsenal workload (gun tubes, gun mounts, and recoil mechanisms) has decreased significantly since the end of the cold war. The arsenals are utilized at less than 20 percent of capacity. As a result, a smaller workload base must recover a relatively fixed amount of overhead. The Assistant Deputy Comptroller nonconcurred with the recommendation, stating that the revolving fund form of financial management is based on the principle of full cost recovery. Full cost recovery requires that for any work performed all direct costs plus an applicable share of overhead expenses must be recovered from the customer. The Army has taken actions to directly finance the unutilized capacity of these facilities and thus exclude these costs from the chargeable rate. The Assistant Deputy Comptroller further stated that allowing the Arsenals to charge private contractors less than their DoD customers, in an era of scarce resources, is counterproductive to sound financial management. Further, the concept of full cost recovery is a basic principle that must be followed.

Audit Response. The Assistant Deputy Comptroller comments recognize the issue but do not provide a flexible alternative. As we stated in our Report No. 99-203 on this pilot program, the Army industrial facilities are not required to charge their customers full costs. The DoD Financial Management Regulation requirement that the Army industrial facilities charge full costs is more restrictive than 10 U.S.C. 4543, which provides the option to charge only variable costs. Additionally, the Army industrial facilities have been specifically excluded from 10 U.S.C. 2208 and 2553. Provisions in 10 U.S.C. 2208 require that working capital funded activities recover full costs of goods or services sold. Provisions in 10 U.S.C. 2553 require that other industrial facilities include in their prices costs that are not required by 10 U.S.C. 4543. The fact that the Army industrial facilities have been excluded from 10 U.S.C. 2208 and 2553 and made the subject of a separate statute (10 U.S.C. 4543) with less restrictive cost provisions makes it clear that the Army industrial facilities can be treated differently from other industrial facilities. The intent of 10 U.S.C. 4543 is to provide the Army industrial facilities relief from statutes and regulations that require that the prices offered to potential customers include costs that are unrelated to actual manufacturing of products or services required by the potential customers. To facilitate the pilot program, the DoD Financial Management Regulation should be modified to permit the Army industrial facilities to charge, at a minimum, only variable cost. Because this is a pilot program the modification to the regulation could include a time limit. We request that the Under Secretary of Defense (Comptroller) reconsider its position on the recommendation and provide comments in response to the final report.

2. We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics request Congress to waive, for the pilot program, the requirement in 10 U.S.C. 4543(b)(2) that the industrial facilities obtain advance payment from purchasers of their articles and services.

Under Secretary of Defense for Acquisition, Technology, and Logistics Comments. The Under Secretary of Defense for Acquisition, Technology, and Logistics did not comment on the recommendation. We request that the Under Secretary provide comments in response to the final report.

Appendix A. Audit Process

Scope and Methodology

We audited Army implementation of the pilot program authorized by section 141 of the FY 1998 Defense Authorization Act and extended by section 115 of the FY 2000 Defense Authorization Act. The Defense Authorization Acts authorize the Army to sell during FYs 1998 through 2001 manufactured articles and services of up to three Army industrial facilities to persons outside DoD without determining whether the articles and services are available from the United States commercial sources as required by 10 U.S.C. 4543(a)(5). To determine the effect of the pilot program on opportunities for United States manufacturers, assemblers, developers, or other concerns; Army industrial facilities; and small businesses to enter into or participate in contracts and teaming arrangements under DoD weapon system programs, we

- examined Army guidance on the pilot program;
- reviewed information on the 12 contracts awarded under the pilot program to Rock Island Arsenal, Watervliet Arsenal, and the McAlester Army Ammunition Plant;
- reviewed the Army's experience and results under the pilot program and discussed the results with officials at the Army Materiel Command, the Army Operations Support Command, Rock Island Arsenal, Watervliet Arsenal, and the McAlester Army Ammunition Plant; and
- discussed pilot program assessment with officials at the Army Materiel Command; the Army Operations Support Command; Rock Island Arsenal; Watervliet Arsenal; and the McAlester Army Ammunition Plant.

Limitations to Scope. We did not review the management control program because the scope of the audit was limited to determining the results of the pilot program in response to tasking in the Defense Authorizations Acts for FYs 1998 and 2000.

General Accounting Office (GAO) High Risk Area. The GAO has identified several high risk areas in the DoD. This report provides coverage of the DoD Infrastructure Management and the DoD Weapon Systems Acquisition high risk areas.

Use of Computer-Processed Data. We did not use computer-processed data to perform this audit.

Audit Type, Dates, and Standards. We performed this program audit from September 2000 through January 2001 in accordance with auditing standards

issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD.

Contacts During the Audit. We visited or contacted individuals and organizations within the DoD, and selected contractor organizations. Further details are available upon request.

Prior Coverage

During the past 5 years, the General Accounting Office issued one audit report and the Inspector General, DoD, issued two audit reports that discussed Army industrial facilities.

General Accounting Office

GAO Report No. GAO/NSIAD-99-31 (OSD Case No. 1674), "Army Industrial Facilities: Workforce Requirements and Related Issues Affecting Depots and Arsenals," November 1998.

Inspector General, DoD

IG, DoD, Report No. 99-203, "Status of Implementation of the Pilot Program on Sales of Manufactured Articles and Services of Army Industrial Facilities," July 8, 1999.

IG, DoD, Report No. 99-121, "Pilot Program on Sales of Manufactured Articles and Services of Army Industrial Facilities," April 2, 1999.

Appendix B. Summary of Contracts Obtained Under the Pilot Program

Contracts		Dollar Value
Rock Island Arsenal		
(1) Machine Top Ring Assembly for the Armored Combat Earthmover Prime Contractor: LOC Performance Products	Customer: Army	$ 38,885
(2) Engineering Services/IIT Research Prime Contractor: IIT Research	Customer: Army	20,005
(3) Metallurgical Study of Lower Housing Assembly Metal Fragments Prime Contractor: Day & Zimmermann	Customer: Army	7,113
Subtotal		66,003
Watervliet Arsenal		
(1) Machining and inspection of internal thread for Launch Assembly Prime Contractor: B&B Devices	Customer: Defense Logistics Agency	15,278
McAlester Army Ammunition Plant		
(1) Load, assembly, and pack MK 82, Joint Defense Attack Munitions Prime Contractor: Boeing Aircraft Company	Customer: Navy	35,704
(2) Demilitarization of 105-mm HEAT Tank Ammo Projectiles Prime Contractor: Primex Technologies	Customer: Army	64,490
(3) Navy Harpoon System Prime Contractor: McDonnell-Douglas	Customer: Navy	504,825
(4) Base Hardness Prime Contractor: Aliant Techsystems	Customer: Army	67,017
(5) Pallets for Javelin Prime Contractor: Independent Pipe Products	Customer: Army	21,235
(6) BLU 109/UK Prime Contractor: General Dynamics Land System	Customer: Air Force	28,476
(7) Demilitarization of AMRAAM Missile Components Prime Contractor: Raytheon	Customer: Air Force	11,135
(8) 5 Years Demilitarization of 750Lbs Bombs Prime Contractor: PB/NAMMO*	Customer: Army	5,200,000
Subtotal		5,932,882
Total		**$6,014,163**

*PB/NAMMO Parsons Brinkerhoff Nordic Ammunition Company

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
  Deputy Under Secretary of Defense (Acquisition Reform)
Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)

Department of the Army

Assistant Secretary of the Army for Acquisition, Logistics, and Technology
Commander, Army Materiel Command
  Commander, U.S. Army Operations Support Command
    Commander, McAlester Army Ammunition Plant
    Commander, Rock Island Arsenal
    Commander, Watervliet Arsenal
Auditor General, Department of the Army

Department of the Navy

Naval Inspector General, Department of the Navy

Department of the Air Force

Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service

Non-Defense Federal Organization

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

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 Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform
House Subcommittee of Technology and Procurement Policy, Committee on Government Reform

Under Secretary of Defense (Comptroller) Comments

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER
(Program/Budget)

FEB 16 2001

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Draft Audit Report on Pilot Program on Sales of Manufactured Articles and Services of Army Industrial Facilities Project Number D2000CH-239 dated January 31, 2001

This memorandum responds to your request for comments on the draft audit report on Pilot Program on Sales of Manufactured Articles and Services of Army Industrial Facilities. The draft report includes recommendation that the Under Secretary of Defense Comptroller waive certain provisions in DoD Financial Management Regulation Volume 11B, Chapter 64 regarding rates charged to non-DoD customers.

The findings and recommendations in this report are almost identical to two earlier audits on this topic. This draft request recommends that the Comptroller waive a basic principle of revolving fund operations for purposes of this pilot test. For the reasons stated below, we continue to oppose any changes that allow DoD activities to charge less than full costs for goods or services.

We applaud the intent of the audit recommendations which would have the arsenals find other sources of work, specifically work for or in partnership with the private sector. This would increase utilization and help reduce the overall cost of infrastructure. Core Arsenal work load (gun tubes, gun mounts, and recoil mechanisms) has decreased significantly since the end of the cold war. The arsenals, as pointed out in the audit, are utilized at less than 20 percent of capacity. As a result, a smaller work load base must recover a relatively fixed amount of overhead. The revolving fund form of financial management is based on the principle of full cost recovery. This requires that for any work performed, all direct costs plus an applicable share of overhead expenses must be recovered from the customer. The Army has taken actions, endorsed by the Comptroller and the Congress, to directly finance the unutilized capacity of these facilities and thus exclude these costs from the chargeable rate.

We support the Army's efforts to ensure that the costs charged to the customers reflect the true operating costs and do not include unutilized or mobilization costs. However, the audit recommends that we allow the Arsenals to charge private contractors less than we would charge our own DoD customers. In an era of scarce resources, this idea is counterproductive to sound financial management. Revolving fund activities have wide latitude in establishing rates

for work performed. However, the concept of full cost recovery is a basic principle that must be followed. The audit does not provide a rationale that would allow us to support a change in this principle, even in a pilot program.

Therefore I cannot concur with the recommendations in the draft report. My point of contact on this matter is Mr. Ralph Proctor. He may be reached at (703) 697-1880.

Warren Hall
Assistant Deputy Comptroller
(Program/Budget)

Attachment
As stated

Draft Audit Report on Pilot Program on Sales of
Manufactured Articles and services of Army Industrial Facilities
Project Number D2000CH-239 dated January 31, 2001

Recommendation 1. We recommend that the Under Secretary of Defense (Comptroller):

a. Waive the requirement to charge full costs contained in Volume 11B of the DoD Financial Management Regulation and allow the industrial facilities to charge variable costs for articles and services provided until Volume 11B can be amended.

   Nonconcur. See USD(C) letter of January 11, 2001.

b. Amend Volume 11B of the DoD Financial Management Regulation as permitted by 10 U.S.C. 4543(b)(3)(A), which authorizes industrial facilities that manufacture large caliber cannons, gun mounts, or recoil mechanisms, or components thereof, to charge their buyers, at a minimum, the variable cost associated with the articles or services provided.

   Nonconcur. See USD(C) letter of January 11, 2001.

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

JAN 11 2001

MEMORANDUM FOR COMMANDER, HEADQUARTERS, U.S. ARMY
OPERATIONS SUPPORT COMMAND

SUBJECT: Reinvention Lab Waiver Request 99-08

Under the provisions of the Department's Reinvention Laboratory Waiver Policy, the Operations Support Command (formerly Industrial Operations Command) has requested a waiver to OUSD(C) policy regarding pricing of work load at two Army arsenals and one ammunition plant. Based upon the information provided and current regulations governing the operation of the Defense Working Capital Fund, your request must be denied.

A basic principle of revolving fund operations is that rates are set to recover the full cost of operations. Your request asks that this principle be waived. You have stated that current OUSD(C) policy violates the provisions of Title 10 USC 4543, "Army Industrial Facilities: Sales of Manufactured Articles or Services Outside the Department of Defense," and therefore a waiver under the Reinvention Lab umbrella is required until the DoD regulations are revised. Paragraph (b) of USC 4543 states:

> (3) in the case of the sale of commercial articles by a facility that manufactures large caliber cannons, gun mounts, or recoil mechanisms, or components thereof, authorize such facility –
> (A) to charge the buyer, at a minimum, the variable costs that are associated with the commercial article or commercial services sold.

Paragraph b(3) states that the minimum amount the facility is allowed to charge is the variable cost of the work performed. Thus, while section 4543 would permit your requested pricing policy for work performed under that section, it is not required. To authorize such a pricing policy would be at variance with established DoD policy, based on 10 USC 2208, that requires recovery of all expenses incurred, both direct and overhead. We have concluded that such a variance would not be in DoD's best interests.

Further, the Defense Working Capital Fund (DWCF) Corporate Board reviewed various recommendations from the DWCF Reform Task Force related to rates. The recommendations for those groups were forwarded to the Deputy Secretary of Defense for decision. The final decision of the Deputy Secretary of Defense reconfirmed the existing policy. Therefore, there will be no revisions to the DoD regulation, and no interim Reinvention Lab waiver is required.

It should be noted that the Department was successful in raising the level of Unutilized Plant Capacity (UPC) funding for the Army arsenals in the FY 2001 budget. Therefore, the fixed costs funded with the UPC appropriation are automatically excluded from the arsenal stabilized rates for all customers.

The point of contact on this issue is Mr. Ralph Proctor. He may be reached at (703) 697-1880 or DSN 227-1880.

William J. Lynn

Audit Team Members

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

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