

November 27, 2006

The Honorable Carl Levin  
United States Senate  
Washington, D.C. 20510

The Honorable John McCain  
United States Senate  
Washington, D.C. 20510

The Honorable Henry Waxman  
House of Representatives  
Washington, D.C. 20515

The Honorable Chris Shays  
House of Representatives  
Washington, D.C. 20515

Dear Senators Levin and McCain and Representatives Waxman and Shays:

The Project On Government Oversight (“POGO”) is an independent nonprofit organization that investigates and exposes corruption and other misconduct in order to achieve a more accountable federal government. POGO has a keen interest in government contracting matters, especially matters related to wasteful spending. We are writing to you because of your demonstrated interest in trying to remedy this systemic problem.

Recently, POGO obtained an as-yet-undisclosed Department of Defense (DoD) Inspector General (IG) report that shows enormous cost increases (in some cases nearly 900 percent higher) in Hamilton Sundstrand’s “9-year \$860 million strategic sourcing commercial contract for noncompetitive spare parts used on Defense weapons systems.”<sup>1</sup> Hamilton Sundstrand is a subsidiary of United Technologies Corporation and designs and manufactures aerospace systems (including parts for the F-16 aircraft) for government and commercial

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<sup>1</sup> In 1996, the DoD entered into an exclusive distributor agreement with Hamilton Sundstrand to supply the military with aircraft spare parts. That agreement was followed up by a 9-year contract in 2004. DoD IG, “Commercial Contract for Noncompetitive Spare Parts with Hamilton Sundstrand Corporation (D-2006-122),” p. i, September 29, 2006. Hereinafter referred to as the “DoD IG report.”

buyers. The IG's report highlights concerns with the "rapidly increasing cost of noncompetitive spare parts for Defense weapon systems."<sup>2</sup> This report is the third by the DoD IG that discusses the unreasonableness of prices paid for spare parts purchased from Sundstrand (now Hamilton Sundstrand).<sup>3</sup>

As you are aware, noncompetitive and commercial item contracts are sometimes linked to, and often are a breeding ground for, wasteful government programs and projects. POGO is very concerned with the big-picture contracting issues that are raised in this latest report – no-bid contracting, stretching the definition of commercial item, and the government's reliance on contractor assertions that all contract-related data is proprietary and therefore concealed from public view. Currently, the statutes and regulations that govern commercial item contracts (including those that are awarded without competition) are confusing, vague, and industry-friendly.

POGO respectfully requests you hold hearings in your respective committees on no-bid commercial item contracts. Ultimately, legislation will be required to put teeth into the Federal Acquisition Streamlining Act of 1994 (FASA)<sup>4</sup> that will require contractors to prove there is a commercial market for their products, not simply that the product is "offered for sale." In addition, legislation is necessary to correct FASA and Federal Acquisition Reform Act of 1996 (FARA)<sup>5</sup> language on competitive contracting requirements; to close the "of a type" loophole that qualifies nearly everything as a so-called "commercial item"; and to require more robust estimates of price "reasonableness" for exempt commercial items. POGO is not alone in urging for action in the commercial item arena. Henry Kleinknecht, Program Director for Contract Management of the DoD Inspector General's Office, testified before the Acquisition Advisory Panel (also known as the SARA or 1423 Panel) that the laws and guidance on commercial item determinations and the commercial item exception to cost or pricing data are unclear and are in need of clarification.<sup>6</sup>

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<sup>2</sup> DoD IG report, at p. i.

<sup>3</sup> Hamilton Standard and Sundstrand Corporation merged in June 1999.

<sup>4</sup> Pub. Law 103-355.

<sup>5</sup> Pub. Law 104-106.

<sup>6</sup> Testimony of Henry Kleinknecht, Program Director for Contract Management of the DoD Inspector General's Office, before the Acquisition Advisory Panel, June 29, 2006. Available at <http://www.acquisition.gov/comp/aap/documents/Final%2029%20Jun%2006%20Meeting%20Minutespost%20br.pdf>.

## **Harm Caused by No-Bid Contracting**

There have been many stories about outrageous no-bid Iraq reconstruction and Hurricane Katrina contracts, but this IG report helps to prove that noncompetitive contracts are becoming the rule, rather than the exception, in federal contracting. In the Hamilton Sundstrand case, the government is buying nearly \$900 million worth of aircraft spare parts without any competition. This arrangement hinders the government's ability to obtain best value for taxpayers and creates an impression that agencies favor select contractors. The government must correct the current trend of entering into contracts without competitive bidding that engrosses nearly 50 percent of federal dollars spent.

### **Inappropriate Commercial Item Designation Removes Oversight**

An additional concern raised in the DoD IG's report is the problem created for the government when certain goods are purchased as a commercial item.<sup>7</sup> The commercial item designation strips away specific oversight protections and places a large burden on the government to ensure that taxpayer dollars are being spent wisely.<sup>8</sup> Specifically, the lack of cost or pricing data hinders the government's ability to verify cost reasonableness and to evaluate whether taxpayer dollars are being wasted. The commercial item contracting vehicle was proposed by Hamilton Sundstrand and agreed to by the government with the intent to "standardize and simplify" the pricing process.<sup>9</sup> Unfortunately, the result of that process has not benefitted taxpayers.

Although some of the items were similar to those in the commercial market, the Air Force considered all of the spare parts to be "of a type" commonly found in the commercial marketplace.<sup>10</sup> The DoD IG report stated that "the Air Force negotiating team used questionable commercial item determinations that exempted Hamilton Sundstrand from the requirement to submit cost or pricing data" to the government.<sup>11</sup> The report also stated that, although Hamilton Sundstrand's contract "may meet the liberal statutory commercial item definition, the Air Force did not use commercial marketplace pricing to price any of the 1,011" items that were reviewed by the DoD IG that totaled \$19.6 million.<sup>12</sup>

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<sup>7</sup> The IG report does not differentiate commercial from noncommercial items. It is hard to believe, however, that all of the spare parts were commercial items as declared by Hamilton Sundstrand and approved by government officials.

<sup>8</sup> DoD IG report, at pp. 10-14.

<sup>9</sup> DoD IG report, at p. 30.

<sup>10</sup> DoD IG report, at pp. 8-14.

<sup>11</sup> DoD IG report, at p. i.

<sup>12</sup> DoD IG report, at p. 57.

When asked to provide cost data from 1998 through 2004, Hamilton Sundstrand “repeatedly refused attempts by DoD contracting officials to obtain the information necessary to determine price reasonableness for noncompetitive spare parts since the implementation of FASA and FARA.”<sup>13</sup> On April 11, 2006, Hamilton Sundstrand again refused to provide the Air Force with cost data on certain items.<sup>14</sup>

Without marketplace pricing, the Air Force primarily relied on previous prices and, in the minority of cases, cost-based strategies that placed the government “at high risk of paying excessive prices and profits and precludes good fiduciary responsibility for DoD funds.”<sup>15</sup> Those oversight protections, however, provided very little assurance that the government was paying fair and reasonable prices for spare parts. The IG report stated that the majority of items (549 out of the 1,011 items – totaling over \$3.2 million) had no historical or forecasted demand and that and additional 246 items (totaling \$10.8 million) were reviewed using the risky price analysis strategy.<sup>16</sup> Simply stated, DoD did not have reliable data to negotiate prices for a majority of the spare parts that the IG reviewed.

As a result, several DoD negotiated prices were “significantly higher than the prices paid by some commercial customers.”<sup>17</sup> For example, DoD paid as much as \$15.05 for a straight headless pin while Hamilton Sundstrand sold two pins to a commercial customer for \$3.88 each – that transaction resulted in the government paying “288 percent higher than the best commercial customer price.”<sup>18</sup> An “insulation sleeve” used to protect electrical wiring on the T-38 aircraft had been sold to the government at the price of \$8.51 in 2004, but most recently was sold at a negotiated price of \$85.02 (899 percent higher than the Air Force’s previous purchase).<sup>19</sup> The housing for the T-38 generator was negotiated at a price of \$5,203, however, an Air Force official priced that item at about \$300 each.<sup>20</sup>

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<sup>13</sup> DoD IG report, at p. 32.

<sup>14</sup> DoD IG report, at p. 34.

<sup>15</sup> DoD IG report, at p. 15. Cost-based determinations were used to review \$7.9 million and price analysis was used in to review \$11.6 million of the \$19.6 million spent on the 1,011 spare parts purchased under Phase 1 of the no-bid contract.

<sup>16</sup> DoD IG report, at pp. 31-32.

<sup>17</sup> DoD IG report, at p. 37.

<sup>18</sup> DoD IG report, at p. 37.

<sup>19</sup> DoD IG report, at p. 41.

<sup>20</sup> DoD IG report, at p. 42.

Based on those poor buying practices, the IG recommended that the Air Force should “develop alternate sources of noncompetitive Hamilton Sundstrand items,” the Air Force should better monitor commercial item and price reasonableness determinations, and that DoD should clarify the regulations governing commercial item price reasonableness determinations.<sup>21</sup>

In October, Senator McCain was credited by the Air Force for questioning the purchase of the C-130J cargo plane using a commercial item contract instead of a more traditional contracting vehicle. That effort will lead to the “repricing [of] 39 aircraft, resulting in institutional net savings of \$168 million.”<sup>22</sup> Senator McCain previously applied the same scrutiny to the KC-767A tanker, exposing the “Boeing Tanker” lease boondoggle, and saving the taxpayers billions. Unfortunately, the DoD has not yet learned from its previous mistakes.

### **Proprietary Data Used as a Smokescreen**

POGO is opposed to the blanket use of the commercial proprietary data designations, which hinders the public’s access to contracting information. POGO believes that the government is relying too heavily on contractor assertions about what information is commercial proprietary data. POGO further believes that the practice is nothing more than a smokescreen to hide waste, fraud, and abuse that may cause a company or the government public embarrassment.

POGO is not alone in its belief. On October 26, 2006, the Special Investigator General for Iraq Reconstruction (SIGIR) released a report that found that an Iraq contractor “routinely marks almost all information it provides to the government as ... proprietary data” which is “not consistent” with contracting regulations and “inhibits transparency of government activities and the use of taxpayer funds, and places unnecessary requirements on the government to both protect from public disclosure information received from [contractors] and to challenge inappropriate proprietary markings. ... In effect, [the contractor] has turned [contracting] provisions designed to protect truly proprietary information and to enhance procurement competition by protecting proprietary data from unauthorized disclosure into a mechanism to prevent the government from releasing normally transparent information, thus potentially hindering competition and oversight.”<sup>23</sup>

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<sup>21</sup> DoD IG report, at p. ii.

<sup>22</sup> Secretary of the Air Force, Office of Public Affairs, Press Release (051006), “AF announces C-130J contract conversion,” October 25, 2006. Available at <http://www.af.mil/pressreleases/release.asp?storyID=123029915>. Downloaded November 15, 2006.

<sup>23</sup> Special Inspector General for Iraq Reconstruction (SIGIR), “Interim Audit Report on Inappropriate Use of Proprietary Data Markings by the Logistics Civil Augmentation Program (LOGCAP) Contractor (SIGIR-06-035),” p. 2, October 26, 2006. Available at <http://www.sigir.mil/reports/pdf/audits/06-035.pdf>.

Although part of the blame rests with contractors, the government has an independent duty to review a contractor's commercial proprietary assertion – the government should not simply rubber stamp these claims. In the case of Hamilton Sundstrand, the government is protecting no-bid data from phantom competitors who cannot benefit from this knowledge given the fact that the government is locked into the contract for 9 years. Additionally, the shielded data pertains to commercial items – a designation that should require public access to ensure that market forces are truly driving those government spending decisions.

POGO is also concerned that the government is concealing, in essence, overrun data. In hearings chaired by Representative Christopher Shays (R-CT), J. William Leonard, Director of the Information Security Oversight Office, National Archives and Records Administration, said that he has “never encountered” a case in which the government considered the amount a contractor has overcharged it as being proprietary information.<sup>24</sup> Mr. Leonard also testified that he would be “hard pressed to readily come up with a rationale” to justify the government hiding overcharging information.<sup>25</sup> Harold C. Relyea, an information specialist with the Congressional Research Service, agreed with Leonard's testimony, stating that overcharges are “hardly proprietary information” and that it would be a “terrible abrogation of responsibility” for an agency to accept a contractor's assertion about what information is proprietary.<sup>26</sup>

This is not the first time the government has had a problem with potential overcharging on a Hamilton Sundstrand's spare parts contract. A previous DoD IG report showed that in 1998 the Defense Logistics Agency (DLA) paid Sundstrand \$4.5 million (280 percent) more than fair and reasonable prices for \$6.1 million of “commercial items” purchased from 1994 through 1996.<sup>27</sup> Those higher prices were the result of noncompetitive contracting of commercial items when there was “no competitive commercial market to ensure the reasonableness of prices,” and of the government's inability to review contractor cost or pricing data.<sup>28</sup>

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<sup>24</sup> Hearing Before the House Subcommittee on National Security, Emerging Threats, and International Relations of the House Committee on Government Reform, “Emerging Threats: Overclassification and Pseudo-classification,” p. 86, March 2, 2005. Available at <http://www.fas.org/sgp/congress/2005/030205overclass.pdf>. Downloaded November 1, 2006.

<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

<sup>27</sup> DoD IG Report (98-064), “Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111,” February 6, 1998. Available at <http://www.dodig.mil/Audit/reports/fy98/98064-s.htm> (unredacted summary) and <http://www.dodig.mil/Audit/reports/fy98/98-064-s.pdf> (redacted report). Downloaded November 14, 2006. See DoD IG report, at p. 3.

<sup>28</sup> DoD IG report, at p. 3.

In a 2003 report, the DoD IG found that DLA “paid prices that were \$7.4 million (77.7 percent) higher than fair and reasonable prices on 35 orders (29 contracts) for 11 sole-source Hamilton Sundstrand spare parts procured” from 1999 through 2002.<sup>29</sup> The government found that the exclusive nature of the contract and DoD’s reliance on “inaccurate and misleading information other than cost or pricing data” contributed to the higher prices.<sup>30</sup>

Air Force contracting officers and the contractor itself benefit from concealing cost overcharges from public scrutiny. As a result, no one is held accountable. The Hamilton Sundstrand contract is only the latest instance that calls into question the integrity of the federal contracting system. To regain public confidence in that system, the government must ensure that the contracting process is open to the public – including requests for proposals, contract data, and contracting officers’ decisions and justifications.

### Conclusion

POGO urges you to hold hearings on the big picture issues raised herein and to initiate a review of the Hamilton Sundstrand spare parts contract, including the government’s justification(s) for the no-bid award, the decision to purchase all spare parts as commercial items, and the decision to conceal contract information from the public. Consequently, Hamilton Sundstrand’s contract, or a portion thereof, should be terminated and competitively bid under a more appropriate contracting vehicle.

Thank you for your leadership in these matters. If you have any questions or comments, please contact me or POGO’s general counsel Scott Amey at (202) 347-1122.

Sincerely,



Danielle Brian  
Executive Director

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<sup>29</sup> DoD IG Report (D-2004-012), “Sole-Source Spare Parts Procured From an Exclusive Distributor (Project D2002CH-0029.000),” October 16, 2003. Available at <http://www.dodig.mil/Audit/reports/fy04/04012sum.htm> (redacted summary) and <http://www.dodig.mil/Audit/reports/fy04/04-012.pdf> (redacted report). Downloaded November 14, 2006. See DoD IG report, at p. 4.

<sup>30</sup> DoD IG report, at p. 4.