

UNCLASSIFIED

STATEMENT BY

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BEFORE THE HOUSE

COMMITTEE ON OVERSIGHT AND REFORM

ON

MANAGING OVERPRICING OF SPARE PARTS

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THE HOUSE COMMITTEE ON OVERSIGHT AND REFORM

Chairman Cummings, Ranking Member Jordan, and distinguished Members of the Committee on Oversight and Reform, thank you for the opportunity to testify today on matters relating to the Department of Defense's ability to be a good steward of the taxpayer's funds in cases when we are procuring spare parts from an exclusive supplier. As you have heard from the lead auditor of Department of Defense Inspector General (DoDIG), this is not a new problem, and it is an intractable one.

I am Kevin Fahey, the Assistant Secretary of Defense for Acquisition (ASD (A)). I retired in December 2015 after 34 years serving as a civilian in the Department of Defense (DoD) and came back in February 2018 to serve as the ASD(A) because I believed there was an opportunity to enact reform that would benefit the warfighter and the nation. My focus is overall Acquisition reform with an emphasis on decreasing Contractor - Procurement Action Lead Time (PALT) and leveraging innovative technology and nontraditional defense contractors. The DoD and the Defense Industrial Base (DIB) are true partners in the DoD Acquisition Ecosystem. The Department could not survive without a thriving industrial base and vibrant innovation. Military strength goes hand in hand with our equipment. I appreciate the opportunity today to discuss the review conducted by the Office of the Inspector General at the Department of Defense relating to contracts for military spare parts.

On March 20, 2017, U.S. Representative Ro Khanna sent a letter to the Department of Defense Inspector General describing reports of "waste, fraud, and abuse" by TransDigm Group and calling for an investigation. He wrote that TransDigm was able to operate as a hidden monopolist by (i) engaging in a series of unreasonable price increases of products for which it is the only supplier; (ii) disguising its cost structure and identity from Pentagon procurement officers;

and (iii) unreasonably hiking prices. The letter also cited several large price increases that occurred after the suppliers were acquired by TransDigm. Representative Khanna's letter asked the DoD Inspector General to investigate (1) TransDigm price increases borne by DoD and whether performance improvements were behind the increases, (2) how procurement officers would have treated TransDigm differently had their filings been accurate, and (3) how to lower short-term costs to DoD of procurement from TransDigm subsidiaries. Based on Representative Khanna's request, the Inspector General investigated TransDigm's dealings with DoD contracting officers and published DODIG-2019-060, "Review of Parts Purchased From TransDigm Group, Inc." on February 25, 2019. I fully concur with all of the recommendations contained in this report.

TransDigm and its subsidiaries design, produce, and supply specialized parts for aircraft and airframes. TransDigm has built its long-term business strategy on buying exclusive licenses or entire companies that manufacture military-unique, high demand, low value parts for DoD weapons systems and then drastically increasing the price of those parts. TransDigm has acquired more than \$1 billion in sales from sole-source aftermarket parts suppliers in recent years and now has over 101 subsidiaries. It owns or exclusively licenses more than 2,500 spare parts for military aircraft. In 2017, TransDigm reported operating profit margin of more than 40 percent.

My role, as the Department's Acquisition Lead, is to ensure that the DoD acquires goods and services, at fair and reasonable prices, when and where our warfighter needs them. For the period of Fiscal Year (FY) 2015 to April 11, 2019, DoD had 4,697 contract actions for a total contract value of \$634.72 million with TransDigm and its 101 subsidiaries. Of the contracts awarded to TransDigm, 28 percent were sole source transactions totaling \$273M, or 43 percent of the total value of contracts awarded to TransDigm and its subsidiaries. These figures are

extremely bothersome. The IG determined that TransDigm earned excess profit on 46 of 47 parts purchased by the Defense Logistics Agency and the Army, even though our contracting officers followed the Federal Acquisition Regulations (FAR) and the Defense Federal Acquisition Regulation Supplement (DFARS), which prescribe procedures to be used in determining whether prices were fair and reasonable for the 47 parts. When the IG compared the prices for the 47 parts on 113 contracts for TransDigm's uncertified cost data, it determined that only one part purchased under one contract was awarded with a reasonable profit. The remaining contracts had profit percentages ranging from 17 to 4,451 percent. When contracting officers requested cost data for 16 of the 47 parts reviewed, TransDigm denied 15 requests for uncertified cost data and fulfilled the request for certified cost data for only one part. As such, once TransDigm refused to provide the requested cost data for the 15 parts, our contracting officers were left with the limited options of either buying the parts without receiving cost data from TransDigm or not buying the parts needed to meet mission requirements. Is what TransDigm is doing illegal? No. Do I consider gouging our tax payers for excessive costs immoral and unconscionable in the face of getting our warfighters what they need to fight? Yes.

In light of what the Department has seen to date, I am sure you are wondering what we have done to try and curb this practice. Consistent with the IG report recommendations, DLA and Army asked TransDigm for a voluntary refunds of parts that were confirmed to be overpriced. Neither organization has heard back from TransDigm on these requests. We reviewed existing laws and regulations and while in most cases they protect the Department's and taxpayers interest, they cannot prevent a company from exploiting a position where they own the intellectual property and are in a sole source position. As such, on February 3, 2019, the Under Secretary of Defense for Acquisition and Sustainment provided the Department's comments and recommendations in response to a Government-Industry Panel report conducted pursuant to

section 813 of the FY 2016 National Defense Authorization Act. The Department supports the panel's majority position that there is a need for regulatory change as part of improved DFARS policy and guidance that would result in the government having a right of first refusal when an original equipment manufacturer attempts to license a part or parts for a weapons system on an exclusive basis. In the meantime, I have taken several actions within my span of control. I have directed the Heads of the Contracting Activities to report to the Principal Director, Defense Pricing and Contracting all contractors who refuse to provide cost or pricing information. This will provide the Department holistic insight into such denials of requests for cost or pricing data. Secondly, I have appointed a group of functional experts to review the information to determine the scope of the problem; to identify sellers who routinely refuse to provide cost information; and to prioritize the parts and dealers that bear watching. Additionally, to improve our negotiating position with these contractors, Defense Contracting Management Agency's Commercial Item Group will be engaged to perform should cost analyses for these high priority parts.

Conclusion

Our warfighters are the best in the world, but they also rely on some of the best equipment in the world. We have had a long and mutually beneficial relationship with most of industry partners, who are patriotic and honorable businesses, but occasionally a bad actor skews public opinion against the industry, diverts management attention away from other challenges, and at worst endangers our warfighters. Thank you for the opportunity to testify this afternoon, and I look forward to your questions.