



INSPECTOR GENERAL

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for a Hearing on**

**“DOD Inspector General Report on Excess Profits
by TransDigm Group, Inc .”**

**Before the
Committee on Oversight and Reform
U.S. House of Representatives
May 15, 2019**

Chairman Cummings, Ranking Member Jordan, and members of the committee, thank you for inviting us to appear before you today to discuss the Department of Defense Office of Inspector General (DoD OIG) report entitled, “Review of the Parts Purchased From TransDigm Group, Inc.”

Our audit examined the prices that TransDigm charged the DoD for spare parts for aircraft and airframes. Specifically we examined a sample of 47 spare parts provided by TransDigm and we determined that TransDigm earned profits of over 15 percent on 46 of the 47 spare parts we reviewed. The profits for these parts ranged from 17 percent to over 4,400 percent. We also determined that TransDigm refused to share cost data when requested by DoD contracting officers, and that the inability of contracting officers under the current legal framework to compel TransDigm to provide such data contributed to the DoD significantly overpaying for the spare parts it must buy to support the warfighter.¹

I am the Principal Deputy Inspector General Performing the Duties of the Inspector General, and I will discuss in my testimony this morning our long-standing concerns about sole-source procurements, such as those with TransDigm. While these concerns are not new, the prices charged by TransDigm provide another clear, and recent, demonstration of the problem.

With me is Theresa Hull, our Assistant Inspector General for Audit, Acquisition, Contracting, and Sustainment, the DoD OIG directorate that conducted the audit of TransDigm. She will provide in her testimony specific details about the findings of our audit of TransDigm.

Background and Long-standing Problems With Pricing of Sole-Source Spare Parts

First, it is important to note that the issues raised in our TransDigm audit are not limited to just this company and its contracts with the DoD. However, TransDigm’s unwillingness to

¹ DoD OIG Report No. DODIG-2019-060, “Review of Parts Purchased From TransDigm Group, Inc,” February 25, 2019

share cost data, and DoD contracting officers' limited success in negotiating fair and reasonable prices for sole-source parts, are representative of findings that the DoD OIG has highlighted in our audit reports going back many years.²

Often, our reports have identified the lack of cost data available to DoD contracting officers as the root cause for contractors' obtaining excessive profits on sole-sourced parts. DoD contracting officers' use of certified or uncertified cost data to perform cost analysis is often the most reliable way to determine whether a price is fair and reasonable.

Certified cost data is cost or pricing data that contractors provide to the contracting officer. Uncertified cost data is pricing data, cost data, and other information that is also provided by the contractor, but which is not certified and often necessary for the contracting officer to determine a fair and reasonable price.

The Federal Acquisition Regulation (FAR) states that certified cost data is required for contracting officers to award contracts above a certain dollar threshold, which is established by the Truth in Negotiations Act (TINA). This threshold was raised in the 2018 National Defense Authorization Act from \$750,000 to \$2 million.

² DoD OIG Report No. 98-064, "Audit Report on Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111," February 6, 1998.

DoD OIG Report No. D-2006-055, "Spare Parts Procurements From TransDigm, Inc.," February 23, 2006.

DoD OIG Report No. D-2008-048, "Report on Procuring Noncompetitive Spare Parts Through an Exclusive Distributor," February 6, 2008.

DoD OIG Report No. D-2011-061, "Excess Inventory and Contract Pricing Problems Jeopardize the Army Contract With Boeing to Support the Corpus Christi Army Depot," May 3, 2011.

DoD OIG Report No. D-2011-104, "Pricing and Escalation Issues Weaken the Effectiveness of the Army Contract With Sikorsky to Support the Corpus Christi Army Depot," September 8, 2011.

DoD OIG Report No. DoDIG-2014-088, "Defense Logistics Agency Aviation Potentially Overpaid Bell Helicopter for Sole-Source Commercial Spare Parts," July 7, 2014.

DoD OIG Report No. DoDIG-2015-137, "Improvements Needed on DOD Procurements From Robertson Fuel Systems," June 25, 2015.

DoD OIG Report No. DoDIG-2015-120, "Defense Logistics Agency Did Not Obtain Fair and Reasonable Prices From Meggitt Aircraft Braking Systems for Sole-Source Commercial Spare Parts," May 8, 2015.

DoD OIG Report No. DoDIG-2015-103, "Summary of DoD Office of Inspector General Spare-Parts Pricing Audits: Additional Guidance is Needed," March 31, 2015.

DoD OIG Report No. DoDIG-2016-023, "Improvements Needed in the Defense Logistics Agency's Evaluation of Fair and Reasonable Prices for C-130 Aircraft Spare Parts," November 16, 2015.

DoD OIG Report No. DoDIG-2016-047, "Defense Logistics Agency Did Not Appropriately Determine Fair and Reasonable Prices of F108 Engine Sole-Source Commercial Parts," February 16, 2016.

Although the intent of raising the threshold was to streamline the acquisition process, which is a laudable objective, the increase in the threshold results in contracting officers having less information to use during their negotiations with contractors to determine a fair and reasonable price, especially when a contractor is the sole-source for parts.

Moreover, if the contract is for the acquisition of commercial items, the FAR does not require certified cost or pricing data, even if the acquisition is above the TINA threshold.

In addition, current statutory and regulatory requirements discourage contracting officers from requesting uncertified cost data from contractors. The FAR states that, for all acquisitions contracted by negotiation, the contracting officers must obtain uncertified cost or pricing data from the contractor when it is the only means left to determine whether the price is fair and reasonable. The FAR lists six other options contracting officers should consider, including the use of historical prices, before using uncertified cost data.

Moreover, the Defense Federal Acquisition Regulation Supplement (DFARS) lists cost data as a last option for determining price reasonableness. For contracts awarded under simplified acquisition procedures, the FAR does not list obtaining cost data as an option for the contracting officer.

Prior OIG Audits

Our prior audits have repeatedly found problems with determining a fair and reasonable price for sole-sourced parts.

For example, in 1998, we reported that Sundstrand Aerospace, a manufacturer of aerospace products, refused to negotiate catalog prices for commercial items based on price analysis of previous cost-based prices; refused to provide Defense Logistics Agency (DLA) contracting officers with "uncertified" cost or pricing data for commercial catalog items; and

terminated Government access to the company cost history system. Our recommendations included that contracting officers should determine the reliability of previous prices before using price analysis to establish prices are fair and reasonable, and that the contracting officers insist that contractors provide uncertified cost or pricing data.³

We first audited TransDigm in 2006 and found similar findings to our recent report. In our 2006 audit, we concluded that the DoD was unable to effectively negotiate prices for spare parts procured from TransDigm subsidiaries. Using cost analysis, we calculated that the DLA had paid approximately \$5.3 million more than the fair and reasonable price for 77 parts. Our recommendations included requiring the DLA to emphasize the importance of validating the reasonableness of previous Government prices when using price analysis as a tool to justify fair and reasonable prices and emphasize the importance of obtaining cost or pricing data. We also recommended that DLA either establish a strategic supplier alliance with TransDigm subsidiaries using cost data to negotiate fair and reasonable prices, or develop and execute a strategy to reengineer and competitively procure high-dollar-value spare parts.⁴

In 2015, in another audit, we determined that a DLA contracting officer did not obtain fair and reasonable prices for 51 of 54 sole-source, commercial spare parts procured from the Meggitt Aircraft Braking Systems Corporation companies, and the contracting officer relied on previous over-inflated prices to determine current contract prices. We recommended that the contracting officer establish fair and reasonable pricing for future sole-source contracts for commercial parts by performing a thorough review of previous prices, sales data, and requesting cost data.⁵

³ DoD OIG Report No. 98-064, "Audit Report on Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111," February 6, 1998.

⁴ DoD OIG Report No. D-2006-055, "Spare Parts Procurements From TransDigm, Inc.," February 23, 2006

⁵ DoD OIG Report No. DoDIG-2015-120, "Defense Logistics Agency Did Not Obtain Fair and Reasonable Prices From Meggitt Aircraft Braking Systems for Sole-Source Commercial Spare Parts," May 8, 2015.

Also, in 2015 we issued a summary report on the contracting problems with spare parts pricing and inventory that the DoD OIG had identified and reported. The summary report noted that since 1998, we have issued 32 reports related to spare parts pricing. In only 3 of the 32 reports did we find that the DoD had obtained fair and reasonable prices for spare parts. We found that the DoD did not receive fair and reasonable prices for spare parts in 20 of the 32 reports. We noted that the DoD did not perform adequate cost or price analysis when it purchased commercial and noncommercial spare parts. We recommended that the DoD finalize and issue policies to the Military Services and Defense agencies that reiterate and strengthen the FAR and the DFARS requirements to obtain fair and reasonable prices when purchasing spare parts.⁶

The DoD took some actions in response to our recommendations to these reports by issuing and reiterating policy on fair and reasonable pricing of spare parts; providing additional training to contracting officers; meeting with contractors to discuss pricing and mutually developing strategy; initializing reverse engineering cases for some parts; requiring contracting officers to verify price reasonableness of prior contractor prices; and elevating and reporting contractor denials of cost data. However, 20 years later, we are still identifying the same issues, as reflected in our recent audit of TransDigm.

Ms. Hull will now discuss the recent audit of TransDigm, which exemplifies how the broader issues I have just described to you affects the prices that the DoD pays when purchasing spare parts.

⁶ DoD OIG Report No. DoDIG-2015-103, "Summary of DoD Office of Inspector General Spare-Parts Pricing Audits: Additional Guidance is Needed," March 31, 2015.

TransDigm's Products and Business Model

Chairman Cummings, Ranking Member Jordan, and members of the committee, TransDigm and its subsidiaries design, produce, and supply specialized parts for aircraft and airframes, including for the C-17 Globemaster III, the AH-64 Apache, the F-16 Fighting Falcon, and the CH-47 Chinook.

From April 2012 through January 2017, the DoD awarded contracts valued at \$471 million directly to TransDigm or to its subsidiaries.

More than three-quarters of TransDigm's net sales come from products for which TransDigm believes it is the sole-source provider. We identified that TransDigm was the sole-manufacturer for 39 of the 47 spare parts that we reviewed in our audit.

TransDigm also practices what is called value-based pricing. This is a technique for setting the price of a product or service based on the "economic value" it offers to customers. What this means is that if the DoD has only one source for the part and that part is needed to operate a weapons platform, such as plane or ship, then the value of that part to the DoD is very high, while the cost to manufacture the part could be very low.

Sole-sourced parts are, by their nature, difficult to price on a fair and reasonable basis because the normal market structure and market dynamics do not always exist for sole-sourced parts. Often with sole-sourced parts, the price for the part is not what a commercial market would set; rather when competitive forces are absent, the price becomes what the DoD is willing to pay for a part that is essential for the DoD weapons platform, such as an aircraft.

Our Audit Findings

In our audit of TransDigm, which we issued in February of this year, we reviewed a sample of 47 spare parts that TransDigm subsidiaries sold to the DoD, between January 2015 to January 2017, on 113 contracts, with a total value of \$29.1 million for the 47 parts.

Of those 47 spare parts, we only found one instance in which TransDigm received a profit of 15 percent or less for that part when compared to the costs for TransDigm to make the part, which is the costs that we obtained from TransDigm. The remaining 46 spare parts that we reviewed had profits to TransDigm in excess of 15 percent, ranging from profits of 17 percent to 4,451 percent. In total, we determined that for these 46 parts, which cost the DoD \$26.2 million, TransDigm earned \$16.1 million in excess profit above the 15 percent profit we used as our benchmark for purposes of our audit.

In some instances, the DoD contracting officers had attempted to obtain from TransDigm the cost of making a part in order to determine whether the price TransDigm wanted to charge for the part was reasonable. For example, on 16 occasions, DoD contracting officers requested cost data from TransDigm. However, TransDigm was not obligated by law to provide that data, and it refused to do so in response to 15 of the 16 requests. The one instance that TransDigm did provide the requested cost information was in the only contract above the TINA threshold, and was therefore the only instance when the contracting officer could not award the contract without obtaining the data from TransDigm. Significantly, this was the only time that TransDigm received a profit of less than 15 percent for a part (it received a profit of 11 percent for that part).

For the remaining 15 contracts where TransDigm refused to provide cost data, the contracting officers had to rely on other FAR methods to determine a fair and reasonable price.

However, because most of the parts (39 of the 47) were manufactured solely by TransDigm, the DoD contracting officer bought the part at a price that resulted in large profit percentages for TransDigm.

It is clear that the more insight contracting officers have into the cost of a part, the better their chances to negotiate a fair and reasonable price. However, the contracting officers had limited options once TransDigm refused to provide the requested cost data: either buy the spare parts without receiving cost data from TransDigm, or not purchase the spare parts needed to meet mission requirements, which could potentially impact the warfighter.

For example, contracting officers determined that eight spare parts were fair and reasonable based on the “best obtainable price.” Contracting officers justified using this method because they had exhausted other methods of determining price reasonableness, and at least five contracting officers stated that the need for the spare part was urgent enough that they had to buy the part at the price offered by TransDigm. In this example, the contracting officers had to choose between supporting our warfighters or potentially paying excessive prices for the spare parts.

I also want to note that our findings are consistent with a 2018 review by the DoD regarding the negotiated prices for parts from a TransDigm subsidiary. The independent review team was led by the Air Force and consisted of representatives from the Air Force, the Defense Contract Audit Agency, and the Defense Contract Management Agency. The independent review team determined, consistent with our findings, that TransDigm’s spare parts were overpriced and that TransDigm took advantage of its sole-source position and refused to provide cost data.

Regulatory Reform Needed for Sole-Source Offerors Who Deny Cost and Pricing Data

Our body of work in spare parts pricing demonstrates the need for change and the need to address the high prices charged by, and excessive profits obtained by, contractors like TransDigm.

To correct the deficiencies detailed in our recent TransDigm report, we recommended in our report several administrative actions that the DoD could pursue. First, we believe that the DoD should seek voluntary refunds from TransDigm for the \$16.1 million in excess profit that we identified. Second, we recommend that the DoD update and enforce policy guidance that DoD contracting officers track and report within the DoD when a contractor that provides sole-source parts refuses to provide cost data. When we asked the DoD about its contracting officers' compliance with this existing guidance, DoD officials stated that they were unaware of the requirement.

However, we also believe that these administrative efforts will likely have minimal impact without fundamental regulatory and statutory changes. As discussed earlier, current statutes, such as TINA, as well as simplified and commercial acquisitions process, streamline administrative processes and limit the documentation necessary to enact certain acquisitions. Current statutes do not deter companies that deliberately and aggressively seek out markets where these statutory provisions have combined to hinder the Government's ability to obtain sufficient information to ensure that reasonable prices are paid for spare parts.

Specifically, TransDigm seeks out spare parts sold to the Government by sole-source manufacturers often in quantities under the TINA threshold or through commercial contracts

which have minimal cost information available to substantiate price reasonableness. As a result, the DoD has paid TransDigm prices that result in huge profits.

We recommend that Congress consider several legislative reforms. The first would amend existing acquisition statutes to require that contracting officers obtain at a minimum, uncertified cost or pricing data before awarding a contract to a sole-source offeror for the procurement of spare parts, including those determined to be commercial items, regardless of the contract dollar value. Certified cost or pricing data would be required for contract dollar values that exceed the TINA threshold. The legislation could also consider waiving the requirement to provide the cost data if:

- the contracting officer receives documentation verifying that the offeror submitted cost or pricing data to a contracting officer before the award of a previous contract for the same or similar spare parts within the last year and that contracting officer relied on this data to make a fair and reasonable price determination, or
- the part is a commercially available off-the-shelf item sold in substantial quantities in the commercial marketplace and offered to the Government without modification; and,
- any price increase over the previous contract price does not exceed a reasonable adjustment for inflation.

The second potential change would be to update the statutory and regulatory definitions of “adequate price competition” for spare parts to exclude those instances where all offerors of the spare parts obtain the part from a single source or from subsidiaries of that source. The DoD contracting officers determined prices for 4 of 47 parts in our sample to be fair and reasonable at

the time of contract award based on “competition.” According to the FAR, a price is based on adequate price competition if two or more responsible offerors, competing independently, submit priced offers that satisfy the Government’s requirement.⁷ The FAR further states that adequate competition generally requires no additional data to determine price reasonableness.⁸ However, when we reviewed the contracting files for these four contracts, we determined that for three out of four of the contracts awarded based on competition, the final offerors planned to source the parts from the same manufacturer, TransDigm. While the offerors may be competing “independently,” it is questionable whether true competition exists if all the “competitors” are sourcing the spare parts from the same manufacturer.

Ultimately, TransDigm was the only manufacturer at the time for three of the four parts competitively awarded, giving TransDigm the opportunity to set the market price for those parts because the other competitors planned to buy the parts from TransDigm before selling them to the DoD.

We believe that, armed with these and other new statutory provisions, contracting officers would be better able to obtain crucial information necessary to level the playing field and award contracts for spare parts with these sole-source manufacturers that do not result in profits like those obtained by TransDigm and others. Without these steps, we believe that the DoD may continue to pay excessive prices for spare parts that it needs, as we found in the TransDigm audit.

⁷ FAR 15.403-1(c)(1).

⁸ FAR 15.403-3(b), “Adequate Price Competition.”

Thank you for the opportunity to testify this morning, and we look forward to answering your questions.