



June 2017

# SUPPLY CHAIN MANAGEMENT

## DOD Could More Efficiently Use Its Distribution Centers

Accessible Version

# GAO Highlights

Highlights of [GAO-17-449](#), a report to congressional committees

## Why GAO Did This Study

In fiscal year 2015, DLA generated \$23 billion in revenues from supply chain management sales to the military departments and other customers, such as federal agencies. These sales included commodities and distribution services provided through the Defense-wide Working Capital Fund, a revolving fund.

Senate Report 114-255 and House Report 114-537 included provisions for GAO to evaluate DLA's costs to provide commodities and services using the Defense-wide Working Capital Fund. This report identifies trends in the costs and annual prices that DLA has charged for commodities and distribution services; and evaluates the extent to which DOD has taken steps to more efficiently use its network of U.S. distribution centers. GAO analyzed the most currently available DLA cost data, estimated and actual revenue, and prices for commodities and distribution services since fiscal year 2009; reviewed DOD documentation; and interviewed knowledgeable DOD officials.

## What GAO Recommends

GAO recommends that DOD assess and direct the implementation of actions, as appropriate, that can be taken using existing authorities to close, realign, or dispose of existing infrastructure to more efficiently use the department's network of U.S. distribution centers. DOD concurred with the recommendation.

View [GAO-17-449](#). For more information, contact Andrew J Von Ah at (213) 830-1011 or [vonaha@gao.gov](mailto:vonaha@gao.gov).

June 2017

## SUPPLY CHAIN MANAGEMENT

### DOD Could More Efficiently Use Its Distribution Centers

## What GAO Found

GAO found that since fiscal year 2009, the Defense Logistics Agency (DLA)—the largest logistics combat support agency for the Department of Defense (DOD)—had reduced costs and maintained fairly constant prices for commodities, such as repair parts, clothing, and food. When developing annual budgets, DLA has generally underestimated revenue from the sales of commodities. The underestimated revenue contributed to gains that were applied to future year prices in the form of reductions, and helped offset inflationary increases in material costs.

GAO also found that since fiscal year 2011, DLA had reduced costs for distribution services (e.g., the processing and storing of inventory) by about 25 percent through the use of existing authorities to reduce infrastructure. However, DLA has often increased annual prices for distribution services by more than 10 percent due, in part, to a declining workload. DLA has generally overestimated revenue from the sales of distribution services. The overestimated revenue contributed to losses as well as to price increases in subsequent years as DLA sought to recover those losses.

DOD has taken steps to increase the use of DLA's 17 U.S. distribution centers to improve efficiency of DLA's operations, but additional opportunities for efficiencies exist across DOD's network of approximately 256 U.S. distribution centers. In January 2017, DOD revised guidance to require storage of government-owned inventory at DLA's distribution centers instead of at privately owned storage when both are located in the same geographic area to reduce costs. DOD has also identified inefficiencies in the provision of its distribution services. Specifically, the military departments, along with DLA, provided distribution services using U.S. distribution centers that often were in close proximity to or located on the same installation. To address inefficiencies, DOD established a program to, among other things, decrease the number of U.S. distribution centers. In October 2014, DOD discontinued the program without implementing its plan to reduce the number of distribution centers. Though DLA has been able to use existing authorities to realign functions and demolish some facilities to gain efficiencies at its distribution centers, DOD officials told us the department needs Base Realignment and Closure authority—a process whereby Congress authorizes an independent federal commission to review and determine whether to forward to the President for approval DOD's proposals to realign and close military installations—to address any additional inefficiencies. GAO found, however, that DOD had not assessed the extent to which the department could further use its existing authorities to minimize unnecessary overlap or duplication in its network of distribution centers. Without assessing the use of its existing authorities, inefficiencies in DOD's network of U.S. distribution centers that the department has previously identified may remain.

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**Abbreviations**

|                  |   |
|------------------|---|
| DLA              | Defense Logistics Agency                              |
| DOD              | Department of Defense                                 |
| OUSD Comptroller | Office of the Under Secretary of Defense, Comptroller |

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June 21, 2017

The Honorable John McCain  
Chairman  
The Honorable Jack Reed  
Ranking Member  
Committee on Armed Services  
United States Senate

The Honorable Mac Thornberry  
Chairman  
The Honorable Adam Smith  
Ranking Member  
Committee on Armed Services  
House of Representatives

The Department of Defense (DOD) manages a complex, multibillion-dollar system for delivering needed commodities and services to support U.S. military forces worldwide. DOD's goal in operating this system, referred to as the department's supply chain, is to deliver the right item to the right place at the right time and at the right cost. The Defense Logistics Agency (DLA)—DOD's largest logistics combat support agency—provides commodities and services to support U.S. military forces. To operate supply chain management activities, DLA uses the Defense-wide Working Capital Fund, a revolving fund whereby DLA's customers pay for the support that they receive.<sup>1</sup> In fiscal year 2015, DLA generated \$23 billion in revenue to reimburse the fund from supply chain management sales to the military departments and other customers, such as federal agencies and U.S. international allies. These sales included commodities (e.g., troop support items such as clothing, medicine, food, and consumable repair parts for weapon systems) and distribution services (e.g., the processing and storing of inventory).<sup>2</sup> While DLA aims to stabilize its prices during each budget execution year, the military departments have expressed concerns about fluctuations in distribution service prices between budget years. In addition, DLA and the military

<sup>1</sup>The Defense-wide Working Capital Fund is a revolving fund that the Secretary of Defense has established under the authority of 10 U.S.C. § 2208 to generate revenue that the Department of Defense is to use to carry out future operations.

<sup>2</sup>A consumable repair part is an item that is normally expended or used up beyond recovery for the purpose it was designed or intended.

departments operate a large network of approximately 256 distribution centers.<sup>3</sup> Some of these centers are co-located or in close proximity to one another.

For more than 25 years, we have identified opportunities for DOD to improve the effectiveness and efficiency of its supply chain management to support the needs of U.S. military forces while reducing the department's spending to potentially make funds available for other defense priorities. For example, in 1990 we added DOD's supply chain management to our list of high-risk areas in the federal government due, in part, to weaknesses in inventory management practices and procedures in forecasting the demand for inventory items and other challenges.<sup>4</sup> In February 2017, we found that DOD had made significant progress in improving inventory management, although additional actions were needed to improve two other aspects of supply chain management—materiel distribution and asset visibility.<sup>5</sup> Further, in June 2016 we reported on the military departments' efforts to implement a 2005 Base Realignment and Closure recommendation to transfer retail supply, storage, and distribution functions from the military departments to DLA to gain efficiencies in delivering these functions.<sup>6</sup> We found that the Air Force had transferred all of its retail functions to DLA and that the Navy had transferred its fleet readiness centers' retail functions, but not its shipyards, to DLA. We found that the Army and the Marine Corps had not transferred their retail functions from their depots to DLA. We recommended that DOD conduct business case analyses, drawing on lessons learned, to determine if further transfers of retail functions are warranted. DOD concurred with our recommendations.

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<sup>3</sup>A distribution center is a site where DLA or the military departments perform storage and processing (e.g., receipt and issuance). DLA operates 24 distribution center locations, 17 of which are located inside and 7 of which are located outside of the continental United States.

<sup>4</sup>GAO's high-risk program highlights major areas that are at high risk for waste, fraud, abuse, or mismanagement, or are in broad need of reform.

<sup>5</sup>GAO, *High-Risk Series: Progress on Many High-Risk Areas While Substantial Efforts Needed on Others*, [GAO-17-317](#) (Washington, D.C.: February 2017).

<sup>6</sup>Retail supply, storage, and distribution functions refer in this context to those involving inventory that is held at the consumer (i.e., military service) level for the purpose of directly providing inventory to the end user (i.e., the individual maintenance depots). See GAO, *Defense Inventory: Further Analysis and Enhanced Metrics Could Improve Service Supply and Depot Operations*, [GAO-16-450](#) (Washington, D.C.: June 9, 2016).

Senate Report 114-255 and House Report 114-537, to accompany bills for the National Defense Authorization Act for Fiscal Year 2017, include provisions for us to evaluate DLA's overhead costs to provide commodities and distribution services funded using the Defense-wide Working Capital Fund. We examined material costs of commodities and operating costs—including direct and indirect costs—to provide commodities and distribution services.<sup>7</sup> We also examined the relationship between costs, estimated revenue, and the prices that DLA has charged for its commodities and distribution services. Specifically, we identified any trends since fiscal year 2009 in (1) the costs and the annual prices that DLA has charged for commodities and (2) the costs and the annual prices that DLA has charged for distribution services; and we (3) evaluated the extent to which DOD has taken steps to more efficiently use its network of U.S. distribution centers.

For objectives one and two, we reviewed the process that DLA used to set prices for commodities and distribution services. Specifically, we reviewed cost data, estimated and actual revenue, and prices that DLA ultimately charged for commodities and for distribution services. In addition, we reviewed sections in DOD's Financial Management Regulation specific to working capital funds.<sup>8</sup> For commodities, we analyzed operating costs as a percentage of the material costs of commodities sold, as reported in DOD budget justification materials submitted to Congress for fiscal years 2009 through 2015. We began with fiscal year 2009 to provide us with a 7-year period of data on actual costs. Unlike for commodities, DOD does not have an approach to report DLA's operating costs to provide distribution services in budget justification materials for the Defense-wide Working Capital Fund because DOD is not required to report this information. Therefore, we requested data from DLA on its operating costs, including direct and indirect costs, for distribution services for fiscal years 2009 through 2015. We began with fiscal year 2011 because DLA did not have complete data available for fiscal years 2009 and 2010 and ended with fiscal year 2015 because this was the last full year available with complete data on actual costs at the

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<sup>7</sup>Material costs include all costs to procure a commodity. Operating costs, also referred to as overhead, are nonmaterial costs that are both directly and indirectly related to providing a commodity. Direct costs include those associated with storage and shipping. Indirect costs include those associated with information technology systems and administrative support, among others.

<sup>8</sup>Department of Defense Financial Management Regulation 7000.14-R, vol. 2B, ch. 9, *Defense Working Capital Fund Budget Justification Analysis* (Dec. 2014).

time of our review. We adjusted the operating costs for inflation into constant fiscal year 2015 dollars.

In addition, we obtained data from DLA's business system database on estimated and actual revenue for commodities and distribution services for fiscal years 2009 through 2015. Our analysis ends with fiscal year 2015 because this was the last full year with complete available data on actual revenue at the time of our review. We adjusted the estimated and actual revenue into constant fiscal year 2015 dollars. We compared estimated revenue with actual revenue for commodities and for distribution services to identify any differences. We also analyzed data on aggregate price changes for commodities from DOD's budget materials from fiscal years 2009 through 2017. For distribution services, we analyzed data on prices for selected distribution services from DOD's budget materials from fiscal years 2009 through 2017. We adjusted the prices into constant fiscal year 2017 dollars and calculated the annual percent change. We interviewed officials from the Office of the Under Secretary of Defense, Comptroller (OUSD Comptroller) and Defense Logistics Agency, Finance (DLA Finance) to obtain information on the relationship between costs, revenue, and annual prices within the context of the Defense-wide Working Capital fund. We verified the completeness and accuracy of the data we obtained with OUSD Comptroller and DLA Finance officials and determined that the data were sufficiently reliable for the purposes of addressing our reporting objectives with attribution to DOD and the source documents.

For objective three, we interviewed officials from DLA, the OUSD Comptroller, and two offices within the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics—Logistics and Materiel Readiness and Energy, Installations, and Environment—and obtained documentary evidence to understand how DOD's network of U.S. distribution centers are managed for improved efficiency. We reviewed documents associated with a DOD efficiency initiative, the Strategic Network Optimization program. We compared DOD's efforts to manage its network of distribution centers with responsibilities assigned in DOD Directive 5134.01, Under Secretary of Defense for Acquisition, Technology, and Logistics to assess the extent to which the department has used DOD's existing systems, facilities, and services to avoid unnecessary overlap and duplication to achieve maximum efficiency and economy.

We conducted this performance audit from May 2016 to June 2017 in accordance with generally accepted government auditing standards.



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Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

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### Roles and Responsibilities

The DOD supply chain is a global network through which DLA and the military departments provide commodities and distribution services to the U.S. military forces. The Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics and its subordinate, the Office of the Assistant Secretary of Defense for Logistics and Materiel Readiness, prescribe policies and procedures for the conduct of logistics, maintenance, materiel readiness, and sustainment support, to include supply and transportation, and monitor and review these activities.<sup>9</sup> The Office of the Assistant Secretary of Defense for Logistics and Materiel Readiness also exercises authority, direction, and control over DLA. In addition, the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics has overall responsibility and oversight of DOD real property, including the infrastructure in DOD's network of distribution centers, and its subordinate, the Office of the Assistant Secretary of Defense for Energy, Installations, and Environment, is responsible for managing policy for DOD's real property. The Secretaries of the military departments also have specific assigned responsibilities for real property management that include implementing policies and programs to acquire, manage, and dispose of real property.

The OUSD Comptroller establishes the policies and procedures for DOD's financial management, including the Defense-wide Working Capital Fund. As part of this role, the OUSD Comptroller provides guidance in DOD's Financial Management Regulation to operate the Defense-wide Working Capital Fund and to set prices for commodities

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<sup>9</sup>The National Defense Authorization Act for Fiscal Year 2017, Pub. L. No. 114-328 (Dec. 23, 2016), provides for the reorganization, no later than Feb. 1, 2018, of the Under Secretary of Defense for Acquisition, Technology, and Logistics into two positions—the Under Secretary of Defense for Research and Engineering and the Under Secretary of Defense for Acquisition and Sustainment.

and services that are to reimburse the fund. In addition, the OUSD Comptroller provides oversight of the prices set by DLA during the annual budget process.<sup>10</sup>

DLA is responsible for the effective and efficient provision of commodities and services that have been determined to be appropriate for integrated management by a single agency on behalf of all DOD components, or that have been otherwise specifically assigned. To carry out this responsibility, DLA is organized into five management subgroups for commodities that provide troop support—clothing and textiles, construction and equipment, industrial hardware, medical, and subsistence—three subgroups for commodities that support weapons systems—aviation, land, and maritime—and one subgroup for distribution services.<sup>11</sup>

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## Price and Cost Recovery

During the annual budget formulation process, DLA establishes a price to charge its customers for commodities and distribution services for that upcoming budget year. In the current budget year, however, these prices remain unchanged. This “stabilized” price is intended to protect DLA’s customers, who are appropriated funds based on the expected price, from any market price volatility. Instead, the cash balance of the Defense-wide Working Capital Fund absorbs any fluctuations in the costs to procure or to provide the commodity or distribution services during the current budget year. According to DOD’s Financial Management Regulation, the goal of the fund is to remain revenue-neutral—to neither make a gain nor incur a loss—over time.<sup>12</sup> At the end of execution of each budget year, DLA assesses its actual revenue against its actual costs. Any gains are returned to customers as reductions to future prices. Any losses will be added as increases to future prices, with the aim of ultimately recovering all costs to the fund. A price increase resulting from

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<sup>10</sup>Department of Defense Financial Management Regulation 7000.14-R, vol. 2B, ch. 9, *Defense Working Capital Fund Budget Justification Analysis* (Dec. 2014).

<sup>11</sup>Within its supply chain management activity group, DLA also operates a subgroup focused on disposition services. In addition, DLA also has two other activity groups—energy and document services—that operate through the use of the Defense-wide Working Capital Fund.

<sup>12</sup>Department of Defense Financial Management Regulation 7000.14-R, vol. 2B, ch. 9, *Defense Working Capital Fund Budget Justification Analysis* (Dec. 2014).

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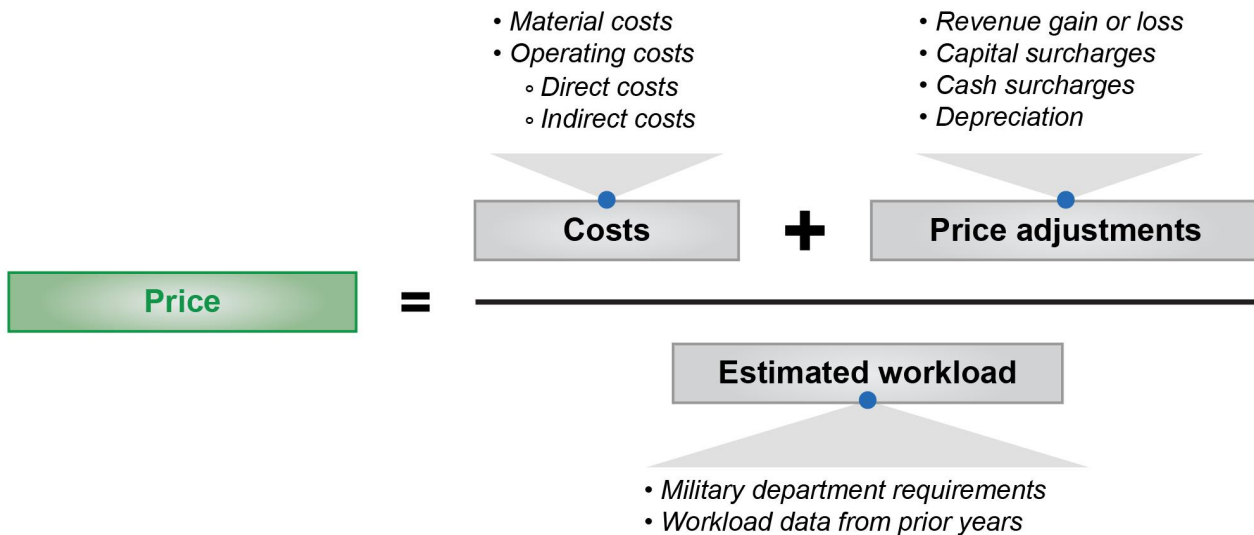
a loss will apply to all consumers of the good or service, regardless of the impact of their demand on DLA's costs. This practice results in some cross-subsidization across the military departments.

DLA considers three components to set prices for a budget year: costs, price adjustments, and estimated workload.

- **Costs:** DLA's commodities include two types of costs, material costs and operating costs, while DLA's distribution services involve only operating costs. Material cost is the cost of procuring a commodity from a vendor (e.g., purchasing fabric and having uniforms sewn) and operating costs are the non-material costs to provide a commodity (e.g., storing uniforms and shipping once ordered). Operating costs—also referred to as “overhead”—are further defined as direct or indirect costs. A direct cost is associated with direct support to a specific mission (e.g., labor to process uniform orders) while an indirect cost is associated with support provided to multiple missions or agency-wide operational activities (e.g., information technology). Both direct and indirect costs can include labor and non-labor costs.
- **Price adjustments:** There are four types of price adjustments that can be used to increase or decrease cash balances with the fund. These include responses to revenue gains or losses as well as cash surcharges, capital surcharges, and depreciations. DLA adjusts prices for both commodities and distribution services based on revenue gains or losses to remain revenue-neutral over time. In addition, DLA may use cash surcharges, capital surcharges, and depreciation to adjust prices for commodities. Cash surcharges are used to recover unplanned investments in inventory to ensure that the appropriate cash balance is maintained. Capital surcharges or depreciations are used to cover the costs associated with capital or infrastructure-related investments, depending on the number of years needed to recover the cost to prevent steep increases in the year-to-year price.
- **Estimated workload:** DLA's estimation of its customers' requirements for a future budget year is based on input from the military departments on their budget planning decisions and execution data from prior years. These estimates may be made as early as 18 months before the budget year.

The sum of the costs and all price adjustments represents the amount of revenue that is required to break even. This total is divided by the estimated workload to determine a price, as shown in figure 1.

**Figure 1: Components of Price for the Defense Logistics Agency’s Commodities and Distribution Services**



Source: GAO analysis of Department of Defense (DOD) information. | GAO-17-449

Note: Material costs are specific only to commodities.

## DLA Has Contributed to Reductions in Costs and Has Maintained Fairly Constant Prices for Commodities since 2009

Since fiscal year 2009, DLA has contributed to reductions in the costs to provide its commodities and has maintained fairly constant prices for them. Specifically, our analysis showed that DLA’s operating costs, as a percentage of material costs, declined by almost 6 percent between fiscal years 2009 and 2015. When developing annual budgets, DLA has also generally underestimated revenue for commodities, which has contributed to gains that were subsequently applied as reductions to future prices. Lastly, we found that DLA has maintained fairly constant prices for commodities, which have not exceeded an annual increase of more than 3.3 percent due, in part, to the reductions in costs and revenue gains. OUSD Comptroller officials told us that they consider increases above 5 percent to be significant.

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## DLA's Operating Costs to Provide Commodities Has Declined by Almost 6 Percent

Since fiscal year 2009, DLA's operating costs to provide commodities to the military departments and other customers has declined by almost 6 percent. As discussed earlier, DLA's commodities include two types of costs, material costs (i.e., the cost of procuring a commodity from a vendor) and operating costs (i.e., the non-material costs to provide a commodity). DOD monitors the operating costs that DLA charges by assessing the proportion of these costs to the material cost, and then reports this information in budget justification materials for the Defense-wide Working Capital Fund.<sup>13</sup>

Our review of this information shows DLA's proportion of operating costs to the total cost declined by 5.7 percent, from 14.0 percent in fiscal year 2009 to 13.2 percent in fiscal year 2015. DLA officials told us they have contributed to reductions in their operating costs, in part through various actions such as improvements to customer delivery methods and integration of information technology systems. For example, for items that are readily available from commercial vendors, such as most medical and subsistence commodities, DLA keeps operating costs low by not purchasing or storing these items. Instead, DLA has these items shipped directly from the vendors to DLA's customers when ordered. In addition, DLA consolidated different legacy financial and business operation databases into one enterprise-wide system to streamline business functions across DLA and to improve the quality and timeliness of data used to inform DLA's operations.

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## DLA Has Generally Underestimated Revenue for Its Commodities

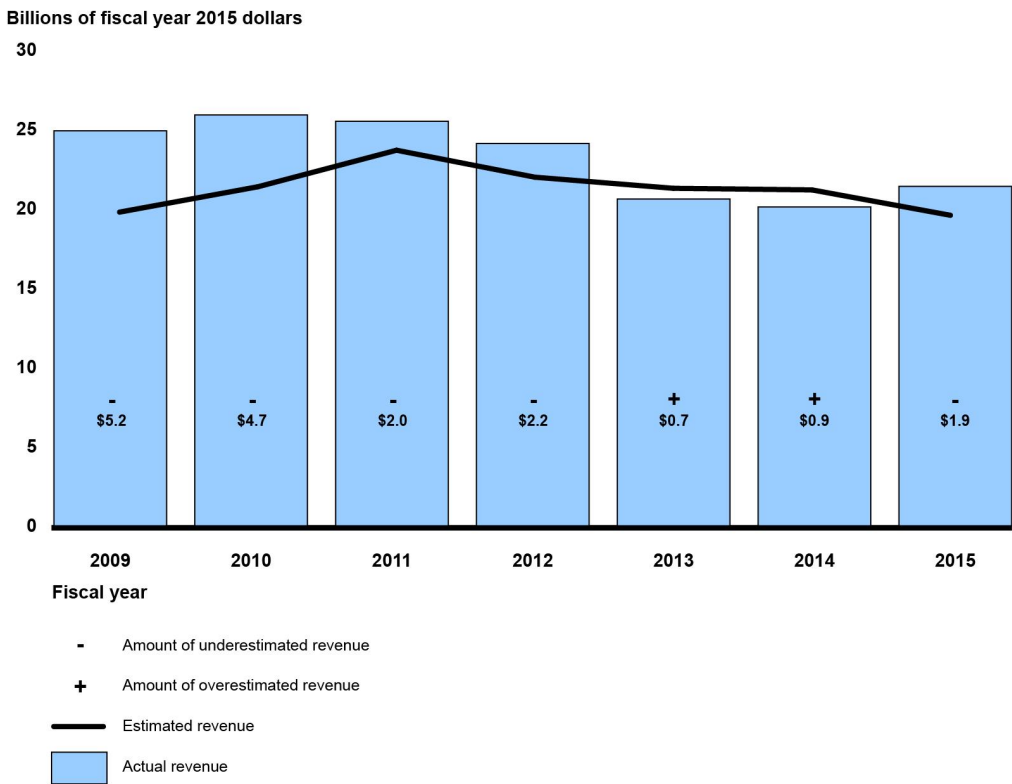
For fiscal years 2009 through 2015, DLA underestimated annual revenue for commodities in all but 2 fiscal years, as shown in figure 2. DLA develops annual revenue estimates based on operating costs and the military departments' estimated workload demands during the annual process to develop a budget and set prices for commodities. When actual revenue is more than estimated revenue, DLA must adjust future prices to return the gained revenue to its customers. Similarly, when actual

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<sup>13</sup>This percentage is referred to as the cost recovery rate.

revenue is less than estimated, DLA must increase future prices to make up for lost revenue.

**Figure 2: Defense Logistics Agency's Actual Compared with Estimated Revenue for Commodities, Fiscal Years 2009-2015**



Source: GAO analysis of Defense Logistics Agency (DLA) data. | GAO-17-449

In the fiscal years that DLA underestimated revenue for commodities, the difference between the estimated and actual revenue ranged between 9.9 percent and 26.4 percent. For these years, DLA yielded a gain above estimated costs that ranged between \$1.9 billion and \$5.2 billion in fiscal year 2015 dollars. According to DLA officials, in years for which they underestimated revenue, the military departments had more workload demand than DLA had initially anticipated. Specifically, the military departments purchased more commodities than anticipated when DLA was formulating the budget for that fiscal year, a process that typically occurs more than 18 months earlier. Some of the difference can be explained by unanticipated changes in DLA's actual workload that were not part of the estimated workload demand. For example, in 2010, the Defense Health Agency implemented a home prescription service that increased revenue for DLA's medical supply chain group. Also, in 2014,

the firefighting equipment and materials, known as “stock group 80”, was transferred from the General Services Administration to DLA, increasing DLA’s customers for the items to all federal, state, and local firefighters.

In contrast, in fiscal years 2013 and 2014, DLA overestimated revenue by 3.2 percent and 4.4 percent, respectively, and experienced lost revenue of approximately \$670 million and \$970 million, respectively, in fiscal year 2015 dollars. These losses are much smaller in magnitude compared with the gains in other fiscal years. The workload demand in these 2 fiscal years was less than DLA had initially anticipated. For example, DLA officials told us that the military departments’ workload demand when formulating the budget for fiscal year 2013 did not anticipate the sequestration ordered in March 2013, which triggered a reduction in spending authority across all DOD accounts funded with nonexempt discretionary amounts.<sup>14</sup> Also, when formulating the budget for fiscal year 2014, the workload estimates did not anticipate lower enacted funding than DOD planned due to the Budget Control Act of 2011.<sup>15</sup>

Our prior work has found that, while challenging to do, the military departments can take action to better estimate their workload demand for commodities. For example, we identified weaknesses in the demand forecasts for spare parts that have contributed to the military departments creating at times inventory in excess of current need and backorders of

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<sup>14</sup>Section 251A of the Balanced Budget and Emergency Deficit Control Act of 1985, Pub. L. No. 99-177 (1985), as amended, requires the Office of Management and Budget to calculate, and the President to order, a sequestration of non-exempt discretionary appropriations accounts when discretionary spending limits established for a particular fiscal year are exceeded. Amounts appropriated for overseas contingency operations are exempt. The fiscal year 2013 sequestration was ordered on March 1, 2013.

<sup>15</sup>The Budget Control Act of 2011, Pub. L. No. 112-25, 125 Stat. 240, 256-59 (Aug. 2, 2011), amending the Balanced Budget and Emergency Deficit Control Act of 1985, establishes limits on discretionary spending for fiscal years 2012 through 2021.

spare parts across DOD.<sup>16</sup> DOD has taken steps to address weaknesses in this forecasting for commodities through the implementation of the department's Comprehensive Inventory Management Improvement Plan.<sup>17</sup> As part of this effort, the Office of the Assistant Secretary of Defense for Logistics and Materiel Readiness, in collaboration with the military departments and DLA, began using two metrics to track and monitor each organization's performance in accurately forecasting the workload demand for spare parts.<sup>18</sup> We have found that DOD has taken actions that have resulted in greater accuracy in its forecasts and that DOD continues to implement additional actions aimed at improved forecasting, including efforts to measure the accuracy of planning factors.<sup>19</sup>

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## DLA Has Maintained Fairly Constant Prices for Commodities

DLA has maintained fairly constant prices for commodities since fiscal year 2009, due in part to reductions in operating costs and large gains in revenue, as previously discussed. Specifically, we found that the aggregate price for all commodities that DLA offers has increased marginally since fiscal year 2009, but that year-to-year fluctuations did not exceed an increase of 3.3 percent between fiscal years 2009 and 2017,

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<sup>16</sup>GAO, *Defense Inventory: Further Analysis and Enhanced Metrics Could Improve Service Supply and Depot Operations*, [GAO-16-450](#) (Washington, D.C.: June 9, 2016); *Defense Inventory: Services Generally Have Reduced Excess Inventory, but Additional Actions Are Needed*, [GAO-15-350](#) (Washington, D.C.: April 20, 2015); *Defense Inventory: Actions Needed to Improve the Defense Logistics Agency's Inventory Management*, [GAO-14-495](#) (Washington, D.C.: June 19, 2014); *Defense Inventory: Defense Logistics Agency Needs to Expand on Efforts to More Effectively Manage Spare Parts*, [GAO-10-469](#) (Washington, D.C.: May 11, 2010); *Defense Inventory: Army Needs to Evaluate Impact of Recent Actions to Improve Demand Forecasts for Spare Parts*, [GAO-09-199](#) (Washington, D.C.: Jan. 12, 2009); and *Defense Inventory: Management Actions Needed to Improve the Cost Efficiency of Navy's Spare Parts Inventory*, [GAO-09-103](#) (Washington, D.C.: Dec. 12, 2008).

<sup>17</sup>DOD's November 2010 plan established overarching goals to reduce department-wide percentages of excess inventory for commodities. The plan was developed and implemented in response to a provision of the National Defense Authorization Act for Fiscal Year 2010. See GAO, *Defense Inventory: Actions Underway to Implement Improvement Plan, but Steps Needed to Enhance Efforts*, [GAO-12-493](#) (Washington, D.C.: May 3, 2012) for our assessment of the implementation plan.

<sup>18</sup>[GAO-15-350](#).

<sup>19</sup>[GAO-17-317](#) and [GAO-16-450](#).



as shown in figure 3. DOD reports the year-to-year change in price in the annual budget justification materials submitted to Congress. OUSD Comptroller officials told us that they consider increases above 5 percent to be significant.

**Figure 3: Annual Percentage Change in the Aggregate Price for Commodities, Fiscal Years 2009-2017**

|                         | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015  | 2016  | 2017  |
|-------------------------|------|------|------|------|------|------|-------|-------|-------|
| Commodities total       | 1.9% | 0.7% | 3.3% | 1.5% | 1.7% | 0.1% | -1.1% | -0.1% | -1.3% |
| Weapon systems subtotal | 2.0  | -1.5 | -4.9 | 3.1  | 1.1  | 0.8  | -2.4  | -0.4  | -4.1  |
| Troop support subtotal  | 1.6  | 1.7  | 1.6  | 2.9  | 3.2  | -0.2 | -0.5  | 0.0   | -0.4  |

- Fiscal years 2009-2013 approach
- Fiscal years 2014-2016 approach
- Fiscal year 2017 approach

Source: Defense Logistics Agency (DLA) data. | GAO-17-449

Note: DLA used three different approaches to calculate the customer price change for fiscal years 2009 through 2017 to standardize the approach used by all of the Department of Defense's working capital funds and ensure that material costs (to procure commodities) were isolated from operating costs (the direct and indirect costs to provide commodities to customers). The time periods for the approaches are: fiscal years 2009 through 2013, fiscal years 2014 through 2016, and fiscal year 2017. Weapon systems include consumable repair parts and troop support includes items such as clothing, medicine, and food.

As discussed earlier, for all but 2 of the fiscal years we reviewed, DLA reduced the costs to provide commodities and returned the gains from prior fiscal years to its customers in the form of reductions in future fiscal year prices. For example, in fiscal year 2009, DLA had a revenue gain of about \$5.2 billion that could be applied to reduce future prices. Such revenue gains have contributed to the marginal increases in DLA's annual prices for commodities by offsetting inflationary increases in material costs and the relatively smaller revenue losses of fiscal years 2013 and 2014, among other things. OUSD Comptroller officials told us they collect information on the aggregate year-to-year change in price for commodities to understand any potential impacts on the budget and to monitor growth in prices attributed to an increase in the costs to provide the commodities. Officials told us they conduct a review when prices increase above 5 percent, seek additional details to understand the specific costs that are influencing the increase, and direct DLA, when necessary, to make adjustments in how it allocates cost when setting a price.

DLA and OUSD Comptroller officials told us that while aggregate prices have remained stable, the individual prices of commodities that DLA offers its customers may experience price increases between fiscal years, and that such increases are usually generated by growth in material costs.<sup>20</sup> To help control increases in material costs, DLA has implemented numerous initiatives that have further contributed to the relative price stability. For example, DLA awarded more long-term contracts (whereby prices are set over the contract period) and introduced reverse auctions (whereby suppliers can view other suppliers' bids with the intent of increasing competition among the suppliers to lower bids).

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## DLA Has Contributed to Overall Reductions in Costs but Has Often Significantly Increased Prices for Its Distribution Services

Between fiscal years 2011 and 2015, DLA has contributed to reductions by about 25 percent in its overall operating costs for providing distribution services, in part, through the use of existing authorities to reduce infrastructure, while the indirect portion of these costs increased by 9.4 percent.<sup>21</sup> This increase in indirect costs was due, in part, to policy-driven changes such as to achieve audit readiness. However, DLA has consistently overestimated revenue since fiscal year 2009 for distribution services, which resulted in losses that DLA must eventually recover in future year prices. Finally, we found that DLA had often increased annual prices above 10 percent for fiscal years 2009 through 2015 as a result of a declining workload and the need to recoup losses, among other things.

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<sup>20</sup>Our methodology focused on aggregate price change. Our prior work on commodities for weapon systems used a methodology focused in individual price change and found that during a 10-year period, 30 percent of the individual items sampled experienced an annual change in price above 5 percent. We also found that a variety of factors influenced price increases: differences in estimated price and actual price once a commodity was procured; time lag between procurements; changes in the quantity procured; accelerated procurements; and increases in raw material costs. See GAO, *Defense Acquisitions: Price Trends for Defense Logistics Agency's Weapon System Parts*, [GAO-01-22](#) (Washington, D.C.: Nov. 3, 2000).

<sup>21</sup>Per our methodology, we requested data from DLA on its operating costs, including direct and indirect costs, for distribution services for fiscal years 2009 through 2015. We began with fiscal year 2011 because DLA did not have complete data available for fiscal years 2009 and 2010.

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## DLA Has Contributed to Reductions in Operating Costs to Provide Distribution Services, but Indirect Costs Have Increased

DLA has contributed to an overall reduction in operating costs of about 25 percent to provide distribution services to the military departments and other customers between fiscal years 2011 and 2015. DLA's operating costs for distribution services can either be direct (e.g., the labor to operate a distribution center) or indirect (e.g., administrative support).<sup>22</sup> According to DLA's data, direct costs have declined by more than half (or 55.8 percent) from about \$1.1 billion in fiscal year 2011 to \$480 million in fiscal year 2015. DLA has achieved cost reductions, in part, by using existing infrastructure-related authorities to implement the following steps:

- Demolishing facilities: DOD has authority to dispose of infrastructure assets under certain conditions.<sup>23</sup> As part of DLA's initiative to reduce excess inventory, officials took steps to demolish warehouses in poor condition that DOD determined were no longer needed through its demolition approval process. Since 2012, DLA has taken action to demolish 42 buildings, totaling 4.6 million gross square feet. These efforts were concentrated at distribution centers in Richmond, Virginia; Mechanicsburg, Pennsylvania; and San Joaquin, California. According to DLA officials, this effort contributed to reducing DLA's costs to operate the facilities and achieved cost savings for the department.
- Closing and realigning operations: DOD has authority to close or realign facilities outside of a Base Realignment and Closure process based on certain thresholds.<sup>24</sup> In 2013, DLA used this authority to

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<sup>22</sup>Distribution services do not have material costs.

<sup>23</sup>The General Services Administration has delegated to the Secretary of Defense the authority to dispose of real property assets (and associated personal property) with a fair market value of less than \$50,000, or to work with the General Services Administration for disposal of property with higher fair market values. 41 C.F.R. §102-75.1055.

<sup>24</sup>Section 2687 of Title 10, U.S. Code establishes congressional notification requirements that DOD must meet when implementing certain closures or realignments. DOD may close or realign installations without being subject to those requirements if the proposed action falls below two specific thresholds: (1) closure of any installation with fewer than 300 direct-hire DOD civilian authorized positions and (2) realignment of any installation with at least 300 direct-hire DOD civilian authorized positions, if the realignment will involve a reduction of fewer than 1,000 civilian positions, or less than 50 percent of the total civilian authorized positions.

consolidate all of its San Joaquin regional operations at its Tracy Defense Distribution Depot and to terminate its operations at Sharpe Army Depot, reducing costs to DLA by about \$8.5 million in fiscal year 2015. According to officials, this effort achieved a cost savings and future cost avoidance for DLA, but the Army continues to operate the space that DLA formerly used at Sharpe Army Depot. Therefore, the effort did not achieve a cost savings for the department as a whole.

Although direct costs have declined, indirect costs have increased for distribution services by 9.4 percent over the same period. Specifically, DLA identified three different categories of indirect costs that have significantly increased since fiscal year 2011. Most of these costs are considered policy-driven changes, but DLA has taken steps to manage growth in these areas and continues to look for opportunities to reduce them in the future. The indirect costs, which have been adjusted into constant fiscal year 2015 dollars, are as follows:

- **Audit readiness:** The costs associated with achieving audit readiness across DLA increased from \$1.3 million in fiscal year 2011 to \$151.9 million in fiscal year 2015, more than a hundredfold increase. DLA officials stated they allocated an average of 1.6 percent of these costs to distribution services. According to DLA officials, in order to add inventory controls associated with the department's congressionally mandated efforts to become auditable, DLA had to invest in technology and hire additional civilian employees to implement the inventory controls.<sup>25</sup> To manage growth in audit readiness costs, DLA officials told us that they have taken steps to consolidate contract support and rely more heavily on its existing workforce.
- **Information technology:** Information technology costs across DLA increased from \$842.8 million in fiscal year 2011 to \$974.4 million in fiscal year 2015, an increase of about 15.6 percent. DLA officials stated they allocated 7 percent of these costs to distribution services. DLA officials also stated that the increase in information technology costs were primarily for sustainment and the modernization of information technology infrastructure to improve business operations

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<sup>25</sup>The National Defense Authorization Act (NDAA) for Fiscal Year 2013 required the Financial Improvement and Audit Readiness Plan to state the actions taken to ensure validation of the audit readiness of the Department of Defense (DOD) Statement of Budgetary Resources no later than September 30, 2014. Pub. L. No. 112-236, Div. A, title X, subtitle A, §1005 (Jan. 2, 2013). Congress further addressed accountability in the NDAA for Fiscal Year 2014 by requiring a full audit of DOD's fiscal year 2018 financial statements and requiring that those results to be submitted to Congress no later than March 31, 2019. Pub. L. No. 113-66, Div. A, title X, subtitle A, §1003 (Dec. 26, 2013).

and capabilities as well as to purchase greater data storage and more bandwidth to ensure the continuity of business operation systems and secure communications. DLA officials also told us they have taken steps to manage growth in information technology costs. For example, DLA leveraged the Defense Information Services Agency's lower cost teleconferencing and voice services.

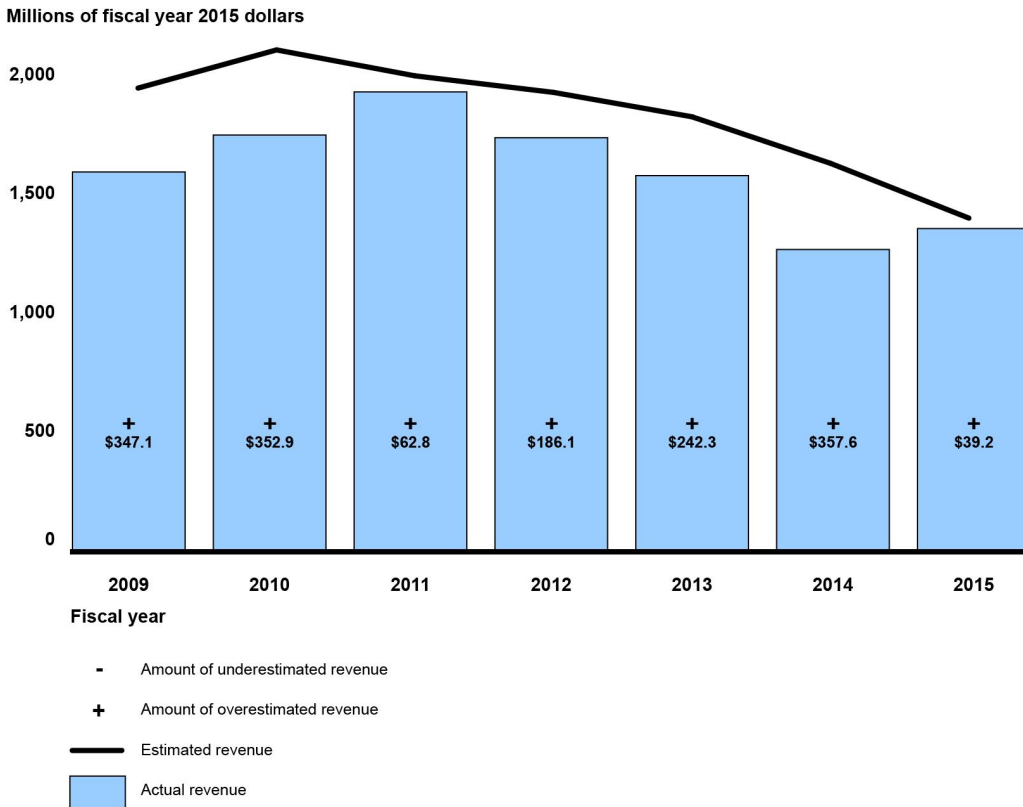
- Infrastructure support: Infrastructure support costs increased from \$83.4 million in fiscal year 2011 to \$125.8 million in fiscal year 2015, an increase of more than half or about 51 percent. According to DLA officials, the rise in infrastructure support costs is due to the sustainment, restoration, and modernization of the aging facilities that DLA operates and to demolition costs. For example, many of the buildings that DLA operates at its distribution centers were constructed during the 1940s and 1950s and are close to the end of their lifecycle, requiring more funds to maintain. To try to control these cost increases, DLA officials told us that they fund the suggested sustainment, restoration, and maintenance costs at a lower percentage than DOD's model suggests and prioritize repairs that are health and safety related, but such a strategy can result in higher costs over the long term if needed maintenance continues to be deferred. Also, since fiscal year 2012, DLA has invested about \$24.4 million to demolish aged facilities to avoid future infrastructure support costs.

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## DLA Has Consistently Overestimated Revenue for Its Distribution Services

For fiscal years 2009 through 2015, DLA consistently overestimated revenue for its distribution services. As with commodities, DLA develops annual revenue estimates based on operating costs and the military departments' workload demands during the annual process to develop a budget and set prices for distribution services in advance of the budget request. When the actual revenue is less than estimated revenue, DLA adjusts future prices to recover the loss in its operating costs. Such adjustments contribute to increasing prices in future budget years. According to DLA data, distribution services have experienced annual losses ranging from \$39.2 million to \$352.9 million in every year from fiscal year 2009 through fiscal year 2015, as shown in figure 4.

**Figure 4: Defense Logistics Agency's Actual Compared with Estimated Revenue for Distribution Services, Fiscal Years 2009-2015**



Source: GAO analysis of Defense Logistics Agency (DLA) data. | GAO-17-449

According to DLA officials, they have generated less revenue than estimated for distribution services because the military departments' workload demand was less than they had initially anticipated when formulating the budget for the budget year at least 18 months earlier. Some of the difference can be explained by unanticipated changes in DOD's planned operations. For example, DLA planned in years 2008 through 2010, based on the military departments' estimates, that the workload to move equipment and materiel from Iraq to other locations would be greater in fiscal years 2010 through 2013 than the actual workload demand for those years. Also, DLA planned in 2011 and 2012, based on the military department's plans for withdrawal from Afghanistan that the workload demand for processing inventory to these locations would decrease in fiscal years 2013 and 2014. However, the actual reduction in workload demand was greater than planned.

DLA officials stated there are opportunities for the military departments to improve their estimates of workload demand for distribution services. As such, DLA has taken actions since 2014 to work with the military departments to improve workload estimates by holding quarterly meetings with senior-level military department representatives from their finance and logistics offices. According to DLA officials, these quarterly cost summits are used to discuss estimates of workload demand and how differences during budget execution can affect DLA's cost recovery and the military departments' budgets. For example, during the November 2016 cost summit, DLA officials provided 5 years of data for second destination transportation costs—a distribution service cost associated with processing—that compared the price each military department was charged based on their combined workload estimates with the cost for the actual amount each military department had used.<sup>26</sup> DLA officials had not previously shared these data with the military departments. DLA reported that over the 5 years, two of the three military departments had used less second destination transportation than their workload estimate and cumulatively had overpaid by approximately \$100 million, while the third military department had underpaid by \$12.6 million.<sup>27</sup> In response to questions during the cost summit about the status of the surplus payments, DLA officials stated that any gains were returned through reductions in price to all customers regardless of whether they had previously overpaid or underpaid compared with their workload estimate. DLA plans to continue to share data that compares estimates with actuals to encourage the military departments to develop more accurate workload estimates. In addition, DLA has proposed to the military departments to not include second destination transportation in the price for processing, but to bill separately for actual second destination transportation costs.

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<sup>26</sup>Second destination transportation is the movement of freight among and between depots, logistics centers, and field activities. It does not refer to the transportation of freight from commercial suppliers to DOD locations.


<sup>27</sup>The price for processing includes a set fee for second destination transportation that is based on a combined workload estimate from the military departments. Since the price does not change during the budget year, variations in the actual workload will result in military departments either paying more or paying less than the set fee for second destination transportation.

## DLA Has Often Increased Prices Significantly for Its Distribution Services

Since fiscal year 2009, DLA’s annual prices for distribution services have often increased above 10 percent. DOD reports its annual prices for distribution services in the budget justification materials, but does not include information on the year-to-year change in price. Therefore, we calculated the year-to-year change in annual price for four types of distribution services to determine the trends in pricing. The four types of distribution services—covered storage, open storage, specialized storage, and processing—all experienced significant price increases. For example, covered storage prices increased by more than 10 percent in 5 out of the 9 years reviewed. The largest increases in the price for all distribution services occurred in fiscal year 2017, as shown in figure 5.

**Figure 5: Annual Percentage Change in Price for Selected Distribution Services, Fiscal Years 2009-2017**

|                     | 2009 | 2010  | 2011 | 2012 | 2013 | 2014  | 2015 | 2016 | 2017              |
|---------------------|------|-------|------|------|------|-------|------|------|-------------------|
| Covered storage     | 7.9  | 31.6  | 16.0 | 16.3 | -4.8 | -12.2 | 11.1 | 0.7  | 31.5              |
| Open storage        | -1.3 | -38.0 | 18.4 | 17.3 | -6.8 | -1.4  | -3.1 | 0.6  | 42.7              |
| Specialized storage | 20.7 | 12.1  | 17.3 | 16.4 | -4.9 | -1.4  | -1.3 | 0.6  | 51.3              |
| Processing          | -3.4 | 8.7   | 3.9  | -0.6 | 11.6 | -1.4  | -1.7 | 0.7  | 13.1 <sup>a</sup> |

 Increase of 10 percent or more

Source: GAO analysis of Defense Logistics Agency (DLA) data. | GAO-17-449

<sup>a</sup>This amount is specific to continental U.S. processing. DLA established a separate rate for overseas processing in fiscal year 2017 that increased by 138.8 percent from fiscal year 2016. In years prior to fiscal year 2017, DLA had one price for processing regardless of location.

As discussed earlier, any losses from prior fiscal years as a result of overestimated revenue must be eventually recovered by DLA in its future pricing. In addition to such losses, DLA’s declining workload at its distribution centers has also contributed to significant increases in annual prices for distribution services. DLA officials told us that the costs to operate these centers are relatively fixed and do not fluctuate based on the workload. As DLA’s workload has declined with combat operations in Iraq and Afghanistan and through inventory reduction initiatives, DLA has had to continue to apply the fixed costs of operating these distribution centers to the declining workload. For example, in fiscal year 2009, DLA spread the operating cost across a larger storage workload, which



resulted in an average cost per cubic foot for covered storage of \$3.05, but by fiscal year 2012 these costs spread across a smaller workload resulting in an average cost per cubic foot of \$5.67.

Moreover, DLA's decision to delay recovering its prior revenue losses when setting prices for distribution services in fiscal years 2014 through 2016 led to the largest price increases for distribution services in fiscal year 2017 for the period reviewed. Specifically, DLA set lower-than-actual prices to keep prices constant in fiscal years 2014 through 2016 while military departments recovered from budgetary cuts due to sequestration. In fiscal year 2017, DLA returned to its usual procedure and set prices based on estimated costs, estimated workload, and prior years' losses.

When we asked OUSD Comptroller officials about these price increases, they told us that they do not separately track the aggregate price changes for distribution services over time. Instead, the officials stated that they can assess price growth in distribution services through the price change information reported in the budget justification materials because the costs for approximately 70 percent of DLA's distribution services workload is included in DLA's prices for commodities.<sup>28</sup> Moreover, when workload decreases and DLA experiences prior-year revenue losses in providing distribution services, the Financial Management Regulation allows DLA to increase prices significantly to recover its full operating costs.<sup>29</sup>

DLA has taken steps to manage growth in indirect costs and to improve workload estimates for distribution services. In addition, DLA officials stated they have also sought opportunities to reverse the recent decline in workload for distribution services in order to lower prices. Specifically, our analysis of DLA covered storage shows that its usage declined from 70.8 million cubic feet in fiscal year 2009 to 42.1 million cubic feet in fiscal year 2015, a decrease of 41 percent. To address this decline in usage, DLA reviewed how the department is consuming these services and found instances where the military departments are using private storage for government-owned inventory in close proximity to DLA distribution

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<sup>28</sup>The remaining percentage is associated with DLA's costs to process military service-owned inventory.

<sup>29</sup>Per DOD's *Financial Management Regulation* for the Defense Working Capital fund, DLA is expected to ensure that the full costs of providing commodities and services are recovered when setting the price. See Department of Defense Financial Management Regulation 7000.14-R, vol. 2B, ch. 9, *Defense Working Capital Fund Budget Justification Analysis* (Dec. 2014).

centers. For example, the Army's Stryker program stores inventory in commercial locations that are located near DLA distribution centers in Anniston, Alabama and Puget Sound, Washington. DLA estimates moving Stryker inventory from storage owned by private companies to DLA distribution centers in Anniston, Alabama and San Joaquin, California could save DOD approximately \$4 million in distribution costs in the first year.<sup>30</sup> In addition, according to DLA officials, they found instances where the military departments had moved storage workload from DLA's distribution centers to their own storage facilities. DLA officials told us that increasing their workload could contribute to reducing prices and this could be achieved by changing, when appropriate, the military departments' practice of obtaining distribution services outside of DLA.

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## DOD Could More Efficiently Use Its Distribution Centers, Including Those That DLA Operates

DOD has taken steps to increase the use of its U.S. distribution centers, but additional opportunities exist to more efficiently use this network of distribution centers, including those that DLA operates. For example, the department has recently taken steps to address the military departments' use of private storage when DLA distribution centers are in the same vicinity as the private storage locations. In January 2017, the department revised DOD Instruction 5000.02, Operation of the Defense Acquisition System, to require that program managers who are responsible for contracts with DOD maintenance depots store government-owned inventory at DLA's distribution centers when located in the same geographic area as those depots.<sup>31</sup> According to officials, this revision is intended to reduce unnecessary costs to DOD's total budget by utilizing DOD's existing investment in DLA's network. In addition, the department sought authority from Congress to make DLA's storage and distribution services support available to defense weapon system contractors. The National Defense Authorization Act for Fiscal Year 2017 provided such authority under a 6-year pilot program whereby DLA and defense weapon

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<sup>30</sup>DLA reviewed the Army's contract costs and compared it with the actual costs of government storage in the DLA distribution network. After the first year, the difference in the costs should be considered as cost avoidance. DLA found that many of the Stryker customers are located in Southern California and in the Pacific region and transferring materiel from Washington to California would likely reduce transportation costs.

<sup>31</sup>DOD Instruction 5000.02, *Operation of the Defense Acquisition System* (Jan. 7, 2015) (incorporating Change 1, Jan. 26, 2017 and Change 2, Feb. 2, 2017).

system contractors can enter into a separate contract for the storage and distribution of materiel and spare parts used in the support of a defense weapon systems contract.<sup>32</sup>

DOD has other opportunities to more efficiently use its network of distribution centers to provide distribution services. Specifically, DOD previously identified inefficiencies, including overlapping and duplicative distribution service functions, across its distribution network. The Under Secretary of Defense for Acquisition, Technology, and Logistics has the responsibility to ensure that its policies and programs are designed and managed to improve efficiency, among other things, and to use DOD's existing systems, facilities, and services to avoid unnecessary overlap and duplication and to achieve maximum efficiency and economy.<sup>33</sup> As a subordinate to the Under Secretary of Defense for Acquisition, Technology, and Logistics, the Assistant Secretary of Defense for Logistics and Materiel Readiness has been delegated the responsibility and authority to prescribe policies and procedures in the department for the conduct of logistics and materiel readiness, to include supply and transportation, among others.<sup>34</sup> In carrying out this responsibility, starting in 2010, DOD established a program called Strategic Network Optimization that identified and undertook actions to address inefficiencies in its distribution network. The program had a three-phased approach with each phase primarily focused on one of the following areas: transportation, inventory, and infrastructure.

In the context of distribution infrastructure, Strategic Network Optimization program officials identified in 2011 that DLA and the military departments provided distribution services—including storage and processing—at 256 distribution centers in the United States that often are in close proximity to one another and, in some cases located on the same installations. In addition, they found that 91 of the distribution centers accounted for 95 percent of the total network's historical workload while the other sites

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<sup>32</sup>National Defense Authorization Act for Fiscal Year 2017, Pub. L. No. 114-328 (Dec. 23, 2016).

<sup>33</sup>DOD Directive 5134.01, *Under Secretary of Defense for Acquisition, Technology, and Logistics (USD (AT&L))*, (Dec. 9, 2005) (incorporating Change 1, Apr. 1, 2008).

<sup>34</sup>DOD Directive 5134.12, *Assistant Secretary of Defense for Logistics and Materiel Readiness* (May 25, 2000) (incorporating Change 1, Oct. 27, 2010).

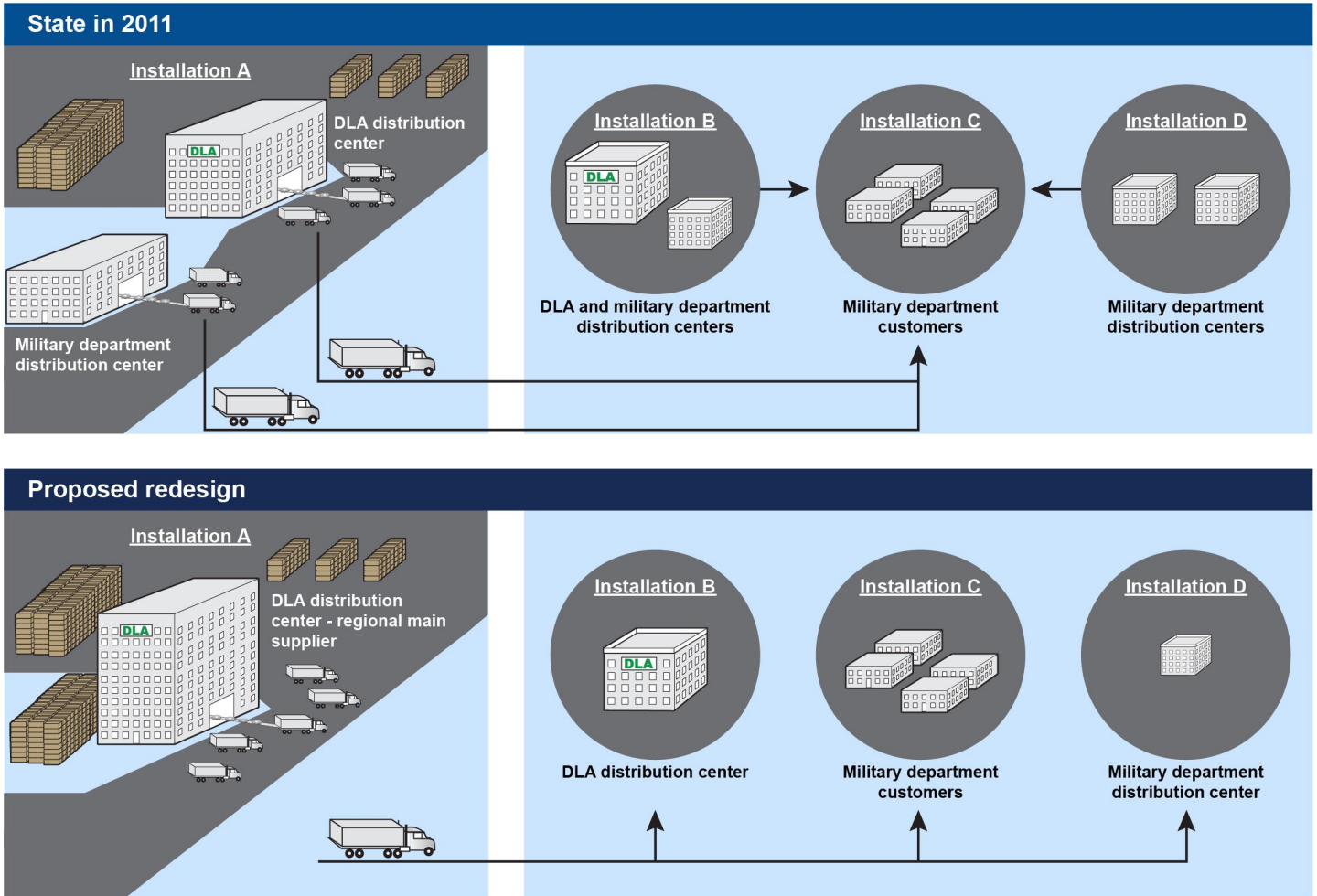
accounted for the remaining 5 percent.<sup>35</sup> To address this issue, Strategic Network Optimization program officials suggested a number of possible actions to improve the efficiency of the distribution service network. In January 2012, the Joint Logistics Board approved an approach whereby 5 DLA distribution centers were designated as the main suppliers within an assigned region of the United States to the remaining 12 DLA distribution centers, which are smaller, and to other distribution centers run by the military departments.<sup>36</sup> The 5 main suppliers would ship inventory to all customers within the distribution network. Each of the other distribution centers would be limited to providing service to local customers located on its individual installation. See figure 6 for an example of the regional consolidation that was proposed in the redesign of the U.S. distribution network. This approach was intended to minimize DLA and the military departments providing unnecessary overlapping or duplicative distribution services by redistributing the workload. In addition, the workload redistribution was to have decreased the number of distribution centers within DOD's network and increased DLA's overall distribution services workload.

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<sup>35</sup>DOD, Strategic Network Optimization (SNO) Project Report: Spiral 3 Report Interim Draft (Oct. 2011). We requested a copy of a final report, but DLA officials stated that they could not locate a final report.

<sup>36</sup>The Joint Logistics Board is a senior-level governance body for logistics and supply chain management. The Joint Logistics Board is co-chaired by the Assistant Secretary of Defense for Logistics and Materiel Readiness and the Joint Staff Director of Logistics, and has senior-level participants from the military services, the combatant commands, and DLA.

**Figure 6: Example of Regional Consolidation Proposed in a Redesign of the Department of Defense’s U.S. Distribution Network**



Source: GAO analysis of Department of Defense (DOD) information. | GAO-17-449

In October 2014, DOD discontinued the Strategic Network Optimization program. By this time, DOD had implemented a majority of the actions for the first two—transportation and inventory—of the program’s three phases. But DOD had not yet developed a business plan to guide the implementation of the third phase intended to reduce infrastructure in the distribution network through consolidation. According to DOD and DLA officials, all of the remaining actions from the first and second phases of the program were incorporated into normal business processes. DOD and DLA officials acknowledged that unnecessary overlap and duplication continues to exist in DOD’s network of distribution centers. However, in

the case of the effort to reduce infrastructure, the officials stated that without Base Realignment and Closure authority, they would not be able to address unnecessary overlap and duplication in functions at DOD's U.S. distribution centers, as many of the distribution centers are owned by the military departments.<sup>37</sup> According to DOD and DLA officials, proposals within the department on the appropriate course of action to address unnecessary overlap and duplication in DOD's network of distribution centers have evolved since the 2011 study to include options for base closures.<sup>38</sup> In each annual budget request since fiscal year 2013, the department has requested Base Realignment and Closure authority, but Congress has yet to approve DOD's request.

DOD has existing authorities it can use to minimize unnecessary overlap and duplication and more efficiently use the department's network of distribution centers. For example, DOD could use its existing authorities to close or realign its installations and functions outside of a Base Realignment and Closure round. However, if doing so would exceed certain thresholds set out in 10 U.S.C. § 2687—based on the number of civilian personnel affected or potentially affected—DOD must notify Congress and wait 60 days after notification before taking any irreversible

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<sup>37</sup>Under the Base Realignment and Closure process, Congress authorizes by statute an independent federal commission to review—and determine whether to forward to the President for approval—DOD's proposals to realign and close military installations. Between 1988 and 2005, the department, acting under statutory authorities, conducted five rounds of base realignments and closures. The first of these, in 1988, was accomplished independently by DOD, which received subsequent congressional approval through the Defense Authorization Amendments and Base Closure and Realignment Act of 1988, Pub. L. No. 100-526, Title II, §§ 201-209 (Oct. 24, 1988). The last four rounds (1991, 1993, 1995, and 2005) were authorized under the Defense Base Closure and Realignment Act of 1990, Pub. L. No. 101-510, title XXIX, part A, §§2901-2911 (10 U.S.C. 2687 note), which has been amended numerous times in the years since, but was last amended to authorize a round of closures and realignments by the National Defense Authorization Act for Fiscal Year 2002, Pub. L. No. 107-107, Title XXX, §§ 3001-3008 (Dec. 28, 2001).

<sup>38</sup>For example, DOD's March 2016 *Infrastructure Capacity* study reported the department has an infrastructure in excess of 22 percent and argued that authorization of a Base Realignment and Closure is necessary to reduce excess infrastructure. Moreover, the Defense Business Board recommended in October 2016 that DOD should pursue another Base Realignment and Closure round with a focus on closure to reduce excess logistics infrastructure.

actions.<sup>39</sup> In addition, DOD has authority to dispose of real property through demolition when a facility's condition has deteriorated. We found that DOD had not assessed the extent to which it could use existing authorities to minimize unnecessary overlap and duplication and more efficiently use the department's network of U.S. distribution centers, beyond the actions DLA has already taken. We previously reported that while DOD makes hundreds of basing decisions a year that are not subject to congressional notification, it has yet to take any actions that require notification.<sup>40</sup> In discussions about DOD's existing authorities, officials at the Office of the Assistant Secretary for Energy, Installations, and Environment told us that the department does not believe 10 U.S.C. § 2687 is a viable tool to achieve significant base closures because under that section, DOD's authorities are narrowly circumscribed and the statutory requirements are burdensome. However, other DOD components could assess and implement similar actions as DLA using existing authorities.<sup>41</sup> Further, in discussing the current fiscal pressures and budgetary constraints within the department and the need to reduce lower priority programs to comply with the Bipartisan Budget Act, DOD's budget overview for fiscal year 2017 states that "the need to reduce unneeded facilities is so critical that in the absence of authorization for a new round of base realignment and closure, the department will explore any and all authorities that Congress has provided to eliminate wasteful infrastructure."<sup>42</sup> While these actions may not entirely address

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<sup>39</sup>Section 2687 of Title 10, U.S. Code establishes congressional notification requirements that DOD must meet when implementing certain closures or realignments. DOD may close or realign installations without being subject to those requirements if the proposed action falls below two specific thresholds: (1) closure of any installation with fewer than 300 direct-hire DOD civilian authorized positions and (2) realignment of any installation with at least 300 direct-hire DOD civilian authorized positions, if the realignment will involve a reduction of fewer than 1,000 civilian positions, or less than 50 percent of the total civilian authorized positions.

<sup>40</sup>GAO, *Military Bases: DOD Has Processes to Comply with Statutory Requirements for Closing or Realigning Installations*, [GAO-13-645](#) (Washington, D.C.: June 27, 2013).

<sup>41</sup>In addition to the disposal of real property and the closure and realignment previously discussed, DOD Instruction 4165.70, *Real Property Management* (Apr. 6, 2005) provides guidance on leasing vacant and partially vacant space on military installations to non-DOD entities.

<sup>42</sup>The Bipartisan Budget Act of 2013, Pub. L. No. 113-67 (2013), followed by the Bipartisan Budget Act of 2015, Pub. L. No. 114-74 (2015), adjusted and extended discretionary spending limits established under the Budget Control Act of 2011, Pub. L. No. 112-25 (2011), into fiscal year 2025.

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inefficiencies in its network of U.S. distribution centers, they could achieve efficiencies and potential cost savings.

Without maximizing the use of its existing authorities in the absence of a Base Realignment and Closure round, DOD's network of distribution centers will continue to result in inefficiencies and pose difficulties in minimizing price increases for distribution services. In addition, the department will continue to spend funds on storage and distribution costs that could be applied to support higher priorities.

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## Conclusions

Under current fiscal pressures and budgetary constraints within the department, DOD has sought to provide its commodities and distribution services to its U.S. military forces as efficiently as possible while reducing costs. Further, DOD has identified inefficiencies in how it provides distribution services at its network of U.S. distribution centers. DOD maintains that it needs Base Realignment and Closure authority; however, the department has not assessed whether it can use existing authorities to minimize unnecessary overlap and duplication, and more efficiently use this network. Any actions resulting from DOD's assessment, if implemented, could also have the potential to realize near-term savings in storage and distribution costs that could be made available to support higher priorities.

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## Recommendation for Executive Action

To minimize unnecessary overlap and duplication and more efficiently use DOD's U.S. distribution centers, we recommend that the Secretary of Defense direct the Under Secretary of Defense for Acquisition, Technology, and Logistics (or the subsequent Under Secretary for Acquisition and Sustainment), in conjunction with the Director of DLA, and the Secretaries of the Army, the Air Force, and the Navy, to assess and direct the implementation of actions, as appropriate, that can be taken using existing authorities to close, realign, or dispose of existing infrastructure.



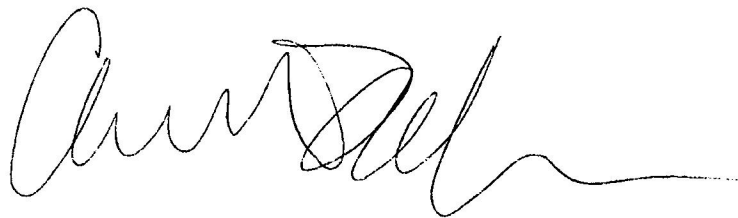
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## Agency Comments

We provided a draft of this report to DOD for review and comment. In its comments, DOD concurred with our recommendation and cited various statutes that constrain both the department's authority to conduct large-scale closures or realignments of installations and small-scale closures, realignments, or disposals of facilities, including the infrastructure in the network of U.S. distribution centers. DOD's comments are reprinted in their entirety in appendix I. DOD also provided technical comments, which we incorporated as appropriate.

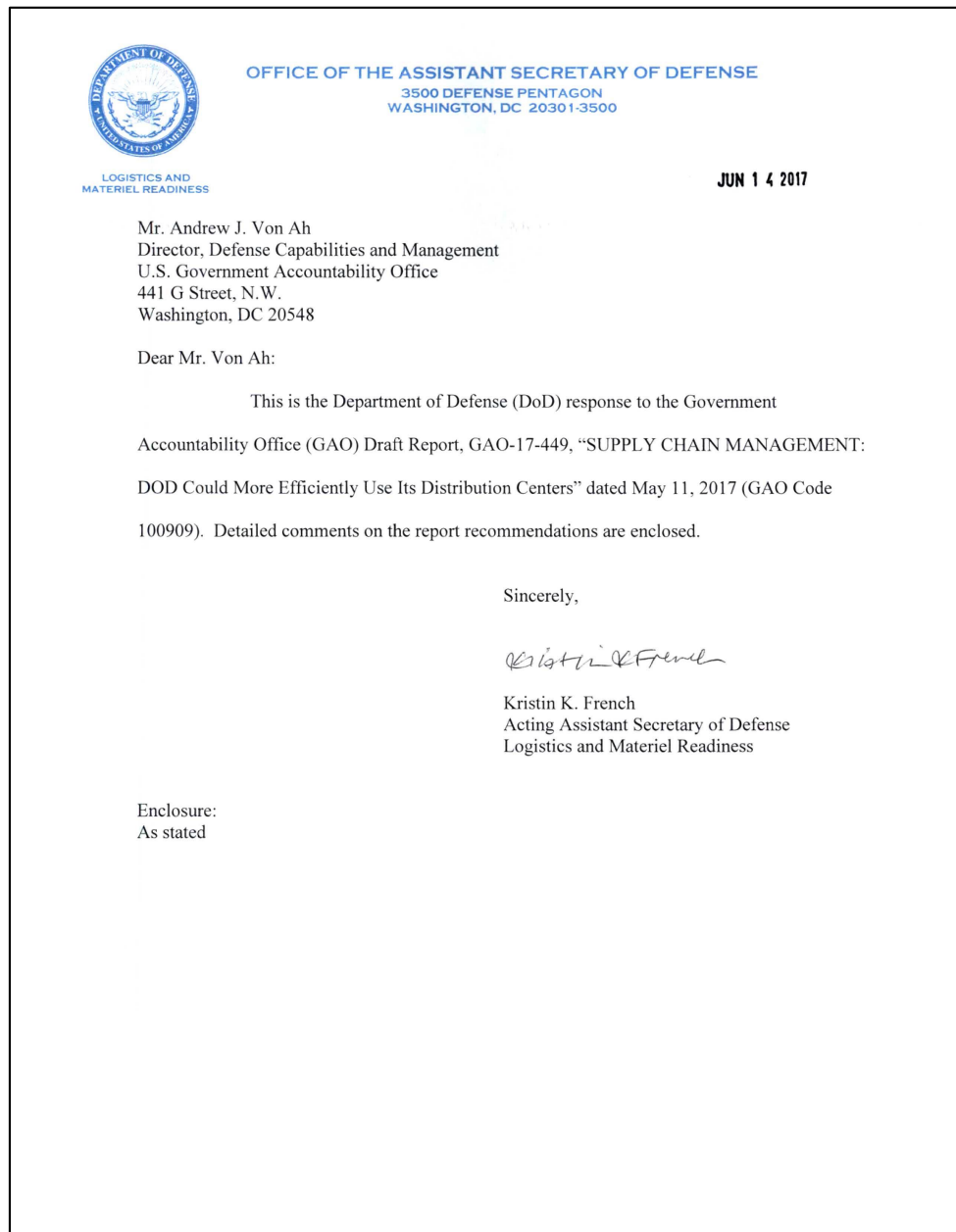
We are sending copies of this report to the appropriate congressional committees and to the Secretary of Defense; the Under Secretary of Defense for Acquisition, Technology, and Logistics; the Under Secretary of Defense, Comptroller; the Director of DLA, and the Secretaries of the Air Force, Army, and Navy. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (213) 830-1011 or [vonaha@gao.gov](mailto:vonaha@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix II.



Andrew J. Von Ah  
Director  
Defense Capabilities and Management

# Appendix I: Comments from the Department of Defense



GAO Draft Report Dated May 11, 2017  
GAO-17-449 (GAO CODE 100909)

“SUPPLY CHAIN MANAGEMENT: DOD COULD MORE EFFICIENTLY USE ITS DISTRIBUTION CENTERS”

DEPARTMENT OF DEFENSE COMMENTS  
TO THE GAO RECOMMENDATION

**RECOMMENDATION 1:** To minimize unnecessary overlap and duplication and more efficiently use DOD’s U.S. distribution centers, the Government Accountability Office (GAO) recommends that the Secretary of Defense direct the Under Secretary of Defense for Acquisition, Technology, and Logistics (or the subsequent Under Secretary for Acquisition and Sustainment), in conjunction with the Director of Defense Logistics Agency (DLA), and the Secretaries of the Army, Air Force, and Navy, to assess and direct implementation of actions, as appropriate, that can be taken using existing authorities to close, realign, or dispose of existing infrastructure.

**DOD RESPONSE:** Concur with Comment. The Department will “assess and direct implementation of actions, as appropriate, that can be taken using existing authorities to close, realign, or dispose of existing infrastructure.” However, the Department would like to note that those existing authorities are very limited without a congressional authorized BRAC round.

The Department has the authority to close and realign military installations outside of a congressionally authorized BRAC round provided that action does not trigger the thresholds established in either section 2687 or section 993 of title 10, United States Code. Section 2687 places limits on the Secretary’s authority relative to how the proposed action affects civilian personnel. At installations with fewer than 300 authorized civilian employees, section 2687 imposes no restrictions. At installations with 300 or more authorized civilian employees, the Secretary cannot close the base nor can he realign the base by moving more than 1000 authorized civilian positions or 50% of the authorized civilian positions, whichever is less, without satisfying section 2687’s study and congressional reporting requirements and waiting the specified period of time. Regardless of the size of the installation, Section 993 prohibits the Secretary from reducing the number of military members assigned to an installation by more than 1000, until the Secretary complies with its study and congressional notification and wait requirements

If the action exceeds the thresholds in either statute, the Secretary may still have the authority to undertake the action, but only after satisfying the extensive study and congressional reporting requirements and waiting the specified period of time required by each section. The requirements of section 993 are similar to traditional congressional notice and wait requirements, albeit with a long waiting period. Section 2687, however, requires the Department to provide Congress an extensive report on the proposal and limits the timeframe within which that report can be provided (as part of the annual budget request). The report must include an evaluation of the fiscal, local economic, budgetary, environmental (i.e., full NEPA analysis with all its time

consuming and public involvement requirements), strategic, and operational consequences of the proposed closure or realignment; and the criteria used to develop the recommendation, which at a minimum must include the ability of the local infrastructure at both existing and receiving locations to accommodate the missions and the costs associated with any needed transportation infrastructure improvements. The Secretary can undertake the action only after the expiration of 30 legislative or 60 calendar days, following submission of the report, whichever is longer.

While the study and reporting requirements of section 2687 may seem nothing more than procedural, they have amounted to prohibitions. The Department has not executed any closures or realignments above the thresholds set out in section 2687 or pursuant to the national security or military emergency exemption in that section, outside of an authorized BRAC process since Congress enacted section 2687 in 1977.

Although relatively small in scale, even below threshold actions are not without legal constraints. The decision to close or realign, the selection of the receiving location, the construction or renovation of facilities, and property disposal would all be subject to the National Environmental Policy Act (NEPA), including public notice and judicial review.

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# Appendix II: GAO Contact and Staff Acknowledgments

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## GAO Contact

Andrew J. Von Ah (213) 830-1011 or [vonaha@gao.gov](mailto:vonaha@gao.gov)

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## Staff Acknowledgments

In addition to the contact named above, Tina Won Sherman (Assistant Director), Vincent Buquicchio, Tim Carr, Lina Grant, Mae Jones, Susan Langley, Amie Lesser, Benjamin Sclafani, and Michael Silver made key contributions to this report.

# Appendix III: Accessible Data

## Data Tables

**Accessible Data for Figure 2: Defense Logistics Agency's Actual Compared with Estimated Revenue for Commodities, Fiscal Years 2009-2015**  
(Bar chart)

| Year | Revenue (Billions of fiscal year 2015 dollars) |
|------|--|
| 2009 | 24.9   |
| 2010 | 25.9   |
| 2011 | 25.5   |
| 2012 | 24.1   |
| 2013 | 20.6   |
| 2014 | 20.1   |
| 2015 | 21.4   |

(Line chart)

| Year | Revenue (Billions of fiscal year 2015 dollars) |
|------|--|
| 2009 | 19.7   |
| 2010 | 21.3   |
| 2011 | 23.6   |
| 2012 | 21.9   |
| 2013 | 21.2   |
| 2014 | 21.1   |
| 2015 | 19.5   |

**Accessible Data for Figure 3: Annual Percentage Change in the Aggregate Price for Commodities, Fiscal Years 2009-2017**

|                         | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015  | 2016  | 2017  |
|-------------------------|------|------|------|------|------|------|-------|-------|-------|
| Commodities total       | 1.9% | 0.7% | 3.3% | 1.5% | 1.7% | 0.1% | -1.1% | -0.1% | -1.3% |
| Weapon systems subtotal | 2.0  | -1.5 | -4.9 | 3.1  | 1.1  | 0.8  | -2.4  | -0.4  | -4.1  |
| Troop support subtotal  | 1.6  | 1.7  | 1.6  | 2.9  | 3.2  | -0.2 | -0.5  | 0.0   | -0.4  |

Source: Defense Logistics Agency (DLA) data. GAO-17-449

**Accessible Data for Figure 4: Defense Logistics Agency's Actual Compared with Estimated Revenue for Distribution Services, Fiscal Years 2009-2015**  
(Bar chart)

| Year   | Revenue (Millions of fiscal year 2015 dollars) |
|--------|--|
| "2009" | 1589.1   |
| "2010" | 1744.5   |
| "2011" | 1925.7   |
| "2012" | 1732.8   |
| "2013" | 1573.9   |
| "2014" | 1263.1   |
| "2015" | 1350.9   |

(line chart)

| Year   | Revenue (Millions of fiscal year 2015 dollars) |
|--------|--|
| "2009" | 1937   |
| "2010" | 2097.5   |
| "2011" | 1988.5   |
| "2012" | 1918.9   |
| "2013" | 1816.4   |
| "2014" | 1620.7   |
| "2015" | 1390.2   |

**Accessible Data for Figure 5: Annual Percentage Change in Price for Selected Distribution Services, Fiscal Years 2009-2017**

|                     | 2009  | 2010  | 2011  | 2012  | 2013  | 2014  | 2015  | 2016 | 2017               |
|---------------------|-------|-------|-------|-------|-------|-------|-------|------|--------------------|
| Covered storage     | 7.9   | 31.6* | 16.0* | 16.3* | -4.8  | -12.2 | 11.1* | 0.7  | 31.5*              |
| Open storage        | -1.3  | -38.0 | 18.4* | 17.3* | -6.8  | -1.4  | -3.1  | 0.6  | 42.7*              |
| Specialized storage | 20.7* | 12.1* | 17.3* | 16.4* | -4.9  | -1.4  | -1.3  | 0.6  | 51.3*              |
| Processing          | -3.4  | 8.7   | 3.9   | -0.6  | 11.6* | -1.4  | -1.7  | 0.7  | 13.1 <sup>dx</sup> |

\*Increase of 10 percent or more

Source: GAO analysis of Defense Logistics Agency (DLA) data. | GAO-17-449

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## Agency Comment Letters

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### Accessible Text for Appendix I: Comments from the Department of Defense

#### Page1

LOGISTICS AND MATERIEL READINESS

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

3500 DEFENSE PENTAGON

WASHINGTON, DC 20301-3500

JUN 1, 2017

Mr. Andrew J. Von Ah

Director, Defense Capabilities and Management

U.S. Government Accountability Office

441 G Street, NW. Washington, DC 20548

Dear Mr. Von Ah:

This is the Department of Defense (DoD) response to the Government

Accountability Office (GAO) Draft Report, GAO-17-449, "SUPPLY CHAIN MANAGEMENT: DOD Could More Efficiently Use Its Distribution Centers" dated May 11, 2017 (GAO Code 100909). Detailed comments on the report recommendations are enclosed.

Sincerely,

Kristin K. French

Acting Assistant Secretary of Defense Logistics and Materiel Readiness

Enclosure: As stated



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GAO Draft Report Dated May 11, 2017 GA0- 17-449 (GAO CODE 100909)

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### Page 3

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