Audit Report

ACQUISITION OF MEDICAL ITEMS

Report No. 98-154 June 15, 1998

Office of the Inspector General
Department of Defense

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Acronyms

DAPA	Distribution and Pricing Agreement
DBPA	Decentralized Blanket Purchasing Agreement
DLA	Defense Logistics Agency
DSCP	Defense Supply Center Philadelphia
DVA	Department of Veterans Affairs
FSS	Federal Supply Schedule
GSA	General Services Administration
MTF	Medical Treatment Facility
NDC	National Drug Code

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June 15, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION AND TECHNOLOGY

SUBJECT: Audit Report on the Acquisition of Medical Items (Report No. 98-154)

We are providing this report for your review and comment. This report is the fourth in a series of reports on dual management of commercially available items. This audit was requested by the Assistant Deputy Under Secretary of Defense (Materiel and Distribution Management). We considered comments from the Acting Principal Assistant Deputy Under Secretary of Defense (Logistics) on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Therefore, we request that the Acting Principal Assistant Deputy provide additional comments on the recommendation and potential monetary benefits by August 14, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Tilghman Schraden at (703) 604-9186 (DSN 664-9186), e-mail tschraden@dodig.osd.mil, or Mr. Thomas Kelly at (215) 737-3886 (DSN 444-3886), e-mail tkelly@dodig.osd.mil. See Appendix F for the report distribution. The audit team members are listed inside the back cover.

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Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 98-154 **June 15, 1998**
(Project No. 6LD-5044.01)

Acquisition of Medical Items

Executive Summary

Introduction. This audit was requested by the Assistant Deputy Under Secretary of Defense (Materiel and Distribution Management). This report is the fourth in a series of reports on dual management of commercially available items by the Defense Logistics Agency (DLA) and other Government organizations. Medical items comprise 11 Federal supply classes but are generally managed as 3 categories: pharmaceuticals, medical and surgical supplies, and equipment. For FY 1997, DLA centrally supported the acquisition of about $1 billion of medical items for DoD medical treatment facilities; the medical treatment facilities acquired many more millions of dollars of medical items locally by contract and Government credit card. The Department of Veterans Affairs contracted for about $2.4 billion of medical items in support of its medical facilities and other customers.

Audit Objectives. The audit objectives were to determine the extent of products available through non-Defense Federal organizations for which DoD also operated central procurement programs and to evaluate whether the DoD programs were providing services without added benefit to DoD. The specific objective of this audit was to evaluate the cost-effectiveness of DLA centrally acquiring medical items concurrent with the Department of Veterans Affairs. We also reviewed the adequacy of the management control program applicable to the stated objectives.

Audit Results. DLA acquisition resources were expended unnecessarily to centrally support the acquisition of commercially available medical items for DoD medical treatment facilities. By using the acquisition services of the Department of Veterans Affairs for those medical items that are not military unique as well as reducing its central procurement operations and realigning personnel acquisition resources, DoD could better use an estimated $48 million over the FY 1999 through FY 2004 Future Years Defense Plan. More benefits could accrue from paying lower prices for medical items. See Part I for a discussion of the audit results.

The management controls we reviewed were effective in that no material management control weakness was identified. See Appendix A for details on the management control program.

Recommendation. We recommend that the Under Secretary of Defense for Acquisition and Technology transfer acquisition responsibility to the Department of Veterans Affairs for all medical items except those categorized as military unique and realign acquisition personnel resources accordingly.

Management Comments. The Acting Principal Assistant Deputy Under Secretary of Defense (Logistics) partially concurred with the recommendation. DLA will form a team with the Department of Veterans Affairs to eliminate duplication where possible. Additionally, DLA will consider alternatives such as lowering surcharges or imposing a flat fee in cases where the surcharge on purchases is made through Department of Veterans Affairs contracts. Part I summarizes management comments and Part III contains the complete text of those comments.

Audit Response. Comments from the Acting Principal Assistant Deputy were not fully responsive. With the intention of eliminating duplication, DLA and the Department of Veterans Affairs have been the focus of several initiatives that have resulted in similar cooperative arrangements between the Departments over the last 20 years. Yet, the duplication in acquiring medical items has persisted. Consequently, the alternatives proposed by the Acting Principal Assistant Deputy offer limited prospect for eliminating duplication in acquiring medical items and realizing potential monetary benefits. We request that the Acting Principal Assistant Deputy reconsider his position and provide comments on the final report by August 14, 1998.

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Part I - Audit Results

Audit Background

The Under Secretary of Defense for Acquisition and Technology is the principal staff assistant and advisor to the Secretary of Defense for all matters relating to acquisition. This audit was requested by the Assistant Deputy Under Secretary of Defense (Materiel and Distribution Management), a subordinate element of the Under Secretary. The Assistant Deputy was concerned that products available through non-Defense Federal organizations were being procured by the Defense Logistics Agency (DLA) without added benefit to DoD. This report is the fourth in a series of reports on dual management of commercially available items. Medical items acquired by the Government are included in Federal Supply Group 65. See Appendix C for a description of the 11 classes in Federal Supply Group 65. In FY 1997, DLA centrally supported DoD medical treatment facilities (MTFs) in the acquisition of about $1 billion of medical items; the MTFs (hospitals and clinics) acquired many more millions of dollars worth of medical items locally by contract and Government credit card. The Department of Veterans Affairs contracted for about $2.4 billion of medical items in support of its medical facilities and other customers in FY 1997.

Supply Consolidation Within Civilian Agencies. Since 1949, the General Services Administration (GSA) has had the responsibility to supply personal property to all Government organizations. GSA was given the authority to direct and manage the Federal Supply Schedule (FSS) Program. The FSS Program provides Federal agencies with a simplified process of acquiring commonly used supplies and services in varying quantities at lower prices while obtaining discounts associated with volume buying. Competitively awarded contracts, called FSS contracts and containing instructions for placing delivery orders, are made with commercial firms to provide supplies and services at set prices for established periods of time. Under the FSS Program, ordering agencies issue orders directly to the contractor, receive shipments, pay the contractors, and administer individual orders.

In 1961, GSA began to transfer its responsibility to award FSS contracts for medical items to its largest customer, the Veterans Administration, now the Department of Veterans Affairs (DVA). The transfer of responsibility from GSA to DVA was completed in January 1981. Awards are made by the DVA National Acquisition Center in Hines, Illinois. DVA acquisition support for medical items has primarily been for its own medical facilities and other civilian agencies.

Under the Veterans Health Care Act of 1992, pharmaceutical manufacturers must make their products available through FSS contracts in order to receive reimbursement for drugs covered by Medicaid. The Act also requires that pharmaceutical manufacturers sell their products to DVA, DoD, the Public Health Service, and the Coast Guard at no more than 76 percent of the average price they charge non-Federal customers--a level referred to as the Federal ceiling price.

In addition to FSS contracts, DVA awards decentralized blanket purchasing agreements (DBPAs) and national contracts to obtain better prices than can be achieved from FSS contracts. National contracts are awarded to one manufacturer as a mandatory supplier of a specific item chosen through a formulary. For its contracting service, DVA assessed its customers a surcharge of 0.5 percent (it charged higher rates for equipment items) on each sale during FY 1997.

Supply Consolidation Within DoD. In 1961, DoD established its own central supply agency, the Defense Supply Agency (now DLA), to eliminate duplication of supply functions among the Military Departments. The primary focus of DLA is to support military operations in peace and in war, and to provide relief efforts during times of national emergency. DLA supports the Military Departments with medical items through its subordinate agency, the Defense Supply Center Philadelphia (DSCP), formerly named the Defense Personnel Support Center, located in Philadelphia, Pennsylvania.

DSCP primarily supports the acquisition of medical items by issuing distribution and pricing agreements (DAPAs). DAPAs are agreements with suppliers to sell their products to DSCP customers at a set price for an established period of time; suppliers can increase the price as often as monthly but can reduce it anytime. DSCP awards DBPAs and other individual contracts for unique requirements. For its contracting service during FY 1997, DSCP assessed its customers a surcharge on each sale: 1.3 percent for DAPA items, 5 percent for DBPA items, 55 percent for depot items, and 2 percent to 6.7 percent for equipment.

Initiatives to Eliminate Duplication. Contracting authority for medical items is essentially vested in two Government agencies: DVA to support civilian agencies and DLA to support DoD. Over the years, a number of studies and agreements have been made, as well as directives issued, to eliminate the inevitable duplication arising from such a dual acquisition arrangement. The first significant initiative was proclaimed in 1964, when DoD and GSA agreed to eliminate any unnecessary duplication and overlap within the Government supply system. The latest initiative was in July 1995, as part of the National Performance Review. A combined working group of DoD, DVA, and Government health officials concluded that substantial, increased leverage may be achieved through a combined purchasing effort by DoD and DVA. Significant initiatives to eliminate duplication by DoD and DVA are further discussed in Appendix D.

DoD Acquisition Reform Initiatives. Section 912 of the National Defense Authorization Act for FY 1998 (Public Law 105-85) requires that DoD reduce acquisition positions by between 15,000 and 25,000. DoD is expected to achieve this objective by identifying areas of duplication, overlap, and redundancy among acquisition organizations. The essence of Public Law 105-85 is stated in the DoD November 1997 reform initiative, "The Business Strategy for Defense in the 21st Century," which prescribes that DoD

will streamline organizations to remove redundancy and maximize synergy and will reduce excess support structures to free resources and focus on core competencies.

Audit Objectives

The audit objectives were to determine the extent of products available through non-Defense Federal organizations for which DoD also operated central procurement programs and to evaluate whether the DoD programs were providing services without added benefit to DoD. The specific objective of this audit was to evaluate the cost-effectiveness of DLA centrally acquiring medical items concurrent with DVA. We also reviewed the adequacy of the management control program applicable to the stated objectives. See Appendix A for a discussion of the audit scope and methodology, and our coverage of the management control program. See Appendix B for a discussion of prior coverage.

Acquisition Resources

DLA acquisition resources were expended unnecessarily to centrally support the acquisition of commercially available medical items for DoD MTFs. Although DLA was provided acquisition responsibility for medical items that were not military unique, DLA was not providing the most cost-effective acquisition services. By using the acquisition services of DVA for those medical items that are not military unique as well as reducing its central procurement operations and realigning personnel acquisition resources, DoD could better use an estimated $48 million over the FY 1999 through FY 2004 Future Years Defense Plan. More benefits could accrue from paying lower prices for medical items.

DLA and DVA Acquisition Services

DLA acquisition services for medical items largely duplicated those provided by DVA. DLA essentially used the same acquisition techniques as DVA to engage suppliers to provide the same medical products.

Acquisition Strategies. DLA and DVA used the same acquisition strategies to provide customers with most medical items, either through "prime vendors" (distributors) or direct delivery from other distributors and manufacturers. Within the United States, DLA and DVA engaged at least 13 prime vendors to distribute pharmaceuticals, medical and surgical supplies, and small equipment. The use of prime vendors and direct delivery is essentially the adoption of commercial distribution practices that have been in use for some time by most commercial hospitals, clinics, and pharmacies in the United States.

Prime Vendor. Under the prime vendor process, a single vendor buys medical items from a variety of manufacturers and the inventory is stored in commercial warehouses. A customer orders the medical items from the prime vendor using electronic ordering systems at prices pre-negotiated by either DLA or DVA with distributors and manufacturers. The prime vendor ships most items to the customer the next day. Prime vendors were engaged by both DLA and DVA to manage and distribute many medical items within designated areas for a fee. DLA and DVA employed many of the same prime vendors, although not for the same areas. Prime vendors are the primary means of delivering medical items acquired under DAPAs and most FSS contracts.

Direct Delivery. Under direct delivery, a prime vendor is not engaged and the customer deals directly with the manufacturer. Direct delivery is the primary method of delivering medical items acquired under DBPAs, some FSS contracts, and equipment contracts.

The use of prime vendors and direct delivery meant that DLA and DVA no longer performed most of the traditional logistics functions in support of customers, such as processing requisitions and maintaining on-hand stock. DLA and DVA essentially provided only a contracting role. In this role, we could discern no major difference between DLA and DVA. Regardless of the acquisition instrument employed--whether a DAPA in the case of DLA, a supply schedule in the case of DVA, or a DBPA in the case of both DLA and DVA--the result was the same: distributors and manufacturers were engaged to provide medical items for set prices for given periods of time.

Commodity Groups. For management purposes, both DLA and DVA grouped the 11 medical classes into 3 commodity groups: pharmaceuticals, medical and surgical supplies, and equipment. As of September 30, 1997, DLA and DVA had acquisition responsibility for line items in the three commodity groups as shown in Table 1.

Table 1. FY 1997 Acquisition Responsibility for Medical Line Items

Medical Items by Commodity Group	Line Items Acquired by DLA	Line Items Acquired by DVA
Pharmaceuticals	25,102	21,666
Medical and surgical supplies	190,313	about 200,000
Equipment	selected contracts	about 18,100
Total	**215,415**	**239,766**

Our analysis of individual items within the three commodity groups showed that DLA and DVA engagements were not only with the same distributors and manufacturers but often for the same items.

Pharmaceuticals. DLA and DVA duplication in procuring pharmaceuticals was extensive. DLA and DVA each engaged medical manufacturers and distributors to sell more than 20,000 pharmaceutical products annually. More than 80 percent of the pharmaceuticals were distributed to DoD MTFs through prime vendors. We compared pharmaceutical products offered by DLA and DVA that had National Drug Codes (NDCs).[1] The comparison matched 15,727 NDCs between the two agencies, which meant they duplicated procurement support for 15,727 pharmaceutical products. Another significant portion of the pharmaceutical products could not be readily compared because the products, such as the containers used for dispensing prescriptions and

[1] NDCs are 11-digit numbers that identify the manufacturer, the item, the dosage, and the quantity pack of a particular pharmaceutical.

various over-the-counter cremes and lotions, did not have NDCs. However, there were thousands of those items without NDCs, meaning that duplication in procuring pharmaceuticals was probably much greater than the 15,727 products with matching NDCs.

Medical and Surgical Supplies. DLA and DVA duplication in procuring medical and surgical supplies was significant. As of September 30, 1997, DLA and DVA each engaged medical manufacturers and distributors to sell from 190,000 to 200,000 line items of medical and surgical supplies annually. Medical and surgical supplies are items not categorized as pharmaceuticals or investment equipment. Unlike pharmaceuticals, which have NDCs, medical and surgical supplies lack uniform product identification codes. Without uniform product coding for medical and surgical supplies and a complete automated database for all DVA items (only about 40,000 of 200,000 line items were automated), we could not effectively evaluate the duplication in acquiring medical and surgical supplies. However, DLA had tasked a contractor in September 1997 to perform an analysis of DLA and DVA medical and surgical items. The contractor determined that DLA offered 61.2 percent of 37,766 medical and surgical supplies downloaded from the DVA database.

Equipment. Duplication by DLA and DVA in procuring equipment was evident, but the extent of duplication could not be quantified. DLA mostly acquired equipment for MTFs by awarding individual contracts, whereas DVA awarded FSS contracts for about 18,000 equipment products. DVA did not maintain automated records that would enable a detailed comparison. Therefore, we judgmentally selected 44 DLA purchases for individual pieces of equipment and found that MTFs could have obtained the same equipment through DVA FSS contracts in 18 instances. Of the 18 purchases, DLA made 13 by placing orders on DVA FSS contracts, requiring DoD customers to pay the DLA surcharge ranging from 5.9 percent to 6.7 percent in addition to the DVA surcharge already included in the FSS contracts.

Military-Unique Items

Medical items acquired by DLA were predominately not unique to the military and were available through DVA. DLA records showed that of the 215,000 medical items it acquired, less than 0.05 percent (100 items) had a military-unique role. Nevertheless, DoD has historically held that maintaining its own central procurement capability for medical items was necessary because it bought the most medical items and only it could extend services to the Military Department supply systems. That DoD rationale may have been valid in the past. However, in FY 1997, DVA not only bought more medical line items than DoD but expended more than twice the funds on acquiring medical items centrally than DoD, as shown in Table 2.

Table 2. FY 1997 DoD and DVA Expenditures for Medical Items

Medical Items by Commodity Group	DoD Expenditures (in millions)	DVA Expenditures (in millions)
Pharmaceuticals	$750.7	$1,695.5
Medical and surgical supplies	119.8	233.8
Equipment	101.8	454.6
DBPA (includes all three commodity groups)	67.4	not reported
Total	**$1,039.7**	**$ 2,383.9**

Additionally, the compatibility of DLA and the Military Department supply systems has much less relevancy in the current logistics of commercially available medical items. MTFs seldom use the Military Department supply systems for medical items; instead, they deal directly with prime vendors or manufacturers or purchase the items locally.

DLA Perspective

In today's environment, DLA officials justify their central acquisition capability by pointing to the benefits gained from performing a readiness function, providing better customer support, and using improved business practices. However, the justification for DLA to continue its acquisition services for those reasons was not compelling.

Readiness Function. DLA performed a readiness function for medical items that DVA was not capable of, but the function did not necessitate the use of DLA acquisition resources. The readiness function involved identifying and making provisions for critical items that distributors or manufacturers may otherwise not be able to supply in sufficient quantities within predetermined time frames. Within DoD, the Military Departments identified less than 4 percent of the medical items that DLA acquires as critical and appropriate for identifying and making readiness provisions.[2] For those critical items, readiness provisions are identified and made by a group of about 60 technicians in the

[2] For the preponderance of medical items, the readiness function is not vital because DoD requirements in total represent only about 1 percent of the annual sales of manufacturers. Any increase in requirements should easily be satisfied within the existing inventory of distributors and the production capability of manufacturers. Also, the Military Departments require highly mobile units to keep 10 to 15 days of medical items on hand in the event of a quick deployment.

readiness business unit of the DSCP medical directorate. Separate acquisition groups within the medical directorate, with input from the readiness business unit, either negotiate surge options with prime vendors or, in some instances, actually buy and store items.

The same service provided by the DSCP acquisition groups could be provided by DVA. Although DVA did not have the readiness resources to identify and make readiness provisions, it had demonstrated, when called upon, the capability to provide the same acquisition services for medical items during a national emergency that DSCP had provided to the Military Departments. For example, responsible officials at the Army Medical Command told us that DVA successfully supported the deployment of Fort Hood units to Kuwait in 1996 by exercising surge options in prime vendor contracts for pharmaceuticals.

Customer Support. DLA and DVA provided similar customer support in terms of the number of different items offered to customers. Both DLA and DVA offered MTFs more than 200,000 line items in FY 1997. DVA offered its customers about 25,000 items more than DLA. The number of line items offered by both DLA and DVA well exceeded the buying trends of the MTFs we reviewed. For example, available records at the MTFs showed that no more than 15,000 different medical and surgical supplies were acquired during FY 1997, including fewer than 5,000 products on a recurring basis. Accordingly, the customer support now provided by DLA and required by DoD MTFs would appear well within the existing capability of DVA.

Business Practices. Both DLA and DVA either initiated or adopted commercial practices that made contracting for medical items more efficient. For example, DVA was the first to introduce the prime vendor concept to its customers in FY 1992. In 1997, DLA cut costs by introducing pre-packaged, pre-assembled consumable medical supplies designed for a specific medical procedure and medical facility. Indeed, DoD logistics and health care officials have alluded to us that the business benefits achieved through competition with DVA justify continued dual acquisition of medical items. However, the efficiencies gained internally from dual acquisition may have been offset by higher administrative costs of suppliers and, in turn, increases in medical item prices.

Industry Perspective

Selected manufacturers and prime vendors viewed dual acquisition channels for medical items as an inefficient Government operation.

Manufacturers. Manufacturers were critical of the dual acquisition practiced by DLA and DVA. We received 15 responses to 38 questionnaires that we sent to high-volume manufacturers that sold medical items to the Government. Of the 15 respondents, 11 stated that they had incurred additional administrative costs from dealing with multiple Government agencies. The manufacturers stated that the additional administrative costs were the result of coping with

different operating systems and regulations, performing duplicative functions, and having more paperwork. Some of the specific comments or concerns made by manufacturers were:

"DoD requirements do not mirror commercial market realities or practices."

"The FSS Program can do the entire job with a fraction of the hassle."

"We see no advantage in duplicate contracts serving one market sector."

Prime Vendors. A representative of the Health Industry Distributors Association and six prime vendor representatives who we interviewed were critical of the dual procurement by DLA and DVA for medical items. All the representatives were consistent in their statements citing the needlessness of dual acquisition. The representatives stated that the Government's dual acquisition of medical items caused the distributors to incur additional administrative expense from bidding multiple contracts and maintaining separate records for DLA and DVA.

Customer Perspective

MTF customers often satisfied their needs for medical items locally and the balance of their requirements could be satisfied by either DLA or DVA. MTF customers obtained medical items locally through local contracts and Government credit cards and centrally through prime vendors and DLA depots. To determine the buying methods (locally and centrally) for the different categories of medical items, we evaluated nine MTFs that purchased more than $274.4 million of medical items in FY 1997. See Appendix E for the nine MTFs we evaluated.

o To obtain pharmaceuticals, six MTFs used DLA prime vendors and three used DVA prime vendors. Prime vendors supplied between 81 percent and 92 percent of the pharmaceuticals used by the nine MTFs. The balance of pharmaceuticals was obtained through local contracts, Government credit cards, or DLA depots.

o To obtain medical and surgical supplies, eight MTFs used DLA prime vendors and one had contracted its own prime vendor. However, the prime vendors were not the primary source of supply for the MTFs. Prime vendors supplied only between 12 percent and 45 percent of the medical and surgical supplies used by the MTFs. Based on available records, the nine MTFs purchased, on average, at least two-thirds of their medical and surgical supplies through local contracts or local purchases using Government credit cards. A small amount was also obtained through DLA depots.

o To obtain equipment, five MTFs generally satisfied their needs locally, except for a few specialty buys that were handled by either DLA or DVA. Of the other four MTFs, one preferred DLA, two preferred DVA, and one used a mix of DLA, DVA, and local sources.

As a single acquirer of medical items, DVA could have satisfied the central buying needs of DoD MTFs and often at less cost. The decision to use prime vendors contracted by either DLA or DVA seemed to be based more on precedence than on the result of in-depth evaluation. Responsible officials at the nine MTFs expressed preferences for certain aspects of both DLA and DVA acquisition services but cited operational requirements and cost as the main reasons they might use to choose between DLA and DVA acquisition support.

Operational Requirements. The most important operational requirement issue with MTFs was response time in delivering needed products. Responsible officials at MTFs discounted the issue of readiness, stating that they expected to transition to mobilization with the same vendors. To measure response time in delivering needed products, medical contracts require prime vendors to meet "fill rates." As such, the salient factor in satisfying the operational requirements of MTFs was not who engaged the prime vendor but whether the prime vendor could deliver the needed products within an established time frame. At the nine MTFs we reviewed, the fill rates for pharmaceuticals were consistently 95 percent or better regardless of whether DLA or DVA contracted the prime vendor. From the standpoint of contracting a prime vendor to deliver items to MTFs, both DLA and DVA did the job equally well.

Cost of Medical Items. Although cost of medical items was the second most important logistics issue with MTFs, only two of the nine MTFs we reviewed could produce documentation of performing a product price comparison between DLA and DVA. One of the two MTFs, which was supported by a DVA prime vendor, had concluded that DVA prices were generally better. The second MTF, which had formerly been supported by a DVA prime vendor, had concluded that DLA prices were generally better based on an analysis performed by DSCP; however, the price comparison omitted the DLA prime vendor distribution fee.

Our price comparison of pharmaceutical products showed that DVA prices were lower for 83 percent of 200 items reviewed. Using DLA prime vendor sales data for the top 200 pharmaceuticals sold to DLA customers as of July 1997, we compared DLA prices to DVA FSS contract prices (including surcharges). Our comparison showed that DVA prices were lower for 165 of the 200 items. Significant variances occurred only when either DLA or DVA entered into contracts that guaranteed large sales of particular items. For 123 items, the variances were small, less than 1 percent of the price of the item, and reflected the higher cost DLA has of doing business.

The analysis of duplicate medical and surgical supplies that DLA tasked to a contractor in September 1997 also compared prices. That analysis showed that DVA prices (with its surcharge) for medical and surgical supplies were equal to or lower than DLA prices (without its surcharge) for 56.8 percent of the comparable items.

Benefits From Single Acquisition

DoD could better use an estimated $48 million over the FY 1999 through FY 2004 Future Years Defense Plan by using the acquisition services of DVA for those medical items that are not military unique, reducing its central procurement operations, and realigning acquisition personnel resources. More benefits could accrue from paying lower prices for medical items.

Surcharge Savings and Personnel Realignment. Use of DVA for acquisition of medical items that are not unique to the military could provide DoD MTFs with significant savings in surcharge costs. Most of the DLA central procurement operations for medical items could be reduced and the acquisition personnel resources realigned. During FY 1997, DoD MTFs used DLA acquisition services to purchase about $1 billion of medical items and, at a minimum, were charged 1.3 percent for items obtained through prime vendors to pay for DLA acquisition services and other costs; higher surcharge rates were charged for equipment and other items not obtained through prime vendors. In contrast, DVA charged its customers 0.5 percent for pharmaceuticals and medical and surgical supplies; higher surcharge rates were charged for equipment but still had at least an 0.8 percent difference from what DLA charged.

The difference of 0.8 percent in DLA and DVA surcharge rates for all medical items reflects the cost of doing business and lies, in part, in the number of personnel employed by each Government agency to perform acquisition services. DLA employed about 340 individuals at DSCP for the acquisition-related support of about 215,000 line items. DVA employed about 100 individuals at its National Acquisition Center for the acquisition-related support of about 240,000 line items. Accordingly, much of the $46 million that DLA spent on labor and nonlabor expenses to support the acquisition of medical items by MTFs would not have been incurred by DVA, which would have been reflected in lower charges to DoD MTFs. Based on DVA charging its customers a 0.5 percent surcharge, and assuming DoD medical requirements will remain constant, DVA would charge DoD MTFs about $48 million less than DLA over the FY 1999 through FY 2004 Future Years Defense Plan ($1 billion times 0.8 percent [1.3 percent minus 0.5 percent] times 6 years). That $48 million would be funds from the Military Department operation and maintenance appropriations that could be put to better use. Additionally, the 340 DLA positions devoted to medical item acquisition could be realigned with work load more consistent with the DLA combat support mission.

We recognize that DLA and DVA operations cannot be related exactly and many variables exist in projecting benefits from using DVA services. We also recognize that DVA did not contract for all the medical line items bought by DoD MTFs in FY 1997 and that DLA did obtain some prices that were better than DVA prices. However, we believe our computation of benefits is reasonable considering that we used the minimum difference in surcharge rates to compute benefits and that DVA already buys much of the medical items now supported centrally by DLA.

Lower Prices. Through consolidation of customer requirements, the MTFs could accrue additional benefits from lower prices for medical items. Generally, suppliers give better prices to customers based on market share. Under the DoD and DVA Shared Procurement Program (the Program) for medical supplies, DLA and DVA avoided dual acquisition by dividing medical items common to both their acquisitions programs and awarding indefinite-delivery contracts to single suppliers of the items. Under the Program, each Government agency essentially leveraged the requirements of the entire Federal Government to obtain better prices. Over the 13 years that the Program was in full operation, about $702 million was realized from reduced product costs, avoided inflation costs, and lowered administrative expenses. DLA and DVA discontinued using the Program with the advent of the Prime Vendor Program, which negated some of those advantages. At the height of the DoD and DVA Shared Procurement Program, about half the dollar value of medical items acquired by DoD MTFs was through a single buyer. Under the Prime Vendor Program, the same medical items, except for a handful of equipment-type items, were contracted for by both DLA and DVA. Further, manufacturers and prime vendors incurred additional administrative expense from dealing with two Government agencies. Accordingly, an opportunity exists to put millions of dollars to better use if DVA were to consolidate the requirements of the Government, including DoD, to achieve larger volume buying discounts.

Summary

In an era of downsizing and shrinking budgets, the use of DoD acquisition resources to purchase commercially available medical items is unwarranted. No perceptible advantage was gained from DoD using scarce resources to perpetuate the dual acquisition of medical items when another Federal department could purchase medical items with no reduction in readiness and at less cost. Commercial suppliers of medical items found it burdensome to deal with multiple Government agencies for the same products and would welcome more streamlined procedures. Transferring the acquisition responsibility for commercially available medical items to DVA would also allow DoD to put millions of dollars to better use and would be in accord with long-standing studies advocating single acquisition of medical items. It would also be in the spirit of Public Law 105-85 and the DoD November 1997 reform initiative.

Recommendation, Management Comments, and Audit Response

We recommend that the Under Secretary of Defense for Acquisition and Technology transfer acquisition responsibility to the Department of Veterans Affairs for all medical items except those categorized as military unique and realign personnel acquisition resources accordingly.

Management Comments. The Acting Principal Assistant Deputy Under Secretary of Defense (Logistics) partially concurred, and stated that, to eliminate avoidable overlap in Federal acquisition programs, DLA will form a team to work with DVA to eliminate duplication where possible. He also stated that DLA will initiate actions to address specific issues raised by the draft report. He did not agree to the recommended transfer of medical acquisition responsibility to DVA. Although the DVA prime vendor performed admirably in successfully meeting the challenges of supporting the deployment of units from Fort Hood to Kuwait, it cannot be concluded that DVA can assume all readiness functions now performed by DLA on the basis of this quite limited deployment situation. He added that a report on the progress of both negotiations with DVA and internal DLA actions will be provided by November 30, 1998.

Audit Response. Although the Acting Principal Assistant Deputy Under Secretary of Defense (Logistics) partially concurred with the recommendation, we consider his comments not fully responsive. His proposed alternatives offer limited prospect for eliminating duplication in acquiring medical items and achieving potential monetary benefits. For the past 20 years, DLA and DVA have had an agreement, at the request of the Office of Management and Budget, to eliminate duplication in acquiring medical items. Our audit showed that extensive duplication still exists despite the interest and actions of two, high-level Government working groups focusing on eliminating the duplication since 1994. Based on the history of the two departments for resolving this issue, we believe that forming a DLA team to work with DVA to eliminate duplication "where possible" will only perpetuate the status quo. That is, because DVA is the designated manager of the Federal Supply System for acquiring commercially available medical items for the Federal Government, it has no incentive or reason to reduce its work load. Conversely, DLA maintains an adamant position on readiness as an issue in the acquisition of commercially available medical items. We disagree with the DLA position on readiness and, specifically, excluded readiness functions and associated resources in our recommendation to transfer acquisition responsibility to DVA. The specific acquisition responsibility that duplicates DVA responsibility, and is clearly "avoidable overlap," is that of negotiating prices for medical items and awarding contracts to medical manufacturers and prime vendors. We continue to believe there is no inherent readiness connection to providing those acquisition services.

To disagree with our recommendation on the basis that DVA has limited experience in deployment situations is really a rebuttal against the use and capability of prime vendors. Prime vendors are the critical players in meeting

the supply needs of MTFs during deployment, not DLA or DVA. Prime vendors are engaged to fill peacetime needs and to surge when larger quantities of supplies are needed for deployments. The same prime vendor engaged by DVA to support Fort Hood, and which has proven its ability to meet surge requirements, is also engaged by either DVA or DLA to support 10 other DoD MTFs. Accordingly, we request that the Acting Principal Assistant Deputy Under Secretary of Defense (Logistics) reconsider his position on the recommendation and potential monetary benefits, and provide additional comments on the final report.

Part II - Additional Information

Appendix A. Audit Process

Scope and Methodology

This audit is the fourth in a series of audits of the dual management of commercially available items by DLA and other Government organizations. The first three audits dealt with determining the extent and cost-effectiveness of DLA acquiring specific categories of items concurrent with GSA. This audit deals with determining the extent and cost-effectiveness of DLA acquiring medical items concurrent with DVA.

To determine the cost-effectiveness of DLA acquiring medical items concurrent with DVA, we compared the services provided by DLA, the DoD central buyer of medical items, to the services provided by DVA; analyzed the added value of acquisition services performed by DLA; and reviewed the buying needs of MTFs. To gain a historical perspective on how dual purchasing occurred and perpetuated, we obtained and reviewed prior audit reports from 1976 to the present by the Inspector General, DoD, and the General Accounting Office, as well as directives, memorandums, and agreements from the Office of Management and Budget, DoD, DVA, and GSA, dated December 1960 through November 1997. We also interviewed responsible officials from those organizations.

To compare the services provided by DLA and DVA, we analyzed each organization's approach to buying medical items and product selection. For our analysis of buying approach, we looked at contract methods, the provisions of the contracts, and means of distribution. For our analysis of product selection, we compared the three general categories of medical items: for pharmaceuticals, we matched DLA and DVA databases using NDCs; for medical and surgical supplies, we reviewed a September 1997 contractor-performed analysis requested by DLA; and, for equipment, we compared our own judgment sample of 44 FY 1997 purchases by DLA to DVA FSS contracts.

To analyze the added value of acquisition services performed by DLA, we analyzed benefits purported in the areas of readiness, customer support, and business practices. For readiness, we discussed the computation of mobilization requirements with Military Department logistics and medical officials and reviewed the functional requirements of the medical directorate at DSCP. For customer support, we compared the number of different medical items offered by DLA and DVA during FY 1997 to the number of different medical items required by nine MTFs. For business practices, we reviewed DLA and DVA initiatives and discussed the pros and cons of dual acquisition with DoD officials. We also solicited the opinions of manufacturers and distributors about dealing with multiple Government agencies for the same items. To determine how manufacturers viewed dual acquisition, we sent 38 questionnaires to the top sellers of medical items to the Government. The 15 manufacturers that responded represented about $655 million in sales to the Government during

1996. To determine how prime vendors viewed dual acquisition, we personally interviewed representatives of the six prime vendors that served Army, Navy, and Air Force MTFs. We also interviewed a representative of the Health Industry Distributors Association.

To review the buying needs of MTFs, we selected nine MTFs: three that served the needs of the Army, three the Navy (including the Marine Corps), and three the Air Force. They were representative of large and medium sized MTFs within DoD. All nine were also on or near bases that would experience different stages of mobilization. Additionally, some of the MTFs were current or former customers of prime vendors contracted by DVA. At the MTFs, we obtained, as available, FY 1997 logistics databases to ascertain MTF buying habits (local or central acquisition) for each of the categories of medical items. We also discussed with responsible officials at MTFs the performance attributes that would make DLA or DVA the preferred source of acquisition support. For the two most important attributes--filling operational needs and lower costs--we compared the performance of DLA and DVA. For filling operational needs, we obtained and reviewed reports on contractor fill rates. For lower costs, we obtained and analyzed cost comparisons prepared by MTFs, if available. We also reviewed a September 1997 contractor-prepared cost analysis requested by DLA, and we performed our own analysis on a sample of the 200 highest selling pharmaceuticals acquired by DLA. The pharmaceuticals represented 46 percent of the pharmaceuticals sold to MTFs over a 4-month period ending September 30, 1997.

Also, to support our audit conclusion, we analyzed the benefits that would accrue from single acquisition of medical items. To compute potential fund reductions and personnel benefits, we obtained and compared FY 1997 funding, surcharge rates, and staffing records for the medical directorate of DSCP and the National Acquisition Center of DVA. To show potential discounts from larger volume buying, we obtained and reviewed historical documents maintained by DSCP on the DoD and DVA Shared Procurement Program for medical items for the period June 1978 through November 1993.

Use of Computer-Processed Data. For the audit, we collected computer-processed data from multiple sources including the Military Departments, DLA, DVA, and Government contractors. The primary sources of computer-processed data from DLA and DVA were the bulletin boards at DSCP and DVA. We also obtained automated records of medical item acquisitions and the pricing of items from prime vendor computer systems. The reliability of computer-processed data used in our analyses of medical items was not determined. However, the reliability of the data would not materially affect the audit results.

Audit Type, Dates, and Standards. We performed this economy and efficiency audit from July 1997 through February 1998 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included tests of management controls considered necessary.

Contacts During the Audit. We visited or contacted individuals and organizations within the Office of Management and Budget, DoD, DVA, GSA, the Health Industry Distributors Association, and commercial distributors and manufacturers of medical items. Further details are available on request.

Management Control Program

DoD Directive 5010.38, "Management Control Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of Review of Management Control Program. We reviewed the adequacy of DLA management controls to avoid duplication of effort in the acquisition of medical items. DLA management controls are operating as intended. Because we did not identify a material weakness, we did not assess management's self-evaluation.

Adequacy of Management Controls. DLA management controls were effective in that we identified no material management control weakness.

Appendix B. Summary of Prior Coverage

During the past 5 years, three audit reports have been issued that related to the dual management of items by DLA and other Government agencies. The three audit reports are summarized below.

Inspector General, DoD, Report No. 98-144, "Dual Management of Commercially Available Items - Information and Imaging Solutions," June 3, 1998. The report states that the DLA information and imaging solutions initiative duplicated and competed with the GSA, National Industries for the Blind, and other DLA procurement and supply programs. The report recommended that management controls be established to prevent duplication of DLA commercial item procurement initiatives with centralized procurement programs of other Government organizations. The Acting Principal Assistant Deputy Under Secretary of Defense (Logistics) concurred with the recommendation, stating that DLA will minimize the duplication of centralized procurement programs of Government organizations. In its contracting actions, DLA should be aware of potential overlaps and make a judgment in each case. At the direction of DLA, the Defense Industrial Supply Center canceled the solicitation for information and imaging solutions on March 10, 1998. The comments from the Acting Principal were generally responsive but we requested additional comments to clarify planned actions.

Inspector General, DoD, Report No. 98-037, "Dual Management of Commercially Available Items--Battery, Food Service and Photographic Products," December 12, 1997. The report states that DLA duplicated integrated materiel management of the commodities reviewed. The report recommended that duplication by DLA and GSA in procuring battery, food service, and photographic products be eliminated. It also recommended that DoD requisitioners be reminded that they have the authority to use sources of supply other than the integrated materiel manager when the other sources of supply offer the best value. The Deputy Under Secretary of Defense (Logistics) concurred with the recommendation to eliminate duplication in procuring items in the Federal Supply Classes included in the audit and to issue a reminder to the Military Departments concerning the flexibility they have in obtaining materiel from various sources of supply. DLA partially concurred and agreed that both DLA and GSA procure DLA-managed items; however, DLA was working to provide the customer multiple sources of supply and a range of services. DLA nonconcurred with the recommendation to provide a written analysis that identified items that GSA is best suited to procure and suggested that an analysis would be nonproductive. DLA concurred with the recommendation to provide justification for retaining the management of items of the Federal Supply Classes that are not predominately military or classified as nonessential. We believe that DLA resources should not be directed toward procuring common commercial items that are available to DoD customers through GSA.

Inspector General, DoD, Report No. 97-205, "Dual Management of Commercially Available Items--Defense Logistics Agency Electronic Catalog," August 15, 1997. The report states that portions of the DLA electronic catalog program duplicated GSA supply programs, particularly the FSS and Advantage programs. The report recommended that duplication between the electronic catalog and GSA supply programs be eliminated and that management controls be established to prevent duplication of DLA commercial-item procurement initiatives with centralized procurement programs of other Government organizations. DLA nonconcurred with the recommendations and stated that the electronic catalog supported the National Performance Review and will assist DLA in reengineering its business practices to implement new ways and better ways of doing business in support of its customers. DLA further stated that the 12- to 18-month period catalog demonstration will provide valuable sales information to determine which commercial catalog items are most important in the operational support of the Armed Forces. In mediation, DLA agreed to do a customer survey in coordination with the Inspector General, DoD.

Appendix C. Federal Supply Group 65

Federal Supply Group 65 has 11 classes.

Class	Description
6505	drugs, biologicals, and official reagents
6508	medicated cosmetics and toiletries
6510	surgical dressing materials
6515	medical and surgical instruments, equipment, and supplies
6520	dental instruments, equipment, and supplies
6525	X-ray equipment and supplies; medical, dental and veterinary
6530	hospital furniture, equipment, utensils, and supplies
6532	hospital and surgical clothing and textile special purpose items
6534	optician instruments, equipment, and supplies
6545	medical sets, kits, and outfits
6550	in vitro diagnostic substances, reagents, test kits, and sets

Appendix D. Significant Initiatives to Eliminate Duplication

Over the past 33 years, a number of initiatives were undertaken to eliminate duplication among Federal Departments in centrally acquiring commercially available items. Following is a summary of the more significant initiatives.

o **December 1964.** DoD and GSA agreed to eliminate any unnecessary duplication and overlap within the Government supply system and to establish a sound and continuing basis for assignment of responsibility for management of commodities determined to be susceptible to integrated management within DoD and those susceptible to integrated management within the Federal Government as a whole. DoD agreed to consider (but eventually declined) supporting all Federal agencies with medical items.

o **February 1971.** DoD and GSA agreed to eliminate avoidable duplication and overlap within their respective supply systems and those of other Federal agencies. The agreement assigned management responsibility to GSA for those Federal Supply Classes or commodities commonly used by Federal agencies that were commercially available on the civilian economy and not predominately of a military nature. The agreement assigned to the Defense Supply Agency (now DLA) the management responsibility for those Federal Supply Classes or commodities commonly used in military operations or weapon support, irrespective of their use by civilian agencies. As an exception, the agreement specifically noted that notwithstanding their basic commercial nature, medical items were considered appropriate for management by the Defense Supply Agency.

o **January 1978.** The Office of Management and Budget requested the Secretary of Defense and the Administrator of Veterans Affairs (now the Secretary, DVA) to develop a cooperative arrangement by which the responsibility for central purchase of all medical items would be divided between their agencies without duplication. The arrangement was to include provisions for the joint development and use of requirements-type contracts and the establishment of item entry controls to preclude duplicate purchasing of new items.

o **June 1978.** DoD and the Veterans Administration (now DVA) agreed to divide the purchasing responsibility, without duplication, for medical items; develop an item entry control system to preclude duplicate purchasing of new items; establish procedures to review, simplify, and eliminate the multiplicity of specifications for medical items; form task groups to develop plans to implement the agreement; and form a Joint Steering Group to furnish policy guidance to the task groups. Subsequently, DoD and the Veterans Administration partnered a joint procurement project called "Improving Purchasing and Supply Management" or shared procurement. The primary focus of that agreement was on depot-stocked items. Each agency wrote

non-duplicative contracts that leveraged their combined requirements for advantageous pricing. Either agency could place orders. The program was implemented in FY 1981.

o **January 1994.** The Interagency Committee on Supply Management, Working Group No. 2, was chartered by GSA to designate specific agency responsibility for Government-wide contracting authority for specific classes or groups of items. The intent was to eliminate redundant contracting responsibilities between agencies; to take advantage of agency expertise for given commodities and services; and to benefit from the aggregated buying power. The finding of the group was that DoD and DVA, the two agencies primarily looked at, were not prepared to change their procurement processes and authority.

o **July 1995.** The Vice President requested a joint study of ways to reinvent and integrate the DoD and DVA Health Care Systems. As a result, a Combined Purchasing Work Group was established in April 1996 to evaluate, as one of several administrative and operational initiatives, the use of DoD and DVA combined purchasing power to reduce costs and improve services. The work group believed that substantial, increased leverage might be achieved through an integrated DoD and DVA purchasing effort.

Appendix E. Medical Treatment Facilities Reviewed

During FY 1997, DoD operated 586 MTFs, comprised of 115 hospitals, including medical centers, and 471 clinics. The nine MTFs we selected for review included three MTFs each from the Army, the Navy (including the Marine Corps), and the Air Force. The selected MTFs purchased more than $274.4 million of medical items in FY 1997. The nine selected MTFs were:

Brooke Army Medical Center, Fort Sam Houston, Texas
Evans Army Community Hospital, Fort Carson, Colorado
Womack Army Medical Center, Fort Bragg, North Carolina
Naval Medical Center, Portsmouth, Virginia
Naval Hospital, Naval Training Center, Great Lakes, Illinois
Naval Hospital, Marine Corps Air Station, Cherry Point, North Carolina
Keesler Medical Center, Keesler Air Force Base, Mississippi
Wilford Hall Medical Center, Lackland Air Force Base, Texas
Wright-Patterson Medical Center, Wright-Patterson Air Force Base, Ohio

Appendix F. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
  Deputy Under Secretary of Defense (Acquisition Reform)
  Deputy Under Secretary of Defense (Logistics)
    Assistant Deputy Under Secretary of Defense (Materiel and Distribution Management)
  Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)
Assistant Secretary of Defense (Health Affairs)
Assistant Secretary of Defense (Public Affairs)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
  Commander, Defense Supply Center Philadelphia
Director, National Security Agency
  Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
General Accounting Office
National Security and International Affairs Division
Technical Information Center
Inspector General, General Services Administration
Inspector General, Department of Veterans Affairs

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology, Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, Criminal Justice, Committee on Government Reform and Oversight
House Committee on National Security

Part III - Management Comments

Acting Principal Assistant Deputy Under Secretary of Defense Logistics Comments

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ACQUISITION AND TECHNOLOGY
(L/MDM)

27 MAY 1998

MEMORANDUM FOR DOD INSPECTOR GENERAL
THROUGH: CAIR

SUBJECT: Draft Audit Report on Acquisition of Medical Items (Project No. 6LD-5044.01)

This responds to your memorandum of March 30, 1998, on the subject draft audit report. One recommendation was addressed to the Under Secretary of Defense for Acquisition and Technology. Our detailed comments on that recommendation are included in the attachment.

James B. Emahiser
Acting Principal Assistant Deputy
Under Secretary of Defense (Logistics)

Attachment

cc: Director, DLA

ATTACHMENT

"We recommend that the Under Secretary of Defense for Acquisition and Technology transfer acquisition responsibility to the Department of Veterans Affairs for all medical items except those categorized as military unique and realign personnel acquisition resources accordingly."

This office partially concurs with the recommendation. We agree with the intent of the recommendation, which is to eliminate avoidable overlap in Federal acquisition programs. Toward that end, the Defense Logistics Agency (DLA) will form a team to work with the Department of Veterans Affairs (DVA) to eliminate duplication where possible. In addition, DLA will initiate actions internally to address specific issues raised by the draft report. For example, the surcharge on purchases made through DVA contracts (discussed on page 7 of the report) will be reviewed to ensure that charges assessed are commensurate with the level of service provided. Alternatives such as lower surcharges or the imposition of a flat fee in such cases will be considered. A report on the progress of both negotiations with DVA and internal DLA actions will be provided by November 30, 1998.

We do not agree with the report's finding on page 9 that, based on a 1996 deployment of units from Fort Hood to Kuwait, DVA has demonstrated the capability to provide the same acquisition services for medical items during a national emergency that DLA currently provides for the Military Departments. While the DVA prime vendor contractor performed admirably in successfully meeting the challenges of this particular event, we cannot conclude that DVA can assume all readiness functions now performed by DLA on the basis of this quite limited deployment situation. Therefore, we do not agree to the recommended transfer of medical acquisition responsibility to DVA. Rather, we propose that the actions outlined above and the resulting report be used to increase efficiencies while maintaining the essential medical readiness capability provided by DLA.

Audit Team Members

This report was prepared by the Readiness and Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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