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March 28, 2006

# Acquisition Management

## Report on the Procurement Processes and Procedures for the C-40 Lease and Purchase Programs and C-22 Replacement Program (C-40)

(D-2006-066)

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**Acronyms**

| | |
|---|---|
| DFAS | Defense Finance and Accounting Service |
| FAAA | Final Acquisition Action Approval |
| FAR | Federal Acquisition Regulation |
| IOC | Initial Operational Capability |
| IPT | Integrated Process Team |
| NIPRNet | Non-secure Internet Protocol Router Network |
| PNM | Price Negotiation Memorandum |
| SAF/AQ | Office of the Assistant Secretary of the Air Force (Acquisition) |
| SIPRNet | Secret Internet Protocol Router Network |
| USD(AT&L) | Under Secretary of Defense for Acquisition, Technology, and Logistics |

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March 28, 2006

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION, TECHNOLOGY, AND LOGISTICS
ASSISTANT SECRETARY OF THE AIR FORCE (ACQUISITION)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
AUDITOR GENERAL, DEPARTMENT OF THE AIR FORCE
DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY

SUBJECT: Report on the Procurement Processes and Procedures for the C-40 Lease and Purchase Programs and C-22 Replacement Program (C-40) (Report No. D-2006-066)

We are providing this report for your information and use. No written response to this report is required. The Under Secretary of Defense for Acquisition, Technology, and Logistics requested this audit. In response to admissions by Ms. Darleen Druyun, the former Principal Deputy Assistant Secretary of the Air Force (Acquisition and Management), that she may have allowed personal interests to affect her judgment on acquisitions she made from 1993 to 2002, the Under Secretary of Defense for Acquisition, Technology, and Logistics commissioned an internal study. During the course of the study, the C-40 Lease and Purchase Programs and C-22 Replacement Program (C-40) were identified for further review.

The overall objective of the audit was to determine whether the C-40 Lease and Purchase Programs and C-22 Replacement Program (C-40) were procured in accordance with the Federal Acquisition Regulation (FAR). Specifically, we evaluated the acquisition decisions regarding the C-40 Lease and Purchase Programs and C-22 Replacement Program (C-40). In addition, we determined whether the contractor payments were made in accordance with the FAR.

We concluded that the contracting actions of the Air Force were fair and reasonable. We also determined that the contractor payments at the time of the award were reasonable and in compliance with the FAR. Furthermore, we found no evidence that Darleen Druyun exerted improper influence over the procurement decisions or contract actions.

We appreciate the courtesies extended to the audit staff. If you have any specific questions or desire additional information about this audit or report, contact Mr. Raymond D. Kidd at (703) 325-5515 or Ms. Linda A. Pierce at (216) 706-0074 x234.

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# Introduction

**Background.** The C-22 (Boeing 727) aircraft and Commander support aircraft provided worldwide transportation for regional Commanders, other senior government officials, and foreign dignitaries. The aging C-22 (Boeing 727) aircraft needed to be replaced because of operational restrictions and the commercial market phasing out the platform. Other aircraft supporting Commander missions were also aging and needed to be replaced. The C-40 series aircraft was selected to replace both the C-22 (Boeing 727) aircraft and Commander support aircraft.

**Audit Request.** We performed this audit at the request of the Under Secretary of Defense for Acquisition, Technology, and Logistics (USD[AT&L]). An internal study commissioned by the USD(AT&L) was conducted in November 2004 in response to admissions by Darleen Druyun, the former Principal Deputy Assistant Secretary of the Air Force (Acquisition and Management), that she may have allowed personal interests to affect her judgment on acquisition decisions she made from 1993 to 2002. The study was designed to determine whether further reviews were necessary on Air Force acquisition actions that Druyun was involved in during her tenure; the C-40 Lease and Purchase Programs and C-22 Replacement Program (C-40) were identified for further review. The USD(AT&L) requested that we determine whether issues surrounding those programs were actual problems or reasonable contract actions.

**Audit Objectives.** The overall objective of this audit was to determine whether the C-40 Lease and Purchase Programs and C-22 Replacement Program (C-40) were procured in accordance with the FAR. Specifically, we evaluated the acquisition decisions regarding the C-40 Lease and Purchase Programs and C-22 Replacement Program (C-40). In addition, we determined whether the contractor payments were made in accordance with the FAR.

## Acquisition of the C-40 Aircraft

**Sole Source Determination.** [redacted] The [redacted] contract was a sole source firm-fixed-price contract with Boeing for one C-40B aircraft to be used as a Commander support aircraft. Under the [redacted] contract, a commercial "green aircraft"[1] was customized to meet the C-40B mission requirements. In addition, the contract called for 10 successive option years of support services. The purchase was a commercial acquisition using FAR Part 12, "Acquisition of Commercial Items."

The C-40B is a modified Boeing Business Jet 737-700 intercontinental executive transport with military-unique flight deck features; a secure voice, data, and fax passenger communication system; and a passenger data system. The data system can [redacted] The mission of the

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[1] "Green aircraft" are aircraft directly off the assembly line before being customized for the owner. They actually have a green protective coating before they are outfitted and painted.



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C-40B aircraft is to transport the Commanders to locations throughout the world to conduct command responsibilities.

**Acquisition History.** The FY 1999 Senate Appropriations Committee Report (Senate Report 105-200) tasked the Deputy Secretary of Defense and the Vice Chairman of the Joint Chiefs of Staff to present a Commander support aircraft consolidation plan to submit to the congressional defense committees no later than March 1, 1999. The Senate Report states that the DoD lacked reliable, affordable, and appropriate aircraft assets to meet Commander support aircraft requirements. DoD prepared a "Consolidation and Replacement Plan for CINC[2] Support Aircraft" (J-8 study) signed on March 8, 1999, by the Deputy Secretary of Defense and the Vice Chairman of the Joint Chiefs of Staff. DoD agreed with the assessment that the existing Commander fleet needed to be replaced.

The FY 2000 Defense Appropriations Act Conference Report included a $63 million plus-up for one operational support aircraft. The FY 2000 House Appropriations Committee Report 106-244, July 20, 1999, referred to the operational support aircraft as a Boeing 737-700ER for Commander, U.S. Central Command. On April 1, 1999, Druyun signed and approved the Milestone 0 Acquisition Decision Memorandum for the Commander Aircraft Replacement Program and authorized the beginning of the acquisition phase.

On March 20, 2000, the Assistant Secretary of the Air Force (Acquisition) signed the Final Acquisition Action Approval (FAAA) of the actions described in the Justification and Approval document. The FAAA was signed with the exception that the contract award not go into effect until the approved Air Mobility Command Operational Requirements Document for the "CINC Support Aircraft Replacement Program" defined the requirement for a 737-700 type aircraft. Headquarters Air Mobility Command prepared the "Operational Requirements Document, CINC Support Aircraft Replacement Program" (ORD), May 19, 2000. The Air Force Acting Associate Deputy Assistant Secretary (Contracting) signed a memorandum, June 21, 2000, which stated that the ORD defined the requirement for a Boeing 737-700 type aircraft and that the FAAA exception was cleared, allowing the program office to proceed with the planned schedule of contract actions.

The main justification for the sole source procurement of the C-40 aircraft was contained in the Justification and Approval document, which stated that the Initial Operational Capability (IOC) date for the aircraft was July 2001. The Aeronautical Systems Center at Wright-Patterson Air Force Base conducted market research to determine sources capable of providing a missionized aircraft and associated contractor logistical support by the IOC date. Boeing was the only source capable of providing an aircraft and associated contractor logistical support to meet the mission requirement and the IOC date. Specifically, the Aeronautical Systems Center found that because of the aircraft's unique configuration and the Commander mission, Boeing was the only source that could maintain the aircraft in its modified configuration, support the communication system, and establish operations by the IOC date.

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[2] "Commander-in-Chief" (CINC) was formerly used as a title for military officers. In an October 24, 2002, memorandum, the Secretary of Defense discontinued the use of the title and acronym for military officers. The term was replaced with the title "Commander," as used throughout this memorandum, unless in reference to a specific program or document. The title "Commander-in-Chief" is currently used exclusively for the President of the United States.



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An Integrated Process Team approach was used to develop the Air Force pricing objective for the C-40B aircraft purchased under contract [redacted] The price under contract [redacted] was used as the basis to negotiate the prices for additional C-40B/C aircraft [redacted] Contract [redacted] permitted the Government to acquire up to seven C-40 series aircraft and support; the contract was awarded under FAR Part 12, "Acquisition of Commercial Items."

**Conclusion.** The contracting actions were reasonable, and the Air Force did not pre-determine Boeing as sole source for the C-40 procurement. The determinations made in the Justification and Approval document clearly demonstrated that Boeing was the only available source capable of meeting the aircraft requirements and the IOC date. In addition, we found no evidence that Darleen Druyun exerted improper influence over the procurement decisions or contract actions.

## C-40 Lease Program

**Summary of Legislation.** Section 8159 of the DoD Appropriations Act for FY 2002 (Multi-Year Aircraft Lease Pilot Program) provided authority for the Secretary of the Air Force to lease and make payments on up to four Boeing 737 aircraft in a commercial configuration. The lease was not to exceed 10 years per aircraft inclusive of any options to renew or extend the initial lease term. In addition, the lease was not to exceed 90 percent of the fair market value of the aircraft. Increased travel requirements resulting from the events of September 11, 2001, mandatory retirement of aging aircraft, and on-going modernization programs resulted in a shortfall of airlift capacity in the Air Force Special Air Mission Fleet. To alleviate this operational shortfall, the Air Force leased four C-40 aircraft under the authority of Section 8159.

**Description of C-40 Lease Program.** The Boeing 737 Multi-Year Aircraft Lease Pilot Program was a sole source acquisition utilizing commercial business practices. The Air Force awarded a single firm-fixed-price multi-year contract to Boeing for three leased C-40Cs and one leased C-40B, plus insurance costs. The aircraft lease contract [redacted] was awarded on September 17, 2002, for a total price of [redacted] The contract provided for two leased C-40C aircraft with options for one additional C-40C and one C-40B when funding was available. As of September 22, 2005, the Air Force had issued 29 modifications to the basic contract and the total contract price was [redacted] which included the two option aircraft. Modification [redacted] of contract [redacted] provided ordering provisions for contractor logistics support for the four C-40 series leased aircraft. [redacted]

**Establishment of the C-40 Lease Prices.** [redacted] According to the price negotiation memorandum (PNM), most of the significant issues were negotiated at high levels in the Air Force and Boeing. The PNM states that the Office of the Assistant Secretary of the Air Force (Acquisition) (SAF/AQ) provided an aggressive schedule to the C-40 program office at Wright-Patterson Air Force Base for developing an Air Force objective (lease price) for the C-40 aircraft. On April 29, 2002, the Office of Contracting for the Aeronautical Systems Center developed the Air Force objectives for leasing the C-40 and

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forwarded the objectives to Druyun at SAF/AQ. [redacted]

**Review and Approval of the C-40 Lease Program.** In a memorandum to the Secretary of the Air Force, the USD(AT&L) and the Under Secretary of Defense (Comptroller), acting as co-chairs for the DoD Leasing Review Panel, approved the Air Force proposal for a multi-year lease of four 737 (C-40) aircraft. The Report to the Congressional Defense Committees outlined the Air Force implementation plans and financial analysis of the lease versus purchase alternatives of the C-40 Program. The financial analysis indicated that a lease program was economically sound. The four Congressional Committees on Armed Services and Appropriations approved the DoD proposal to reprogram $37.2 million to establish the Boeing 737 (C-40) Lease Pilot Program in FY 2002. The Air Force also provided the Government Accountability Office with program information, including estimates for operation and support costs and information related to the residual value of the aircraft. [redacted]

**Conclusion.** We concluded that the lease prices were fair and reasonable. While the C-40 program office was not involved in the lease price negotiations, the contracting officer believed that the negotiated lease prices were economically justifiable. When the program office was directed to develop the Air Force objective, the educated estimates were based on previous buys and market research. The Air Force objective was approximately $94 million greater than what the Air Force and Boeing officials negotiated. Therefore, while the negotiation process was unique and did not follow standard operating procedures, such as including the contracting officer in the lease negotiations, the program office determined that the established lease prices were fair and reasonable.

## Contract Financing

**Interim Payment.** [redacted] We reviewed the contract files and determined that the Air Force paid [redacted] for a C-40B aircraft. The contract terms required an initial payment of [redacted] to be made on the contract award date. The Defense Finance and Accounting Service (DFAS) made the initial payment to Boeing on December 5, 2000. This interim payment was [redacted] of the aircraft price; however, it was only [redacted] of the total contract price.

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[3] SAF/AQQU is an office symbol, not an acronym. The first layer (AQ) represents the Air Force Acquisition Executive, a political appointee beneath the Secretary of the Air Force (SAF). The second layer (AQQ) is the Director of Global Reach Programs, an Air Force major general, who manages the mobility systems portfolio for the Acquisition Executive. The third organizational layer (AQQU) manages the tactical airlift, trainer, Special Operations Forces (SOF), and special missions airlift.



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Because the terms of the [redacted] contract provided for an immediate payment of [redacted] of the aircraft price, we reviewed the applicable FAR guidance for the treatment of commercial financing terms. FAR 32.202-1(a), "Use of Financing in Contracts," states:

> It is the responsibility of the contractor to provide all resources needed for performance of the contract. Thus, for purchases of commercial items, financing of the contract is normally the contractor's responsibility. However, in some markets the provision of financing by the buyer is a commercial practice. In these circumstances, the contracting officer may include appropriate financing terms in contracts for commercial purchases when doing so will be in the *best interest of the Government* [italics added].

The contracting officer determined that the [redacted] interim payment of the total aircraft amount would be in the "best interest of the government." In this procurement, the green aircraft was to be completed at contract award. Including the interim financing payment in the contract terms allowed the Air Force to procure the aircraft in significantly less time than a new order for the aircraft would have taken (up to two years). Based on market research at the time, the contracting officer determined that a typical financing arrangement [redacted] For the [redacted] contract, the Air Force did not make any payments prior to the completion of the green aircraft. [redacted] According to the contracting officer, the price was highly advantageous to the Air Force because of the pressing need for the aircraft and the availability of the green aircraft in October 2000.

**Conclusion.** The interim payment of 95 percent of the aircraft price at the time of award of the contract was reasonable and in compliance with the FAR as it was common practice in commercial aircraft purchases to include such specialized financing terms. Without the interim financing arrangement, Boeing may not have been willing to sell the aircraft at a price that was considered advantageous to the Government and provide the Air Force with a C-40 aircraft in time to meet the IOC date. We also concluded that Darleen Druyun did not improperly influence the contracting actions.

## Disbursements Review

**Disbursements for Contract** [redacted] We reviewed disbursements for the [redacted] contract and determined that as of January 24, 2003, an unliquidated obligation [redacted] was outstanding for the Air Force purchase of a C-40B aircraft from Boeing. The unliquidated obligation had been dormant from January 24, 2003, to October 19, 2005. The [redacted] unliquidated obligation was created when DFAS Columbus posted interim finance payments made to Boeing as Work in Progress. The Defense Contract Management Agency Seattle Boeing office submitted signed documentation on September 20, 2004, to DFAS Columbus requesting that the contract be closed because the contract was complete. During our review of the disbursements for the [redacted] contract, we determined that the [redacted] unliquidated obligation was still outstanding. The Defense Contract Management Agency Seattle Boeing office submitted additional documentation to DFAS Columbus in October 2005. DFAS Columbus posted appropriate accounting entries to reduce the [redacted] b(4)



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unliquidated obligation to a $0 balance effective October 19, 2005. Other disbursements on contract [redacted] appeared appropriate.

**Disbursements for Contracts** [redacted] **and** [redacted]. We extended our review of disbursements to include contracts [redacted] and [redacted] We reviewed disbursements from contract [redacted] for the purchase of C-40C aircraft from Boeing and took no exception to the respective disbursements. Additionally, we reviewed the disbursements from contract [redacted] for the leasing of the C-40 series aircraft from Boeing and took no exception to the respective disbursements.

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