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UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

PROCUREMENT AND SYSTEMS ACQUISITION DIVISION

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MAR 22 1973

The Honorable Elliot L. Richardson
The Secretary of Defense

Attention: Assistant Secretary of Defense (Comptroller)

Dear Mr. Secretary:

The General Accounting Office has reviewed the procurement in the Far East of recombined milk[1] and milk products totaling $15 million annually. We examined contracts awarded to contractors in Japan, Okinawa, Korea, Taiwan, Thailand, and Vietnam to find out whether the cost of these milk products could be reduced.

We determined, on the basis of current operations, that the Department of Defense could annually save (1) $1.5 million by replacing the operation of milk plants by commercial contractors with the Army and Air Force Exchange Service, (2) $170,000 by using the Military Sealift Command to transport supplies and ingredients from the United States to the Far East, and (3) $708,000 by purchasing nonfat dry milk from U.S. Government surplus stocks.

POTENTIAL SAVINGS BY USE OF IN-HOUSE OPERATIONS

Throughout most of the Far East, U.S. military requirements for dairy products are satisfied by commercial contractors. The contractors are American firms and operate milk plants in six Far East countries. The U.S. Army Procurement Agency, Japan, is responsible for awarding dairy contracts, and on July 1, 1972, it had seven outstanding contracts valued at about $14.7 million a year, as shown below.

[1] Recombined milk is made by mixing dry milk and fat with water.

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Location	Amount of contract (millions)
Government-owned milk plants:	
Japan	$ 2.5
Okinawa	3.0
Korea	3.3
DaNang, Vietnam	1.4
Contractor-owned milk plants:	
Thailand	1.1
Taiwan	.6
Saigon, Vietnam	2.8
Total	$14.7

The U.S. military services in the Philippines use the Exchange Service to operate a Government-owned milk plant at Clark Air Force Base, which supplies dairy products to all U.S. Forces in the Philippines. The Exchange began making dairy products in the 1950s when military requirements were too small to attract commercial dairies.

The legal status of an Exchange is that of an instrumentality of the United States. As such, it is entitled to the immunities and privileges enjoyed by the Federal Government, such as the use of Government-owned surplus dry milk and immunity from foreign taxes. Although Exchange working funds are nonappropriated, facilities for Exchange activities are provided from appropriated funds, either through new construction or allocation of existing building space.

Using available cost data for the Exchange operation in the Philippines (and adjusting it as necessary to conform with conditions in other countries), we concluded that an Exchange operation throughout the Pacific could produce milk and milk products for about $1.5 million less a year than commercial plant operators. This annual saving, based on current operations, would accrue mainly from eliminating contractor profits and foreign taxes.

We presented our findings to the Commander in Chief, Pacific, and in October 1972 we learned that actions had been initiated to study the feasibility of our suggestion for an in-house operation of these milk plants. The Army advised us that the Exchanges in Japan and Okinawa (the countries under Army's command) had been directed to devise a plan for establishing in-house operation of dairy plants.

POTENTIAL SAVINGS BY USE OF MILITARY SEALIFT COMMAND

The contractors for Japan, Okinawa, Korea, and Taiwan ship ingredients and supplies to the Far East by commercial ocean transportation. Private contractors can use Military Sealift Command (MSC) only when commercial transportation is unavailable or inadequate.

Army officials told us that when the contracts were awarded in 1968 they had no feasible alternative to using commercial shipping because MSC's efforts in Southeast Asia had made shipments to other countries in the Far East unreliable. This problem, however, no longer exists, and MSC has provided reliable ocean transportation of ingredients and materials to the Philippines. MSC shipments to Japan, Okinawa, and Korea during the 1971 and 1972 west coast dock strike were satisfactory. Also, the milk contractors in South Vietnam and Thailand have used MSC exclusively and have been satisfied with MSC deliveries. We estimate that using MSC contracts in lieu of contractor-provided commercial shipping would save $170,000 a year on shipments of nonfat dry milk and vegetable fat alone. Additional savings would be realized for other ingredients and materials.

In October 1972 the Army contracting officer informed us that, on the basis of our review, milk contracts in Japan, Okinawa, and Korea were being revised to substitute MSC transportation for commercial carrier transportation. Contracting officials had determined that cost savings dictated that these changes be made.

POTENTIAL SAVINGS BY USE OF U.S. GOVERNMENT-OWNED SURPLUS NONFAT DRY MILK

The Exchange milk plant in the Philippines uses surplus nonfat dry milk and pays about 5 cents a pound less than the price paid by commercial contractors in the commercial market.

The Commodity Credit Corporation's regulations, however, do not allow private contractors to buy surplus dry milk. Before these regulations were issued, a contractor had obtained an export subsidy from the Corporation for dry milk for use under a U.S. military contract. This contractor based his dairy prices to the Government upon the higher commercial dry milk prices, thereby receiving additional profit at the Government's expense. Corporation regulations were designed to prevent such abuses in the future.

If surplus dry milk were used at plants throughout the Far East, Defense's costs for dairy products would be reduced by an estimated $708,000 annually.

AGENCY COMMENTS

On July 18, 1972, we presented our findings to the Commander in Chief, Pacific. He commented that:

1. The prospect of further troop withdrawals from Vietnam made any decision to transfer the operation of the Saigon or DaNang milk plants from the incumbent contractor impractical.

2. The Taiwan and Thailand contractor-owned plants would require substantial capital investments for plant facilities and production and distribution equipment and, in both areas, current military requirements offered barely minimum economical production quantities. In addition, a 2-year leadtime would be needed to

   --submit documentation and obtain congressional approval for military construction,

   --secure an allocation of funds for and to purchase equipment,

   --establish and recruit personnel, and

   --file environmental impact statements.

3. The Government-owned milk plants in Korea, Japan, and Okinawa offered more favorable environments for shifting to in-house capabilities. A cost comparison should be made, considering overhead costs, procurement costs, lost income taxes, and insurance costs. (These factors had been considered in our computation of savings.)

4. The cost differential between MSC and commercial shipping of ingredients and containers should not be used in the cost comparison unless it was ascertained that contract modifications providing for contractor use of Government transportation was not feasible.

5. Using surplus dry milk and reducing dry milk costs would be reviewed.

RECOMMENDATIONS

We recommend that the Department of Defense consider the possibilities of reducing the costs of dairy products by shifting to in-house capabilities for all plants. We recognize the negative aspects of making these changes, particularly in Vietnam. Any management decision to convert to in-house operations in any Far East country, however, should include the likelihood of some need for products and the most economical means of meeting these needs. The Exchange management of the milk plants should be considered first, because it can provide financial resources and management expertise more quickly and economically than can the present operations or appropriated fund activities.

We also recommend that Defense thoroughly examine the possibilities of using MSC transportation and surplus Government-owned dry milk at plants in which the changes for their use have not been made.

We shall appreciate receiving your comments on these matters and shall be pleased to furnish any additional information you may desire.

Copies of this letter are being sent to the Director, Office of Management and Budget; the Secretary of the Army; and the President, Commodity Credit Corporation.

Sincerely yours,

Frank P. Chemery

for Director