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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Military Exchange Systems: How They Can Provide More Benefits For Military Personnel

Consolidating and centralizing the military services' exchange systems could reduce costs and increase their economic benefits to service personnel.

If the Department of Defense did not require exchange systems to help fund other morale, welfare, and recreation activities, these systems could operate without appropriated-fund support; they could focus their attention on their primary mission of providing goods and services to military personnel at the lowest practicable prices.

The Department of Defense did not agree with GAO's conclusions and recommendations.



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COMPTROLLER GENERAL OF THE UNITED STATES

WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses the organizational structure of military exchange systems and the Department of Defense requirement for exchanges to generate profits as a source of funds for other morale, welfare, and recreation activities. The report contains recommendations to the Secretary of Defense which could improve benefits to military personnel by consolidating exchange functions and reducing costs to taxpayers by alternative funding of those activities.

We are sending copies of this report to the Director, Office of Management and Budget, the Secretary of Defense, and the Secretaries of the services.

A handwritten signature in black ink, reading "James B. Heath".

Comptroller General
of the United States



D I G E S T

Department of Defense and service officials are more concerned today than ever before with improving the quality of life of military personnel. Difficulties in recruiting and retaining personnel in the All-Volunteer Force are causing officials to seek ways to increase benefits to service personnel and to make military life more attractive. (See p. 1.)

Certain military establishments, known as "exchanges," provide authorized customers with articles and services at the lowest practicable prices and are a source of funds for other types of morale, welfare, and recreation (MWR) activities. The exchanges are organized into three separate worldwide systems. This report shows how consolidating and centralizing these systems and alternative funding practices could reduce costs and improve benefits to military personnel. (See p. 2.)

BENEFITS OF CONSOLIDATION

Reports of the Logistics Management Institute in 1968, the Office of Management and Budget in 1975, and the Defense Audit Service in 1978--as well as the services' own experience--have shown that consolidating could improve customer service and lower costs. Defense and service officials did not follow up on those reports because (1) they were not convinced large savings would occur, (2) they believed a consolidated system would be unmanageable and would not be supported by the Congress, and (3) other matters took higher priority. (See p. 5.)

FPCD-80-50

The Army and Air Force integrated and centralized management of their exchange systems and saved an estimated \$96 million annually. Consolidation in 1980 of all three services' catalog business, a small segment of exchange activities, is expected to reduce operating costs by about \$1.5 million. (See pp. 7 to 9.)

GAO's analysis of selected exchange functions also indicates that consolidation could reduce costs and improve benefits. For example, lower prices could result from centralized procurements based on Defense-wide requirements. (See pp. 9 and 10.)

Before deciding whether to consolidate the three exchange systems, Defense must weigh the advantages and disadvantages and compare them with alternative organizational structures. Defense has known the potential advantages since 1968, yet it has not made a followup study to help decide the matter. (See p. 13.)

RECOMMENDATIONS

To reach a decision on consolidation, the Secretary of Defense should direct the Armed Forces Exchange Coordinating Committee, or a similar study group, to identify the potential cost savings; the improved benefits to service personnel; and the feasibility of consolidating the three Defense exchange systems in whole or in part. The analyses should include

- quantifying attainable savings and improved benefits to service personnel and
- assessing Defense and service officials' concerns about consolidation and the most appropriate method for addressing them.
(See p. 15.)

Defense did not agree that it should analyze the potential savings and benefits from consolidating exchange functions. On the basis of its experience and the findings in this report, it did not think such benefits would be significant. It said that catalog sales were consolidated on the basis of GAO's findings and that it would actively pursue functional centralization in the separate exchange systems. (See p. 15.)

EXCHANGES CAN BE SELF-SUFFICIENT

If Defense did not require exchange systems to help fund other morale, welfare, and recreation activities, these systems could operate without appropriated-fund support. Also, they could focus their attention on what they believe is their primary mission of providing goods and services to military personnel at the lowest practicable prices and could establish customer-savings goals rather than profit goals. (See p. 16.)

In 1978 the exchange systems had net earnings of \$194 million, which was \$49 million more than the amount the exchanges considered necessary to pay dividends to other morale, welfare, and recreation activities and to provide enough cash to operate successfully. The additional earnings were used primarily to increase cash and short-term investments over planned levels. (See p. 18.)

If the exchanges had paid all of their expenses charged to appropriated funds (\$149.6 million) rather than providing funds for other activities, they still would have had \$16 million more than needed to be self-sufficient. Preliminary operating results for 1979 show exchange profits of \$222 million--about \$31 million more than required to be self-sufficient. (See pp. 17 and 18.)

Unless specifically asked, Defense does not routinely inform the Congress of the amount of exchange profits, how these funds are distributed, and the use of exchange dividends by the services. (See p. 19.)

Defense and service officials oppose changing current funding practices primarily because they believe the Congress would not fund the morale, welfare, and recreation activities at their current levels. The activities, including the exchanges, received \$710 million in appropriated-fund support in 1978. GAO believes the Congress would have provided a lesser amount--\$677 million--in 1978 to fully fund activities had Defense justified them for the morale and welfare of service personnel and had it explained that alternative funding was more costly. (See pp. 19 and 20.)

RECOMMENDATIONS

The Secretary of Defense should

- eliminate the requirement to distribute exchange profits as a source of funds for other morale, welfare, and recreation activities;
- require the exchange systems to reimburse appropriations for costs incurred in support of exchange operations; and
- budget for and justify to the Congress the full cost of activities now partially funded with exchange profits. (See p. 21.)

Until these actions are taken, Defense should provide the Congress with information on exchange profits, how the profits are distributed, and how they are used by the services. (See p. 22.)

AGENCY COMMENTS

Defense did not agree that these activities should be fully funded directly because (1) the costs are presently shared equitably, (2) appropriated funds are needed to pay costs overseas to keep prices comparable, (3) a \$33-million reduction would cause prices to increase, and (4) it had experienced difficulty in recent years acquiring appropriated funds to support those activities. GAO's proposed funding alternative would not affect sharing costs overall, would not cause prices to increase, and would not require as much appropriated fund support as the present funding method.

Defense also disagreed on the need to routinely advise the Congress of the amount and use of exchange profits because sufficient data is presently being provided. (See pp. 22 and 23.)

MATTER FOR CONSIDERATION BY THE CONGRESS

The Senate and House Committees on Appropriations should consider the direct funding of morale, welfare, and recreation activities to reduce costs to the taxpayers and to increase oversight in this area. As a basis for determining which funding method to adopt, GAO suggests that the Committees request Defense to submit data on the appropriated funds required for each alternative. If the present method of indirectly funding these activities is retained, the Committees should review the share of exchange profits being distributed and the use of funds for investments as well as for operating the activities. (See p. 23.)

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ABBREVIATIONS

AAFES	Army and Air Force Exchange Service
GAO	General Accounting Office
MCES	Marine Corps Exchange Service
MWR	morale, welfare, and recreation
NAVRESSO	Navy Resale and Services Support Office

CHAPTER 1

INTRODUCTION

Department of Defense and service officials are more concerned today than ever before with improving the quality of life of military personnel. Because of difficulties in recruiting and retaining sufficient personnel under the All-Volunteer Force, these officials are seeking ways of increasing benefits to service members to make military life more attractive. This report shows that better service and lower prices in military exchanges is one way to increase benefits.

Defense operates military exchanges as an important part of its morale, welfare, and recreation (MWR) program. MWR activities 1/ are essential to the morale and esprit de corps of military personnel and, according to Defense officials, contribute to improved combat readiness. The program is intended to provide service members and their families with various types of activities similar to those available to civilians. The program is also intended to make individuals more satisfied with military life and attract dedicated men and women to military careers.

Nonappropriated funds for operating MWR activities come from the sale of goods and services, primarily by military exchanges, to military customers. The exchanges were established by the military services to provide (1) customers with articles and services necessary for their health, comfort, and convenience at the lowest practicable prices and (2) earnings to be used for funding other types of MWR activities. In 1978 exchange sales totaled \$4.3 billion; exchanges provided \$116.5 million for other types of MWR activities. (Details on exchange earnings and dividends are in app. I.)

MWR activities also receive appropriated fund support primarily in the form of military and civilian personnel, transportation, and utilities. Funds are appropriated annually in the Defense Appropriation Acts, which contain general provisions for "welfare and recreation"; however, specific amounts for MWR activities are not set out.

1/MWR activities include military resale exchanges, libraries, clubs, golf, bowling, gymnasiums, hobby shops, and other recreation activities.

The services operate three separate exchange systems on military installations throughout the world. Each exchange system has different organizational structures and management practices, but they perform identical functions.

- The Army and Air Force Exchange Service (AAFES), with 227 exchange outlets, is the largest of the three exchange systems. Its 1978 sales of \$2.9 billion accounted for about 67 percent of the combined sales volume of all military exchanges. AAFES operates from a centralized headquarters which establishes operational, procurement, and financial policies. There are four levels of management--headquarters, exchange regions, area exchanges, and installation exchanges.
- The Navy Resale and Services Support Office (NAVRESSO), under the control of the Naval Supply Systems Command, provides technical and administrative support to 148 independent exchanges. Its 1978 exchange sales totaled about \$1.1 billion. NAVRESSO has organized exchanges within defined geographic areas into area support complexes. Where complexes have been established, support functions, including procurement, are centralized. NAVRESSO also manages Navy commissary stores and ships' stores afloat, the Navy food service program, and the Navy clothing and textile research program. It also provides technical guidance to the small exchange program of the Military Sealift Command.
- The Marine Corps Exchange Service (MCES) is an administrative division under control of the Marine Corps Deputy Chief of Staff for Installations and Logistics. In 1978, sales of its 17 exchanges totaled \$271 million. MCES headquarters provides accounting and management reviews of independent Marine Corps exchanges. Exchange officers are responsible for all exchange operations, including procurement, personnel, and pricing.

In July 1967 the exchange systems established the Armed Forces Exchange Coordinating Committee, a policy committee of senior representatives of the three exchange systems whose purposes are to review operational situations, discuss common problems, and seek general agreement on matters requiring joint or coordinated action.

Most of the customers of the three exchange systems are military personnel (both active and retired) and their dependents. Customers can purchase similar products and services in exchanges whether they are operated by AAFES, NAVRESSO, or MCES.

The three exchange systems use:

- The same or similar suppliers of goods and services for their retail outlets. The suppliers generally are manufacturers and distributors of national brand merchandise.
- Similar marketing channels--retail stores to sell clothes, jewelry, toiletries, etc; vending machines; food services; and barbers, beauticians, opticians, and automobile services.

Since 1949 we have issued several reports on MWR activities. We have repeatedly indicated that there is no clear policy for providing appropriated fund support and no adequate justification or accounting for its use. In our August 1977 report, 1/ we stated:

"* * * we believe it very appropriate that their true costs be identified and that thereby the Congress have the opportunity to decide how much money will be appropriated for this function."

We recommended that the Congress support with appropriated funds the kinds of public community activities available in the civilian sector.

SCOPE OF REVIEW

We examined legislation, documents, records, and reports on generation and distribution of nonappropriated funds by military exchanges, appropriated fund support, and efforts to improve management and operation of exchanges.

Information was developed, analyzed, and discussed with officials at the following locations:

1/ "Appropriated Fund Support for Nonappropriated Fund and Related Activities in the Department of Defense" (FPCD-77-58, Aug. 31, 1977).

1. Offices responsible for exchange operations.
 - NAVRESSO, Brooklyn, New York.
 - AAFES, Dallas, Texas.
 - MCES Headquarters, Quantico, Virginia.
2. Offices responsible for distribution of funds generated by exchanges.
 - Office of the Adjutant General, Department of the Army Headquarters, Washington, D.C..
 - Headquarters, Air Force Manpower and Personnel Center, San Antonio, Texas.
 - Naval Military Personnel Command, Department of the Navy, Rosslyn, Virginia.
 - Headquarters, Marine Corps Personnel Services Division, Arlington, Virginia.
 - Offices of the Secretary of Defense responsible for military personnel policy and budget, Arlington, Virginia.

CHAPTER 2

CENTRALIZING AND CONSOLIDATING EXCHANGE

FUNCTIONS COULD IMPROVE SERVICE PERSONNEL BENEFITS

The services' experience has demonstrated that, by centralizing exchange functions, major savings can be achieved and benefits to service personnel can be increased. Integrating the Army and Air Force exchange system functions in the early 1970s resulted in estimated annual savings of \$96 million, prices for goods and services that were both lower and uniform, and a better stock assortment. Similar types of benefits may be realized by consolidating and centralizing functions of the three exchange systems. All of the resultant savings should be passed on to service members through lower prices.

After 1968 three study groups examined the three systems and reported that consolidating the systems should be considered because of the potential for reducing operating costs and improving benefits. Defense and service officials have not made the necessary feasibility studies because (1) they are not convinced that large savings would result, (2) they believe a consolidated exchange system would be unmanageable, (3) they believe the consolidation would not be supported by the Congress or by retailers in the private sector, and (4) other matters took higher priority.

The Armed Forces Exchange Coordinating Committee seeks ways to improve exchange operations. We believe that, because of the potential for large savings in the areas of procurement and distribution and increased benefits to service members, Defense should assign responsibility to this Committee or a similar study group to identify the cost savings and to study the feasibility of consolidating the exchange systems in whole or in part.

RESULTS OF PAST STUDIES

Since 1968 three studies were made of the management of the exchange systems. Each study report concluded that consolidating the exchange systems should be considered because of the potential for reducing operating costs and for improving benefits. Defense did not quantify the advantages and the disadvantages of consolidating the exchange systems, nor did it study the methods for implementing consolidation.

In 1968 Defense contracted with the Logistics Management Institute to study military exchanges for the then Assistant Secretaries of Defense (Installations and Logistics; and Manpower and Reserve Affairs). As part of the study, the Institute was requested to develop optimum organizational structures considering good management, sound retailing, and best customer service. The study group considered three major organizational alternatives:

- Retaining the three exchange systems organizationally separate with standardized policies, procedures, formats, and functions to increase their responsiveness and reduce their operating costs.
- Reducing the three systems to two by combining the Navy and Marine Corps systems into one system; the two systems would have standard policies, procedures, formats, and functions.
- Combining the three exchange systems into one Defense-wide exchange system.

In its 1968 report, the Institute concluded that a consolidated Defense-wide exchange system was the optimum organizational structure and probably the best way to achieve the operating efficiencies and improved customer service. The Institute also reported that consolidation could reduce or eliminate redundancy among the exchange systems.

The military services opposed consolidation because they were concerned that it would result in a large operation that would produce unfavorable repercussions from critics of exchanges. The services agreed with many of the Institute's recommendations and took some actions to improve the separate systems. For example, AAFES and NAVRESSO increased their emphasis on analyzing distribution costs and improving shipping methods and storage facilities; however, they took no action on the consolidation issue.

In January 1975 the Office of Management and Budget issued a study report on military exchange organization and operation. According to the report, improved management could increase operating efficiencies and offer better service to the customer and reduced operating costs. A consolidation would reduce overhead above the base level, lower distribution costs, and afford greater opportunities for savings because certain functions (management, procurement, warehousing, inventory control, fiscal) would be centralized within geographic areas. Retail chains operate in a similar

fashion. The report stated that consolidation should be a long-range objective; further study and consideration were necessary. Defense took no action to study the feasibility of consolidating the three exchange systems because of the military services' opposition and because of higher priority matters.

In 1978 the Defense Audit Service completed a comparative evaluation of the management policies and procedures of the three military exchange systems. In July 1978 it reported several conclusions, including the need for the Assistant Secretary of Defense (Manpower, Reserve Affairs and Logistics) to consider the possibility of consolidating the three exchange systems.

AAFES conceded that some savings could result from consolidation, but it emphasized the need to resolve issues arising from the differences in the mode and types of operations of the three exchange systems. According to NAVRESSO, before action is taken there must be demonstrated proof that consolidation is economical and that management expertise is available to operate the resultant retailing organization. MCES questioned whether a consolidated system would offer a real advantage over a decentralized system. Defense took no action; it indicated that it would await the results of our examination.

RESULTS OF PAST CONSOLIDATIONS

Merging segments of the exchange systems have resulted in major savings. AAFES estimated that integrating Army and Air Force exchange functions saved \$96 million--\$52 million in reduced operating costs and \$44 million in lower merchandise prices. Further, consolidating AAFES and NAVRESSO mail order catalog services, a small segment of exchange activities, is expected to reduce operating costs by about \$1.5 million.

Integrated management--AAFES

In 1968 the Departments of the Army and the Air Force tested integrated management in the 6th Army and the Strategic Air Command exchanges in the United States. At the end of the 1-year test period, commanders of 26 of the 27 participating installations recommended adopting integrated management permanently. Although commanders relinquished management control over exchanges to a central AAFES headquarters, they recognized these overriding advantages:

- More effective supervision of personnel, which improved customer service and raised performance standards.
- More centralized resources, which improved exchange facilities and overall upgrading of merchandise, services, sanitation, and housekeeping.
- Reduced administrative workload for commanders in areas not directly related to their primary military mission. The number of military personnel staff-hours devoted to exchange activities was reduced by 49,625 during the 1-year test period, without divesting essential command prerogatives and while retaining command influence over and in support of exchanges.

Supported by the success of its test, AAFES phased in integrated management of all Army and Air Force exchanges from September 1970 through January 1972. Central control of exchanges resulted in common programs, policies, and procedures and eliminated duplication and excessive layers of management. AAFES estimated that integrated management saved \$52 million annually, primarily in personnel reductions. It saved

- about \$17.4 million by consolidating overhead functions and personnel of several exchanges into area and regional exchange offices,
- about \$24.5 million by centralizing accounting, merchandising, information systems, warehousing, and other distribution functions, and
- about \$3.6 million by centralizing a worldwide computer system.

Consolidation of catalog systems

AAFES and NAVRESSO operate separate mail order catalog systems to serve authorized patrons, primarily those overseas. In fiscal year 1978, catalog sales totaled \$58.5 million.

In a May 22, 1979, report to the Chairmen, House and Senate Committees on Appropriations, we said that about \$1 million in nonappropriated funds and about \$500,000 in appropriated funds could be saved by consolidating the two systems into the larger AAFES system. Although Defense

disagreed with our estimate of savings in appropriated funds, it agreed that consolidation was feasible, and it directed the military departments to consolidate catalog operations by July 1980.

POTENTIAL BENEFITS FROM CONSOLIDATING
SELECTED EXCHANGE FUNCTIONS

Our analysis of selected exchange functions indicated that consolidation could yield large savings by

- reducing merchandise costs through procurements based on Defense-wide requirements;
- reducing distribution costs by improving management and control over freight, warehousing, and inventory costs; and
- improving control over capital expenditures for constructing facilities and purchasing equipment.

Consolidation could also improve benefits to service personnel by reducing prices and improving customer service in military exchanges.

Lower prices

Centralized procurement by a single exchange system of consolidated Defense-wide requirements could reduce costs. Opportunities for large-volume procurements, and thus lower prices, exist primarily for merchandise currently purchased under numerous small-purchase orders by NAVRESSO and MCES. Further consolidation of individual AAFES, NAVRESSO, and MCES requirements for relatively small quantities of certain items should permit more opportunities for large volume procurements. A single exchange system using a single staff to purchase all exchange requirements would be economical and would eliminate the present duplication in the procurement function.

Experiences of both AAFES and NAVRESSO demonstrate that substantial price reductions can be negotiated on large-volume procurements for systemwide requirements rather than repetitive purchases of small quantities. The consolidation of purchase needs of many exchanges results in volume discounts, transportation savings, and a stronger bargaining position. Of the three exchange systems, AAFES used systemwide procurement most frequently, NAVRESSO used it infrequently, and MCES did not use it at all. A special analysis

by AAFES of 1976 procurements showed that consolidated procurements reduced costs by \$44 million.

AAFES support functions are centralized in its headquarters, with operational responsibilities flowing through region chiefs and commanders of overseas areas to area exchange general managers. This organizational structure permits centralized procurement at the headquarters and regional level. It also permits AAFES to buy in volume and to negotiate lower prices, discounts, and allowances. For example, before 1978, AAFES regions separately purchased certain audio accessories for their respective exchanges. An AAFES selection committee later determined that a systemwide contract was appropriate for these items. The prices negotiated for a 1979 contract systemwide were 20 to 25 percent lower than the 1977 prices despite inflation.

NAVRESSO negotiates unit prices with many vendors and publishes them for individual exchanges which purchase their own merchandise. Exchanges issue purchase orders to vendors citing prices that NAVRESSO negotiated. NAVRESSO has found that negotiations with vendors on the basis of consolidated requirements of all exchanges result in substantially lower prices. Since 1974 NAVRESSO has attempted to increase its procurements under systemwide contracts. By November 1979 it had completed 65 contracts for a total value of \$26.4 million; this saved about \$3.8 million.

In 1976 and again in 1979 the Inspector General, Naval Supply Systems Command, recommended that NAVRESSO increase procurements under systemwide contracts because of the substantial savings available from this procurement method. NAVRESSO officials said that they needed more personnel to accomplish even a modest goal of 300 contracts by the end of 1980. Consolidating with AAFES procurement function could facilitate meeting this goal without additional staff.

MCES has no central procurement function and no procurement staff. NAVRESSO contracts are provided to each exchange officer responsible for the procurement function.

Lower distribution costs

The three exchange systems maintain separate distribution networks and inventory management systems. From the viewpoint of a Defense-wide exchange program, distribution and inventory management are fragmented, uncoordinated worldwide functions. One consolidated distribution system could

provide (1) the flexibility for controlling freight, warehousing, and inventory costs on the basis of Defense-wide needs, (2) more effective use of facilities and equipment, and (3) a single staff of experts to supervise these functions.

AAFES estimated that its worldwide distribution cost for 1978 totaled \$259.7 million, including \$59.8 million of appropriated funds for overseas shipments of merchandise. NAVRESSO and MCES with decentralized management systems do not accumulate worldwide distribution costs.

Although costly, premium transportation, large numbers of warehouses, and large inventories are necessary to insure availability of the specific items customers want in military exchanges. Controlling these costs requires decisions on the number, location, and sites of warehouses and on freight policies and inventory policies which permit tradeoffs between customer service and cost. Tradeoffs can be made only with accountability for all associated costs and knowledge of how changes in each cost element contributes to total cost. Defense, with three separate distribution systems, does not have information to effectively reduce total distribution costs.

Of the three exchange systems, AAFES--with centralized procurement, major distribution centers, and its own fleet of vehicles--is the only system capable of managing its distribution costs. AAFES has the flexibility to consider tradeoffs in merchandise prices; customer service; and freight, warehousing, and inventory costs. It estimated savings of at least \$11 million annually in doing so.

Navy exchanges are managed by Navy officers who report directly to local commanding officers. Facilities and equipment are under the operational control of local commands. NAVRESSO has some control over merchandising and distribution. But without information on costs and without system-wide distribution centers or a fleet of vehicles, it has little flexibility to make the kinds of tradeoffs available to AAFES.

The decentralized distribution system does not permit tight control of freight, warehousing, and inventory costs. Navy exchange procurements are primarily free-on-board destination, even though free-on-board origin permits greater

flexibility in controlling and minimizing freight costs. ^{1/} Control over local deliveries from warehouses and inventory management is decentralized to base level.

MCES exchanges are the least centrally controlled of the three exchange systems. They offer little opportunity for tradeoffs of freight, warehousing, and inventory costs.

In summary, controlling freight, warehousing, and inventory costs is complex because thousands of items are purchased from thousands of suppliers for over 390 exchange outlets. Each purchase requires decisions on direct shipment or warehousing, mode of transportation, and choice of carrier. Developing economic tradeoffs on items is costly and can be done more effectively Defense-wide. A consolidated single exchange system would permit greater opportunities for

- obtaining lower freight rates due to larger volume shipments,
- reducing the number of out-of-stock instances through shared central warehouses,
- pooling of capital investments in warehouse and material-handling equipment to achieve single mechanized warehouses for a geographic area, and
- eliminating duplication in local distribution and transportation.

More effective capital expenditures

Funds and capital budgets are independently maintained by the three exchange systems. In 1978 the systems spent \$83.5 million on constructing new facilities and purchasing new equipment. The decision to construct a new exchange or to purchase new equipment has a long-term impact on operations because of the large capital outlay required.

A consolidated exchange system would provide for a single construction program that could use standard designs

^{1/} Under free-on-board destination procurements, the freight costs are paid by the supplier; under free-on-board origin procurements, they are paid by the buyer.

for constructing outlets and warehouses and standard equipment in all exchanges. Defense-wide planning of construction projects would help to insure proper priority for improving the facilities, and construction costs would be reduced by using

- a single staff of qualified architects and engineers to supervise and manage construction, modification, and design and
- standard designs and lists of standard operating equipment compatible and interchangeable throughout the Defense exchange system.

Improved exchange benefits

The benefits of getting goods and services at less than commercial prices can be improved for service personnel. More economical exchange operations and reduced costs through volume purchases resulting from consolidation would permit

- lower and uniform prices for goods and services,
- uniform stock assortment providing balanced selection of merchandise at exchanges worldwide, and
- standard merchandising display techniques and fixtures.

CONCERNS OF DEFENSE AND SERVICE OFFICIALS

Defense and service officials expressed concerns that a consolidated exchange system may not provide large savings, may be unmanageable, and may not be supported by the Congress or retailers in the private sector. The potential advantages of a consolidated system have been known to Defense since 1968; however, because of these concerns, the followup study necessary to make a decision on this matter has not yet been made.

Before deciding whether to consolidate the three exchange systems, Defense must weigh the advantages and disadvantages and compare them with alternative organizational structures. We noted that some costs may, in fact, increase under a consolidated system. For example, the AAFES executive management program provides more liberal and thus more costly retirement benefits than either the NAVRESSO or the MCES programs. Since a consolidated system may increase the

number of executive management personnel, costs would increase if they are granted retirement benefits similar to those provided by AAFES.

Also, Defense should assess whether current salary structures would make it difficult to acquire management talent to operate a consolidated exchange system. AAFES already accounts for over 67 percent of the combined \$4.3 billion annual Defense exchange sales.

NAVRESSO and MCES officials emphasized the need for local commands to retain control over local exchanges because of base commanders' responsibility for the morale of their service personnel. Experiences of Army and Air Force commanders show that this matter can be resolved. Management control over exchanges can be centralized at a single exchange headquarters, with local commanders retaining essential command prerogatives and influence over exchanges.

In our opinion, any disapproval by the Congress and retailers in the private sector could be overcome if the services properly explain that the primary goal of merging is to improve the quality of military life. Further, we would not necessarily expect sales of a combined operation to be greater than the total of the separate exchange systems.

CONCLUSIONS

The services' experience has demonstrated that, by merging exchange functions, large savings can be achieved and benefits to service personnel can be increased. Integrating the Army and Air Force exchanges resulted in (1) estimated annual savings of \$96 million, (2) prices for goods and services that were both lower and uniform, and (3) a better stock assortment. Similar benefits may be possible by consolidating the three existing exchange systems.

The financial advantages and the desirability of consolidating exchange functions have been identified in three independent studies besides our own. In view of the potential for substantial benefits to military personnel, we believe it is time for the Office of the Secretary of Defense to take a strong leadership role in assessing the benefits of consolidating and centralizing exchange functions in whole or in part. The Coordinating Committee or a similar study group could assess this on a function-by-function basis, followed by promptly identifying the benefits without waiting for the entire exchange systems to be reviewed.

RECOMMENDATION

To reach a decision on consolidation, we recommend that the Secretary of Defense direct the Coordinating Committee, or a similar study group, to identify potential cost savings; the improved benefits to service personnel, and the feasibility of consolidating the three exchange systems in whole or in part. The analyses should include

- quantifying attainable savings and improved benefits to service personnel and
- assessing Defense and service officials' concerns about consolidation and the most appropriate method for addressing them.

AGENCY COMMENTS

Defense did not agree that it should analyze the potential savings and benefits from consolidating exchange functions. On the basis of its experience and the findings in this report, Defense did not think that consolidating the exchange systems would produce significant net benefits. Defense said, however, it took action to consolidate catalog sales on the basis of GAO's findings and that it would actively pursue functional centralization in the separate exchange systems.

Identifying potential benefits from consolidation is Defense's responsibility, and more specifically the exchange systems, in order to carry out the primary mission of providing goods and services to military personnel at the lowest practicable prices. As Defense points out, we made a sufficient analysis of the catalog function to demonstrate significant savings. We continue to believe that Defense should follow up by analyzing other functions. As we suggested, this assessment could be made on a function-by-function basis. Functions such as procurement or distribution could be accomplished without necessarily consolidating the entire exchange systems.

CHAPTER 3

ALTERNATIVE FUNDING OF MWR ACTIVITIES CAN REDUCE

NEED FOR APPROPRIATED-FUND SUPPORT

The military exchange systems could have operated without the \$149.6-million appropriated-fund subsidy they received in 1978 had they not been required by Defense regulations to distribute earnings to other MWR activities. The exchange systems earned enough profit in 1978 to operate independently and be self-sufficient except that they had to distribute part of those earnings--\$116.5 million--to supplement appropriated funds received by other MWR activities. The remaining funds (\$33 million) were used to increase cash and short-term investment balances of the exchange systems. Thus, providing an additional \$116.5 million in appropriated funds to those activities and eliminating support for exchanges would have reduced overall MWR appropriated funds by \$33 million and improved congressional oversight.

Changing funding practices for MWR activities would improve benefits to military personnel also. Without the requirement to make profits to support other activities, the exchanges could concentrate on what they believe is their primary mission--to provide goods and services to military personnel at the lowest practicable prices. Exchanges could then establish customer-savings goals rather than profit goals.

Exchange officials agreed that the exchanges could operate independently and be self-sufficient if they were not required to distribute funds to other MWR activities. Defense and service officials, however, expressed concern that the Congress would not support other MWR activities at the current level (combined appropriated and nonappropriated exchange funds of \$677 million). Since the Congress appropriated \$710 million in 1978 to fund MWR activities, including the exchanges, we believe it would have provided the reduced amount--\$677 million--to fully fund those activities had they been justified for the morale and welfare of service personnel.

EXCHANGES CAN BE SELF-SUFFICIENT

The exchange systems make enough profit to pay for the expenses charged to appropriated funds and to operate successfully. The cost of operating exchanges is paid from sales revenues (nonappropriated funds) and from funds appro-

priated by the Congress. In 1978 the three exchange systems' earnings of \$194 million were enough to pay operating costs of \$149.6 million paid with appropriated funds. There would be no need to increase prices to be self-sufficient. Sales revenues were used to (1) pay for merchandise, (2) pay salaries and wages of civilian non-appropriated-fund employees, (3) purchase and maintain equipment, supplies, and services, (4) construct facilities, and (5) pay transportation and utility costs in the United States.

The amount of appropriated funds used to pay exchange operating costs for fiscal year 1978 are shown below.

	Millions (note a)
Transportation overseas of exchange merchandise	\$ 78.5
Utilities and rent	20.0
Military personnel costs	18.0
Services of other employees	16.8
Real property repair and maintenance	9.5
Communications	6.1
Other	<u>.7</u>
Total appropriated funds	<u>\$149.6</u>

a/The services reported to the Office of the Secretary of Defense appropriated funds totaling \$130.1 million. We adjusted the amount by \$19.6 million to account for estimated unreported and underreported costs. Defense officials agreed with these estimates.

The three exchange systems retain funds for working capital which is used primarily for new facilities and equipment--\$83.5 million in 1978. The retained funds consist primarily of a part of the reported net earnings plus depreciation of facilities and equipment. The 1978 exchange systems' net earnings exceeded appropriated funds by \$44.4 million. These funds, plus depreciation charges of \$61.9 million, would have made \$106.3 million available for capital investment, an amount greater than was spent for new facilities and equipment.

The exchanges would have had enough cash to operate successfully had they been required to pay all their expenses. The exchange systems projected as sufficient net income of \$145 million for 1978 to finance capital investments and to distribute income to the services. The

1978 operations, however, resulted in a net income of \$194 million, which was \$49 million more than anticipated needs and \$16 million more than necessary to be self-sufficient. The increased net income was used primarily to increase cash on hand and short-term investments over the planned levels necessary for a successful operation.

Similarly, 1979 ^{1/} operations resulted in an estimated net income of \$222 million, or \$40.8 million more than that anticipated in financial plans as needed to finance capital requirements and distribute income to the services. Earnings were about \$31 million greater than necessary to operate successfully without appropriated funds.

The potential for a self-sufficient exchange system is further illustrated by the opportunities to reduce current operating costs and obtain lower merchandise prices as discussed in chapter 2.

DISTRIBUTION OF NET EARNINGS TO
SUPPLEMENT APPROPRIATED FUNDS

The services use the exchange systems' funds from net earnings to supplement appropriated funds for other MWR activities related primarily to physical fitness or self-development. Although the processes for distributing dividends differ among the services, the funds were used to (1) operate and maintain MWR activities, (2) construct facilities, (3) pay costs of administering central funds, or (4) increase investments by the central funds for future program costs. The 1978 dividends were distributed as follows:

^{1/}Before we completed our fieldwork, the exchange systems provided the following information on 1979 operations--estimated appropriated funds, \$139.3 million; estimated net earnings, \$222 million; and income distributed to the services' MWR programs, \$129.5 million.

<u>Military service</u>	1978 <u>dividends</u>	General welfare and recreation programs (note a)		Payroll and related costs of administering central welfare funds	Invested for future program costs
		<u>Operations and maintenance</u>	<u>Construction of facilities</u>		
----- (millions) -----					
Army	\$ 41.1	\$22.7	\$16.0	\$1.8	\$.6
Air Force	29.9	16.5	5.5	1.4	6.5
Navy	36.3	29.8	4.7	.5	1.3
Marine Corps	<u>9.2</u>	<u>7.7</u>	<u>-</u>	<u>.2</u>	<u>1.3</u>
Total	<u>\$116.5</u>	<u>\$76.7</u>	<u>\$26.2</u>	<u>\$3.9</u>	<u>\$9.7</u>

a/We assumed that all income distributed to local recreation funds was used for operations and maintenance.

Congressional oversight could be improved by subjecting to the appropriation process those MWR costs that are paid for with exchange dividends. Unless specifically asked, Defense does not routinely inform the Congress of the amount of exchange profits or how these funds are distributed and used by the services. The Congress is furnished information semiannually on MWR facilities' construction projects which are financed with nonappropriated funds and which are estimated to cost more than \$25,000. A portion of exchange dividends are used to finance some of these projects.

Providing the funds, currently generated by exchanges, in a budget would give the Congress a means for reviewing and making its own independent evaluations of the results achieved by Defense. Further, it would require Defense to justify the efficient and effective use of these funds and their impact on the well-being of service personnel.

DEFENSE AND THE MILITARY SERVICES OPPOSE CHANGE

Defense and the military services oppose changing the funding practices because they believe that (1) the Congress would not support MWR activities at the current level, (2) if funds were made available, current ceilings on civil service personnel would prevent the use of these funds, and (3) service personnel would be required to pay, through exchange

prices, certain exchange operating costs--such as transportation overseas of exchange merchandise--which are now paid with appropriated funds, thus reducing the economic benefits to service personnel of the exchange privilege.

The primary concern that Congress would not support MWR activities at the current level may be unwarranted. In 1978 the Congress appropriated \$710 million to fund MWR activities, including \$149 million provided to the exchange systems. We believe that the Congress would have provided a reduced amount--\$677 million--to fund these activities had Defense justified them and explained that the alternative practice of funding exchanges was more costly. For example, Subcommittees of the House Armed Services Committee 1/ have in the past criticized Defense for allowing its exchange systems to make profits which are used to pay for other MWR activities. They believed that these MWR activities should be funded entirely through appropriations.

Defense's concerns about the effects of manpower ceilings have merit, but the problem can be overcome. The Office of Management and Budget's predominant method of controlling Federal employment has been to establish personnel ceilings on the last day of the fiscal year for each agency. The Congress has set additional ceilings on Defense. Also, section 311 of the Civil Service Reform Act of 1978 (Public Law 95-454) provides that the total number of civilian employees in the executive branch at the end of fiscal years 1979, 1980, and 1981 not exceed the number of such employees on September 30, 1977. This provision expires on September 30, 1981. Ceilings do not apply to personnel who are paid with nonappropriated funds. If funding practices were changed and these costs were paid from appropriated funds without an increase in personnel ceilings, Defense could be severely restricted in carrying out its MWR programs.

A possible solution could be for Defense to request congressional approval to use appropriated funds to reimburse non-appropriated-fund activities for the cost of these employees. The Congress has authorized this practice at NAVRESSO headquarters for its employees who work on commissary operations, an appropriated-fund activity.

1/Special Subcommittee hearings held in 1949, 1953, 1957, and 1969.

Exchange officials are concerned that self-sufficient exchange systems would reduce the economic value of exchange benefits to service personnel because sales revenues would be used to pay costs now being paid for with appropriated funds. There is no need to increase prices to be self-sufficient. As discussed above, current exchange systems' profits exceed the amount of appropriated funds used to support exchanges. We believe the value of exchange benefits, will improve because customer-savings goals instead of profit goals would focus management's attention on reducing exchange prices.

CONCLUSIONS

The military exchange systems could operate without appropriated funds if they did not have to generate profits for other MWR activities. The exchange systems would have had enough earnings and cash flow in 1978 to be successful had they not been required to distribute part of these earnings to supplement appropriated funds received by other MWR activities. Thus, direct funding of those activities would have saved taxpayers \$33.1 million in 1978.

We believe that changing funding practices for MWR activities could improve benefits to military personnel. Without the requirement to provide funds for other MWR activities, the exchanges could concentrate on their primary mission--to provide goods and services to military personnel at the lowest practicable prices.

RECOMMENDATIONS

We recommend that the Secretary of Defense

- eliminate the requirement to generate exchange profits as a source of funds for other MWR activities,
- require the exchange systems to reimburse appropriations for costs incurred in support of exchange operations, and
- budget for and justify to the Congress the full cost of MWR activities now partially funded with exchange profits.

Until these actions are taken, Defense should provide the Congress with information on exchange profits, how the profits are distributed, and how they are used by the services.

AGENCY COMMENTS

Defense disagreed with our conclusions and recommendations for alternative funding, stating that:

- The cost of MWR activities is fairly and equitably shared by the taxpayers and by military personnel.
- Appropriated funds are needed for transportation, utilities, and rent overseas to make the costs of merchandise overseas comparable to costs in the United States.
- A reduction of \$33 million in the total MWR program would compel increased fees and charges to military personnel.
- It has experienced difficulties in recent years in acquiring appropriated funds for MWR activities due to restricted operations and maintenance funding by the Congress, readiness priorities, and civilian personnel ceilings.

We are not questioning the fairness in sharing MWR activities costs between taxpayers and military personnel, but rather we are proposing an alternative method of funding those activities. With regard to the need for appropriated funds to support exchanges overseas, the exchange systems' financial statements clearly show that the current pricing structure produces enough income to pay for expenses presently charged to appropriated funds. The exchange systems could be self-sufficient if Defense would not require them to generate profits as a source of funds for other MWR activities. There is no need to increase prices at overseas exchanges or elsewhere. As shown on page 16, the additional funds (\$33 million) were used to increase cash on hand and short-term investments of the exchanges, which had no effect on fees charged by other activities.

We have recognized in this report Defense's concern about acquiring enough appropriated funds for its total MWR program. Defense, however, did not address the fact that the alternative we proposed would require less appropriated funds than its current practice.

Defense disagrees on the need to give the Congress information on the amount and use of exchange profits because it believes enough information is made available in budget presentations; semiannual reports on construction projects; and when requested, financial management reports and other data.

The information Defense provides to the Congress does not disclose the amount of exchange profit generated, how much is distributed to other MWR activities, or how the funds are used. We continue to believe that the Congress needs this critical information to make judgments concerning the proper share of profits to be distributed and the use of those funds for investments rather than for operation of the activities.

MATTER FOR CONSIDERATION
BY THE CONGRESS

The Senate and House Committees on Appropriations should consider the direct funding of MWR activities to reduce costs to the taxpayers and to increase oversight in this area. As a basis for determining which funding method to adopt, we suggest that the Committees request Defense to submit data on the appropriated funds required for direct and indirect funding of MWR activities. If the present method of indirectly funding MWR activities is retained, the Committees should review the share of exchange profits being distributed and the use of these funds for investments and operation of MWR activities.

EXCHANGE SYSTEMS NET EARNINGS AND DIVIDENDS PAIDDURING FISCAL YEARS 1974-79Net earnings

<u>Fiscal year</u> <u>(note a)</u>	<u>AAFES</u>	<u>NAVRESSO</u>	<u>MCES</u>	<u>Total</u>
	----- (millions) -----			
1974	\$ 79.1	\$53.4	\$14.2	\$146.7
1975	87.1	47.2	14.8	149.1
1976	78.5	45.9	13.6	138.0
1977	82.1	41.8	14.0	137.9
1978	131.8	46.2	16.0	194.0
1979	157.4	46.5	18.1	222.0

Dividends paid

<u>Fiscal year</u> <u>(note a)</u>	<u>AAFES</u>	<u>NARESSO</u>	<u>MCES</u>	<u>Total</u>	<u>Percent of earnings paid as dividends</u>
	----- (millions) -----				
1974	50.0	39.0	7.5	96.5	65.8
1975	58.0	35.3	7.2	100.5	67.4
1976	62.0	37.2	7.0	106.2	77.0
1977	63.8	37.9	8.0	109.7	79.5
1978	71.0	36.3	9.2	116.5	60.1
1979	81.0	36.8	11.7	129.5	58.3

a/Fiscal year ends on January 25th of the following year.



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ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D. C. 20301

22 MAY 1980

Honorable H. L. Krieger
Director, Federal Personnel
and Compensation Division
U.S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Krieger:

This is in response to your draft report dated April 24, 1980, on "Opportunities to Increase Military Exchange Benefits for Service Personnel," FPCD-80-50, OSD Case #5424.

This draft report is the result of a survey initiated by your office on November 22, 1978 with the stated objective of identifying means for evaluating (1) the need for the Department of Defense to provide exchanges, (2) the cost-effectiveness of operating three separate exchange systems, and (3) whether exchanges are providing only necessary goods and services at reasonable prices and only where needed.

The draft report is a wide-ranging document which recommends that the Department of Defense study the consolidation of the three exchange systems; that we eliminate the requirement to distribute exchange profits as a source of funds for other MWR activities; that we eliminate appropriated fund support for the exchange systems by requiring them to directly fund costs or to reimburse appropriations for support services; and, finally, that we budget for and justify to the Congress the full cost of Category III MWR Activities now partially funded with exchange profits.

[15] In our judgment the findings in the draft report do not sufficiently justify the above recommendations, nor does the report portray accurately the DoD position regarding the funding and operation of morale, welfare, and recreation (MWR) programs.

[22]

In 1976 the DoD assisted by OMB undertook a comprehensive study of the MWR program in consideration of previous recommendations made by the Congress, the GAO, and others. During the course of this study the method of funding and, specifically, the authorization for appropriated fund support was considered in great detail. One of the products of

this study was the publication of DoD Directive 1330.2, "Funding of Morale, Welfare and Recreation (MWR) Programs," dated March 17, 1978, attached at Tab A. This directive was furnished to the applicable committees of the Congress and to your office following publication. We believe that this directive is responsive to the needs of our Armed Forces personnel and their families and that it fairly and equitably provides for the shared funding of MWR activities by the taxpayers and by the Armed Services personnel themselves.

- [17] The basic rationale for providing appropriated fund support to military exchanges rests not upon the need to generate dividends for other MWR activities but rather to provide an essential institutionalized benefit to our Armed Services personnel, particularly those stationed or deployed outside the continental United States. For example, the largest single element of authorized appropriated fund (APF) support is for transportation of exchange goods overseas (54% of total APF support). The second largest element of APF support is for utilities and rents overseas (18%). Thus, nearly three quarters of the total appropriated fund support for exchanges is authorized in order to provide our Armed Services personnel abroad with exchange goods and services at approximately the same cost as they could be purchased in the continental United States. The other elements of authorized appropriated fund support in DoD Directive 1330.2 are generally what is referred to in the commercial sector as general and administrative (G&A) expenses. A portion of these G&A expenses are also incurred overseas.
- [22]
- [21] The recommendation in your draft report to eliminate all appropriated fund expense for the exchange services would heavily penalize our personnel stationed abroad, in terms of increased cost of living. Specifically, with regard to overseas transportation support, a previous GAO report, subject: "Effects of Reduced Funds for Transportation Overseas of Military Exchange Merchandise," dated August 14, 1979, LCD-79-224, OSD Case #5260, recognizes that if appropriated fund support were eliminated in this area, more foreign-made merchandise would be procured for sale in overseas exchanges; the cost of living, and thus the COLA, would be increased; and, to the extent U.S. goods continue to be shipped overseas, foreign flag carriers would be utilized to minimize transportation costs.

[GAO comment: As demonstrated in this report (see pp. 16 to 18), the exchanges can operate without the appropriated funds and without price increases if the requirement to generate profits is removed. The conclusions in the prior GAO report were based on the present funding method and did not consider other alternatives.]

The reimbursement of G&A expenses would also result in the exchange services reimbursing the government for such mandatory items as veterinarian and medical inspections and for communication, legal, and personnel support services which are provided to the exchanges "out of pocket" at little or no additional incremental cost to the government. Despite these considerations, the draft GAO report recommends that appropriated fund support for exchanges be withdrawn and that it be partially offset by direct Congressional appropriations into Category III Activities (as listed in DoD Directive 1330.2) at a savings to the taxpayer of 33 million dollars. We submit that when the MWR program is viewed in toto, a reduction of \$33 million would compel increased fees and charges to our service personnel.

[20]

[22]

As rationale for supporting direct appropriations into Category III Activities, the draft report suggests this would give Congress greater visibility over MWR expenses. This Department has and will continue to provide to the Congress any and all information that it needs to provide oversight over MWR activities. In this regard we have provided budget annexes to the Congress since FY76 and have provided post-fiscal year estimated appropriated fund support data and nonappropriated fund (NAF) expenditure data to those Congressional committees that have requested same. The semi-annual NAF construction report submitted to the Congress reports all construction starts costing over \$25,000 -- not only those over \$300,000 as noted on page 19 of your draft report. In addition, we receive numerous requests for specific, detailed information from individual members of Congress, which we answer expeditiously. Our records have been fully accessible to your office. In short, we have made every effort to respond to the Congress and to give the appropriate oversight committees every bit of financial data that they require. We have, in fact, volunteered these data in some instances because we feel that full and forthright disclosure is absolutely required to retain Congressional support for vital MWR programs.

[19]

[23]

[GAO comment: As discussed on p. 19, Defense has provided data requested by the Congress but this information did not include the amount of exchange profits and the use of them.]

We have recently prepared a revision to DoD Instruction 7000.12, "Financial Management of MWR Activities," which is designed to further refine our financial management procedures and reporting system. While these management reports are internal to this Department, they have and will continue to be provided to the appropriate committees of the Congress and to your office.

[20] We do not believe that additional appropriations directly into Category III will enhance the visibility of this program to the Congress nor do we believe that it is feasible and practical to do so. The draft report cites several instances of Congressional inquiry into this subject over the past 30 years, all of which have resulted in the same general conclusion reached by Chairman Vinson of the House Armed Services Committee in 1949: "The only way you can get a recreation program is through some money from some profit made from these stores (exchanges)." The trend of the past four fiscal years indicates the impracticability of fully funding Category III Activities with appropriated funds. The authorizations for appropriated fund support in DoD Directive 1330.2 have never been met. Due to restricted operations and maintenance funding, readiness priorities, and civilian personnel ceilings, the appropriated fund support for Category III Activities decreased from 56.6% of total program cost in FY 1976 to 48% in FY 1979. The draft report recognizes that civil service ceilings currently preclude additional appropriated fund support even if the funds themselves were to be made available. Beyond this the draft report might address the significant personnel turbulence that would occur through the conversion of several thousand NAF employees to civil service positions, and it might address the difficulties we would confront in constructing or renovating facilities with NAF if the exchange dividend is discontinued. Our letter on the funding of MWR construction sent to the Chairmen of four Congressional Committees on February 16, 1980 (attached at Tab B) is predicated on the continuation of exchange dividend in order to provide nonappropriated funding for those NAF-designated types of facilities listed in Enclosure 2 to the letter.

[GAO comment: If the Congress is provided data to show that direct funding of other MWR activities is less costly, we believe the Congress would provide those funds.]

[15] The draft report does not accurately state the position of this Department with regard to your recommendation that we study the consolidation of the three exchange systems. Based on our operational experience and the findings in the draft report, we do not think that there is a substantial probability that significant net benefits would accrue by consolidation of retail sales organizations. Catalog sales have, however, been consolidated as a result of earlier GAO findings. The draft report confuses the discussion of organizational consolidation and functional centralization. This Department has and will continue actively to pursue the latter, and, in fact, the draft report itself cites many such initiatives within the Army and Air Force Exchange System. With regard to organizational consolidation, the report does not make a strong case for consolidating the system. It does not provide evidence -- or even suggest a means of acquiring evidence -- that, for example, prices, patron support services, customer complaints, out of stock positions, or other quantitative indicators would be better in a consolidated system, nor even does it compare exchange performance with that of commercial retailers.

[9]

As a result of the Defense Audit Service report on the "Comparative Evaluation of the Management Policies and Procedures of the Military Exchange Systems," dated July 26, 1978, this office established the following seven criteria for evaluating exchange performance:

- Markup on Cost of Goods Sold
- Operating Expenses as a Percentage of Direct Sales
- Net Income as a Percentage of Direct Sales
- Inventory Turnover
- Sales per Manyear
- MWR Dividend as a Percentage of Net Income
- Per Capita MWR Dividend

[9] The GAO survey used no such quantitative techniques -- the draft report merely cites internal AAFES functional centralization savings as a model for the other exchange services. It does not mention similar centralization in the other exchange services made possible through improved communications and ADP technology. Data cited in the draft report do not support the position that central warehousing, transportation, or procurement would in fact improve support to our patrons and insure more efficiencies and economies. No source is given for the statement that transportation costs are cheaper FOB origin than FOB destination. No references are made to commercial practice.

[GAO comment: We have demonstrated in this report (see p. 9) that centralized warehousing, transportation, and procurement can reduce prices to the customers and improve management of the distribution system. We did not make the statement that transportation costs are cheaper FOB origin than FOB destination.]

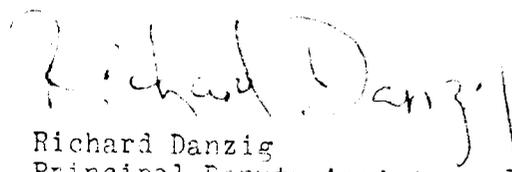
It is interesting to note that the working draft prepared for the exit conference on February 5, 1980, contained a statistical tabulation which clearly showed that after elimination of appropriated fund support the Marine Corps Exchange Service (MCES) (the most decentralized of our three services) generated net earnings as a percent of sales, five and six times higher than the Navy Resale and Services Support Office (NAVRESSO) and the Army and Air Force Exchange Service (AAFES), respectively. While we agree with your auditors that such a comparison is distorted by the fact that the MCES does not have to operate losing exchanges in remote areas, nonetheless we feel that your draft report could have provided comparative data on individual exchanges as a means of evaluating their effectiveness. The draft report also does not evaluate the very probable negative aspects of organizational consolidation. For example, it does not examine the difficulties of span of control, increased distribution costs, increased opportunity for fraud, or decreased managerial incentive at the individual exchange level. Further, it does not address the impact on many small businesses now selling or providing services to our exchanges, reduced merchandise selection to the patron, or responsiveness to customer needs.

[GAO comment: The purpose of this study was not to evaluate the operation of each of the separate exchange systems but to determine whether potential benefits could be achieved by consolidating functions. We demonstrated this for catalog operations, now Defense should analyze the other functions.]

This Department shares your objective to improve management in the exchange services and in other MWR activities. We will continue to pursue all avenues offering prospective net benefits to the taxpayers and to our Armed Forces personnel. We do not, however, believe that the draft report provides a basis for evaluating exchange missions or for improving the total MWR program. It is the Department's position that implementation of the recommendations in the draft report would result in reduced benefits to our people.

[GAO comment: Defense criticized the lack of evidence to support our position. However, even though four different groups have identified the potential for savings through consolidation, Defense has yet to study the matter. Its objections continue to be based on its beliefs rather than on a detailed study.]

Sincerely,


Richard Danzig
Principal Deputy Assistant
Secretary of Defense (MRA&L)

GAO note: The numbers in brackets refer to pages in this report.



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