PN-AAK-451

IMPROVEMENTS ARE NEEDED IN AID'S PROCEDURES FOR PROJECT COMMODITY PROCUREMENT

AUDIT REPORT NO: 0-000-81-142
September 30, 1981

Millions of procurement dollars could be saved if improvements in AID's project commodity procurement are made. We found that AID is paying unreasonably high prices for project commodities because the commodities are being purchased from middlemen who buy from other middlemen resulting in pyramiding prices. Also, purchase agents do not have an incentive for obtaining the best price because their fee is based on a percentage of cost. The Agency is in the process of reevaluating its project commodity procurement procedures to avoid the conditions described in this report.

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EXECUTIVE SUMMARY

Introduction

This report discusses the potential for saving millions of procurement dollars.

AID accumulates data indicating that over $700 million is spent annually to finance commodities for foreign assistance activities. (There are other funds spent for commodities by overseas missions and in contracts that are not included in this total.) About $500 of the $700 million is used to finance commodity import programs and other large purchases which were not included in this review. This review is focused on the other $200 million. A large portion of the $200 million was handled by middlemen in one of their several roles. On different occasions they act as purchasing agents, suppliers of record or contractors.

Most of the actual procurement is done by the host government. This is the result of AID policy as set forth in Policy Determination number 68 (as revised August 27, 1979). The Policy states, "AID policy is, therefore, one of preference that the procurement of AID-financed project goods and services required to implement bilateral project agreements be undertaken by Borrowers/Grantees rather than by AID." Regardless of who does the procurement, AID has a complex set of pricing rules required by law and regulation that must be observed. The Foreign Assistance Act and AID Regulations requires that commodities be procured at prevailing export market prices or lower.

This rule is not very specific but we believe that it conveys the intention that procurements should be made as economically as possible. The Surveillance and Evaluation Division of AID's Office of Commodity Management has the responsibility for monitoring compliance with AID's pricing rules. Division officials examine about 700 of the more than 7,000 annual transactions and either recovered or denied payments totaling about $2.6 million in calendar year 1980. Their reviews are for compliance with regulations and do not assure the most economical procurement.

Purpose and Scope of Review

The purpose of the review was to evaluate the effectiveness and economy of AID-financed commodity procurement involving middlemen and in particular to discover if prices were too high in terms of the law, regulations and good business practices.

From purchases totaling about $23 million, we reviewed prices paid in purchases amounting to $3.6 million from 103 contractors,

purchasing agents, manufacturers and suppliers. We selected procurement transactions from a computer listing of recently paid vouchers. The selection was based on the volume of transactions with any one firm and the location of the firms. We visited some firms and reviewed pricing documentation from many more. The review included AID pricing regulations, purchasing agreements and records of purchasing agents. We discussed our findings with AID officials and officials of the firms visited. Because of travel fund shortages, we limited our review primarily to AID-financed project procurements under host government contracts.

Poor Procurement is Costing AID Millions

In our opinion, AID is paying millions of dollars a year more than necessary because it finances the procurement of project commodities at unreasonable prices. We believe that the conditions we found are widespread and indicative of conditions to be found throughout AID-financed procurement because the conditions were either caused or encouraged by the project procurement system. This system and other conditions causing AID to pay higher prices for commodities are summarized below and discussed in the body of this report in more detail.

The Procurement Policy

As part of an overall AID thrust to place more responsibility for development on the host government (recipient country), AID's policy is to have the recipient country perform the procurement function. The original policy statement recognized that many developing countries did not have the capability of doing this and therefore stated that if a recipient did not have the capability, AID should provide the necessary technical assistance to teach them. Full implementation of the policy could have obvious developmental benefits.

The problem is that only the first half of the AID policy was implemented. The second half has not been done. Consequently, the procurement function was thrust upon the recipient countries without adequate technical assistance to teach them how to do it. This difficulty was exacerbated by the depletion of AID procurement technicians in the field. Other problems with AID's host government contracting policy are discussed in prior Inspector General Audit Reports No. 79-71, "Review of the Application of Host Country Contracting Mode", and unnumbered report of Sept. 19, 1978 "Implementation of AID's Policy on Preference of Mode of Contracting for Bilateral Assistance Projects". A list of findings from these reports is included as Exhibit D. Taken together the findings in these reports indicate that while host country contracting may be sound in theory, it is seriously flawed in practice.

AID Handbooks provide very little help in solving the procurement problem. They do set forth some rules to observe but do

not, for the most part, tell either a recipient country or an AID mission employee how and where to procure the commodities at the lowest prices.

Therefore, what has evolved is a separate procurement system for each overseas mission involving many contractors and purchasing agents. There is no assurance that commodities are being obtained at the lowest possible prices.

Moreover, there is little indication that either the recipient country or the AID missions care much about price as long as sufficient funds are available to procure the necessary commodities.

The procurement transactions discussed in this report show a wide range of price mark-ups from 13 to over 700 percent. However, to be conservative we estimate that at least 15 percent of the project procurement dollar could be saved (see Exhibit B). Many procurements suggest that the savings could be much higher.

Commodity Specifications Can Discourage Price Competition

Contractors and purchasing agents buy items from retail catalog firms even though they are available from other sources at much lower prices. This is caused by (1) a lack of commodity performance specifications that could broaden competition, and (2) the incentive for purchasing agents to pay higher prices because their fees are generally a percentage of cost.

In one case a purchasing agent bought commodities costing over $1.3 million from retail catalog suppliers. If purchased from a wholesaler, the prices are commonly 40 to 50 percent lower (see page 6).

We examined one procurement containing 185 line items and found that 172 of the items were purchased from the source suggested by the mission/recipient government. One item was for six (6) torque wrenches at a cost of $2,294.88. These wrenches could have been procured from a wholesaler for $305.35. Because of poor specification preparation the two kinds of wrenches were not equal. As a result of the audit the Surveillance and Evaluation Division has determined that the higher priced one selected was overpriced in terms of regulations and a refund is being sought.

AID missions and recipient countries specify catalog items because they do not have the technical ability to write performance specifications. We recognize that each mission and recipient

country cannot readily be provided with the necessary technical ability to write specifications. Accordingly, to avoid higher prices, alternative solutions must be developed by AID as discussed later in this summary.

Procurement Agreements - No Incentive to Obtain Lowest Prices

Recipient governments have a number of agreements with purchasing agents and contractors to obtain commodities for a fee based on a percentage of the cost of the commodities. In our view, these arrangements provide a disincentive to obtain the lowest price. Also, we do not believe that the recipient governments are learning procurement techniques while they merely contract out, in effect, the procurement function. For example, two purchasing agents that were included in the review bought large quantities of commodities from retailers or other suppliers whose prices reflected middleman profits. For example, a purchasing agent bought a piano from a middleman for a price of $1,400 and on another action bought an identical piano direct from the manufacturer for $965.00. The first transaction resulted in an unnecessary markup of 45 percent. Moreover, by paying the $1,400 the purchasing agent received a percentage of cost on a higher price. (The issue of the justification for buying pianos is being handled as a separate matter.)

In another case, a purchasing agent purchased floor polishers, accessories and scissors from a middleman at a cost of $2,226. The middleman had paid only $1,576 for these items. The difference represents a markup of 41 percent and again the purchasing agent received a percentage of cost on a higher price.

Purchasing agents are used because the recipient countries do not themselves have procurement capability. We believe that purchasing agents should be used only as a last resort, and suggest that the general use of purchasing agents should be phased out. Also, the agreements with purchasing agents have the attributes of a cost-plus-a-percentage-of-cost contract. 1/ Federal Procurement Regulations (see part 1-3.401(b)) state that "The cost-plus-a-percentage-of-cost system of contracting shall

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1/ Those contracts which meet the following test:

1. Whether payment is at a predetermined percentage rate.
2. Whether this rate is applied to actual performance costs.
3. Whether the contractor's entitlement is uncertain at the time of contracting.
4. Whether entitlement increases commensurately with performance cost.

not be used." In response to our inquiry, the Office of the General Counsel advised that the specific cost-plus-a-percentage-of-cost arrangement presented to them as an example violated contracting principals, if not the law. The General Counsel is currently reviewing the matter. Our review includes 46 commodity procurement agreements of this nature with two firms and we believe there are other firms with similar arrangements.

Formal Competitive Bidding Practices Do Not Ensure the Lowest Available Prices

A number of purchasing agents attempt to use competitive bidding for procurements but we found that about one-half of these attempts resulted in an award to a "sole responsive bidder." The bidding procedures used by purchasing agents were inadequate because (1) specifications would commonly be brand name or a specific catalog item rather than performance specification and (2) the best sources of the commodities (producers) were not always notified.

It is difficult to put a price tag on the lack of good competitive bidding, but we did trace through transactions to see what the potential for savings would be. For example, a purchasing agent awarded a cement procurement to a supplier for $112,812. We found the supplier had purchased the cement from a producer for $84,000 and marked it up 34 percent. The purchasing agent then added his seven percent. The cost of the cement paid for by AID eventually amounted to $120,708.

Procurement From Middlemen Increases Cost

Purchasing agents routinely obtain commodities from middlemen. They do it because it is easy. Also, it increases the purchasing agents profits as the costs rise.

The two middlemen we reviewed in some detail marked up prices from 13 to 37 percent. It is clearly not in AID's interest or the recipient country's interest to procure through layers of middlemen.

AID relies on the supplier's price certification made in Form 282 and Regulation No. 1 to protect against overpricing. These are after-the-fact protections which we do not believe substitute for good procurement practices.

In completing the certificate the supplier certifies that he has complied with the pricing provisions of Regulation No. 1, however, AID does not have the resources to monitor all the transactions. We found many apparent violations of pricing regulations and there

was a wide spread of price markups by middlemen. In fact, many of the middlemen bought commodities from other middlemen which further increased the commodity cost financed by AID. It is virtually impossible in some cases to trace commodities through layers of middlemen to finally reach the producer. It is safe to assume, we believe, that prices have been significantly marked up along the way.

DISCUSSION WITH MANAGEMENT OFFICIALS

We met with senior officials of the General Counsel's Office and the Office of Commodity Management, Bureau for Program and Management Services. The report was discussed in detail. Management officials did not dispute major conclusions and findings of this report; they agreed with the need to develop and apply a procurement methodology for AID-financed project commodities to assure the Agency that is is obtaining reasonable prices and avoiding unnecessary price pyramiding. In this regard, the reevaluation recommended has already started.

CONCLUSION AND RECOMMENDATION

AID does not have a system of procuring AID-financed project commodities that assures a reasonable price. The system--if it can be called one--has devolved into each AID mission and recipient government creating its own mechanism for procurement.

Neither the AID missions, recipient countries, nor AID Washington has the technical ability and resources to economically procure the project commodities needed for development activities. Therefore, alternatives have to be found.

We believe that AID must restructure the method of procuring project commodities to assure that economical prices are obtained at the time of purchase. Accordingly, we recommend that:

1. The Bureau for Program and Management Services reevaluate AID's present project procurement policy including consideration of:

    a. The success of AID's efforts to encourage recipients to develop their own procurement capabilities;

    b. The extent that AID's indirect involvement in commodity procurement satisfies responsibilities for buying at price levels prescribed by the Foreign Assistance Act;

c. The extent that AID's operating resources are applied to surveillance of commodity prices versus programming their use; and

d. Alternatives for economical procurements including

-- Federal Government sources such as the federal supply service of the General Service Administration;

-- Direct AID procurement;

-- Training to improve cost consciousness and commodity procurement expertise of AID mission and recipient government personnel;

-- Direct AID contracting out of the procurement function with an entity that would be a procurement specialist as opposed to a purchasing agent and under a contractual arrangement that provides an incentive for obtraining the lowest price.

BACKGROUND

In 1980, AID accumulated data indicating that over [1/] $700 million was spent to finance commodities for foreign assistance activities. About $500 million of the $700 million on which AID accumulates data is spent for commodity import programs and other large procurements which is being considered for a future audit. This review is focused on the other $200 million. A large portion of this $200 million is handled by middlemen in one of their several roles. On different occasions they act as purchasing agents, suppliers of record or contractors.

Normally, AID does not purchase the commodities because its policy is to place this responsibility with host governments receiving assistance. This policy is consistent with a basic AID principle that recipient countries should implement their own development programs. However, the policy also requires the recipient to comply with a complex set of AID rules on commodity prices.

The Foreign Assistance Act and AID Regulations require that commodities be procured at prevailing export market prices or lower. AID's implementing rules for project procurement, contained in Handbook 15, give the recipient the responsibility for assuring that no more than reasonable prices are paid for any goods or services financed by AID. Reasonable price is defined as no more than the lowest available competitive price. The lowest available competitive price requirement is satisfied if the buyer has followed good commercial practice and accepts the most advantageous competitive offer, price and other pertinent factors considered.

Aside from the benefit to development which may result from assuming responsibility for commodity procurement, it is important for the recipient to follow AID's pricing rules to avoid financial liability for overpricing. AID Regulation 1 and the provisions of the loans and grants provide recourse to AID for obtaining refunds from the recipient for overpricing.

Both AID and recipients have recognized the need for specialized procurement expertise to comply with AID's rules. AID has recognized that a number of less developed countries lack the expertise to assume responsibility for procurement of AID-financed commodities. For example, AID's policy that recipient countries should implement their own development programs is excepted if:

1/ There are additional commodity procurements contained in contracts for technical services and in overseas mission expenditures that are not included in this total. These additional expenditures are estimated to be $300 to $400 million.

"...a contracting entity of the country is judged to have insufficient experience and competence in contracting methods acceptable to AID, then the policy would call for the provision of formal or informal technical assistance to host countries who need it in the transition from direct AID to country contracting."

Another approach taken by AID enabling it to avoid getting directly involved in commodity procurement has been encouraging the use of procurement service agents, such as AAPC, Inc. formerly the African American Purchasing Center. These firms contract directly with the recipient government, or subcontract with country contractors. These procurement agents are U.S. firms, located in the U.S., who arrange the purchase of commodities for a fee or surcharge.

AID rules set out the maximum prices which can be charged by U.S. suppliers of commodities. These suppliers must refund any element of their selling price which is considered overpricing under the following guidelines.

The purchase price may not exceed the market price prevailing in comparable export sales in the U.S. at the time of the purchase or prices generally charged by the supplier in comparable export sales.

In the absence of comparable sales; if the supplier is not the producer, purchase price may not exceed the sum of:

- supplier's purchase price or producer's sale price, whichever is lower, and
- the lower of the supplier's or his competitor's usual mark-up over direct cost.

The Surveillance and Evaluation Division in the Office of Commodity Management has the major responsibility for monitoring compliance with AID's price rules for commodities. In some cases, the Division's review for price compliance is not undertaken until after payment. However, AID requires the supplier to submit the "Supplier's Certificate and Agreement With AID" when requesting payment. In this document the supplier certifies compliance with the appropriate price provisions and agrees to refund any portion not eligible for AID financing if there is a finding of noncompliance.

The Surveillance and Evaluation Division examines about 700 of the more than 7000 annual transactions. In calendar year 1980 this Division either recovered or denied payments totaling about

$2.6 million. These recoveries result only from overpricing in terms of regulations. Allowed prices under the regulations can be far in excess of the most economical procurement. The Surveillance and Evaluation Division has only five people to perform this work.

Purpose and Scope of Review

The purpose of our review was to evaluate the effectiveness and economy of AID-financed commodity procurement involving middlemen with particular attention to the level of commodity prices and the adequacy of AID's price surveillance. Our review sample was selected from vouchers totaling about $23 million worth of commodities.

From purchases totaling about $23 million, we reviewed prices paid in purchases amounting to $3.6 million from 103 contractors, purchasing agents, manufacturers and suppliers. We selected procurement transactions from a computer listing of recently paid vouchers. The selection was based on the volume of transactions with any one firm and the location of the firms.

We visited four firms having procurement agreements or supply contracts with recipient governments. We also reviewed pricing documentation from 99 firms supplying commodities to the direct contractors and visited three intermediate supply firms. We reviewed AID pricing regulations, purchasing agreements and contractor and purchase agent's records supporting pricing of AID financed project commodities. We discussed our findings with AID officials in Washington and responsible officials at the firms we visited. Because of travel fund shortages, we limited our review primarily to AID-financed project procurements under host government contracts.

FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

THE PROCUREMENT POLICY

It is AID policy that the implementation of development projects, including procurement be done by the host countries. In this regard Policy Determination No. 68, revised August 27, 1979, states in part:

> "A fundamental principle of AID and its predecessor agencies has been that the countries it assists should themselves undertake the implementation of their development programs, rather than employ AID as agent to do so.
>
> This principle rests on a number of considerations, the first and most important of which is that the ultimate responsibility for all development projects rests with the countries whose projects they are. Moreover, the process of implementation is itself an important opportunity for development of technical, institutional and administrative skills. To the extent AID performs as implementing agent, countries forego those benefits. Finally, AID is not principally a procurement agency and must conserve its staff resources for its primary fuctions as a planning, financing and monitoring agency."
>
> "AID policy is therefore, one of preference that the procurement of AID financed project goods and services required to implement bilateral project agreements be undertaken by Borrowers/Grantees rather than by AID. The policy applies to all country specific project assistance procurement."

In discussing host country implementation of development activities AID Handbook 1, Part VII - 1 states in part:

> "These policies are interrelated and sometimes conflicting, especially in the short term. For example, in many cases Agency-financed development projects can be managed more efficiently by U.S. than by local personnel; and in extreme cases (e.g., in some least-developed countries) reasonably competent local talent is so scarce that it may be necessary to have AID or other U.S. managerial personnel involved at each stage

of the implementation process. At the extreme, efficient utilization might thus conflict sharply with the second AID policy of relying on LDC institutions. However, if the U.S. personnel have as a prime goal the building of LDC institutions and managerial competence through on-the-job managerial training of local personnel, with a gradually increased role in actual project implementation, then the conflict virtually disappears in the long run. While AID policy cannot provide precise answers as to appropriate "trade-offs", it would clearly be advisable to accept some (or sometimes a substantial) temporary loss in efficiency in return for a gain in LDC managerial competence resulting from the implementation experience, so that the LDC will later be able to speed up its economic-social development."

This section of Handbook 1 goes on to state:

"Greater reliance on LDC implementation of AID-financed projects/programs does not reduce the Agency's responsibility to assure efficient utilization of AID resources; and Missions and Bureaus must therefore continue to exercise oversight over Agency-financed activities. However, a larger role for LDC's will enable AID to concentrate more of its resources on planning, design, and evaluation functions, including the training of LDC personnel in these areas, so as to assure effective as well as efficient projects/programs."

We believe that the portion of AID policy that pushes toward host country implementation of development activities (including procurement) has largely been achieved. However, it is our opinion that the portion of the policy statement that recognizes that many countries do not have the capability and states that AID will assist in developing the capability has not been sufficiently addressed. AID is therefore left with the remainder of the policy which states in effect that AID is still responsible for the efficient utilization of resources.

AID NEEDS TO IMPROVE ITS CONTROL AND SURVEILLANCE OVER PRICES PAID - OVERVIEW

AID is not directly involved in the procurement of the project commodities that it finances. AID relies on a price surveillance unit to monitor prices and detect overpricing. This unit does not have sufficient staff to do the job, therefore, this safeguard is not working. We sampled purchases totaling $3.6 million and estimate potential savings at $544,525 (or 15 percent) by implementing more economical procurement practices (see Exhibit B).

We believe that this estimate of potential savings is conservative and that the actual savings from economical procurement could be much higher than 15 percent.

This section of our report describes conditions which make commodities more expensive to AID. We do not believe there are any quick or easy solutions which would be effective. Accordingly, our report does not attempt to recommend corrective actions for specific procurement actions we consider questionable. Rather, we believe the most productive approach for AID is for review and consideration of its procurement policy options at the highest management level.

COMMODITY SPECIFICATIONS CAN DISCOURAGE PRICE COMPETITION

Contractors and procurement service agents buy AID-financed commodities from retail catalog firms even though available from other sources at substantially lower prices. They also buy brand name items although similar items may be available at lower prices. Other commodities which would do the job could often be obtained at lower prices if procurement specifications described utility or performance standards rather than source or brand names.

One purchase agent limited procurements to specific brands of commodities costing about $400,000. We estimate that 15 percent of this price or $60,000 could have been saved if the purchase had not been restricted to a specific brand or source. Another agent bought commodities costing over $1.3 million directly from eight retail catalog suppliers in 1980. We estimate AID could have saved at least 15 percent or $195,000 if this purchase agent had not obtained these commodities from retail catalog suppliers.

Another example illustrates the differences between wholesaler and catalog prices. 1/

1/ These examples were obtained from a procurement in which the wholesaler offer was selected and are presented here to illustrate the difference between wholesale prices and catalog prices.

Item Description	Quantity Purchased	Prices Quoted		
		Wholesaler	Catalog Supplier #1	Catalog Supplier #2
Hack Saws	42	$ 126.00	$ 180.60	$ 167.16
Hand Saws	42	163.80	475.44	375.00
Flat Files	48	276.96	337.08	286.08
Round Files	48	175.68	213.72	175.20
Hand Drills	42	957.60	1,190.70	1,549.38
Totals		$1,700.04	$2,397.54	$2,552.82
Price Increase Over Wholesale (percent			41	50

Obviously, even more saving could be made if the commodities were purchased from the manufacturer. We can not estimate the overall extent of savings available Agency-wide by eliminating such practices. In the first place, although the original source may be a catalog supplier, the commodity is sometimes obtained by the purchase agent through a middleman and AID's records only show the first level of supplier. Also, for the majority of transactions, AID records simply do not identify the producer. In any case, these practices and inordinately high prices, which violate Agency pricing policies, are not being detected by AID.

Why Agents Buy Brand Name and From Catalog Suppliers

We reviewed eight payment vouchers submitted to AID by one purchase agent for commodities obtained from retail catalog suppliers. These vouchers contained 185 items. The agent purchased 172 of the items from the source suggested by the AID mission or recipient country without making any useful price comparisons. Many of these items were available from alternative sources at considerable savings. For example, in one case six torque wrenches costing $2,294.88 were purchased from the suggested source even though available from an alternative source for $304.35. It should be noted that the different wrenches were not exactly equal in quality because of poor specification preparation. However, it was determined that the expensive wrenches selected were overpriced even in terms of regulations and a refund is being sought.

We found a high correlation between the suggested source and the source from which purchased. Usually the agent had obtained prices only from the suggested sources, however, we noted one case that the purchase agent did not limit himself to the suggested source, but bought from a distributor at considerable savings. The agent obtained four bids on these commodities and purchased them at prices that were 33 percent below the suggested source. (See page 17). This was an exception to the normal practice of most agents.

In our view, three factors contribute to the practices described above, i.e., paying higher prices because commodities are purchased from suggested sources. First, it is likely that AID mission and recipient government personnel often are not adequately trained in commodity procurement and the writing of commodity specifications. Although AID has recognized that such expertise is lacking in some countries, we question whether the need for training has been given adequate consideration. Under present circumstances, the simplest solution for some AID mission and recipient government personnel has been to specify items in catalogs. Second, the purchase agent has no incentive to translate brand names to performance standards. This issue is discussed beginning on page 9. Third, the very practice of using catalog descriptions for commodities would often exclude consideration of similar, less expensive commodities.

Handbook 15 instructions for developing specifications for procurement of commodities provide that:

> Each item is normally described by its technical nomenclature and specifications. When it is expedient to cite catalog references or brand names, the words "or equal" are added and the catalog identified by name of company and date it was used. It is also desirable to use more than one brand name before the "or equal" if possible. Maximum participation by all qualified suppliers is desired and should be made as broad as practicable.

In our opinion, these instructions, while they may allow a little too much leeway in citing catalog sources, are otherwise adequate as general guidance.

Conclusion

During the procurement process steps could be taken to preclude buying from retail levels and catalog suppliers--when specifications are written; and when bids are solicited. We believe it is unreasonable to expect AID missions and recipient country personnel to understand the U.S. supply market and develop effective specifications without specialized training. Such training has to our knowledge never been given.

Under present practices, we also would not expect the procurement agent to translate catalog or brand name specifications into commodity specifications in terms of performance standards. There is no incentive for the agent to take on this additional work since his fee is related to the price he pays for commodities

and changing the specifications could reduce the price to AID and correspondingly the fee he earns.

We also do not believe AID/Washington has the staff or information available to adequately monitor procurement sources and identify uneconomical procurements prior to payment for commodities.

The practice of identifying procurement source is, in our opinion, only symptomatic of a more basic, underlying problem. The remainder of this report describes other practices which we believe are also illustrative of a larger problem.

PROCUREMENT AGREEMENTS -- NO INCENTIVE TO OBTAIN LOWEST PRICES

Recipient governments have a number of agreements with purchase agents and contractors to obtain commodities for a fee based on a percentage of the cost of the commodities. In March 1981, as a preliminary response to our inquiry, AID's General Counsel said that the procurement services portion of one of the agreements, a contract, is specifically precluded by statute. For the other agreement, which was with a procurement service agent, General Counsel said while cost-plus-percentage-of-cost contracting 1/ provisions were violated,

> "...we make no finding as to whether this violates statutory provisions..., or policy provisions applicable to Host Country Contracting as set forth in Handbook 1...The Office of GC/P&T is undertaking a review of Handbook 15 and they will review this question to make a dispositive decision for GC. They will also develop an alternative for or rationale for...doing business...in light of that decision."

During our review, we identified 46 such commodity procurement agreements between recipient governments and purchase agents.

1/ Those contracts which meet the following test:

1. Whether payment is at a predetermined percentage rate.
2. Whether this rate is applied to actual performance costs.
3. Whether the contractor's entitlement is uncertain at the time of contracting.
4. Whether entitlement increases commensurately with increased performance cost.

We are concerned that such agreements provide no incentive for the purchasing agent to obtain the lowest competitive price. Furthermore, such agreements do not appear to support AID's policy of encouraging recipient governments to assume procurement responsibility.

Conclusion

While developing a method of continuing to do business with purchase agents may bring Agency practices within regulations, it will not assure the most economical procurements.

Why Purchasing Agents Are Employed

AID's policy is to place the responsibility for commodity procurement with the recipient government. Many less developed recipients have relatively small procurement staffs with limited experience in purchasing U.S. commodities. Also, AID missions in such countries are limited in providing detailed commodity procurement assistance because of small staffs.

In order to assist recipient governments and AID missions, a non-profit company, AAPC, Inc., was organized to perform procurement services. AID helped establish AAPC, Inc. by providing cash grants. Handbook 15 outlines procedures for using AAPC. Fees are determined as a percentage of the cost of the commodities.

Other firms are providing procurement services for AID recipients around the world under the same type of agreement as AAPC. One purchase service agent, for example, has 29 agreements to obtain commodities worth over $10 million with 15 recipient countries at a fee of seven percent of the price of commodities. Exhibit C shows the recipient countries we reviewed having agreements with purchase agents.

Purchase agents were intended as one alternative for procurement in cases where there is limited recipient country capability. Handbook 15 lists several other procurement sources which could be used, such as the General Services Administration Federal Supply Service, the Defense Supply Agency, and U.S. universities. We believe the use of purchase agents should be phased out and recipient country capabilities in procurement be developed. However, purchase agent's services may be necessary in the short term because no alternative procurement source may be available.

No Incentive to Purchase at Lowest Competitive Price

We reviewed commodity procurement transactions by two purchase service agents. We found numerous instances where commodities could have been obtained at lower prices. We also noted that satisfactory performance, as viewed by the recipient, is more related to delivery dates than prices.

Typical wording of agreements with purchasing agents is as follows:

Case (1) "Authorized agent - Government of Jamaica acting through AAPC. The payment of fees for purchasing commodities authorized by this document are reimbursable at the rate of 7% of the FAS value of transactions plus other agreed fees where applicable."

Case (2) "Authorized Agent - (Name of purchase service agent) Agent's compensation shall consist of a procurement fee of seven percent, assessed on the FAS port of exit value of commodities purchased as shown in each supplier's invoice."

It is obvious that the purchase agent's fee increases as the commodity purchase price increases. Thus, under these existing procurement arrangements, the agent is rewarded for obtaining commodities at higher prices.

Both agents we reviewed purchased large quantities of commodities from retailers or other suppliers whose prices reflected middlemen's profits. In 1980 AAPC purchased over $1.2 million in commodities from three middlemen. These firms buy from other suppliers or manufacturers. Their prices are marked up over cost to obtain profit. One of the three firms increased its prices an average of 37%, or $59,374 over acquisition costs. The other agent we reviewed is purchasing commodities valued at about $120,000 from two middlemen. The agents could have saved the cost of middlemen profits and obtained the commodities at more competitive prices in accordance with AID price rules if they had procured directly from manufacturers or their agents.

For example, AAPC purchased two pianos in 1979, one through a middleman and one directly from the factory. The middleman purchased the piano 2/ from the manufacturer for $965.00 and raised the price to $1,400, making a profit of $435, or 45% of cost.

2/ Why AID is financing pianos is being handled as a separate issue.

AAPC also purchased another of the same model piano from the manufacturer and paid $965. The following table shows the effect on AID-financed price and AAPC's fee of buying through a middleman.

	Factory	Middleman	Percent Increase
Price	$ 965.00	$1,400.00	45
Inland Transportation and Fees	115.00	80.00	
AAPC Fees/charges	75.60	123.11	
Total AID Financed	$1,155.60	$1,603.11	39

In another case, AAPC, Inc. purchased floor polishers and accessories and scissors from a middleman at a cost of $2,226. The middleman had obtained these items from the producers at a cost of $1,596. Thus, AAPC, Inc. paid 39 percent more than was necessary by procuring from a middleman rather than the producer. However, its fee would have been lower.

Also, AAPC, Inc. bought 400 rolls of fencing from a supply catalog at a unit price of $4.40 per roll. In another transaction, the same wire was purchased later, from a middleman, for $3.95 a roll, a saving of 10%. Neither source could be expected to provide the best available price because neither source represented the manufacturer directly. The example illustrates that even among middlemen some prices are worse than others.

It was not possible to determine how much money could have been saved if fees were based on factors other than cost of commodities. However, as illustrated in examples above, the potential for savings is significant.

Conclusions

We believe AID should recognize there are a number of drawbacks to doing business with purchase service agents under present agreements.

- -- Obtaining commodities at lowest prices is doubtful due to lack of incentives.
- -- Monitoring prices is difficult due to lack of comparable price data.
- -- Using agents is not consistent with AID's policy of encouraging recipient countries to take responsibility for procurement of commodities.

FORMAL COMPETITIVE BIDDING PRACTICES DO NOT INSURE LOWEST PRICES

AID regulations stipulate that the Agency will pay no more than "prevailing export market price" for commodities. One method of insuring that it receives such prices is through application of a formal bidding procedure. While purchasing agents usually attempt to follow the procedures for competitive bidding, we found they are often making awards based on just one complete bid. For example, 59 of 125 awards we reviewed were made to "sole responsive bidders".

AID is obviously not receiving the benefits of price competition which results from true competitive bidding. We found, for instance, that price competition can result in savings of up to 50%. We believe that AID's regulation for procurement through formal bidding procedures is adequate but not being enforced in cases where only one responsive bid is being obtained.

Regulation No. 1 and Competitive Bidding

It is difficult to determine "prevailing export market prices" under the best circumstances. AID Regulation No. 1 therefore provides that:

> 3/ A price resulting in an award under a formal competitive bid procedure conducted in accordance with (Regulation 1) will satisfy the ("prevailing market price") requirements: Provided, that AID determines that the formal bid procedure attracted a sufficient number of independent, responsive bids to assure that competition was achieved.
>
> (Emphasis added)

The AID mission and/or host government often review the results of competitive bidding prior to making of an award. For most of the transactions we reviewed, they were not concerned with the number of bids obtained as long as sufficient funds were available and commodities could be quickly delivered. The Surveillance and Evaluation Division of AID has apparently only looked at a few procurements awarded under competitive bidding. However, a recent study by the Surveillance and Evaluation Division suggested that competitive bidding procedures may not be effective in obtaining adequate price competition in all cases. According to the study,

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3/ Effective June 5, 1981 regulations were amended to make formal competitive procurements subject to Regulation No. 1.

responses for some types of commodities are received from a limited number of bidders, all of whom are middlemen and who may be overpricing by virtue of their limited purchasing power. Our findings agree with the study.

Over 40% of the awards in our sample were based on one responsive bid as illustrated in the chart below.

Purchase Service Agent	No. Awards Reviewed	$ Value	No. of Awards With One Resp. Bidder	$ Value
AAPC, In.	16	432,539	11	297,212
Another Purchase Agent	109 1/	1,755,422	48	726,578
Totals	125	2,187,961	59	1,023,790

Why Purchasing Agents Make Single Bid Awards

The purchasing agents we reviewed usually requested bids through advertising, direct mail, and telephone solicitation. However, the number of awards going to middlemen suggests the agents did not identify the best procurement sources. As previously discussed, another factor undoubtably was the specification of source or brand name in the description of commodities sent to suppliers being requested to bid.

One purchasing agent told us that both recipient governments and AID missions place a premium upon an agent's ability to deliver desired commodities quickly. He said that the governments and missions accepted his award recommendations without question over 90% of the time. When questions were raised, they invariably involved an increase in the quantity of commodities or speed of delivery, not the number of bidders or cost. He felt that his company's future as a purchasing agent depended on speed and reliability in delivering commodities.

The Surveillance and Evaluation Division advised us that it has not had the resources to perform reviews prior to award acceptance. The host government and AID missions who do make reviews appear to place greater emphasis on speed of delivery

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1/ Includes recommended awards for which purchase orders have not yet been placed.

than on obtaining price competition. Thus, it appears that single bid awards are being made simply because no objections are being raised prior to the procurement. Obviously, more time is required to properly write commodity specifications and more attention by all concerned; i.e., the agents, the mission, and the recipient, to obtaining more bidding on procurement transactions if AID is to rely on competitive bidding procedures to obtain competitive market prices.

Effects of Single Bid Awards Difficult to Identify

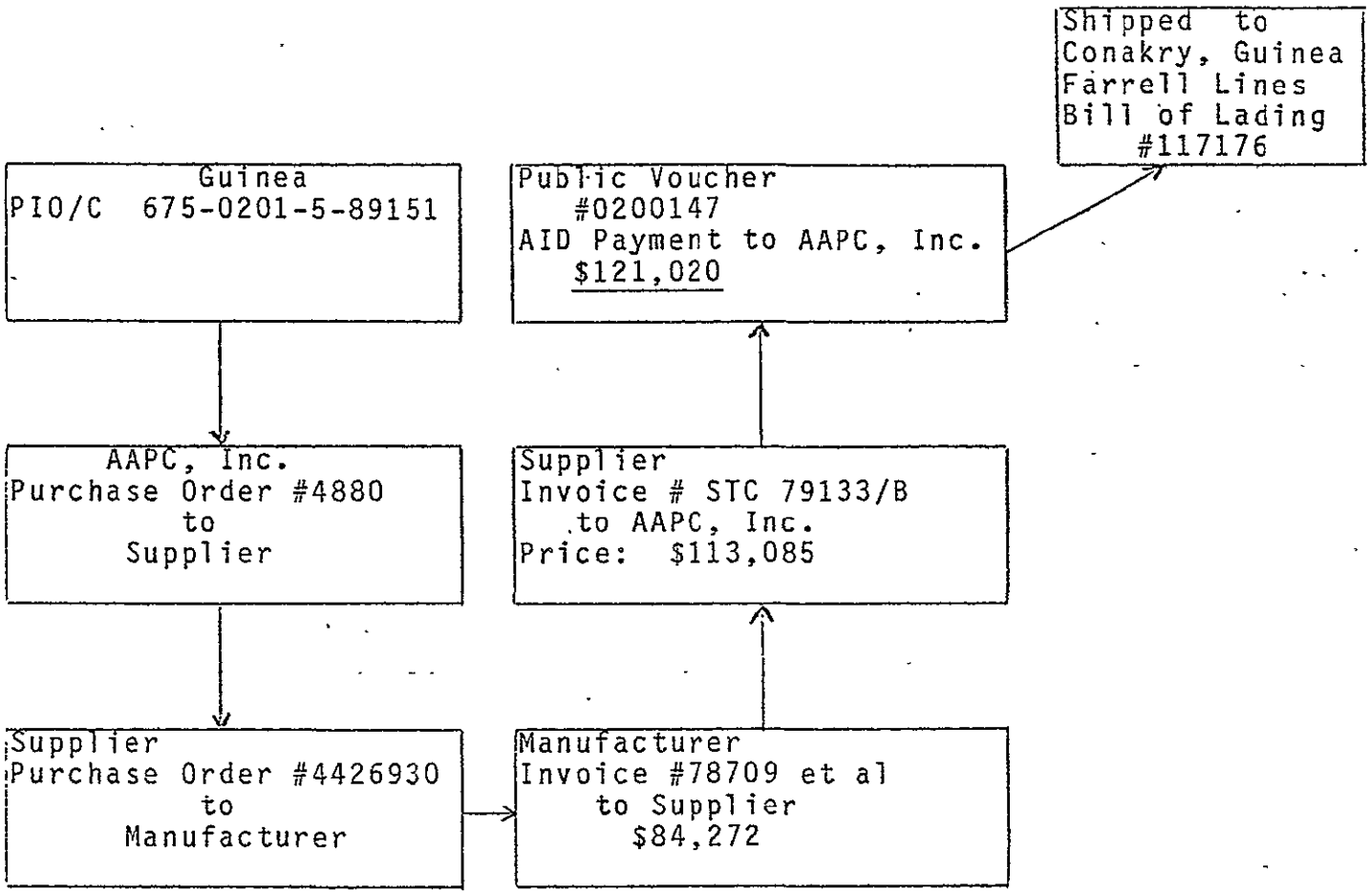
When commodities are purchased with only one bidder's price to consider, the extent that other suppliers could furnish the commodities at lower prices is unknown. One bid does not preclude obtaining the best price - but it is not very likely. In most of the cases we reviewed involving single bid procurement, we could not establish the price effect because competitors prices had not been obtained. However, we found some indications of the effects of inadequate price competition.

One of the most important factors in obtaining adequate price competition is obtaining bids from the appropriate level of supplier. In 32 percent of the transactions we reviewed, the procurement service agents made single bid awards to middlemen and retail catalog suppliers. Such suppliers must obtain commodities from other sources and add a profit to their price quote. To illustrate the effect, a purchase agent awarded a procurement for cement to a supplier. The supplier purchased the cement from a manufacturer for $84,000 and added 34% ($28,812) to the price before submitting a bid to the purchasing agent (see chart on p. 16). The supplier told us that he had received no discount from the manufacturer which would not also have been given to the purchasing agent or the mission.

We were informed by SER/COM officials that this transaction was complicated by improper commodity specifications prepared by an AID-financed contractor. Also, the producer declined to take the contract because of cumbersome paperwork. Nevertheless the transaction illustrates the excessive procurement costs incurred by AID because they did not obtain commodities directly from the manufacturer. We were also informed that the paperwork associated with the transaction amounted to only two or three documents. In our view, the middleman did very little to earn a profit of about $28,000.

ILLUSTRATIVE EXAMPLE OF A SIMPLE (1 PURCHASING AGENT/1 MIDDLEMAN) COMMODITY PURCHASE

(Commodity: 25,000 bags of PORTLAND CEMENT)



Note: Description of Supplier Operation

One middleman we visited handling a substantial amount of AID business was a one man business. Working alone, he spent his day on the telephone arranging and completing commodity purchases from other middlemen and retailers. He subsequently transferred the commodities to purchase service agents. His office, located in New York City, is comprised of a single room, approximately 12 ft. by 12 ft., containing a desk, chair, typewriter, duplicating machine, file cabinet and bookshelf holding retail catalogues and telephone books. He rarely sees the commodities he is passing up the pipeline to AID field projects.

Cases where several bids were obtained illustrate that significant savings can result. In the procurement transaction shown in the chart below, the Mission suggested commodities from a supply catalog source. The agent, however, saved 33% by buying commodities from an alternate source.

	PRICE COMPARISON			
	ALTERNATIVE SOURCE	SUGGESTED SOURCE		
	DISTRIBUTOR	CATALOG SUPPLIER #1	CATALOG SUPPLIER #2	MIDDLEMAN
# of items quoted	28	27	26	28
Prices - 28 items	29,514.86			42,760.62
Prices - 27 items	26,226.26	34,890.78		
Prices - 26 items	26,027.18		40,674.30	
Percent Over Distributor Price	____	33.05	55.08	44.80

Conclusion

Purchasing agent's lack of success in obtaining bids from sufficient numbers of suppliers can be attributed in part to poorly written specifications and the absence of incentives for them to do better.

PROCUREMENT FROM MIDDLEMEN INCREASE COST

The purchasing agents we reviewed routinely obtain commodities from middlemen whose profits are made from marking up prices over the cost. AID Regulation No. 1 recognizes some circumstances for buying from intermediate suppliers who are not the commodity producers. The maximum price for such procurements is based on comparable sales price or a "normal" or "usual" mark-up if there are no comparable sales.

Two intermediate suppliers we reviewed raised prices an average of 13% and 37% respectively, increasing costs on $1.64 million worth of commodities by $245,600. It is clear the cost of

middlemen's profits could have been saved if the agents had omitted the middlemen. Also, in some cases these middlemen purchased from other middlemen, further increasing cost.

Under AID price rules for a sale by a supplier who is not the producer, if comparable sales prices are not available, purchase price shall not exceed:

1) The lower of the price paid by the supplier of the commodity or the price charged by the producer in the original sale of the specific commodity, and,

2) A markup over the amount allowed in (1) above which may not exceed the lower of either the markup over direct cost that is usual and customary in sales by the supplier of the same commodity, or the markup that is usual and customary in such sales by the competitors of the supplier.

In our view, these rules are difficult for AID to apply because of lack of information on comparable prices, producer prices and determining what is usual markup.

We believe it is virtually impossible for AID to determine the extent maximum prices may have been exceeded for the large numbers of transactions involved. The criteria in AID Handbooks are not a useful tool for monitoring such procurement prices.

Reliance on Supplier Price Certification is Ineffective

We reviewed samples of purchase agent's procurements from middlemen to attempt to verify compliance with AID price rules. In no case did the agent have information on comparable market prices or producer's prices in his file. However, documentation for each transaction included AID forms No. 282 completed by the middleman. The form 282 consists of an "Invoice and Contract Abstract", and "Supplier's Certificate and Agreement With the Agency for International Development". In completing the form the supplier certifies that he has complied with the applicable provisions of AID Regulation No. 1 and that purchase price is not higher than allowed under Regulation No. 1. The supplier agrees to refund any amount of purchase price to AID found to be in excess of that allowed by regulation. But because of the lack of comparable prices the agents were not in a position to evaluate prices.

At best, the 282 is an after-the-fact mechanism to review price. The price review when done is only in terms of allowable price. Allowable price can be well in excess of the most economical price.

One middleman we visited had an extensive library of manufacturer's and distributor's price catalogs. These catalogs could

serve to establish comparable prices. If a comparable price cannot be so established, the cost of acquisition and the middleman's normal markup over purchase price becomes the maximum. The question then becomes what is a usual or normal price markup. As suggested by the following schedule of middlemen markups, guidelines are needed to determine normal markup.

Item	Middleman's Purchase Price	AID Purchase Price	Middleman's markup - % of price
Scissors	26.40	61.80	130
Wrench	5.00	10.00	100
Ladder	270.00	308.58	14
Slicer	1,043,30	1,382.00	32
Hoes	150.21	180.00	20
Megaphone	99.25	206.25	108
Construction belt	17,200.00	25,800.00	50

In some cases the middleman purchased the commodity from another middleman and the producer's price was unknown. Where there are no comparable sales, it is also necessary to determine producer's price which would normally be lower than price paid by the middleman.

	Purchase Prices			
Item	Agents'	1st Suppliers'	2nd Suppliers'	Producers'
Water Heater	$ 522.00	327.00	UNK	UNK
Farm Equip.	1,190.00	738.32	UNK	UNK
Calculators	1,133.50	982.75	UNK	UNK

We could not identify the extent that AID-financed commodities are being obtained from suppliers who are not producers because AID's records did not readily identify most of the producers. Also, in cases of more than one middleman, we could not trace through all purchasers to identify the producer and his prices. However, the transactions we sampled provided ample evidence that

-- Purchasing through middlemen increases costs to AID,

-- Agents could obtain the same commodities at lower prices by going directly to producers,

-- Maximum prices are being exceeded and AID price provisions are being violated, and

-- The supplier's certification (AID form 282) does not assure that AID is obtaining a reasonable price.

Conclusion

The presence of middlemen in the process of buying the commodities AID finances is redundant when a purchase agent is already being paid to buy the same commodities. The middlemen's efforts are rewarded with profits, which increases costs unnecessarily. Like the other questionable procurement conditions already described, we believe the presence of middlemen reflects a complete lack of emphasis on economy in AID's procurement policy.

AID SHOULD REEVALUATE ITS PROCUREMENT POLICY

The objective of AID's procurement procedures--which is to develop the recipient's procurement capability in consonance with AID's Host Country implementation policy--has not worked in many countries. (See Exhibit D for a summary of past findings.) Too many recipients have not assumed the responsibilities. Instead, with AID's blessings, they obtain procurement services from U.S. contractors and purchase agents, in effect circumventing the intent of AID's policy objectives. A training program for both mission and recipient government personnel would have been needed, but to our knowledge, was never implemented.

AID's procurement policy also makes it more difficult to ascertain compliance with the price provisions of the Foreign Assistance Act. The Act charges AID with paying no more than prevailing export market prices for the commodities it finances. However, as the act of purchasing has moved from AID to recipient, then in some cases further away to purchase agents and contractors, and still further to middlemen, timely detection of overpricing becomes unlikely.

In 1980, AID spent over $700 million to finance commodity purchases, transportation, insurance and fees related to getting the commodities to the recipient. Five AID employees are assigned to monitor these prices. AID also relies on the suppliers's certification of price compliance; however, this system only provides recourse against overpricing after the fact. The system should establish an economical price at the outset.

We recognize that AID's programmatic concern is to emphasize the accomplishment of development activities and the acquisition of commodities needed to do so rather than the cost of commodities. We also recognize that AID's policy of placing the responsibility for commodity prices on the recipient is supportive of AID's objectives to foster development, so long as this responsibility is accepted. However, we believe these policies are out of balance with the pricing responsibilities placed on AID by the Foreign Assistance Act and the general responsibility of a Federal agency for the economical use of taxpayer's funds.

Recommendations

The Agency should reevaluate AID's present procurement policy including consideration of:

1. The success of AID's efforts to encourage recipients to develop their own procurement capabilities;

2. The extent that AID's indirect involvement in commodity procurement satisfies responsibilities for buying at price levels prescribed by the Foreign Assistance Act;

3. The extent that AID's operating resources are applied to surveillance of commodity prices versus programming their use; and

4. Alternatives for economical procurements including

   -- Federal Government sources such as the federal supply service of the General Services Administration

   -- Direct Aid procurement

   -- Training to improve cost consciousness and commodity procurement expertise of AID mission and recipient government personnel

   -- Direct AID contracting out of the procurement function with an entity that would be a procurement specialist and under a contractual arrangement that provides an incentive for obtaining the lowest price.

EXHIBIT A

LIST OF REPORT RECIPIENTS

Deputy Administrator	1
Assistant Administrator/Bureau for Program and Management Services (AA/SER)	5
Assistant Administrator/Bureau for Africa (AA/AFR)	1
Assistant Administrator/Bureau for Asia (AA/ASIA)	1
Assistant Administrator/Bureau for Latin America and the Caribbean (AA/LAC)	1
Assistant Administrator/Bureau for Near East (AA/NE)	1
Audit Liaison Office (AA/SER)	1
Director, SER/COM	5
General Counsel (GC)	1
Office of Financial Management (FM)	1
Inspector General (IG)	1
RIG/A/EA	1
RIG/A/EAFR	1
RIG/A/Egypt	1
RIG/A/LA	1
RIG/A/NESA	1
IG/PPP	1
AIG/II	1
IG/EMS/C&R	16

SUMMARY OF AUDIT UNIVERSE AND TRANSACTIONS SELECTED FOR DETAILED REVIEW

Type of Supplier	$ value of audit universe (vouchers selected for review)
1. Contractor	$ 484,044
2. Combination Contractor/Middleman	1,644,809
3. Purchase Agent	10,748,680
4. Combination Purchase Agent/Middleman	10,082,200
5. Contractor	160,075
6. Middleman	218,657
Total of audit universe	$23,338,465

POTENTIAL FOR SAVINGS IDENTIFIED IN SAMPLE TRANSACTIONS

Basis for Excessive Procurement Costs	Value of Sample	Estimated Excess Cost	Percent
Restrictive Specifications 1/	$1,305,305	$ 195,795	15%
Price Pyramiding 2/	387,968	77,493	20%
Contractor Markup Over List Price	1,943,218	271,236	14%
	$3,636,491	544,524	15%

1/ PIO/C Specifications taken directly from catalogues.

2/ Multiple Middlemen

EXHIBIT C

Recipients's Purchase Agreements With U.S. Purchase Agents Reviewed

Recipient	Value of Commodities
Bangladesh	$ 812,764
Sri Lanka	1,900,292
Yemen	1,643,000
Seychelles	70,000
Rwanda	180,000
Tanzania	47,283
Burundi	705,000
Djibouti	25,000
Indonesia	3,147,000
Malaysia	697,821
Sao Tome	600,000
Guinea	571,600
Philippines	126,915
Swaziland	543,034
Guyana	30,000
Jamaica	445,866
Niger	372,581
Cameroon	17,200
Ghana	11,200
Kenya	171,000
Somalia	40,000
Upper Volta	331,740
Senegal	152,835
Chad	130,000
	$12,772,131

EXHIBIT D

SELECTED FINDINGS IN IG REPORTS ON HOST GOVERNMENT CONTRACTING

I. Findings in Audit Report 79-71, May 18, 1979 "Review of The Application of Host Country Contracting Mode".

A. Most recipient countries do not have adequate contracting ability and require extensive AID assistance.

B. AID missions do not adequatley assess the capability of host countries to effectively contract.

C. Host country contracts go largely unaudited.

D. There is no complete list of host country contracts.

E. Missions need to improve host country contract documentation.

II. Findings in unnumbered Audit Report dated Sept. 19, 1978 "Implementation of AID's Policy on Preference of Mode of Contracting for Bilateral Assistance Projects."

A. Host country officials don't have the capability to implement contracts therefore the AID missions have to do it for them.

B. AID guidance to the overseas missions on the implementation of host country contracts is inadequate.

C. AID missions do not justify and document exceptions to the host country contracting policy.