GAO

Report to Congressional Committees

April 2020

COMMISSARIES AND EXCHANGES

DOD and Congress Need More Reliable Information on Expected Savings and Costs of Consolidating the Defense Resale Organizations

GAO-20-418

GAO Highlights

Highlights of GAO-20-418, a report to congressional committees

April 2020

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DOD and Congress Need More Reliable Information on Expected Savings and Costs of Consolidating the Defense Resale Organizations

Why GAO Did This Study

DOD operates about 240 commissaries and 2,500 exchanges that sell groceries and retail goods and services to servicemembers, their families, and retirees. Commissaries and exchanges are operated by four resale organizations, and in November 2018 a DOD task force completed a business case analysis on consolidating those organizations.

The National Defense Authorization Act for Fiscal Year 2020 included a provision for GAO to review DOD's business case analysis. This report evaluates the extent to which (1) DOD's business case analysis for consolidating the four resale organizations provided reliable savings and cost estimates and (2) the military departments concurred with the business case analysis and DOD shared their accompanying comments with Congress.

GAO evaluated the business case analysis against DOD- and GAO-identified key elements of economic analyses; reviewed comments on the business case analysis; and interviewed DOD officials.

What GAO Recommends

GAO is making four recommendations, including that DOD reassess and update as necessary its estimates for consolidation savings and costs, and provide additional information to Congress on the military departments' comments on the November 2018 business case analysis. DOD concurred with three recommendations and provided updated estimates. DOD did not concur with the last recommendation. GAO continues to believe providing such information is beneficial, as discussed in the report.

View GAO-20-418. For more information, contact Elizabeth A. Field at (202) 512-2775 or fielde1@gao.gov.

What GAO Found

A Department of Defense (DOD) task force's business case analysis for consolidating the defense resale organizations—the Defense Commissary Agency (DeCA), the Army and Air Force Exchange Service, the Navy Exchange Service Command, and Marine Corps Community Services—may not provide reliable savings and cost estimates. These organizations sell groceries and retail goods to servicemembers, their families, and retirees. The task force recommended consolidating the four resale organizations into a single organization, estimating "net savings" (i.e., savings minus costs) of about $690 million to $1.3 billion during the first 5 years. However, the task force may have overestimated savings and underestimated costs.

- **Savings from reducing the cost of goods sold.** The task force estimated that DOD would save several hundred million dollars annually by reducing the cost of purchasing goods that are resold in stores. Specifically, the task force multiplied the fiscal year 2017 total cost of goods sold for all four resale organizations by industry benchmarks, reasoning that mergers lead to more savings when merging organizations sell a high amount of identical products. However, task force data show that DeCA and the exchange organizations have limited identical products; the overlap between DeCA products and those of at least one exchange organization amounts to less than one-third of the total cost of goods sold. Thus, multiplying the benchmarks by the total cost of goods sold for all four organizations may not have been appropriate.

- **Information technology (IT) costs.** The task force estimated the costs of developing new, common IT systems to operate a consolidated resale organization to be between $326 million and $401 million, about 50 percent of estimated consolidation costs. The task force stated that it based IT cost estimates on data resale organizations provided for major upgrades or system replacements. But GAO found that about 40 percent of the IT cost estimate was based on minor upgrades or partial replacements, not major upgrades or system replacements. Thus, the estimate may be understated.

- **Headquarters relocation costs.** According to the task force, there will be costs if DOD decides to relocate the four defense resale organizations to a new headquarters location. However, the task force did not include cost estimates for relocation in its business case analysis.

According to federal law, the operation of the commissary and exchange systems may not be consolidated unless authorized by Congress. Until the task force reassesses and updates, as necessary, its savings and costs estimates, DOD and Congress will not have reliable information to consider resale consolidation.

The military departments officially concurred with the business case analysis, but provided written comments detailing fundamental concerns with the analysis, such as the use of proprietary industry benchmarks and the estimated savings and costs. In April 2019, DOD reported to Congress that the military departments agreed with consolidation, but did not disclose the accompanying comments. Without more complete reporting of those comments, Congress has limited visibility of the views of the organizations involved in a potential consolidation.

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Abbreviations

AAFES	Army and Air Force Exchange Service
DeCA	Defense Commissary Agency
DOD	Department of Defense
IT	information technology
MCCS	Marine Corps Community Services
NEXCOM	Navy Exchange Service Command

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April 30, 2020

The Honorable James M. Inhofe
Chairman
The Honorable Jack Reed
Ranking Member
Committee on Armed Services
United States Senate

The Honorable Adam Smith
Chairman
The Honorable Mac Thornberry
Ranking Member
Committee on Armed Services
House of Representatives

The Department of Defense (DOD) operates about 240 commissaries and 2,500 exchange facilities worldwide to enhance the quality of life of uniformed servicemembers, their families, and retirees by providing reduced-priced groceries and retail goods and services.[1] Commissaries provide groceries and household goods at reduced prices to eligible customers.[2] To pay for operating costs that exceed the commissaries' sales revenue, Congress directed that approximately $1.3 billion annually from fiscal years 2015 through 2019 be made available from amounts appropriated to the Defense Working Capital Fund for commissary use. Exchanges provide goods and services similar to department or retail stores and also operate other stores, such as gas stations and

[1]According to DOD policy, authorized commissary customers include uniformed personnel, wage Marine personnel, retired personnel, recipients of the Medal of Honor, 100-percent disabled veterans, and authorized family members. As of January 1, 2020, commissary access was also authorized for Purple Heart recipients, former prisoners of war, all veterans with service-connected disabilities, and caregivers of eligible veterans enrolled under the Department of Veterans Affairs Program of Comprehensive Assistance for Family Caregivers. Authorized exchange customers include uniformed personnel, recipients of the Medal of Honor, honorably discharged veterans, military members of foreign nations, and family members of authorized personnel, among others.

[2]DOD is required to establish the sales price of commissary merchandise at the level that will recoup the actual product cost of the item. Additionally, DOD is authorized to establish a variable pricing program in response to market conditions and customer demand, which allows for an alternative sales price surcharge of not more than 5 percent of sales proceeds. Prior to fiscal year 2017, DOD was required to apply a uniform surcharge equal to 5 percent on the sales price.

convenience stores. In fiscal year 2018, the exchanges generated about $12 billion in sales revenue. Unlike commissaries, exchanges rely on non-appropriated funding, including sales and other revenue, to cover operating expenses. Revenue generated by the exchanges also helps fund certain morale, welfare, and recreation activities.[3]

Commissaries and exchanges are operated by four separate organizations, referred to in this report as the defense resale organizations. The Defense Commissary Agency (DeCA) has operated all DOD commissaries since 1991; prior to that, the military services operated their own commissaries. The Army and Air Force Exchange Service (AAFES), the Navy Exchange Service Command (NEXCOM), and Marine Corps Community Services (MCCS) operate their own service-specific exchanges.[4] Each of these four defense resale organizations has its own headquarters, chief executive officer or equivalent, and board of directors.[5] According to federal law, the defense commissary system (DeCA) and the exchange stores system (AAFES, NEXCOM, and MCCS) currently must be operated as separate systems of DOD, and the operation and administration of these defense retail systems may not be consolidated or otherwise merged unless specifically authorized by Congress.[6]

Prior studies have recommended consolidating the existing defense resale organizations, citing the potential to eliminate redundancies and achieve cost savings. For example, in 1990, a DOD study group recommended that the three exchange organizations be consolidated into

[3]DOD's morale, welfare, and recreation programs provide servicemembers and their families with a wide range of benefits designed to support military missions and readiness. Such programs include fitness, libraries, camping, performance arts, and golf. In August 2018, we recommended that DOD evaluate the funding targets it had set for morale, welfare, and recreation programs and develop measurable goals for those programs' performance measures. DOD concurred with those recommendations but has not yet taken action to address them. For more information, see GAO, *Military Personnel: DOD Needs to Improve Funding Process for Morale, Welfare, and Recreation Programs*, GAO-18-424 (Washington, D.C.: Aug. 8, 2018).

[4]In addition to the Marine Corps' exchanges, MCCS also operates the Marine Corps' morale, welfare, and recreation and family programs.

[5]DeCA headquarters is at Fort Lee, VA; AAFES headquarters is in Dallas, TX; NEXCOM headquarters is in Virginia Beach, VA; and MCCS headquarters is at Marine Corps Base Quantico, VA.

[6]10 U.S.C. § 2487 (b).

a single exchange organization, similar to DeCA.[7] In 2015, the Military Compensation and Retirement Modernization Commission went further and recommended that all four resale organizations be consolidated into a single organization.[8]

No consolidation has taken place since DeCA was created in 1991, and DOD stated in a 2016 report that it did not recommend creating a single resale organization at that time due to the differences in how DeCA and the exchange organizations fulfill their specific missions and deliver their respective benefits (we assessed this report in November 2016; see app. I for information on our prior work related to commissaries and exchanges).[9] However, in May 2018, the Deputy Secretary of Defense, citing challenges generally faced by grocers and retailers, stated that consolidating the four defense resale organizations offered the greatest potential to achieve efficiencies needed for the survivability of the defense resale enterprise.[10]

The Deputy Secretary of Defense also directed DOD's Chief Management Officer to establish a task force to perform a business case analysis for consolidating the resale organizations. The task force—which comprised DOD officials supported by contractors, including from Boston Consulting Group—completed the business case analysis in November 2018.[11] In its business case analysis, the task force recommended consolidating the four defense resale organizations into a single organization, and estimated that consolidation would result in "net savings" (i.e., estimated savings minus estimated costs) ranging from $690 million to $1.3 billion during the first 5 years, followed by annual net savings of approximately $390 million to $670 million.

[7]Office of the Assistant Secretary of Defense (Force Management and Personnel), *DOD Study of the Military Exchange System: Volume I Study Report* (Sept. 7, 1990).

[8]Military Compensation and Retirement Modernization Commission, *Report of the Military Compensation and Retirement Modernization Commission: Final Report* (Jan. 29, 2015).

[9]DOD, *Report on Plan to Obtain Budget Neutrality for the Defense Commissary System and the Military Exchange System* (May 2016).

[10]Deputy Secretary of Defense Memorandum, *Enterprise Management of Community Services Task Force* (May 29, 2018).

[11]Community Services Reform Task Force, *Study to Determine the Feasibility of Consolidating the Defense Resale Entities: Business Case Analysis* (Nov. 14, 2018).

The National Defense Authorization Act for Fiscal Year 2020 included a provision that we review DOD's business case analysis.[12] This report evaluates the extent to which: (1) DOD's business case analysis for consolidating the four defense resale organizations provided reliable savings and cost estimates and (2) the military departments concurred with the business case analysis and DOD shared their accompanying comments with Congress.

For our first objective, we reviewed the task force's business case analysis to identify the savings and cost estimates for consolidating the defense resale organizations. We assessed the extent to which the task force developed reliable savings and cost estimates in its business case analysis by evaluating it against the key elements of an economic analysis, as identified in DOD Instruction 7041.03, *Economic Analysis for Decision Making*, the *GAO Cost Estimating and Assessment Guide*, and our *Assessment Methodology for Economic Analysis*.[13] We used our *Assessment Methodology for Economic Analysis* to assess the business case analysis against five key methodological elements that are necessary for an economic analysis: objective and scope, methodology, analysis of effects, transparency, and documentation. Each key element consists of economic concepts that represent best practices. These key methodological elements are not intended to be exhaustive or to supersede or alter relevant federal and agency requirements for economic analysis. We determined whether the business case analysis considered and properly adhered to each of these key elements. We use "fully met" to indicate that the business case analysis considered and followed the best practices for a key element and "partly met" to indicate that the business case analysis partly considered and followed the best practices for a key element.

We also obtained data and met with officials from the task force (including contractors from Boston Consulting Group), the Office of the Secretary of Defense, the military departments, and the four defense resale organizations—DeCA, AAFES, NEXCOM, and MCCS—to understand and evaluate the task force's savings and cost estimates. Additionally, we

[12]Pub. L. No. 116-92, § 633 (Dec. 20, 2019).

[13]DOD Instruction 7041.03, *Economic Analysis for Decision Making* (September 9, 2015) (Incorporating Change 1, October 2, 2017); GAO, *GAO Cost Estimating and Assessment Guide: Best Practices for Developing and Managing Capital Program Costs*, GAO-09-3SP (Washington D.C.: March 2009); and *Assessment Methodology for Economic Analysis*, GAO-18-151SP (Washington, D.C.: Apr.10, 2018).

reviewed prior reports on defense resale reform, including reports from DOD, the Military Compensation and Retirement Modernization Commission, and Boston Consulting Group.[14]

For our second objective, we reviewed the written comments on the business case analysis from the military departments and the defense resale organizations. We also reviewed DOD's April 2019 report to Congress on the task force's business case analysis[15] and evaluated the extent to which it included information on the recommendations of the Secretaries of the military departments, as required by the John S. McCain National Defense Authorization Act for Fiscal Year 2019.[16] Finally, we met with officials from the task force, the military departments, and the four defense resale organizations to discuss the comments and concerns submitted on the business case analysis.

We conducted this performance audit from June 2019 to April 2020 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

In June 2018, DOD's Chief Management Officer established the Community Services Reform Task Force to perform a business case analysis to determine whether consolidating the defense resale organizations would result in efficiencies. The task force conducted its work from July 2018 through November 2018, during which it collected financial and other data from the four resale organizations and conducted workshops with subject matter experts from the resale organizations. In November 2018, the military departments were given an opportunity to

[14]DOD, *Report on Plan to Obtain Budget Neutrality for the Defense Commissary System and the Military Exchange System* (May 2016); *Report of the Military Compensation and Retirement Modernization Commission: Final Report* (Jan. 29, 2015); and Boston Consulting Group, *Military Resale Study: Assessment of Opportunities for the Defense Commissary Agency and Evaluation of Consolidation in the Broader Military Resale System* (July 10, 2015).

[15]DOD, *Report to Congress: The Department of Defense Report on the Development of a Single Defense Resale System* (Apr. 29, 2019).

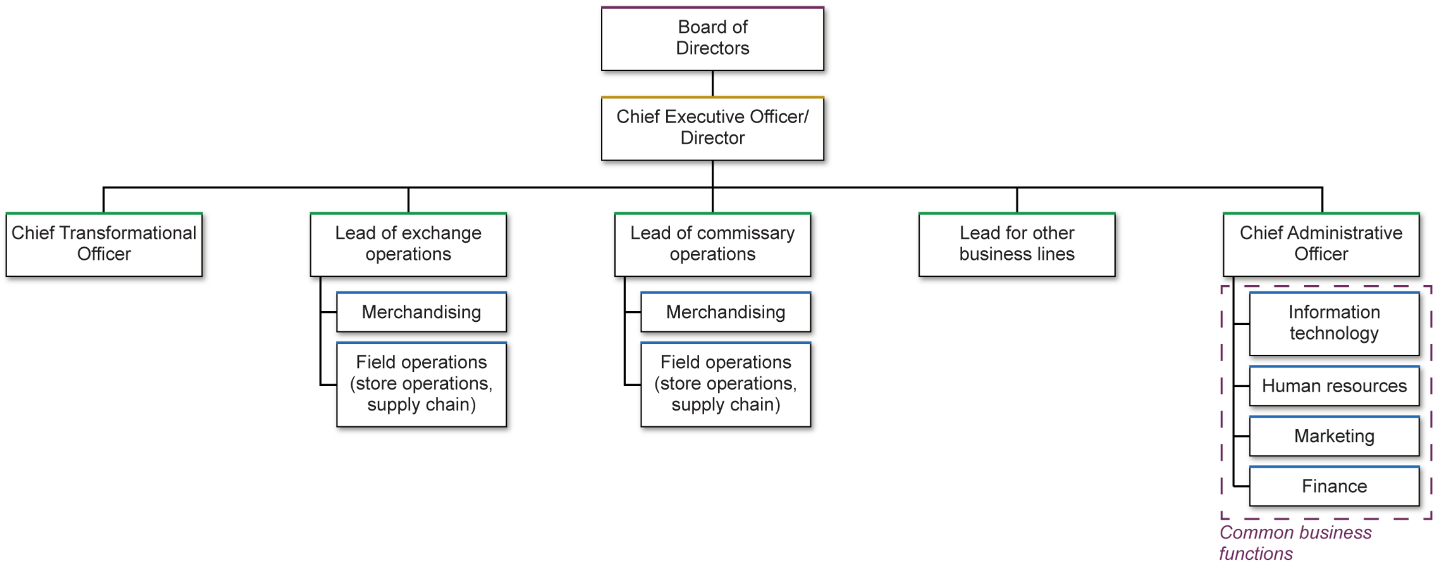
[16]Pub. L. No. 115-232, § 627 (2018).

review the business case analysis, provide comments, and indicate whether they concurred with the analysis.

In its business case analysis, the task force recommended consolidating the four defense resale organizations into a single organization.[17] The task force stated that consolidation would eliminate duplication that currently exists across the resale organizations and increase the competitiveness, or financial viability, of defense resale, which has seen sales declines in recent years. Specifically, the task force recommended that a single chief executive officer or director be responsible for leading the organization and report to a single board of directors. The task force also recommended that separate leadership positions for commissary operations and exchange operations be established, and that a chief administrative officer manage the business functions that are common to the current resale organizations, such as information technology (IT), human resources, marketing, and finances. Figure 1 shows the task force's recommended organizational chart for the consolidated resale organizations.

[17]Other possible courses of action were identified in the business case analysis, to include full consolidation that would combine commissary and exchange stores and exchange-only consolidation. The business case analysis included a brief benefits and risk discussion for each course of action, but the task force did not assess these other possible options in detail.

Figure 1: Task Force's Recommended Organizational Chart for the Consolidated Defense Resale Organization



Source: Community Services Reform Task Force's business case analysis. | GAO-20-418

The task force estimated that the time frame for consolidating the four defense resale organizations would be 5 years for implementation, and that consolidation would result in "net savings" (i.e., estimated savings minus estimated costs) ranging from about $690 million to $1.3 billion during the first 5 years, followed by annual net savings of approximately $390 million to $670 million every year thereafter.[18] Specifically:

- **Estimated savings:** The task force estimated that consolidating the four defense resale organizations would result in savings in three areas: (1) reduction of the cost of goods sold in the commissaries and the exchanges; (2) reduction of the cost of goods and services that are not sold but are necessary for operating stores (e.g., plastic shopping bags and custodial services); and (3) reduction of payroll costs by eliminating redundant personnel.[19] According to the task

[18]According to task force officials, the estimates for savings and costs from consolidation include both appropriated and non-appropriated funding.

[19]According to the business case analysis, the task force expects to achieve personnel savings by reducing the number of current full-time equivalents used to carry out business functions that are common to the four resale organizations and would be consolidated in the new organization, such as merchandising, IT, human resources, finance, and procurement.

force, consolidation would result in estimated savings of $1.4 billion to $2.1 billion over the first 5 years, followed by annual savings of $470 million to $750 million.

- **Estimated costs:** The task force estimated that consolidating the defense resale organizations would result in costs from four areas: (1) development of new, common IT systems; (2) severance pay for separating employees and retention bonuses to incentivize employees to remain;[20] (3) operation of a transformation management office, supported by private contractors, to implement the consolidation; and (4) costs to convert DeCA to a non-appropriated fund organization. According to the task force, consolidation would result in estimated costs of $700 million to $810 million over the first 5 years, followed by annual costs of $80 million.

DOD's Chief Management Officer in March 2019 and the Deputy Secretary of Defense in August 2019 both approved the results of the business case analysis and directed that plans be made for consolidation, pending congressional action to remove the statutory prohibition on consolidating the commissary and exchange systems.[21]

DOD's Business Case Analysis Supporting Defense Resale Consolidation May Not Provide Reliable Savings and Cost Estimates

The task force may have overestimated the expected savings from reducing the "cost of goods sold" (i.e., the cost of purchasing products that are resold in commissaries or exchanges) and underestimated the expected costs from IT consolidation and headquarters relocation.

[20]According to the business case analysis, the task force expects personnel reductions to be realized through attrition, voluntary separation, or involuntary separation. Involuntary separation would result in severance payment costs. The task force also expects there to be retention bonus costs to prevent certain key employees with unique and valuable skills and organizational knowledge from departing.

[21]The business case analysis recommends that DOD introduce legislative proposals to Congress that remove barriers between appropriated and non-appropriated funded organizations to allow for consolidation. As mentioned previously, DeCA relies on appropriated funding and the exchange organizations rely on non-appropriated funding and, based on current law, the commissary and exchange systems must be operated separately.

Appendix II contains our detailed assessment of the business case analysis against the five key elements of an economic analysis.[22]

DOD's Task Force May Have Overestimated the Expected Savings to Be Achieved from Reducing the Cost of Goods Sold

The task force estimated that most of the savings (i.e., about 70 percent annually) to be achieved from consolidating the four defense resale organizations would result from reducing the cost of goods sold. According to the task force's business case analysis, retailers often pay different costs for identical products, and mergers are an opportunity for retailers to compare costs across a larger combined organization and make decisions that maximize savings. In the case of a consolidated defense resale organization, the task force stated in its business case analysis that savings could be achieved by implementing what the task force called category management reforms and by obtaining the lowest cost for identical products sold by both commissaries and exchanges.[23] Task force officials added that one board of directors and one chief executive officer overseeing the consolidated resale organization would be more likely to achieve savings than the current, individual boards of directors and chief executive officers of the resale organizations.

According to the business case analysis, the four defense resale organizations sell a high percentage of identical products, and retail mergers lead to higher savings when the level of identical products sold is high among the merging organizations. Specifically, the task force stated in its business case analysis that about 62 percent of the cost of goods sold for the four defense resale organizations in fiscal year 2017 were for products sold by two or more of the four resale organizations.[24] That is, identical products were either sold by:

[22]GAO-18-151SP.

[23]According to the task force's business case analysis, category management reforms include shifting the volume of goods purchased between different vendors, reducing the number of brands and products on store shelves, and selling more private label products (i.e., store brand alternatives to national brands). In 2015, Boston Consulting Group recommended that DeCA implement similar category management reforms to reduce expenses. DeCA officials told us that they began implementing these reforms in fiscal year 2017 and that DeCA began realizing savings from the reforms in fiscal year 2019, totaling approximately $50 million.

[24]According to the task force, cost of goods sold among the four defense resale organizations totaled $12.8 billion in fiscal year 2017. However, the task force included only scannable products in its analysis, which totaled $9.5 billion in fiscal year 2017. "Scannable" products are products that can be scanned and tracked by a universal product code. Products that are not scannable are generally sold by weight or volume—such as fuel, meat, and produce—and were excluded from the task force's analysis.

- DeCA and one or more exchange organization, or
- Two or more of the exchange organizations (and not DeCA).

In addition to overlap in identical products sold, task force officials told us that savings from category management reforms are dependent, in part, on the amount of overlap in vendors that sell products to the resale organizations. Specifically, task force officials stated that there are opportunities to reduce cost of goods sold through negotiations with vendors that sell items to both DeCA and the exchange organizations. For example, task force officials stated that the consolidated organization could negotiate better prices with a vendor that sells family-size items to DeCA and single-size items to the exchange organizations, even though those items are not identical.

Industry Benchmarks

The industry benchmarks used by the task force are based on proprietary data gathered and owned by Boston Consulting Group based on its experience working with mergers and category management reforms in the private sector retail industry. These benchmarks were presented as a percentage of cost of goods sold; specifically, the task force estimated that savings from obtaining the lowest cost for identical items were from 1 to 1.5 percent of the cost of goods sold, and savings from category management efforts were from 2.5 to 4 percent of the cost of goods sold. We did not review and evaluate the underlying data that were used to develop the proprietary benchmarks.

Source: Community Services Reform Task Force. | GAO-20-418

Based on this information, the task force calculated the estimated savings that would result from reducing the cost of goods sold by multiplying the total cost of goods sold for all four resale organizations in fiscal year 2017 ($9.5 billion) by industry benchmarks developed by Boston Consulting Group (see sidebar for more information on these benchmarks). This calculation showed an estimated annual savings of $329 million to $517 million from reducing the cost of goods sold.

However, additional information from the task force suggests this savings estimate may be overstated because there is limited overlap in the products DeCA sells (i.e., groceries and household goods) and the products the exchange organizations sell (i.e., goods and services similar to retail stores). According to the task force, about $2.2 billion of DeCA's cost of goods sold in fiscal year 2017 were for products also sold by at least one of the exchange organizations, which is equivalent to about 23 percent[25] of the total cost of goods sold for the four resale organizations.[26] This differs from the data provided in the business case analysis, which stated that 62 percent of the total cost of goods sold was for identical products sold by two or more resale organizations; however, that figure also includes products sold by two or more exchange

[25]In written comments on a draft of this report, DOD revised that number, stating that the actual amount of identical products sold by both DeCA and by at least one exchange was about 32 percent of the total cost of goods sold. However, DOD did not provide supporting documentation that would allow us to validate this number.

[26]Task force officials told us there may be other products sold by two or more resale organizations that are similar to each other yet not identical—such as a 6-pack mega roll and an 8-pack regular roll of paper towels, each with the same volume. However, the task force did not include these types of products in its analysis.

organizations and not DeCA (we further discuss product overlap among the exchange organizations below). Given the more limited product overlap between DeCA and the exchange organizations, it is unclear whether using the total cost of goods sold for all four resale organizations as the basis for estimating savings was appropriate.

Additionally, the business case analysis did not fully identify the amount of vendor overlap that exists between DeCA and the three exchange organizations, but the data that were provided in the business case analysis suggest that limited vendor overlap exists. Specifically, the business case analysis provided data for 10 vendors that sell to the defense resale organizations, but those vendors represent less than 20 percent of the cost of goods sold to DeCA and the exchange organizations in fiscal year 2017. Further, only 5 of the 10 vendors identified in the business case analysis sold goods to both DeCA and the exchange organizations, and their cost of goods sold accounted for about 10 percent ($972 million) of the total cost of goods sold for the four resale organizations ($9.5 billion). Based on these data, the extent of vendor overlap between DeCA and the exchange organizations—and, as a result, how much can be saved through category management reforms by consolidating DeCA and the exchange organizations—is unclear.[27]

Although the task force stressed the importance of a conservative estimate in both its business case analysis and in meetings with us, our assessment of the assumptions and methodology for estimating savings from the cost of goods sold found that a more conservative approach could have been used to better ensure estimated savings were not overstated. For example, one method could have been to multiply the benchmarks by the cost of goods sold for just the three exchange organizations (about $5.5 billion in fiscal year 2017, per the task force), as data provided by the task force indicate that about 67 percent of the cost of goods sold for the exchange organizations in fiscal year 2017 were for identical products sold by at least two exchange organizations. Another method, which task force officials suggested after we shared our concerns about their methodology, could have been to multiply the

[27]In written comments on a draft of this report, DOD stated that 97 percent of DeCA's cost of goods sold were from vendors that also sold products to one or more of the exchanges. However, this information was not included in the business case analysis nor provided to us during the course of our review. In addition, DOD did not provide supporting documentation that would allow us to validate the data. According to task force officials, they did not include this information in the business case analysis because they determined it was not needed to support their recommendation to consolidate the resale organizations.

benchmarks by the cost of goods sold for the exchange organizations, plus the portion of DeCA's cost of goods sold that overlaps with at least one exchange organization (about $2.2 billion in fiscal year 2017, per the task force). Either method would be more conservative than the one adopted in the business case analysis and would yield a savings estimate that is about 20 to 40 percent lower, but would be more consistent with the task force's assertion that consolidation savings are dependent on the amount of overlap among the merging organizations.

DOD policy states that an economic analysis should base its analysis of benefits on facts and data whenever possible.[28] Additionally, our *Assessment Methodology for Economic Analysis* states that an economic analysis should examine the effects of an action by considering relevant alternatives and justifying what the world would be like under each alternative; describe and justify the analytical choices, assumptions, and data used; and assess how plausible adjustments to each important analytical choice and assumption affect the estimates of savings.[29]

Ensuring that the estimates for cost of goods savings are accurate is particularly important, as they account for approximately 70 percent of the task force's overall savings estimate from consolidation. However, the task force did not fully identify and analyze in its business case analysis how many identical products are sold by both DeCA and the exchange organizations or how many vendors sell products to both DeCA and the exchange organizations. According to task force officials, they did not provide data on product overlap between DeCA and the exchange organizations because it would not change their savings methodology or estimate, and they did not provide more information on vendor overlap because of the proprietary nature of that data. However, the amount of product and vendor overlap that exists across the four resale organizations will have a direct effect on the amount of savings to be achieved from consolidation, as acknowledged by the task force.

Without the task force reassessing the approach it used to estimate savings from the cost of goods sold and, if necessary, making adjustments to those estimates, decision makers in DOD and Congress may lack confidence in the reliability of the task force's savings estimates

[28]DOD Instruction 7041.03.

[29]GAO-18-151SP.

in the business case analysis and will not have complete information as they consider defense resale consolidation.

DOD's Task Force May Have Underestimated the Expected Costs of Consolidating the Four Defense Resale Organizations

Based on our analysis of the business case analysis, we found that DOD's task force may have underestimated the expected costs of consolidating the four defense resale organizations in two areas: (1) the development of new, common IT systems and (2) the location of a new headquarters for the consolidated organization.

Task Force May Have Underestimated the Cost of Consolidating Defense Resale Organizations' IT Systems

The task force estimated in its business case analysis that most of the costs (i.e., about 50 percent annually) of consolidating the four defense resale organizations will result from developing new, common IT systems to support the consolidated organization. In the business case analysis, the task force stated that it worked with the four resale organizations to calculate a cost estimate of $292 million to $352 million for developing five types of IT systems that are needed for the consolidated organization: merchandising, store inventory management, financial management and general ledger, transportation and logistics, and ecommerce.[30]

According to the business case analysis, the task force's cost estimates for developing new, common IT systems for the consolidated organization were to be based on data provided by the resale organizations on recent or projected costs for replacing similar systems or performing major upgrades to existing systems, when available. For example, the task force's estimate for the merchandising system was approximately $115 million, which the business case analysis stated is based on a $35 million estimate provided by AAFES, a $23.5 million estimate provided by

[30]The task force's business case analysis also includes cost estimates of $34 million to $49 million for other IT-related expenses, such as private contractors to manage the consolidation of IT systems.

NEXCOM, a $15 million estimate provided by MCCS, and a $41 million estimate provided by DeCA.[31]

However, the task force's cost estimate for IT consolidation may be understated because it is based, in part, on less expensive minor IT system upgrades and partial replacements, according to the resale organizations. Based on our analysis of information provided to us by the resale organizations, about $140 million (about 40 percent) of the overall IT cost estimate was based on what the resale organizations described as minor upgrades or partial replacements.

Specifically, while MCCS confirmed the cost estimates attributed to them in the business case analysis were for total IT system replacement costs, the other three resale organizations—AAFES, NEXCOM, and DeCA—disagreed with the task force's characterization that all the data used to calculate IT system estimates represented costs for replacements or major upgrades. AAFES told us that the cost estimates cited in the business case analysis for its merchandising, financial management and general ledger, and transportation and logistics systems reflected minor upgrades of specific modules within the overall systems, and the cost to replace or upgrade the entire system would be significantly higher. NEXCOM stated that the cost estimates for upgrading its merchandising, store inventory management, and financial management and general ledger systems were for minor upgrades, not replacements or major upgrades, as stated by the task force. DeCA told us that the estimate for replacing its store inventory management system only represented 1 year of costs, even though DeCA plans to incur replacement costs through at least 2022.

According to the task force, the task force and the resale organizations agreed on the methodology for estimating IT costs, and the subject matter experts from the resale organizations provided the cost data used in the business case analysis. However, based on information provided by the

[31]The task force stated in the business case analysis that not every resale organization was able to provide recent or projected IT cost data. Specifically, one or more resale organizations were unable to provide data for 4 of the 5 IT system cost estimates. When data were unavailable for a resale organization, the task force used available data from the other resale organizations as the basis for its cost estimates. For example, the total cost estimate for the store inventory management system was based on data from two resale organizations—NEXCOM and DeCA—that totaled $11.7 million to $12.2 million. To account for the unavailable data from AAFES and MCCS, the task force doubled DeCA and NEXCOM's data and arrived at an estimate of $23 million to $24 million for this IT system.

resale organizations, it appears that the task force may not have always based its cost estimate on replacement or major upgrade costs—consistent with the key assumption that new IT systems would be developed for the consolidated resale organization—but, rather, used minor upgrade or partial replacement costs in some cases. Specifically, task force officials told us they believed the estimates provided by the resale organizations were too high to be minor upgrades or partial replacements, based on their understanding of IT requirements for resale operations.

Further, task force officials stated that their overall IT cost estimate was likely overstated, not understated. For example, they stated that their estimate is higher than what is typically spent for a private sector consolidation of similar size.[32] However, the task force stated that it did not use private sector IT cost estimates in its business case analysis because it determined that public sector IT costs would likely be higher than private sector IT costs. Additionally, task force officials told us that some planned spending on existing IT systems by the four resale organizations would not be necessary as a result of consolidation. However, the business case analysis does not quantify how much future spending could be reduced or factor those reductions into the IT cost estimate.

According to the *GAO Cost Estimating and Assessment Guide*, cost estimates are developed based on assumptions that are defined to establish the baseline conditions the estimate will be built from.[33] Additionally, our *Assessment Methodology for Economic Analysis* states that an economic analysis should define an appropriate baseline that represents the best assessment of what the world would be like under that alternative.[34] Thus, estimating costs that reflect the baseline conditions is a key step in developing a sound cost estimate.

Additionally, we have previously reported that federal IT investments frequently fail or incur cost overruns and schedule slippages.[35] As such,

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32 According to the task force's business case analysis, a private sector consolidation with total revenue the size of the defense resale organizations would typically have one-time IT costs of approximately $50 million to $320 million.

33 GAO-09-3SP.

34 GAO-18-151SP.

35 GAO, *High-Risk Series: Substantial Efforts Needed to Achieve Greater Progress on High-Risk Areas*, GAO-19-157SP (Washington, D.C.: Mar 6, 2019).

high-quality data are imperative for ensuring proper management and oversight of IT investments. The task force's IT cost estimate is particularly important, as it represents about 50 percent of the total estimated costs for defense resale consolidation. Until the task force consults with the resale organizations to reassess the methodology for estimating IT costs, decision makers in DOD and Congress may not have a reliable and complete understanding of the estimated costs for the implementation of new, common IT systems, which is information DOD and Congress need as they consider defense resale consolidation.

DOD's Task Force Did Not Provide a Cost Estimate for Relocating the Four Defense Resale Organizations to a New Headquarters Location

According to the task force, there would be costs associated with relocating AAFES, NEXCOM, MCCS, and DeCA to a new headquarters location, to include relocating existing personnel, hiring new personnel, and obtaining real estate. Although no relocation options were presented in the business case analysis, task force officials told us there are multiple options for where to locate the headquarters of a consolidated resale organization. One option cited by the task force would be to create a new headquarters in the Washington, DC, area, which would be the most expensive option, as it would likely involve acquiring new real estate and hiring personnel in a high-cost region. Another option cited by the task force would be to locate all exchange operations and staff at the existing AAFES headquarters in Dallas, TX, and maintain commissary operations and staff at the existing DeCA headquarters at Fort Lee, VA. This option would likely be less expensive, as personnel and available real estate are already present at both locations. In January 2020, task force officials also told us that an even less expensive option they might consider is maintaining commissary and exchange headquarters staff at their current locations, but having personnel work for the consolidated organization, rather than for DeCA or the exchange organizations.

Despite the potential for relocation costs, the task force did not include a range of cost estimates for different relocation options in its business case analysis. According to task force officials, relocation cost estimates were not included because the headquarters location has not been chosen, and costs will vary widely depending on the chosen location. While actual relocation costs will depend on the chosen headquarters location, this fact does not prevent the task force from presenting a range of cost estimates in advance of that decision being made. Task force officials also said that including relocation cost estimates would not have changed the conclusion of the business case analysis. However, without a range of relocation cost estimates, we were unable to assess the effect of relocation costs on the conclusion of the business case analysis.

DOD policy states that an economic analysis should quantify the costs associated with each alternative under consideration whenever possible so that they may be included in the economic analysis calculation.[36] Additionally, our *Assessment Methodology for Economic Analysis* states that an economic analysis should quantify the important costs, where feasible, to inform decision makers about the economic effects of a proposed action.[37] Without developing and providing a range of relocation cost estimates from the least expensive option to the most expensive, decision makers in DOD and Congress will not be fully informed about the costs of consolidation, which is necessary information for deciding whether to consolidate the four defense resale organizations.

Military Departments Officially Concurred with the Business Case Analysis, but DOD Did Not Share Their Accompanying Comments with Congress

The military departments officially concurred with the task force's business case analysis for consolidating the four defense resale organizations. However, the military departments also provided written comments that detailed concerns with fundamental aspects of the business case analysis, to include: the use of proprietary industry benchmarks; estimated savings, costs, and timeline of the consolidation; and the proposed governance structure for the new resale organization. In an April 2019 report to Congress that summarized the business case analysis, DOD stated that the military departments agreed with the consolidation.[38] However, the report did not disclose the military departments' comments and concerns on the business case analysis, which are relevant as Congress considers defense resale consolidation.

In their written comments, the military departments either stated concerns about the consolidation or included critical comments from the exchange organizations—all of which opposed the consolidation.[39] Specifically:

- The Army concurred with the business case analysis but noted that funding for morale, welfare, and recreation programs must be

[36]DOD Instruction 7041.03.

[37]GAO-18-151SP.

[38]DOD, *Report to Congress: The Department of Defense Report on the Development of a Single Defense Resale System* (Apr. 29, 2019).

[39]The resale organizations were not asked to provide an official response to the business case analysis, but they each prepared written comments that, in the case of the three exchanges, were included with their department's responses. DeCA did not take a position on consolidation, but provided technical comments to address data errors it identified and respond to written content in the business case analysis.

preserved or increased as a result of the consolidation. In addition, the Army's comment letter included as an attachment written comments from AAFES, which expressed opposition to the consolidation and detailed concerns with the business case analysis. For example, AAFES stated that the business case analysis relied on unverifiable, proprietary industry benchmarks that overstated the benefits of consolidation, underestimated the costs and time to consolidate, and did not account for recent efforts by the resale organizations to reduce costs by collaborating on a purchasing alliance.[40]

- The Air Force also concurred with the business case analysis, but noted in its comments that mergers and acquisitions have historically cost more, taken longer, and saved less than originally expected. As a result, the Air Force recommended that a phased implementation plan be followed to guard against financial risk. The Air Force also stated that morale, welfare, and recreation funding currently provided by the exchanges should be maintained while opportunities are examined to reduce the need for appropriated funding.
- The Navy initially non-concurred with the business case analysis in December 2018. In its comment letter, the Navy stated that the task force's analysis was flawed beyond repair and included comments from NEXCOM and MCCS that also opposed consolidation. For example, the exchanges' comments stated that the expected cost savings were overstated, that potential inefficiencies from consolidation were not discussed, and that the resale organizations could achieve cost savings through greater collaboration without the need for consolidation. NEXCOM and MCCS also stated concern that the task force's savings projection relied heavily on unverifiable industry benchmarks. In addition, MCCS expressed concern that consolidation could result in unexpected costs from separating exchange operations from the rest of MCCS operations, which also include the Marine Corps' morale, welfare, and recreation and family programs. In January 2019, the Navy changed its position to concur subject to several significant comments and clarifications, and

[40]Officials from the exchange organizations and DeCA told us about a collaborative purchasing alliance they had formed to achieve savings in cost of goods sold. The purchasing alliance has three main objectives: (1) share relevant data to give each resale organization insight into the cost of goods sold for items sold by two or more organizations; (2) identify and exploit opportunities to reduce the number of suppliers selling goods; and (3) maximize the combined buying power of the four resale organizations. Officials cited the purchasing alliance as a way to achieve savings through collaboration, rather than consolidation.

attached a letter detailing comments and concerns similar to those it submitted with its original non-concurrence in December 2018.

Officials from the resale organizations further articulated their concerns about the business case analysis when they met with us. For example, resale officials told us they are concerned that savings are overstated, that costs are understated, and that the proprietary benchmarks used by the task force are unverifiable or may not be applicable to the public sector. Exchange officials also stated that they are worried about the effect of consolidation on morale, welfare, and recreation funding generated by the exchanges. Specifically, exchange officials are concerned that exchange revenue currently used for morale, welfare, and recreation programs could be used to pay for consolidation expenses or to reduce the amount of appropriated funds allocated to the commissaries.

Despite the concerns detailed in the comments from the military departments and resale organizations, DOD did not include them in its April 2019 report to Congress summarizing the results of the business case analysis. The National Defense Authorization Act for Fiscal Year 2019 required DOD to include in its report the recommendations of the Secretaries of the military departments regarding the plan to consolidate the defense resale organizations.[41] When we asked the task force why DOD did not provide Congress with the comments and concerns cited by the military departments and the resale organizations, officials stated that they were advised by DOD's Office of General Counsel not to include the comments because they contained information that may have disclosed DOD's deliberative process.

Task force officials also stated that the savings, cost, and timeline estimates in the business case analysis were conservative, and that the proprietary industry benchmarks are based on years of experience by Boston Consulting Group and similar to those cited by prior studies. Regarding the purchasing alliance formed by the resale organizations to reduce their cost of goods sold, task force officials stated they do not believe such efforts to reduce costs will be sustained without a single chief executive officer and board of directors to ensure those efforts continued, as recommended in the business case analysis. Finally, the task force stated in the business case analysis that any savings achieved from consolidation could be used to increase morale, welfare, and recreation funding or reduce appropriations used to fund DeCA, and that

[41]Pub. L. No. 115-232, § 627 (2018).

decisions on how to allocate savings will be made by the proposed board of directors.

According to task force officials, some of the concerns articulated by the military departments and the exchanges could be motivated by a general opposition to consolidation. However, without a more complete reporting of the military departments' perspectives on consolidation and the task force's response to those comments, Congress may be unaware of the views various organizations within DOD have regarding the business case analysis, which is relevant information as Congress considers defense resale consolidation. Moreover, fully reporting the comments and concerns could strengthen trust and collaboration among the task force, military departments, and resale organizations on any future resale reforms.

Conclusions

Four defense resale organizations currently operate about 240 commissaries (operated by DeCA) and 2,500 exchange facilities (operated by AAFES, NEXCOM, and MCCS) worldwide to provide reduced-priced groceries and retail goods and services to DOD servicemembers, their families, and retirees. DeCA operations are funded in part by appropriations, which have totaled approximately $1.3 billion in recent years. By law the commissary and exchange organizations must be operated separately. In November 2018, a DOD task force completed a business case analysis and concluded that consolidating the four defense resale organizations into a single organization would result in several hundred million dollars in annual cost savings. However, we found that the task force's projected savings from reducing the cost of goods sold may be overestimated, and that projected costs for IT development and headquarters relocation may be underestimated. Further, while the military departments concurred with the task force's recommendation to consolidate, DOD did not fully share their comments and concerns about the business case analysis with Congress. DOD's proposed consolidation will cost several hundred million dollars, take years to implement, and involve multiple DOD organizations. Given the cost and complexity of the proposed defense resale consolidation, DOD can ensure that Congress has the reliable information it needs to consider consolidation by reviewing and updating savings and cost estimates and sharing comments and concerns from the military departments.

Recommendations for Executive Action

We are making the following four recommendations to DOD.

The Secretary of Defense should ensure that the DOD Chief Management Officer direct the task force to reassess its approach to estimating savings from cost of goods sold—to include reassessing its use of the cost of goods sold for all four defense resale organizations rather than, for example, just for the three exchange organizations—and make any necessary adjustments to its savings estimates for consolidation and provide that updated information to Congress. (Recommendation 1)

The Secretary of Defense should ensure that the DOD Chief Management Officer direct the task force, in consultation with the resale organizations, to reassess its methodology for estimating IT costs of consolidation, and make any necessary adjustments to its range of IT cost estimates and provide that updated information to Congress. (Recommendation 2)

The Secretary of Defense should ensure that the DOD Chief Management Officer direct the task force to develop a range of cost estimates for relocating the defense resale organizations, and adjust its range of cost estimates for consolidation and provide that updated information to Congress. (Recommendation 3)

The Secretary of Defense should ensure that the DOD Chief Management Officer provide additional written information to Congress on the comments and concerns from the military departments and resale organizations on the task force's November 2018 business case analysis, as well as the task force's response to those comments and concerns. (Recommendation 4)

Agency Comments and Our Evaluation

We provided a draft of this product to DOD for review and comment. In its comments, reproduced in appendix III and summarized below, DOD concurred with the first three recommendations and did not concur with the fourth recommendation. DOD also provided technical comments, which we incorporated as appropriate.

DOD stated in its letter that it continues to firmly believe that consolidation of above-store operations of DeCA and the military exchanges is the right path forward and that it intends to move forward with this effort. DOD also requested that we consider the first three recommendations as implemented, based on information provided in the letter and as detailed below.

- Regarding the first recommendation for the task force to reassess its approach to estimating savings from cost of goods sold—to include reassessing its use of cost of goods sold by all four defense resale organizations rather than, for example, just the three exchange organizations—and make any necessary adjustments to its savings estimates for consolidation and provide that updated information to Congress, DOD stated that it had reassessed its approach and found that there is significant overlap and, therefore, savings opportunity in products sold by DeCA and the exchanges. DOD also provided revised savings estimates that exclude DeCA's cost of goods sold from its methodology that show net savings ranging from $309 million to $739 million in the first 5 years of consolidation, followed by $255 million to $457 million per year thereafter. These figures are about 44 percent to 55 percent lower than the business case analysis's estimate for the first 5 years and about 32 to 35 percent lower per year thereafter.[42] By providing these revised savings estimates, we believe that DOD has addressed the intent of the recommendation.

- With regard to the second recommendation for the task force to reassess its methodology for estimating IT costs of consolidation, and make any necessary adjustments to its range of IT cost estimates and provide that updated information to Congress, DOD stated that the task force followed up with AAFES, NEXCOM, and DeCA to get an update on the cost estimates these entities expressed concern about to us. However, according to DOD, those resale organizations were unable to provide alternate data to use in place of the numbers in the business case analysis. DOD further stated in its letter that because no alternative data were provided, the department will continue to use the estimate in the business case analysis and will reengage with the resale organizations to develop more detailed IT design plans and make any necessary updates to the IT cost estimates as integration planning moves forward. As DOD develops its more detailed IT design plans and associated cost estimates, we will follow up with the department, including the resale organizations, to determine whether this recommendation has been addressed.

[42]These revised estimates do not take into account the IT and headquarters relocation costs discussed below. Were the relocation cost estimates provided by DOD in its written comments to be included, the net savings estimate for the first 5 years could stay the same, decrease by about $12 million, or decrease by about $118 million, depending on the course of action.

- In commenting on the third recommendation for the task force to develop a range of cost estimates for relocating the defense resale organizations, and adjust its range of cost estimates for consolidation and provide that updated information to Congress, DOD provided three possible courses of action, along with corresponding cost estimates. These possible courses of action, from least expensive to most expensive, are: (1) maintain operations at all four existing locations (no cost); (2) maintain commissary operations at DeCA headquarters, perform all exchange functions at AAFES headquarters, and close the NEXCOM and MCCS headquarters (one-time costs of $5.5 million and recurring annual costs of $1.3 million); and (3) create a new headquarters to perform all commissary and exchange operations near Washington, D.C. (one-time costs of $19.6 million and recurring annual costs of $19.7 million). DOD stated that consolidation would still result in financial benefits, even if the department chooses the most costly of these courses of action. By providing these cost estimates, we believe that DOD has addressed the intent of the recommendation.

While we have determined that DOD has met the intent of the first and third recommendations, we also note that, in its comment letter, the department questioned some aspects of our analysis and conclusions regarding the first three recommendations. We stand by our analysis and conclusions and offer the following response:

- DOD stated in its comment letter that modifying the business case analysis's approach to cost of goods savings would result in an incorrect use of benchmarks and go against industry best practice. For example, DOD stated that estimating savings by using the cost of goods sold for just the three exchange organizations, or for the three exchange organizations plus a portion of DeCA, would be flawed. However, as noted in our report, the latter method was recommended to us by task force officials when we raised concerns about the accuracy of the task force's savings estimates in the business case analysis. In addition, multiplying the benchmarks by the cost of goods sold for the exchange organizations, as opposed to for all four resale organizations, would be more consistent with the assertion in the business case analysis that consolidation savings are dependent on the overlap among the merging organizations.

- DOD questioned the accuracy of some of our figures in the report by providing different data on product and vendor overlap between DeCA and the exchange organizations. However, this information was not included in the task force's business case analysis or offered to us during the course of our audit. In addition, when we asked for supporting documentation that would allow us to validate the new figures, DOD did not provide any.

- DOD stated in its comments that excluding all or including only a portion of DeCA's cost of goods sold implies that there is no opportunity to achieve savings between DeCA and the exchanges. Our report does not make this assertion, but rather offers a methodology that would result in a more conservative savings estimate, consistent with the data presented in the business case analysis and provided by task force officials, to better ensure that estimated savings were not overstated.

As noted above, DOD did not concur with the fourth recommendation for the department's Chief Management Officer to provide additional written information to Congress on the comments and concerns from the military departments and resale organizations on the task force's November 2018 business case analysis, as well as on the task force's response to those comments and concerns. DOD stated in its written response to our report that the department considered all the comments submitted in its decision-making process and that all of the military department secretariats agreed with above-store consolidation, despite their comments on the business case analysis. DOD further stated that the military department comments regarding the business case analysis were shared with congressional committee professional staff, and DOD suggested in its letter that this recommendation be closed.

However, DOD's written response did not provide information on which comments were shared, whether those comments were communicated in writing or orally, or which committee or committees received information on the comments. In their written comments on the business case analysis, the military departments detailed concerns with fundamental aspects of the analysis, to include: the use of proprietary industry benchmarks; estimated savings, costs, and timeline of consolidation; and the proposed governance structure for the new resale organization. We continue to believe that implementing this recommendation would help ensure that Congress has the full information it needs as it considers defense resale consolidation and would also help strengthen trust and collaboration among the various DOD stakeholders involved in defense resale, particularly given their role in any consolidation, should one occur. We will follow up with DOD as part of our regular recommendation follow-up process.

We are sending copies of this report to the appropriate congressional committees; the Secretary of Defense; and the Secretaries of the Army, Air Force, and Navy. In addition, the report is available at no charge on our website at https://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-2775 or FieldE1@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix IV.

Elizabeth A. Field
Director, Defense Capabilities and Management

Appendix I: Prior GAO Work on Commissaries and Exchanges

The National Defense Authorization Act for Fiscal Year 2016 mandated that the Department of Defense (DOD) report on DOD's plan to achieve budget neutrality for commissaries and exchanges—which DOD interpreted as ending the use of appropriated funding—and included a provision for us to assess DOD's report.[1] In November 2016, we found that DOD's May 2016 report did not provide a plan for achieving budget neutrality.[2] DOD reported that it would not be able to eliminate fully the use of appropriated funds for defense resale, but the department did not provide detailed information supporting that conclusion.[3] Instead, the report stated that DOD expected to achieve $2 billion in cost savings over a 5-year period from fiscal year 2017 through fiscal year 2021. However, we found that the report did not include any assumptions, methodology, or specific time frames related to initiatives that would lead to these savings. We recommended that DOD provide information to Congress to support its conclusion about budget neutrality and develop a plan for achieving reductions to defense resale appropriations. DOD concurred with our recommendations, but as of February 2020 had not addressed them.[4]

In March 2017, we reported on DOD's commissary operations, including the extent to which the Defense Commissary Agency (DeCA) had assurance that it was maintaining the desired savings rate for its customers.[5] DeCA's desired savings rate—which at the time of our March 2017 report was 30 percent and is now 23.7 percent—shows how much a customer can expect to save on grocery purchases at a commissary in comparison to purchases at other local grocery stores. We found that DeCA lacked reasonable assurance that it was maintaining its desired savings rate for commissary customers because of weaknesses in its

[1]Pub. L. No. 114-92, § 651 (2015).

[2]GAO, *DOD Commissaries and Exchanges: Plan and Additional Information Needed on Cost Savings and Metrics for DOD Efforts to Achieve Budget Neutrality*, GAO-17-38 (Washington D.C.: Nov. 9, 2016).

[3]DOD, *Report on Plan to Obtain Budget Neutrality for the Defense Commissary System and the Military Exchange System* (May 2016).

[4]DOD's fiscal year 2020 budget request for commissary appropriations was about $270 million lower than its fiscal year 2019 budget request.

[5]GAO, *Defense Commissaries: DOD Needs to Improve Business Processes to Ensure Patron Benefits and Achieve Operational Efficiencies,* GAO-17-80 (Washington D.C.: Mar. 23, 2017).

methodology for calculating the savings rate.[6] For example, the methodology did not use a random sample of overseas commissaries or account for seasonal and geographic variations in item prices. We also found that DeCA's business model departed from practices generally employed by commercial grocery stores. For example, DeCA did not assess the contribution of the sale of each product to a given store's total sales in determining which products to sell, and it had not conducted cost-benefit analyses for its use of stocking and custodial service contracts or product distribution options across all commissaries. We recommended that DOD (1) address limitations identified in its savings rate methodology; (2) develop a plan with objectives, goals, and time frames to improve efficiency in product management; and (3) conduct comprehensive cost-benefit analyses for service contracts and distribution options. As of February 2020, DOD had addressed the first two recommendations but had not addressed the third recommendation.

[6]The task force's November 2018 business case analysis on defense resale consolidation was focused on estimating the benefits and costs of consolidating the four defense resale organizations and did not evaluate the methodology used by DeCA to measure its customer savings rate.

Appendix II: Assessment of the Department of Defense's (DOD) Business Case Analysis on Defense Resale Consolidation

We assessed DOD's business case analysis on consolidating the four defense resale organizations against the five key elements of an economic analysis, as described in our Assessment Methodology for Economic Analysis (see table 1).

Table 1: Our Assessment of the Department of Defense's (DOD) Business Case Analysis on Defense Resale Consolidation

Key element and definition	Our assessment
Objective and scope The economic analysis explains the action examined, including the rationale and justification for the action. The analysis states its objective, and the scope of the analysis is designed to address this objective. Unless otherwise justified, the analysis focuses on economic effects that accrue to citizens and residents of the United States, and its time horizon is long enough to encompass the important economic effects of the action.	Fully met The task force clearly explained in its business case analysis that its purpose was to quantify the outcome from consolidating the four defense resale organizations, and the scope of the business case analysis was limited to this purpose. Specifically, the business case analysis provided estimates of savings and costs for DOD from consolidating the defense resale organizations, concluding that the savings outweighed the costs.
Methodology The economic analysis examines the effects of the action by comparing alternatives, using one of them as the baseline. Unless otherwise justified, it considers alternatives that represent all relevant alternatives, including that of no action. The analysis defines an appropriate baseline. The analysis justifies that the world specified under each alternative considered (including the baseline) represents the best assessment of what the world would be like under that alternative. The analysis identifies the important economic effects for each alternative considered, their timing, and whether they are direct or ancillary effects.	Partly met The business case analysis explains how savings and costs from consolidation are estimated, to include savings from reducing cost of goods sold and implementing category management and costs related to information technology. However, the business case analysis is unclear about whether multiplying the benchmarks by the total cost of goods sold for all four resale organizations as the basis for estimating savings was appropriate. In the business case analysis, the task force multiplied benchmarks by the total cost of goods sold for all four resale organizations in fiscal year 2017. However, task force officials told us that a limited amount (less than one-third) of the total costs of goods sold in fiscal year 2017 were for identical products sold both by the Defense Commissary Agency and by one or more exchange organization. Additionally, the business case analysis states that cost estimates for information technology consolidation were based on recent or projected system replacement or major system upgrade costs provided by the resale organizations. However, information provided by the resale organizations indicates that about 40 percent of the task force's information technology estimate was based, instead, on minor upgrades or partial replacements.

Key element and definition	Our assessment
Analysis of effects Where feasible, the economic analysis quantifies the important economic effects and monetizes them using the concept of opportunity cost. The analysis applies the criterion of net present value, or related outcome measures, to compare these effects across alternatives. It controls for inflation and uses economically justified discount rates. Where important economic effects cannot be quantified, the analysis explains how they affect the comparison of alternatives. Where the equity and distributional impacts are important, the full range of these impacts is separately detailed and quantified, where feasible.	Partly met The task force estimated that consolidating the four defense resale organizations would result in savings from, among other things, reducing the cost of goods sold in the commissaries and the exchanges; implementing other industry strategies to improve productivity and profitability (e.g., vendor negotiation and private label offerings); and reducing the cost of goods and services that are not sold but are necessary for operating stores (e.g., plastic shopping bags and custodial services). However, the business case analysis did not include a range of cost estimates for relocating the four defense resale organizations to a new headquarters. According to the task force, there are multiple options for where to locate a new headquarters location that will vary in cost, but the business case analysis did not provide a range of estimates.
Transparency The economic analysis describes and justifies the analytical choices, assumptions, and data used. The analysis assesses how plausible adjustments to each important analytical choice and assumption affect the estimates of the economic effects and the results of the comparison of alternatives. The analysis explains the implications of the key limitations in the data used. Where feasible, the analysis adequately quantifies how the statistical variability of the key data elements underlying the estimates of the economic analysis impacts these estimates, and the results of the comparison of alternatives.	Partly met The business case analysis describes how it used industry benchmarks to estimate savings from consolidating the defense resale organizations. According to the business case analysis, the industry benchmarks are based on proprietary data gathered and owned by Boston Consulting Group based on its experience working in the retail industry. These benchmarks were presented in percentages and ranged from 1 to 4 percent of cost of goods sold, estimating savings from achieving the lowest common cost and implementing category management reforms. According to the task force, the benchmarks are based in part on experience with mergers of two organizations, so there may be a greater potential for savings with the merger of the four defense resale organizations. However, we did not review and evaluate the underlying data that were used to develop the proprietary benchmarks.
Documentation The economic analysis is clearly written, with a plain language summary, clearly labeled tables that describe the data used and results, and a conclusion that is consistent with these results. The analysis cites all sources used and documents that it is based on the best available economic information. The analysis documents that it complies with a robust quality assurance process and, where applicable, the Information Quality Act. The analysis discloses the use and contributions of contractors and outside consultants.	Partly met The business case analysis is clearly written with a conclusion that is largely consistent with the data and analysis presented in the document. The exchange organizations—which were involved in the task force's work—each submitted written comments disagreeing with fundamental aspects of the business case analysis, and commissary officials told us they also disagreed with the conclusions of the business case analysis. However, the task force did not disclose these disagreements.

Source: GAO analysis of Community Services Reform Task Force's business case analysis. | GAO-20-418

Appendix III: Comments from the Department of Defense

CHIEF MANAGEMENT OFFICER
9010 DEFENSE PENTAGON
WASHINGTON, DC 20301-9010

APR 0 1 2020

Ms. Elizabeth A. Field
Director, Defense Capabilities and Management
U.S. Government Accountability Office
441 G Street, NW
Washington DC 20548

Dear Ms. Field,

This is the Department of Defense (DoD) response to the GAO Draft Report GAO-20-418SU, "COMMISSARIES AND EXCHANGES: DOD and Congress Need More Reliable Information on Expected Savings and Costs of Consolidating the Defense Resale Organizations," dated February 28, 2020 (GAO Code 103631).

Attached is DoD's proposed response to the subject report. My point of contact is Colonel Kendall D. Peters, USAF who can be reached at kendall.d.peters.mil@mail.mil or 571-372-8266.

Sincerely,

Lisa W. Hershman

Enclosure:
As stated

GAO DRAFT REPORT DATED FEBRUARY 28, 2020
GAO-20-418SU (GAO CODE 103631)

"COMMISSARIES AND EXCHANGES: DOD AND CONGRESS NEED MORE RELIABLE INFORMATION ON EXPECTED SAVINGS AND COSTS OF CONSOLIDATING THE DEFENSE RESALE ORGANIZATIONS"

DEPARTMENT OF DEFENSE COMMENTS TO THE GAO RECOMMENDATION

The Department of Defense (DoD) appreciates the opportunity to comment on the GAO's interim report. The Department has carefully considered the GAO's comments as well as input provided by the Military Departments and resale organizations, and concludes that the savings opportunity from consolidation of above-store operations far outweigh the costs. The Department's view is that the recommendations in the Business Case Analysis (BCA) are strongly supported by a sound and conservative methodology, and that its recommendations are consistent with multiple studies conducted on this topic over the past 30 years. Specifically, the Department sees significant savings opportunity from category management – a best practice employed by industry and also across reform efforts currently underway within the DoD and has already demonstrated over $932M in realized savings DoD-wide.

Not only will above-store consolidation reduce duplicate category management efforts, it will also address unnecessary product proliferation in order to focus on items which customers truly want, improve the customer shopping experience, and deploy maximum scale in negotiations with suppliers to reduce costs. The Department continues to firmly believe that consolidation of above-store operations is the right path forward to protect and enhance these important non-pay benefits to service members and their families while generating cost savings for the Department. Thus, it has directed the task force to continue moving forward with integration planning, consistent with the direction from the Deputy Secretary of Defense in August 2019.

While the Department does not plan to modify the BCA's methodology, it is worth noting that above-store consolidation remains a significant net savings opportunity even if the methodology were modified as set forth in the GAO's recommendations. As described in more detail below, using the GAO's methodology, synergies from consolidation would be $1,006M-$1,549M (APF and NAF[1]) in the first 5 years, and $335M-$537M per year thereafter – still a significant opportunity. Using the BCA's cost estimates with the GAO's modified synergy estimate yields a net benefit of $309M-$739M in the first 5 years, and $255M-$457M per year thereafter.[2] Thus, it remains clear that defense resale consolidation provides a significant opportunity, and the Department is committed to pursuing consolidation to generate savings and free up the resources necessary to implement the National Defense Strategy successfully while protecting and enhancing these benefits.

[1] All synergy and cost estimates are combined APF and NAF figures.
[2] In computing the BCA synergies, the task force used conservatively low numbers to estimate savings, while estimating costs on the higher side.

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To illustrate this point, the following synergies are achievable from above-store consolidation:

- The BCA estimates synergies in the first 5 years of $1,390M-$2,142M, and recurring synergies of $473M-$753M per year starting in Year 6. These synergies are driven by efficiencies in cost of goods sold (COGS), indirect procurement, and organizational redesign.
- The GAO questions whether the methodology should include the DeCA portion of COGS savings. If DeCA COGS savings are excluded, as suggested by the GAO, synergies in the first 5 years become $1,006M-$1,549M, and recurring synergies become $335M-$537M.
- Synergies of $1,006M-$1,549M in the first 5 years and $335M-$537M per year thereafter are still substantial and worthwhile to pursue. In reality, there are likely additional opportunities for savings as well in areas such as supply chain management, which were determined as out of scope for the purpose of the BCA.

In determining costs incurred from above-store consolidation, consider the following:

- The BCA estimates one-time costs in the first 5 years of $457M-$570M. These costs are for IT integration ($326M-$401M), personnel (e.g. severance, retention bonuses), and transformation management. Recurring costs for the DeCA NAF transition are estimated to be $80M per year starting in Year 3 of consolidation.
- Despite the fact that the BCA's IT cost data was obtained directly from the resale entities, the GAO observed that AAFES, DeCA, and NEXCOM now question approximately 40% of the one-time IT integration costs identified in the BCA.
- The Department followed-up with AAFES, NEXCOM, and DeCA to get an update on the numbers they questioned. Unfortunately, they were unable to provide alternate data to use in place of the numbers in the BCA. Given that the resale organizations could not provide alternate data, the Department will continue to use the conservative estimate described in the BCA. The Department will reengage with the resale organizations to develop more detailed IT design plans as integration planning moves forward.
- IT integration cost estimates in the BCA are highly conservative. For example, industry benchmarks for IT integration costs of similar sized mergers is 0.3%-2.0% of total revenue, or approximately $50M-$320M if applied to defense resale – significantly lower than $326M-$401M above. Note that it is rare to see the high end of the benchmark unless there is a "rip and replace" major overhaul, which we do not expect here. In addition, the BCA's estimate does not factor in redeploying of projected future IT capital expenditures, which would lower integration costs. This is explained in more detail below.
- IT integration costs are one-time costs and therefore do not impact the recurring net benefit in the future.
- Concerning headquarters relocation costs, the Department will incur no costs if personnel remain where they are today – a highly likely outcome in the short-term. If headquarters are consolidated, it will likely generate savings if personnel are consolidated in one to two existing headquarters location(s) and unused facilities are closed. Calculating the cost of relocation was outside the scope of the BCA, but choosing a headquarters location will be one of the first decisions for leaders in the consolidated organization.

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Regarding net benefit:

- Using the GAO's modified synergy estimates with the conservative cost estimates in the BCA and zero headquarters relocation cost still yields a net benefit of $309M-$738M in the first 5 years, and $255M-$457M per year thereafter.

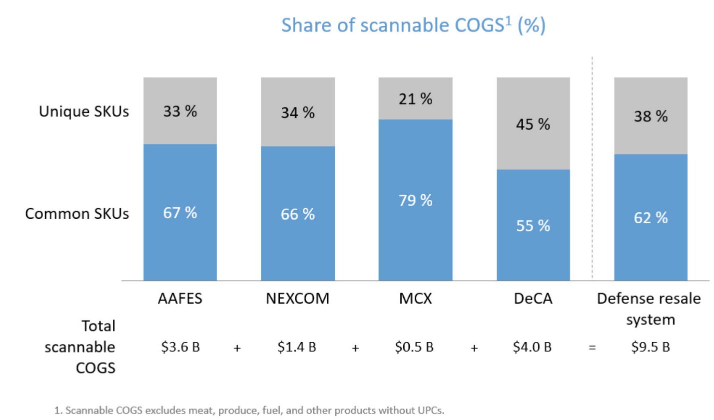
In sum, above-store consolidation would provide a significant net benefit even if the methodology were modified per the GAO's recommendations. However, the Department does not believe that these suggested modifications should be made. The Department has detailed responses to each of the GAO's four recommendations below, which mitigate the concerns they expressed.

RECOMMENDATION 1: The GAO recommends that the Secretary of Defense should ensure that the DoD Chief Management Officer directs the task force to reassess its approach to estimating savings from cost of goods sold – to include reassessing its use of the cost of goods sold by all four defense resale organizations rather than, for example, just the three exchange organizations – and make any necessary adjustments to its savings estimates for consolidation and provide that updated information to Congress.

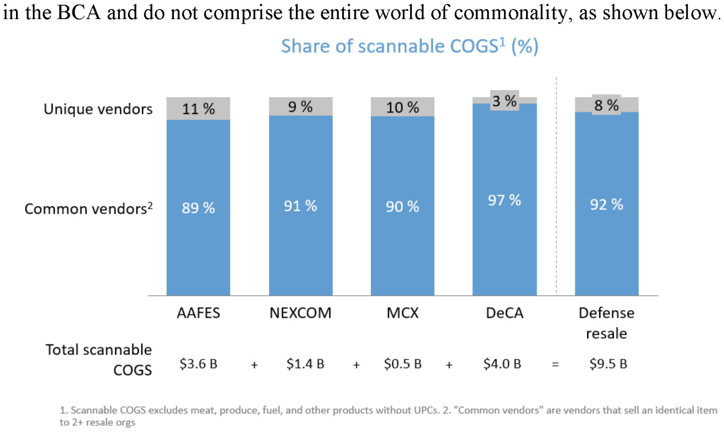
DoD RESPONSE: Concur. The Department has reassessed its approach and finds that there is significant overlap, and therefore savings opportunity, in products sold by DeCA and the exchange(s). In addition, modifying the BCA's approach to COGS savings as suggested by the GAO would result in an incorrect use of benchmarks and goes against industry best practice.

The Department's assessment shows that 55% of total DeCA scannable COGS were for identical items that were also sold at one or more exchange(s); and that 32% of total COGS of the defense resale system in FY2017 were for identical products sold by DeCA and also by at least one exchange. The 32% is lower than the 62% cited in the BCA because the 62% also includes COGS for items sold at two or more exchanges. The 23% cited in the GAO's report is not relevant to this discussion.

3



While 55% is already a high level of overlap, the share of identical vendors is even higher – 97% of DeCA scannable COGS were from vendors that also sold products to one or more exchange(s). Significant overlap in vendors means there is significant opportunity for cost savings. The ten common vendors mentioned in the GAO's report were illustrative examples cited in the BCA and do not comprise the entire world of commonality, as shown below.



Using COGS from just the three exchange organizations to estimate category management savings is an improper use of savings benchmarks. Using COGS from the exchanges plus a portion of DeCA COGS is also flawed. Benchmarks were derived through a simple calculation, [savings from category management effort at a given retailer] divided by [total COGS of that retailer]. Therefore, by definition, benchmarks should be applied to total defense resale COGS, not a subset of COGS. Using benchmarks in this way is normal practice in industry when

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estimating potential synergies of a merger. Moreover, excluding DeCA COGS entirely implies that there is no opportunity for COGS savings between DeCA and the exchanges. Likewise, only including DeCA COGS of identical items sold at the exchange implies there is no opportunity for COGS savings with identical vendors that sell different items to DeCA and the exchanges (e.g., a vendor that sells single bottles of soda to the exchange and 12 packs of soda to DeCA). These implications are not consistent with how category management works in either the private sector or the Department of Defense.

As noted in our general comments above, even if we accept the GAO's recommendation to limit the savings calculation to the overlap of scannable COGS across the exchanges and exclude DeCA, there remains a substantial amount of savings that are being unrealized today. Recommend this recommendation be closed.

RECOMMENDATION 2: The GAO recommends that the Secretary of Defense should ensure that the DoD Chief Management Officer directs the task force, in consultation with the resale organizations, to reassess its methodology for estimating IT costs of consolidation, and make any necessary adjustments to its range of IT cost estimates and provide that updated information to Congress.

DoD RESPONSE: Concur. The IT costs in the BCA were based on data received directly from the resale entities in the fall of 2018. At that time, the resale organizations and the task force agreed that recent and projected IT costs for upgrades and replacements were the best basis for projection of future IT costs. It is unclear why the resale organizations are now questioning this agreed-upon methodology and advancing never before raised objections (either to the Department or GAO) as discussed above. However, as described above, above-store consolidation is still a net positive effort.

In addition, the BCA did not include projected future IT capital expenditures (CapEx) in IT integration costs. In any consolidation, the notion of redeploying future CapEx is fundamental to cost estimates and should be folded into integration costs. The 2018-2022 projected CapEx for just the three exchanges is ~$630M-$760M – a significant amount of investment that could be redeployed toward integrating to a common system instead of individual upgrades.

Although the Department does not believe that any changes to the IT costs will significantly impact the net benefit from above-store consolidation, it had already intended to reengage with the resale organizations to develop a more detailed IT design for a consolidated organization in its next level of integration planning. Through that process, the Department will make any necessary updates to the IT cost estimates. However, a consolidation decision should not await the completion of this detailed planning. Recommend this recommendation be closed.

RECOMMENDATION 3: The GAO recommends that the Secretary of Defense should ensure that the DoD Chief Management Officer directs the task force to develop a range of cost estimates for relocating the defense resale organizations, and adjust its range of cost estimates for consolidation and provide that updated information to Congress.

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DoD RESPONSE: Concur. The BCA excluded the range of cost estimates for relocating the defense resale organizations because a location decision is a highly sensitive decision that would be best left to a later date during detailed integration planning. In addition, costs associated with acquiring real estate and relocating personnel could vary widely. Costs could be managed to zero if all four of the current headquarters remained operational. The Department could even realize a cost reduction if duplicative facilities are closed or possibly sold. On the other hand, establishing a new facility, particularly in the National Capital Region, would be much more costly.

While the BCA did not include a range of cost estimates, three possible Courses of Action (COAs) are described below, to give a sense of the range of relocation costs.

1. Maintain operations at all four existing locations, with a CEO, some C-suite executives, and relevant supporting staff in one of the locations. This is the most likely outcome in the short term. Severance and retention bonus costs, as well as the costs of a Transformation Management Office, are already included in the BCA methodology. Hence, the cost of this COA is $0.
2. Perform all exchange functions at the Army and Air Force Exchange Service (AAFES) headquarters in Dallas, Texas; maintain commissary operations at Defense Commissary Agency (DeCA) headquarters at Fort Lee, Virginia; close the Navy Exchange Service Command (NEXCOM) at Virginia Beach, Virginia, and Marine Corps Exchange (MCX) headquarters at Quantico Marine Corps Base, Virginia. Several assumptions are necessary to estimate costs for this COA.
    - Assume that 10% of NEXCOM and MCX employees choose to relocate to Dallas. Those relocation costs are estimated to be $1.6M.
    - New employees will be hired in Dallas to make up for the difference, which is estimated to cost $3.9M.
    - AAFES HQ will have space to absorb some new employees, but additional office space will be needed. Assuming that the Department leases space, this would cost an estimated $1.3M per year in Dallas.
    - There will be savings associated with closing the NEXCOM and MCX office spaces, but for conservatism, potential savings are not included in this estimate.
    - No changes are required at the DeCA Headquarters.

    COA 2 would have one-time costs of $5.5M, and recurring cost of $1.3M per year.
3. Create a new headquarters to perform all exchange and commissary functions near Washington, DC; close each of the existing resale organizations' headquarters. Several assumptions are necessary to estimate costs for this COA.
    - Assume that 10% of NEXCOM, AAFES, DeCA, and MCX employees choose to relocate to DC. Those relocation costs are estimated to be $5.6M.
    - New employees will be hired in DC to make up for the difference, which is estimated to cost $14M.
    - New office space will be needed. Assuming that the Department leases space, this will cost an estimated $19.7M per year.
    - There will be savings associated with closing the four existing office spaces, but for conservatism, potential savings are not included in this estimate.

    COA 3 will have one-time costs of $19.6M and recurring cost of $19.7M per year.

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None of these COAs will make a significant impact on the estimated net benefit from above-store consolidation. The benefits of consolidation are still overwhelmingly positive, even if the Department chooses the most costly COA. Recommend this recommendation be closed.

RECOMMENDATION 4: The GAO recommends that the Secretary of Defense should ensure that the DoD Chief Management Officer provides additional written information to Congress on the comments and concerns from the military departments and resale organizations on the task force's November 2018 business case analysis, as well as the task force's response to those comments and concerns.

DoD RESPONSE: Non-concur. The Department considered all the comments submitted in its decision-making process. It is important to note that all of the Military Department Secretariats agreed with above-store consolidation, despite their BCA comments. While not attached to the Report to Congress, so as to protect the Department's deliberative process, the Military Department's comments regarding the BCA were shared with the Committee Professional Staff. Recommend this recommendation be closed.

In summary, the benefit from above-store consolidation is overwhelmingly positive, and the Department needs to take action now. This topic has been studied numerous times over the past 30 years, and the Department can no longer wait to reform. Defense resale reform will generate scale and efficiency to drive much needed savings that can be reinvested back into modernizing defense resale, improving the customer experience, and supporting the broader National Defense Strategy. Strong governance will be critical to ensure that reform targets are achieved. Above-store consolidation also aligns with other category management and IT reform initiatives that the Department is spearheading. Any transformational change effort is difficult and will meet resistance, but the Department is committed to a fundamental shift in operations and is ready to move forward. Legislative proposals are being submitted for Fiscal Year 2021 to obtain Congressional authority to consolidate DeCA and the exchanges. The Department will continue to work with Congress to obtain the legislative changes necessary for consolidation and unlock the significant opportunity consolidation provides. Until then, the Department will move forward with the reform efforts it can within the confines of existing law.

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Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

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Staff Acknowledgments

In addition to the contact named above, Suzanne Perkins (Assistant Director), Geoffrey Peck (Analyst-in-Charge), Pedro Almoguera, Noah Gerber, Mae Jones, Matthew Kienzle, Amie Lesser, Felicia Lopez, and Jeanne Sung made key contributions to this report.