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May 28, 2010

The Honorable Carl Levin
Chairman
The Honorable John McCain
Ranking Member
Committee on Armed Services
United States Senate

The Honorable Ike Skelton
Chairman
The Honorable Howard P. McKeon
Ranking Member
Committee on Armed Services
House of Representatives

Subject: *DEFENSE INFRASTRUCTURE: Impact of Purchasing from Local Distributors All Alcoholic Beverages for Resale on Military Installations on Guam*

The military exchange services purchase alcoholic beverages for resale on military installations as part of their mission to provide quality goods and services at competitive low prices to their customers—primarily military service members and their families.¹ The revenue generated from the retail sale of products, including alcoholic beverages, supports most of the operating costs of the exchanges and military package stores as well as Morale, Welfare, and Recreation programs.² Such programs generally provide for the physical, cultural, and social needs of service members and their families, and include fitness centers, child development services, libraries, and recreation centers. As primarily self-supporting enterprises, military exchanges and package stores are funded predominantly with nonappropriated funds, such as cash and other assets generated through business operations and sales to Department of Defense (DOD) authorized patrons, but certain administrative and support costs of the exchanges are paid by DOD using appropriated funds. In Guam, the Navy Exchange Service Command (NEXCOM) operates exchange activities on

¹For the purposes of this report, alcoholic beverages refer to packaged alcoholic beverages sold by the military exchanges and not beverages by the glass. Alcoholic beverages sold by DOD are placed in three categories: (1) malt beverages such as beer and ale; (2) wine products; and (3) distilled spirits such as liquor.

²Military package stores are stores which predominantly carry alcoholic beverages in unopened containers for consumption at a location other than the place of sale.

Naval Base Guam and the Army and Air Force Exchange Service (AAFES) operates exchange activities on Andersen Air Force Base.

Section 652 of the National Defense Authorization Act for Fiscal Year 2010 required us to evaluate the impact of reimposing a requirement that DOD not provide support funds to exchanges unless they purchase all alcoholic beverages intended for resale on military installations on Guam from local distributors (a copy of section 652 is provided in enclosure I of this report).³ Section 8073 of the Department of Defense Appropriations Act, 2008 required that no funds appropriated by that act be used to support nonappropriated fund activities that did not use local distributors when making wholesale purchases of alcoholic beverages for resale at military installations on Guam during fiscal year 2008 (hereafter “local purchase requirement”).⁴ This requirement was not reenacted in the Department of Defense Appropriations Act, 2009,⁵ and currently there is no local purchase requirement on Guam.⁶ This report examines the (1) actions taken by DOD to address the local purchase requirement; (2) impact of the fiscal year 2008 local purchase requirement on wholesale and retail prices; (3) impact of the local purchase requirement on funding for Morale, Welfare, and Recreation programs; and (4) perspectives of NEXCOM and AAFES on the imposition of the local purchase requirement.

To determine the actions DOD took to comply with the local purchase requirement, we obtained and reviewed documentation and interviewed DOD officials and local distributors about the steps taken by NEXCOM and AAFES to purchase alcoholic beverages from local distributors. We also obtained and analyzed documents from NEXCOM and AAFES related to the establishment of alcoholic beverage retail prices under the requirement. We reviewed applicable legal and departmental guidance, including DOD instructions and directives, and compared them with methods used by NEXCOM and AAFES to purchase alcoholic beverages and set retail prices on Guam.⁷ To determine the impact of the local purchase requirement on wholesale and retail prices, we compared wholesale and retail prices before the imposition of the local purchase requirement with those under the requirement. To review DOD’s process for setting retail prices, we obtained and reviewed price surveys performed by NEXCOM and traced wholesale costs to price quotes provided by local distributors. However, retail prices were adjusted at exchanges to reflect the local purchase requirement for only a 1-month period at the end of fiscal year 2008, so we could not project how wholesale or retail prices would be impacted if the local purchase requirement were to be reimposed since experiences under such a limited period of time cannot be projected over time. We also could not identify the overall impact to Morale, Welfare, and Recreation funding because this limited amount of sales data does not show a significant impact on such funding, though it might show impacts over time if the local purchase requirement were to be in effect for a longer period. To identify the perspectives of exchange officials regarding the imposition of the

³Pub. L. No. 111-84, § 652 (2009).

⁴Pub. L. No. 110-116, § 8073 (2007).

⁵Pub. L. No. 110-329, § 8070 (2008).

⁶The Department of Defense Appropriations Act, 2010, Pub. L. No. 111-118, § 8070 (2009).

⁷Department of Defense Instruction 1330.21, Armed Services Exchange Regulations (Jul. 14, 2005); Department of Defense Instruction 1330.09, Armed Services Exchange Policy (Dec. 7, 2005).

local purchase requirement, we interviewed officials from NEXCOM and AAFES headquarters.

We conducted this performance audit from October 2009 through May 2010, 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.

Summary

The local purchase requirement, which prohibited DOD from using funds appropriated by the Department of Defense Appropriations Act, 2008⁸ to support nonappropriated fund activities unless they purchased alcoholic beverages for resale on Guam from local distributors, went into effect on November 13, 2007, when the Department of Defense Appropriations Act for Fiscal Year 2008 was signed into law. However, DOD officials indicated that the exchanges did not begin to purchase alcoholic beverages solely from local distributors until September 2, 2008. The exchanges agreed with local distributors to complete the transition to the local purchase requirement and start purchasing all alcoholic beverages solely from local sources on this date. Following the implementation of the local purchase requirement, both wholesale and retail prices of alcoholic beverages noticeably increased while the number of previously available products decreased. The exchanges adjusted retail prices for alcoholic beverages to account for the increase in wholesale costs. However, these prices were in effect for only 1 month because the local purchase requirement was not re-enacted for fiscal year 2009, and currently there is no local purchase requirement on Guam. As such, we could not isolate the impact that the increase in retail prices had on funding for Morale, Welfare, and Recreation programs because of the limited data from 1 month of sales. NEXCOM and AAFES officials anticipated that reimposing a local purchase requirement would negatively impact the military community because, based on the prior experience, retail prices would increase, while the selection of products available for sale would decrease. Moreover, the officials noted that an increase in alcoholic beverage retail prices due to a local purchase requirement could potentially reduce funding for Morale, Welfare, and Recreation programs because of a resulting decrease in sales.

In commenting on this report, DOD stated that it concurred with the report. DOD also provided technical comments, which we incorporated as appropriate into this report. DOD's comments are reprinted in enclosure IV.

Background

DOD exchanges include groupings of businesses and services that provide primary retailer locations for nongrocery merchandise and services on military installations.⁹ DOD policy states that the exchanges form an integral part of the nonpay compensation system for active duty personnel and have the dual mission of providing (1) authorized patrons, such as service members and their families, with

⁸Pub. L. No. 110-116, § 8073 (2007).

⁹DOD exchange activities on Guam include retail stores, military package stores, convenience stores, and gas stations.

merchandise and services necessary for their health, comfort, and convenience; and (2) a source of funding for the military services' Morale, Welfare, and Recreation programs. In Guam, NEXCOM operates exchange activities on Naval Base Guam and AAFES operates exchange activities on Andersen Air Force Base.

Although NEXCOM and AAFES run their exchanges independently on Guam, NEXCOM provides warehousing and distribution support to AAFES, including the supply and shipment of alcoholic beverages and other merchandise. NEXCOM purchases all alcoholic beverages directly from manufacturers and distributors for retail sale in military exchanges and package stores on Guam, including AAFES exchanges and the package store on Andersen Air Force Base. AAFES places orders for alcoholic beverages with NEXCOM rather than purchasing alcoholic beverages from manufacturers and distributors. NEXCOM operates a distribution center in Agana, Guam that sells and distributes alcoholic beverages directly to the exchanges and package stores.¹⁰

Military exchanges and Morale, Welfare, and Recreation programs are nonappropriated fund activities that are supported primarily with revenue generated from the retail sale of merchandise and services, but appropriated funds are used to pay certain administrative and support costs of the exchanges.¹¹ In addition to helping support the operation of the exchanges, revenue from the exchanges provides a source of funding for Morale, Welfare, and Recreation programs. On October 1, 2009, Andersen Air Force Base became part of Joint Region Marianas with Naval Base Guam.¹² As such, the Navy currently provides funding support for Morale, Welfare, and Recreation programs at Andersen Air Force Base and Naval Base Guam.¹³ The Office of the Commander, Navy Installations Command is the Navy office responsible

¹⁰In addition to the cost of the merchandise, NEXCOM also charges AAFES a service fee equal to 6.95 percent of the cost of merchandise for distribution center costs, such as warehousing and handling inventory.

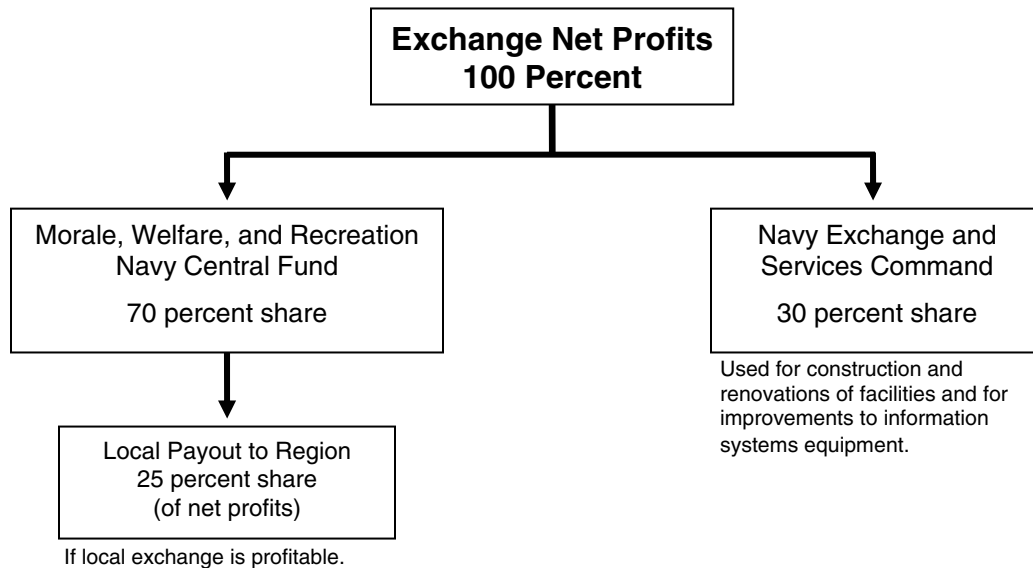
¹¹A table summarizing which costs may be covered using appropriated funds is provided at Enclosure 4 of Department of Defense Instruction 1015.15, Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources (Oct. 31, 2007, incorporating administrative change Mar. 20, 2008).

¹²The 2005 Base Realignment and Closure Commission final report noted that in areas where the military services operate separate installations that share a common boundary or were in close proximity, there was a significant opportunity to reduce duplication and costs by consolidating installations, known as "Joint Basing." For more information on joint basing, see GAO, *Defense Infrastructure: DOD Needs to Periodically Review Support Standards and Costs at Joint Bases and Better Inform Congress of Facility Sustainment Needs*, GAO-09-336 (Washington, D.C.: March 30, 2009).

¹³During the time of the local purchase requirement, Morale, Welfare, and Recreation programs at Andersen Air Force Base were funded from revenue generated by AAFES exchange operations at Andersen Air Force Base. AAFES tracks revenue from alcoholic beverage sales separately from other merchandise categories because it is Air Force policy that such revenue be treated as a supplemental dividend for Morale, Welfare, and Recreation programs on the installation in which the sales were made. AAFES officials indicated that around 2 to 2.5 percent overall alcoholic beverage revenue is deducted by AAFES for capital improvements. The Air Force still uses this process to distribute revenue from alcoholic beverage sales at locations other than Guam which are not joint bases. The Navy has agreed that Andersen Air Force Base will continue to receive funding for Morale, Welfare, and Recreation programs using this method for three years following the creation of Joint Region Marianas. After which, the Office of the Commander, Navy Installations Command will start using its own method to distribute funds.

for overall operation of Morale, Welfare, and Recreation programs within the Navy. Portions of the profits generated from the resale of products by an installation's exchange activities—including alcoholic beverages—are used to support Morale, Welfare, and Recreation programs at that installation. NEXCOM receives 30 percent of such profits, while the Office of the Commander, Navy Installations Command receives the remaining 70 percent. The Office of the Commander, Navy Installations Command distributes 25 percent of an installation's net profits, taken out of its 70 percent share of overall profits, to the Navy region where the installation is located. The remaining amount is used to fund Navy-wide Morale, Welfare, and Recreation programs. Figure 1 illustrates how Morale, Welfare, and Recreation funds are distributed.

Figure 1: Office of the Commander, Navy Installations Command Distribution of Funding Morale, Welfare, and Recreation Programs



Source: Office of the Commander, Navy Installations Command.

DOD Instruction 1330.21 states that when purchasing alcohol for resale, subject to certain exceptions, alcoholic beverages shall be purchased by the exchanges from the most competitive source and distributed in the most economical manner. Under the local purchase requirement, NEXCOM and AAFES could still purchase alcoholic beverages from the most competitive local source, but were limited to the best price offered by local distributors. DOD Instruction 1330.09 provides general guidance regarding the pricing of merchandise, stating that merchandise sold through exchanges should be priced in a substantially uniform manner at the lowest practicable level consistent with the mission to provide authorized patrons with articles necessary for their health, comfort, and convenience. Retail prices for alcoholic beverages are subject to this guidance. While DOD Instruction 1330.09 does not provide any specific guidance for setting retail prices for malt beverages or wine products, it does provide that distilled spirits sold outside the United States and the District of Columbia shall be priced within the range of prices established for exchange stores located in the United States unless the same alcoholic beverages are sold locally for less. According to this instruction, when distilled spirits are available

locally for less than exchange prices, then the exchanges may set retail prices for those products at 10 percent less than the best local shelf price.

Actions Taken by DOD to Address the Local Purchase Requirement

NEXCOM and AAFES collaborated with alcoholic beverage manufacturers and local distributors over a period of 9 months to implement the local purchase requirement contained in the Department of Defense Appropriations Act, 2008 (a copy of the local purchase requirement from the act is included in enclosure II of this report). The local purchase requirement, which prohibited DOD from using funds appropriated by that Act to support nonappropriated fund activities unless they purchased alcoholic beverages for resale on Guam from local distributors, went into effect on November 13, 2007, when the Department of Defense Appropriations Act, Fiscal Year 2008 was signed into law. However, according to DOD officials, due to the time it took to complete the collaboration process, the exchanges did not begin to purchase alcoholic beverages solely from local distributors until September 2, 2008. On this date, all alcoholic beverage retail prices were adjusted at Guam military exchanges to reflect new wholesale costs associated with the local purchase requirement. During the period between November 13, 2007 and September 2, 2008, DOD expended fiscal year 2008 appropriated funds in support of the exchanges.

NEXCOM and AAFES officials stated that they were not aware of the forthcoming local purchase requirement contained in the Department of Defense Appropriations Act, 2008 until after the passage of the act. Therefore, no planning was done to prepare for the transition. Through a series of meetings and correspondence that took place from December 2007 to August 2008, NEXCOM, AAFES, alcoholic beverage manufacturers, and Guam local distributors collaborated to perform the steps necessary to implement the new requirement. Table 1 provides a timeline of key events related to transitioning to the purchase of alcoholic beverages solely from local Guam distributors.

Table 1: Timeline of Key Events to Transition to Local Purchase Requirement

Date	Key events
November 13, 2007	Department of Defense Appropriations Act, 2008 was signed into law.
November 26, 2007	NEXCOM became aware of the local purchase requirement.
December 11, 2007	NEXCOM and AAFES met to begin to develop a joint transition strategy.
January 30, 2008	NEXCOM, AAFES, and alcoholic beverage manufacturers met to discuss the new requirement. NEXCOM and AAFES requested that the manufacturers already supplying alcoholic beverages for retail sale at military installations on Guam provide contact information on various local distributors who held distribution rights for the manufacturers' products on Guam. According to NEXCOM and AAFES officials, due to licensing agreements with the manufacturers, local distributors held the rights to distribute certain alcoholic beverage products on Guam, thereby requiring NEXCOM and AAFES to secure such products from those distributors.
March 7, 2008	NEXCOM and AAFES received all of the contact information from the manufacturers. NEXCOM and AAFES personnel then provided local distributors with current NEXCOM warehouse stock assortments, and requested that the local distributors send them a list of products that the distributors could provide along with accompanying wholesale price quotes for each product.
April 28/29, 2008	NEXCOM and AAFES personnel met with local distributors to discuss wholesale prices, local retail prices, stock assortments, warehouse capabilities, electronic data interchange abilities, and payment terms. According to AAFES officials, this was the earliest date that all local distributors were able to meet.
May 31, 2008	Military installations on Guam sent their forecasted alcoholic beverage requirements to local distributors in order to get updated stock assortments price quotes.
June – July 30, 2008	NEXCOM officials said that the stock lists and price quotes they received from the local distributors were not on time, were missing data and/or required revisions. As such, a second request for stock lists and price quotes was sent out in July 2008.
July 1, 2008	Last shipment date of alcoholic beverages sent from the United States to the NEXCOM distribution center on Guam.
July – August, 2008	Guam distributors submitted pricing, terms, and conditions to NEXCOM and AAFES. AAFES and NEXCOM then worked with local distributors to develop and refine retail business agreements to secure alcoholic beverages. An AAFES official indicated that by July 31, 2008 half of the local distributors had not properly filled out or returned the retail business agreements.
September 2, 2008	NEXCOM and AAFES increased retail prices for all alcoholic beverages to reflect new wholesale costs under the local purchase requirement. Exchanges started to obtain alcoholic beverages from local distributors.

Source: GAO analysis of information provided by NEXCOM and AAFES.

On September 2, 2008, alcoholic beverage retail prices were adjusted at Guam military exchanges to reflect new wholesale costs associated with the local purchase requirement. However, NEXCOM and AAFES officials as well as local distributors indicated that although product prices had increased, in some cases, the exchanges had not ordered alcoholic beverages from local distributors as some products were still in stock. NEXCOM and AAFES officials explained that this date allowed time for local distributors to increase their product supply to support the new military requirements on Guam; allowed time for the local on-hand inventory of alcoholic beverages at NEXCOM's distribution center to be depleted; made it easier for military stores to change price data to reflect new wholesale costs at one time in their information systems; and was the best way to manage customer expectations as it provided a one-time increase in all alcohol product prices and minimized potential disruption of product availability. Four of the five local distributors that we contacted noted that they would require lead time to start supplying alcoholic beverages to the military exchanges. However, this lead time varied depending on the distributor. For instance, one local distributor indicated that it would need 45 days, while another noted that it would require 3 to 6 months, and one indicated that the amount of lead time needed would depend on the type of product ordered by the exchanges. Another

distributor commented that the time frame leading up to the September 2, 2008, date to begin purchasing from local vendors was realistic.

Section 8073 of the Department of Defense Appropriations Act, 2008 required that no funds appropriated by that Act be used to support nonappropriated fund activities that did not use local distributors when making wholesale purchases of alcoholic beverages for resale at military installations on Guam during fiscal year 2008.¹⁴ Notwithstanding section 8073, for 9 of the 10 months the requirement was in effect in fiscal year 2008 NEXCOM and AAFES did not purchase all of their alcoholic beverages for resale locally and DOD continued to use appropriated funds to support them.

The Department of Defense Appropriations Act, 2009, which became law on September 30, 2008, did not include a local purchase requirement for Guam. Therefore, because the local purchase requirement was no longer in effect, on October 1, 2008, NEXCOM and AAFES started to purchase alcoholic beverages from other sources, including directly from the manufacturer, consistent with previous practices.

Impact of the Local Purchase Price Requirement on Wholesale and Retail Prices

Following the imposition of the local purchase requirement on Guam, both wholesale and retail prices of alcoholic beverages noticeably increased while the number of products available to customers decreased. The exchanges set retail prices for alcoholic beverages on Guam using price surveys of the local civilian market that are performed on a monthly basis in conjunction with supplier wholesale price quotes and exchange prices in the United States. If wholesale prices of alcoholic beverages were to increase, then retail prices on the military installations could also increase.

Overall, wholesale prices for alcoholic beverages purchased from local distributors were higher than those prior to the local purchase requirement. DOD instruction 1330.21 provides that the exchanges shall, subject to certain exceptions, purchase alcoholic beverages for resale from the most competitive source for all categories of alcoholic beverages—malt beverages, wine products, and distilled spirits.¹⁵ However, the instruction does not provide additional specific requirements for the purchase of alcoholic beverages for resale at overseas military installations. In the absence of such requirements, NEXCOM and AAFES officials told us that they purchase alcoholic beverages from the most competitive source and indicated that purchasing them directly from the manufacturer is the least expensive method in securing alcoholic beverages for retail sale at military installations on Guam. According to NEXCOM and AAFES officials, seeking the most competitive wholesale price is in line with the mission of the military exchange system in maintaining customer service and generating earnings as a source of funding for military Morale, Welfare, and Recreation programs. This process of purchasing alcoholic beverages from the most competitive source is different for military installations in the United States where certain types of alcohol must be made from a source within the state in which the

¹⁴Pub. L. No. 110-116, § 8073 (2007).

¹⁵DODI 1330.21, § E5.8 (Jul. 14, 2005).

military installation is located. Enclosure III provides information on alcoholic beverage wholesale and retail pricing requirements for DOD locations in the continental United States; Alaska and Hawaii; overseas locations; and Guam with and without the local purchase requirement. Under the local purchase requirement, NEXCOM and AAFES could still purchase alcoholic beverages from the most competitive local source, but were limited to the best price offered by local distributors, essentially restricting the pool of suppliers who could compete for NEXCOM's business.

Retail prices for alcoholic beverages generally increased under the local purchase requirement. DOD guidance regarding the pricing of alcoholic beverages at exchanges permits some flexibility in how retail prices are set at military installations located overseas. DOD Instruction 1330.09 provides guidance for setting retail prices for alcoholic beverages in the exchange system.¹⁶ Although the instruction does not provide specific requirements for how malt beverages and wine products should be priced, it does require that distilled spirits sold outside of the United States be priced within the range of prices established for military exchanges located in the United States, unless the same products are available locally for less.¹⁷ If prices for distilled spirits are less expensive in the local market, then the exchanges may sell the same products for 10 percent less than the best local shelf price. NEXCOM and AAFES officials indicated that without specific requirements or instructions on how to set retail prices for malt beverages and wine products, they ordinarily apply the same pricing requirements that are used for distilled spirits.

Following the imposition of the local purchase requirement, NEXCOM and AAFES factored in the increase in wholesale costs, as reflected in the local distributors' price quotes, when setting retail prices for all alcoholic beverages. NEXCOM officials indicated that wholesale costs provided by local distributors were generally higher than wholesale costs prior to the local purchase requirement. In addition to the distributors' price quotes, NEXCOM and AAFES personnel performed price surveys of certain alcoholic beverage products sold in the local civilian market on Guam, and reviewed price surveys performed in the continental United States to help set retail prices that were based on higher wholesale costs and consistent with local retail prices. During the period when the local purchase requirement was implemented, NEXCOM and AAFES officials indicated that retail prices were raised to an amount that offset increased wholesale costs while still being maintained at the lowest practicable level to ensure customer service and continuing support for Morale, Welfare, and Recreation programs. Table 2 provides information on the change in the wholesale and retail prices and selection of alcoholic beverages under the local purchase requirement.

¹⁶NEXCOM and AAFES exchanges generally have similar retail prices for alcoholic beverages. However, each exchange activity has discretion to mark down retail prices for aged or damaged merchandise.

¹⁷DODI 1330.09, § 4.10.2 (Dec. 7, 2005).

Table 2: Change in the Wholesale and Retail Prices and Selection of Alcoholic Beverages under the Local Purchase Requirement

	Percentage change in wholesale costs under the local purchase requirement	Percentage change in retail prices under the local purchase requirement	Number of products available before local purchase requirement	Number of same products available under the local purchase requirement	Percentage of products that were not available under local purchase requirement
Malt beverages	77%	39%	44	35	-20%
Wine products	52	46	249	193	-22
Distilled spirits	37	21	177	77	-57
Overall	46%	32%	470	305	-35 %

Source: GAO analysis of NEXCOM data.

Note: Products excluded from our analysis of wholesale and retail price changes include products unavailable to the exchanges during the imposition of the local purchase requirement and the same products carried by local distributors but in different sizes.

As shown in table 2, overall wholesale costs for alcoholic beverages increased by approximately 46 percent based on an average of all alcoholic beverage items for sale on Guam. Wholesale costs are based on price quotes supplied to NEXCOM from local distributors. NEXCOM and AAFES officials stated that a number of factors could have contributed to higher wholesale costs as reflected in the price quotes, including higher shipping costs or local government alcohol taxes.¹⁸ However, they also noted that NEXCOM and AAFES do not audit the cost elements (such as profit margin or shipping costs) that make up local distributors' wholesale price quotes. Under the local purchase requirement, the average wholesale cost for a 6-pack of beer or other malt beverages increased by \$2 or 88 percent, and the average wholesale cost for a 30-pack case of beer increased by \$8 or 92 percent. The increase in wholesale costs contributed to overall higher retail prices. For example, the average retail price for a 6-pack of beer or other malt beverages increased by \$2 or 46 percent, and the average retail price for a 30-pack case of beer increased by about \$7 or 44 percent. Although retail prices increased for most items, they decreased for five distilled spirits products and a single wine product.

As local distributors were asked to quote existing product lines and sizes offered by NEXCOM and AAFES, the total number and size of alcoholic beverage products offered by the military exchanges on Guam decreased by 165 items, or approximately 35 percent, due to the unavailability of the same product and size selection from local distributors. The greatest impact was on the number of distilled spirits products offered, which decreased by 100 items. However, in several instances, local distributors carried the same product but in different sizes. For example, local distributors carried the same type of vodka that the military exchanges carried, although in smaller sizes. Therefore, if the local purchase requirement would have continued, the exchanges would have had the option to obtain additional products in different size selections.

¹⁸DOD activities are not subject to local taxes. Thus, having alcoholic beverages handled by the exchanges from wholesale through retail sales conveys a price advantage to the consumer since local taxes are not included in the shelf price, but are included and factored into the shelf price when private sector wholesalers are part of the supply chain.

Impact of the Local Purchase Price Requirement on Morale, Welfare, and Recreation Funding

Alcoholic beverage retail prices reflected the local purchase requirement for only one month as the exchanges raised the retail prices on September 2, 2008 to account for the increase in wholesale costs from purchasing locally, and the local purchase requirement was not reenacted in the Department of Defense Appropriations Act, 2009. As such, it is difficult to fully determine the impact the local purchase requirement had on funding for Morale, Welfare, and Recreation programs on Guam. On September 2, 2008, the exchanges increased retail prices for all alcoholic beverages to reflect new wholesale costs associated with the local purchase requirement. These retail prices were in effect for only 1 month because the local purchase requirement was not reenacted for the following fiscal year. The exchanges subsequently returned to their previous purchase processes and sources on October 1, 2008, thereby limiting the potential impact the local purchase requirement had on funds generated for Morale, Welfare, and Recreation programs. Although AAFES uses data from alcoholic beverage product sales to help determine funding for Morale, Welfare, and Recreation programs, sales volume fluctuated throughout the year making it difficult to isolate the impact caused solely by the local purchase requirement. For example, AAFES retail sales data indicates that alcoholic beverage sales actually increased by about 9.5 percent (from \$187,370 to \$205,241) during September 2008, which was during the time the local purchase requirement was in effect, but declined in October 2008 by about 27 percent (from \$205,241 to \$149,113).¹⁹ In addition, NEXCOM does not calculate the amount of net profit an exchange earns for individual merchandise categories such as alcoholic beverages. Therefore, we could not determine or project the impact of the local purchase requirement on funding for Morale, Welfare, and Recreation programs due to the lack of substantial data.

Perspectives of Exchange Officials on the Impact of the Local Purchase Requirement

According to NEXCOM and AAFES officials, based on the experiences in fiscal year 2008, reimposing a local purchase requirement would negatively impact the military community on Guam because retail prices would increase while the number of products available for sale would decrease. The officials noted that service members and their families would be directly affected because they are the primary patrons of the military exchanges on Guam. Moreover, the increase in prices resulting from the imposition of a local purchase requirement could likely reduce the amount of funds generated for Morale, Welfare, and Recreation programs. For example, maintaining retail prices at the lowest practicable level while wholesale costs are increasing could result in less revenue collected for Morale, Welfare, and Recreation programs. An increase in retail prices of alcoholic beverages may also decrease sales, thereby reducing funds collected for such programs. However, NEXCOM and AAFES officials stated that the impact on Morale, Welfare, and Recreation funds during fiscal year 2008 was negligible because increases in wholesale costs and retail prices of alcoholic beverages under local purchase requirement were only in effect for 1

¹⁹Exchanges also experienced similar sales for the same months during 2007, a period during which the local purchase requirement was not in effect. For instance, alcoholic beverage sales increased in September 2007 by approximately 11.4 percent (from \$152,201 to \$169,551), but declined in October 2007 by approximately 22 percent (from \$169,551 to \$132,471).

month. Nonetheless, these officials also indicated that reimposing a local purchase requirement could potentially reduce the amount of funds generated for Morale, Welfare, and Recreation programs, because they believe increases in retail prices for alcoholic beverages would potentially reduce sales.

Agency Comments

We provided a draft of this report to DOD for review and comment. In response, DOD concurred with the report. DOD also provided technical comments, which we incorporated as appropriate into this report. DOD's comments are reprinted in their entirety in enclosure IV.

We are sending copies of this report to the appropriate congressional committees. We are also sending copies to the Secretary of Defense; the Secretaries of the Army, the Navy, and the Air Force; the Commandant of the Marine Corps; and the Director of the Office of Management and Budget. This report also is available at no charge on our Web site at <http://www.gao.gov>.

If you or your staff have any questions, about this report, please contact me at (202) 512-4523 or leporeb@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 major contributions to this report are listed in enclosure V.



Brian J. Lepore
Director, Defense Capabilities
and Management

Enclosure I

Section 652 of the National Defense Authorization Act, 2010²⁰

REPORT ON IMPACT OF PURCHASING FROM LOCAL DISTRIBUTORS ALL ALCOHOLIC BEVERAGES FOR RESALE ON MILITARY INSTALLATIONS ON GUAM.

(a) REPORT REQUIRED.—Not later than 180 days after the date of the enactment of this Act, the Comptroller General shall submit to the Committees on Armed Services of the Senate and the House of Representatives a report evaluating the impact of reimposing the requirement, effective for fiscal year 2008 pursuant to section 8073 of the Department of Defense Appropriations Act, 2008 (division A of Public Law 110–116; 121 Stat. 1331) but not extended for fiscal year 2009, that all alcoholic beverages intended for resale on military installations on Guam be purchased from local sources.

(b) ELEMENTS.—The report required by subsection (a) shall include the following:

(1) The concerns of nonappropriated funds activities over the one-year imposition of the local-purchase requirement and the impact the requirement had on alcohol resale prices.

(2) The stated justification for any change in the price of alcoholic beverages for resale on military installations on Guam.

(3) The actions of the nonappropriated fund activities in complying with the local purchase requirements for resale of alcoholic beverages and their purchase of such affected products before and after the effective date of the provision of law referred to in subsection (a).

(4) The extent to which nonappropriated funds activities on military installations on Guam are implementing the applicable Department of Defense instruction and the methods used to determine the resale price of alcoholic beverages.

²⁰Pub. L No. 111-84, § 652 (2009).

Enclosure II

Section 8073 of the Department of Defense Appropriations Act, 2008²¹

None of the funds appropriated by this Act shall be used for the support of any nonappropriated funds activity of the Department of Defense that procures malt beverages and wine with nonappropriated funds for resale (including such alcoholic beverages sold by the drink) on a military installation located in the United States unless such malt beverages and wine are procured within that State, or in the case of the District of Columbia, within the District of Columbia, in which the military installation is located: *Provided*, That in a case in which the military installation is located in more than one State, purchases may be made in any State in which the installation is located: *Provided further*, That such local procurement requirements for malt beverages and wine shall apply to all alcoholic beverages only for military installations in States which are not contiguous with another State and Guam: *Provided further*, That alcoholic beverages other than wine and malt beverages, in contiguous States and the District of Columbia shall be procured from the most competitive source, price and other factors considered.

²¹Pub. L. No. 110-116, § 8073 (2007).

Enclosure III

DOD Requirements Related to the Wholesale Purchase and Retail Pricing of Alcoholic Beverages

Department of Defense (DOD) guidance categorizes Guam as an overseas location with regard to the buying and selling of alcoholic beverages.²² DOD Instruction 1330.21 provides guidance for procuring alcoholic beverages for resale. It permits the exchanges to purchase all categories of alcoholic beverages—malt beverages, wine products, and distilled spirits—from the most competitive source for overseas locations. DOD Instruction 1330.09 provides pricing guidance for alcoholic beverages. For locations outside the United States, the exchanges are required to sell distilled spirits at prices within the range of prices established for military exchanges located in the United States, unless the same products are available locally for less. If local prices are cheaper for distilled spirits, then the exchanges may sell the same products for 10 percent less than the best local shelf price. With regard to malt beverage and wine products, they are subject to the general requirement that exchange goods be priced at the lowest practicable level that is consistent with the mission of the exchanges to provide patrons with goods and services necessary for their health, comfort, and convenience. This does not require the exchanges to sell malt beverage and wine products at a specific price. Table 3 provides information on the requirements related to the wholesale purchase and retail pricing of alcoholic beverages.

²²Overseas locations are defined as areas other than the 50 states and the District of Columbia.

Table 3: DOD Requirements Related to the Wholesale Purchase and Retail Pricing of Alcoholic Beverages

	Continental United States (contiguous 48 states)	Alaska and Hawaii	Overseas	Guam—local purchase requirement (fiscal year 2008)	Guam—no local purchase requirement
Malt Beverages					
Wholesale purchase	Purchased from and delivered by a source within the state in which the military installation is located. If an installation is located in more than one state, then the procurement source may be from any state in which the installation is located.	Purchased from and delivered by a source within the state in which the military installation is located.	Purchased from the most competitive source. Distributed in the most economical manner, price, and all other matters considered. ^a	Purchased from and delivered by a source within Guam.	Purchased from the most competitive source. Distributed in the most economical manner, price, and all other matters considered.
Retail pricing	Priced in a substantially uniform manner at the lowest practicable level that is consistent with the mission of the exchanges to provide patrons with goods and services necessary for their health, comfort, and convenience.	Priced in a substantially uniform manner at the lowest practicable level that is consistent with the mission of the exchanges to provide patrons with goods and services necessary for their health, comfort, and convenience.	Priced in a substantially uniform manner at the lowest practicable level that is consistent with the mission of the exchanges to provide patrons with goods and services necessary for their health, comfort, and convenience.	Priced in a substantially uniform manner at the lowest practicable level that is consistent with the mission of the exchanges to provide patrons with goods and services necessary for their health, comfort, and convenience.	Priced in a substantially uniform manner at the lowest practicable level that is consistent with the mission of the exchanges to provide patrons with goods and services necessary for their health, comfort, and convenience.
Wine products					
Wholesale purchase	Purchased from and delivered by a source within the state in which the military installation is located. If an installation is located in more than one state, then the procurement source may be from any state in which the installation is located.	Purchased from and delivered by a source within the state in which the military installation is located.	Purchased from the most competitive source. Distributed in the most economical manner, price, and all other matters considered. Overseas exchanges and package stores must stock an equitable selection of U.S. wines as compared to local wines.	Purchased from and delivered by a source within Guam. Overseas exchanges and package stores must stock an equitable selection of U.S. wines as compared to local wines.	Purchased from the most competitive source. Distributed in the most economical manner, price, and all other matters considered. Overseas exchanges and package stores must stock an equitable selection of U.S. wines as compared to local wines.
Retail pricing	Priced in a substantially uniform manner at the lowest practicable level that is consistent with the mission of the exchanges to provide patrons with goods and services necessary for their health, comfort, and convenience.	Priced in a substantially uniform manner at the lowest practicable level that is consistent with the mission of the exchanges to provide patrons with goods and services necessary for their health, comfort, and convenience.	Priced in a substantially uniform manner at the lowest practicable level that is consistent with the mission of the exchanges to provide patrons with goods and services necessary for their health, comfort, and convenience.	Priced in a substantially uniform manner at the lowest practicable level that is consistent with the mission of the exchanges to provide patrons with goods and services necessary for their health, comfort, and convenience.	Priced in a substantially uniform manner at the lowest practicable level that is consistent with the mission of the exchanges to provide patrons with goods and services necessary for their health, comfort, and convenience.

	Continental United States (contiguous 48 states)	Alaska and Hawaii	Overseas	Guam—local purchase requirement (fiscal year 2008)	Guam—no local purchase requirement
Distilled spirits					
Wholesale purchase	Purchased from the most competitive source. Distributed in the most economical manner, price, and all other matters considered.	Purchased from and delivered by a source within the state in which the military installation is located.	Purchased from the most competitive source. Distributed in the most economical manner, price, and all other matters considered.	Purchased from and delivered by a source within Guam.	Purchased from the most competitive source. Distributed in the most economical manner, price, and all other matters considered.
Retail pricing	Prices discounted no more than 10 percent less than best local shelf price in Alcohol Beverage Control states and 5 percent less in non-Alcohol Beverage Control states.	Prices discounted no more than 10 percent less than best local shelf price in Alcohol Beverage Control states and 5 percent less in non-Alcohol Beverage Control states.	Prices within the range of exchanges located in the United States. If same product is sold locally for less, then spirits may be sold for 10 percent less than the best local shelf price.	Prices within the range of exchanges located in the United States. If same product is sold locally for less, then spirits may be sold for 10 percent less than the best local shelf price.	Prices within the range of exchanges located in the United States. If same product is sold locally for less, then spirits may be sold for 10 percent less than the best local shelf price.

^aThe most economical method of distributing distilled spirits to stores shall be found by considering all components of distribution costs incurred in distributing beverages to stores including all management, logistics, administration, depreciation, utilities, inventory carrying, handling, and distribution costs.

^bAlcohol Beverage Control states are those states that have a state monopoly over the wholesaling and retailing of alcoholic beverages.

Source: Department of Defense Instruction 1330.21, Armed Services Exchange Regulations (July 14, 2005); Department of Defense Instruction 1330.09, Armed Services Exchange Policy (Dec. 7, 2005).

Comments for the Department of Defense



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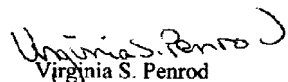
Mr. Brian J. Lepore
Director, Defense Capabilities and Management
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Lepore:

This is the Department of Defense (DoD) response to the GAO Draft Report GAO-10-563R, "DEFENSE INFRASTRUCTURE: Impact of Purchasing from Local Distributors All Alcoholic Beverages for Resale on Military Installations on Guam," dated April 21, 2010 (GAO Code 351433). DoD concurs with the overall report and has no additional comments.

Thank you for the opportunity to comment.

Sincerely,


Virginia S. Penrod
Acting Deputy Under Secretary of Defense
(Military Community and Family Policy)

Enclosure V

GAO Contact and Staff Acknowledgments

GAO Contact

Brian Lepore, (202) 512-4523 or leporeb@gao.gov

Staff Acknowledgments

In addition to the contact named above, Harold Reich, Assistant Director; Grace Coleman; Josh Margraf; Heather May; John Van Schaik; and Michael Willems made key contributions to this report.

Related GAO Products

U.S. Insular Areas: Opportunities Exist to Improve Interior's Grant Oversight and Reduce the Potential for Mismanagement. GAO-10-347. Washington, D.C.: March 16, 2010.

Defense Infrastructure: Guam Needs Timely Information from DOD to Meet Challenges in Planning and Financing Off-Base Projects and Programs to Support a Larger Military Presence. GAO-10-90R. Washington, D.C.: November 13, 2009.

Defense Infrastructure: DOD Needs to Provide Updated Labor Requirements to Help Guam Adequately Develop Its Labor Force for the Military Buildup. GAO-10-72. Washington, D.C.: October 14, 2009.

Defense Infrastructure: Planning Challenges Could Increase Risks for DOD in Providing Utility Services When Needed to Support the Military Buildup on Guam. GAO-09-653. Washington, D.C.: June 30, 2009.

High-Level Leadership Needed to Help Guam Address Challenges Caused by DOD-Related Growth. GAO-09-500R. Washington, D.C.: April 9, 2009.

Defense Infrastructure: Opportunity to Improve the Timeliness of Future Overseas Planning Reports and Factors Affecting the Master Planning Effort for the Military Buildup on Guam. GAO-08-1005. Washington, D.C.: September 17, 2008.

Defense Infrastructure: High-Level Leadership Needed to Help Communities Address Challenges Caused by DOD-Related Growth. GAO-08-665. Washington, D.C.: June 17, 2008.

Defense Logistics: Navy Needs to Develop and Implement a Plan to Ensure That Voyage Repairs Are Available to Ships Operating near Guam when Needed. GAO-08-427. Washington, D.C.: May 12, 2008.

Defense Infrastructure: Planning Efforts for the Proposed Military Buildup on Guam Are in Their Initial Stages, with Many Challenges Yet to Be Addressed. GAO-08-722T. Washington, D.C.: May 1, 2008.

(351433)

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