

Congress of the United States

House of Representatives

COMMITTEE ON OVERSIGHT AND REFORM

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MEMORANDUM

May 15, 2019

To: Members of the Committee on Oversight and Reform

Fr: Majority Staff

Re: Supplemental Memorandum on Actions by TransDigm

On Wednesday, May 15, 2019, at 10:00 a.m., in room 2154 of the Rayburn House Office Building, the Committee will hold a hearing to examine the actions of a defense contractor known as TransDigm Group, Inc. in charging exorbitant prices for spare parts used in military aircraft.

This memorandum summarizes new documents obtained by the Committee regarding TransDigm's extreme profit margins, as well as information from whistleblowers and former company officials about efforts to conceal data from the Department of Defense (DOD) about the company's true costs for manufacturing these parts.

I. NEW DOCUMENTS SHOW TRANSDIGM MAKING EXCESSIVE PROFITS

TransDigm is a public corporation that manufactures parts for military aircraft, including the AH-64 Apache, C-17 Globemaster III, the F-16 Fighting Falcon, and the CH-47 Chinook—each of which is used in Iraq and Afghanistan.¹

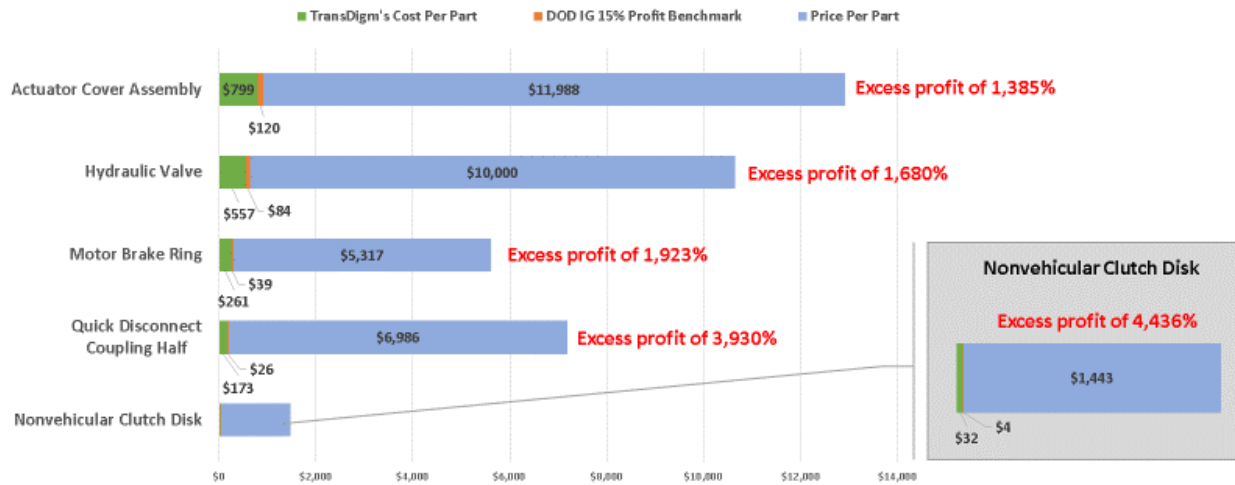
In response to a request from Representative Ro Khanna, the DOD Inspector General (IG) reviewed a sample of 47 spare parts purchased from TransDigm under contracts awarded by the Defense Logistics Agency (DLA) and the Army. The IG determined that TransDigm made “excess profit on 46 of the 47 parts it sold to the DLA and the Army.”²

¹ TransDigm Group, Inc., *2018 Annual Report* (Nov. 9, 2018) (online at www.transdigm.com/investor-relations/annual-reports/).

² Department of Defense, Office of the Inspector General, *Review of Parts Purchased from TransDigm Group, Inc.* (Feb. 25, 2019) (online at www.dodig.mil/reports.html/Article/1769041/review-of-parts-purchased-from-transdigm-group-inc-dodig-2019-060/).

The Committee has now obtained detailed cost and pricing information underlying these contracts. In five of the worst examples examined by the Committee, TransDigm made excess profits of between 1,385% and 4,436%.

TransDigm's Excess Profit for Selected Parts



Prepared by House Committee on Oversight and Reform staff based on the DOD Inspector General's report, "Review of Spare Parts Purchased From TransDigm Group, Inc.," February 25, 2019. Note: The DOD IG calculated excess profit by using the cost per part that TransDigm provided and adding a 15% profit benchmark.

Quick Disconnect Coupling Half

The IG reported that a quick disconnect coupling half, used in the Freedom Fighter F-5 and the T-38 Talon aircraft, cost TransDigm only \$173 to produce, but the company charged DOD \$6,986, resulting in 3,930% excess profit for TransDigm.³



³ Department of Defense, Office of the Inspector General, *Review of Parts Purchased from TransDigm Group, Inc.* (Feb. 25, 2019) (online at www.dodig.mil/reports.html/Article/1769041/review-of-parts-purchased-from-transdigm-group-inc-dodig-2019-060/).

Nonvehicular Clutch Disk

According to the IG, DOD paid \$1,443 for a nonvehicular clutch disk used in the Stratolifter C-135 transport aircraft that cost TransDigm just \$32 to produce, giving TransDigm 4,436% in excess profit.⁴



TransDigm was able to charge these exorbitant prices because it is the sole source provider for all these parts. Since these overcharges were identified in only a small sampling of 113 TransDigm contracts, it remains unknown how much additional excess profit TransDigm is making under its other contracts. DOD issued a total of 4,942 contracts to TransDigm valued at \$471 million from April 2012 through January 2017.⁵

With respect to this sampling of 113 contracts, the IG recommended that DOD request that TransDigm repay \$16.1 million in excess profits identified by the IG.⁶ DOD made this request in January, but counsel for TransDigm informed the Committee in a letter on May 7, 2019: “TransDigm has not yet determined whether it will make a voluntary refund as recommended by the Department of Defense Office of Inspector General.”⁷

Instead, TransDigm provided the Committee with a pricing analysis performed by an outside consultant that compared TransDigm’s price increases to price increases by two competitors. The consultant found that TransDigm’s prices increased between 2015 and 2018 by 6.8%, while the prices of the two competitors that were analyzed increased at rates of 3.9% and 4.6%.⁸ The consultant did not examine the underlying costs to produce the items it examined.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ Letter from John J. Deschauer, Jr., to Chairman Elijah E. Cummings, Committee on Oversight and Reform (May 7, 2019) (online at oversight.house.gov/sites/democrats.oversight.house.gov/files/HORC%20LtrRedacted.pdf).

⁸ Fairmont Consulting Group, *Haystack DoD Pricing Analysis* (May 6, 2019) (online at oversight.house.gov/sites/democrats.oversight.house.gov/files/FCG_TDG%20Haystack%20CY18%20and%20YoY%20Pricing%20Analysis%20CY15-CY18_vF%20050619_Exec%20Summary.pdf).

II. BUSINESS MODEL: ACQUIRE MONOPOLIES AND HIKE PRICES

TransDigm estimates that in fiscal year 2018, about 80% of its net sales “were generated by proprietary products” for which TransDigm is the sole source provider.⁹ TransDigm exclusively licenses or acquires proprietary designs from aerospace and defense manufacturers, “positioning the company as a one-stop shop for hard-to-find replacement parts for planes and other equipment throughout the useful lives of the aircraft.”¹⁰ Since the company was created in 1993, TransDigm has successfully acquired approximately 70 businesses or product lines.¹¹

As a result, TransDigm’s founder and former Chief Executive Officer, Nicholas Howley, received \$278 million in compensation from 2012 to 2017, the most among his peers in the industry. In 2017, TransDigm paid Mr. Howley \$61 million in compensation, more than the combined compensation of the chief executives of Boeing, Lockheed Martin, and Raytheon that year. According to the *New York Times*, Mr. Howley’s compensation was the sixth-highest for chief executive officers in the United States in 2017.¹²

Doug Hillman, former CEO of a TransDigm subsidiary, told Committee staff:

TransDigm management used a “one-two punch” after acquiring a company. It involves two actions: one, raising prices, and two, cutting costs. They cut costs by firing employees. The metric they used was “revenue per head.”

Brad Pedersen, former CEO of TransDigm subsidiary Breeze-Eastern, told the Committee, “They went through every contract at Breeze-Eastern and raised the price where possible.” A March 2017 *Huffington Post* article described TransDigm as “essentially the Martin Shkreli of defense contractors”:

It’s a large holding company that searches for specialty parts used in heavy machinery—unique panels, connectors, cables, and other components—that are produced exclusively

⁹ TransDigm Group, Inc., *2018 Annual Report* (Nov. 9, 2018) (online at www.transdigm.com/investor-relations/annual-reports/).

¹⁰ *Here’s Why TransDigm Paid a Premium for Extant Components Group*, Wisconsin State Journal (Mar. 23, 2018) (online at https://madison.com/business/investment/markets-and-stocks/here-s-why-transdigm-paid-a-premium-for-extant-components/article_05dfa814-c5c3-5f13-b5f5-e2f397c0652e.html).

¹¹ TransDigm Group, Inc., *2018 Annual Report* (Nov. 9, 2018) (online at www.transdigm.com/investor-relations/annual-reports/).

¹² *The Highest-Paid C.E.O.s in 2017*, New York Times (May 25, 2018) (online at www.nytimes.com/interactive/2018/05/25/business/ceo-pay-2017.html?module=inline); *TransDigm Group’s Stock is Up 1,500%, the CEO’s Flush, and Short Seller Andrew Left Sees a Big Bubble*, Bloomberg (Feb. 1, 2017) (online at www.crainscleveland.com/article/20170201/NEWS01/170209988/transdigm-groups-stock-is-up-1500-the-ceos-flush-and-short-seller).

by a single company. TransDigm buys these producers and Pharma Bros them, dramatically inflating the price to exploit their monopoly.¹³

The IG identified 12 parts that previously had been sold to DOD by another contractor. For each part, TransDigm's prices were significantly higher than the price charged by the original manufacturer before TransDigm acquired it. The IG "did not identify any price increases for the 12 parts related to improved performances for those products." The IG found that "the excess profit on the 12 parts ranged from 32 to 3,359 percent."¹⁴

¹³ *Meet the Martin Shkreli of Defense Contracting*, Huffington Post (Mar. 23, 2017) (online at www.huffpost.com/entry/defense-contractor-monopoly-transdigm-mick-mulvaney_n_58d2f8dae4b0b22b0d19ad2a?guccounter=2).

¹⁴ Department of Defense, Office of the Inspector General, *Review of Parts Purchased from TransDigm Group, Inc.* (Feb. 25, 2019) (online at www.dodig.mil/reports.html/Article/1769041/review-of-parts-purchased-from-transdigm-group-inc-dodig-2019-060/).

III. WHISTLEBLOWERS REPORT TRANSDIGM CONCEALED COST DATA

New accounts from whistleblowers and former TransDigm employees indicate that TransDigm intentionally concealed cost data from Defense Department contracting officers.

For example, one former Sales Director for TransDigm described the company's approach with the Defense Department as "taking candy from a baby." The former Sales Director told the Committee: "We were coached not to provide cost data."

Similarly, a former Director of Operations at TransDigm told Committee staff: "We were going out of our way not to disclose costs to the government." This former official also stated: "Nick Howley and management gave a wink wink, nod nod that we want to avoid disclosing any cost data."

Doug Hillman, the former CEO of a TransDigm subsidiary, told Committee staff: "You're punishing your customers instead of working with them to secure long term relationships, reasonable profitability, and growth."

On May 7, 2019, TransDigm sent a letter to the Committee claiming: "TransDigm has no written policy stating that employees should refuse to provide uncertified cost data on request."¹⁵ This letter seems worded carefully to avoid the non-written directions described by the whistleblowers.

The Truth in Negotiations Act (TINA) requires contractors to provide certified cost data for contracts over a certain threshold.¹⁶ Contracting officers requested cost data for 16 of the contracts reviewed by the IG. TransDigm refused to provide data for 15 of those contracts and provided data only for the one contract in which the company was required to do so under the Act.

After independently obtaining the cost data for all 15 of these contracts, the IG found that TransDigm made excess profit in all 15 of the contracts in which the company refused to provide cost data to contracting officers. According to the IG, if TransDigm had disclosed the cost data when requested, DOD could have saved approximately \$2.6 million.¹⁷

The IG found that contracting officers were placed in a difficult situation because nearly all of those parts, 13 of the 15, were only manufactured by TransDigm. According to the IG:

¹⁵ Letter from John J. Deschauer, Jr., to Chairman Elijah E. Cummings, Committee on Oversight and Reform (May 7, 2019) (online at oversight.house.gov/sites/democrats.oversight.house.gov/files/HORC%20LtrRedacted.pdf)

¹⁶ P.L. 115-91 (Congress raised the Truth in Negotiations Act threshold in 2018 to \$2 million).

¹⁷ Department of Defense, Office of the Inspector General, *Review of Parts Purchased from TransDigm Group, Inc.* (Feb. 25, 2019) (online at www.dodig.mil/reports.html/Article/1769041/review-of-parts-purchased-from-transdigm-group-inc-dodig-2019-060/).

Therefore, contracting officers had limited options once TransDigm refused to provide the requested cost data for the 15 parts, either buying the parts without receiving cost data from TransDigm or not buying the parts needed to meet mission requirements.¹⁸

The IG reported that five contracting officers stated that they went forward with contracts even without the cost data they requested because “the need for the spare part was urgent enough that they had to buy the part at the price offered by TransDigm.” TransDigm was the sole manufacturer for 39 of the 47 parts reviewed by the IG.¹⁹

Federal contracting rules prohibit contracting officers and contractors from breaking up contracts just to avoid a requirement that would apply if it were one bigger contract.²⁰ Emails obtained by the Committee show that DOD and TransDigm purposely structured contracts to stay below the Simplified Acquisition Threshold (SAT) that would have required greater transparency and accountability for prices. In an October 2016 email, a contracting officer asked TransDigm if DOD could buy “30 units using two contracts on the same day.”²¹ TransDigm provided an offer for two contracts and told the contracting officer, “That should still keep you under the SAT of 150K per order.”²²

The Committee also obtained information from former TransDigm employees who said they structured agreements to avoid hitting the thresholds that would trigger stricter requirements. A former Sales Director for TransDigm told Committee staff, “The government asked for a multi-year solicitation for BlackHawk parts, we shortened the term of the contract to 9 months so that we wouldn’t go over TINA.” A former Director of Operations at TransDigm told the Committee that former CEO Nick Howley and former President and Chief Operating Officer Ray Laubenthal said of staying below TINA, “You know what to do.”

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ 48 C.F.R. § 13.003(c)(2).

²¹ Email from Defense Logistics Agency to Contract Administrator, Aero Fluid Products (Oct. 14, 2016) (online at oversight.house.gov/sites/democrats.oversight.house.gov/files/TransDigm%201596_Redacted.pdf).

²² Email from Contract Administrator, Aero Fluid Products, to Defense Logistics Agency (Oct. 17, 2016) (online at oversight.house.gov/sites/democrats.oversight.house.gov/files/TransDigm%201596_Redacted.pdf).

IV. TRANSDIGM PRICES DISPROPORTIONATE TO ITS COSTS

TransDigm's Chief Financial Officer told the IG that the company uses a model of what it calls "value-based pricing" that is "based on value to the customer rather than the actual cost of producing a part."²³ A former Sales Director for TransDigm told Committee staff, "value pricing is code for raising prices." The former Sales Director also stated:

We were coached on how to structure agreements. It was suggested to us that we use shorter agreements. Don't sign long-term agreements. We were encouraged to use excuses.

Doug Hillman, former CEO of one of TransDigm's subsidiaries, told Committee staff, "Their direction was to pursue value pricing where value was defined as pushing prices to the point of near customer revolt to divert more value to TransDigm."

Actuator Cover Assembly

TransDigm provided emails to the Committee between a TransDigm subsidiary and a DLA contracting officer who questioned TransDigm's offer of \$11,988 each for 12 actuator cover assembly parts. The contracting office told the TransDigm official, "Our records are indicating the price should be significantly lower." The contracting officer pointed to "a government engineering intrinsic value analysis" that estimated it would cost TransDigm \$1,087.20 to provide each part.²⁴

In response, the TransDigm official claimed: "Our quoted price came directly from our production and material costs of producing 12 units of this part." He also wrote: "Given the amount of labor hours that production on this part would require, and the castings that this part will need, we cannot support a lower price for 12 units than what was quoted."²⁵

The IG found that TransDigm's cost was only \$799 and the company made 1,385% in excess profit.²⁶

Filter Subassembly

The Committee also obtained emails that show an official for a TransDigm subsidiary told a DOD contracting officer that \$5,596 was the best price the company could offer for a filter

²³ *Id.*

²⁴ Email from Acquisition Specialist, Defense Logistics Agency, to Aero Fluid Products (Jan. 14, 2016) (online at oversight.house.gov/sites/democrats.oversight.house.gov/files/TransDigm%202732_Redacted.pdf).

²⁵ Email from Aero Fluid Products to Acquisition Specialist, Defense Logistics Agency (Jan. 16, 2016) (online at oversight.house.gov/sites/democrats.oversight.house.gov/files/TransDigm%202732_Redacted.pdf).

²⁶ Department of Defense, Office of the Inspector General, *Review of Parts Purchased from TransDigm Group, Inc.* (Feb. 25, 2019) (online at www.dodig.mil/reports.html/Article/1769041/review-of-parts-purchased-from-transdigm-group-inc-dodig-2019-060/).

subassembly used in the Hercules C-130 aircraft. He wrote: “Given our costs on this part, it’s the lowest we can go at this quantity.”²⁷ Yet, the IG found that TransDigm’s cost to produce the part was only \$1,189.²⁸

Coupling Used in V-22 and CH-53

Federal regulations require contracting officers to compare the proposed price for an item to historical prices paid by the government or in commercial sales to determine whether a contract price is reasonable.²⁹

In the case of a coupling used in the V-22 Osprey and the CH-53 helicopter, the IG found that TransDigm raised the price from \$1,239 to \$7,325 from 2007 to 2017. Yet, TransDigm’s cost to produce the part as of 2015 was approximately \$287. The IG reported: “TransDigm earned excess profit because prices for the parts had become inflated over time.” The IG also concluded that “some part prices appeared to be inflated at the time the Government first purchased the part from TransDigm further compounding the excess profit.” Essentially, once a contracting officer finds a price to be fair and reasonable, it becomes the baseline for the next contract.³⁰

²⁷ Email from Aero Fluid Products to Contract Specialist, Defense Logistics Agency (Nov. 1, 2016) (online at oversight.house.gov/sites/democrats.oversight.house.gov/files/TransDigm%201841_Redacted.pdf).

²⁸ Department of Defense, Office of the Inspector General, *Review of Parts Purchased from TransDigm Group, Inc.* (Feb. 25, 2019) (online at www.dodig.mil/reports.html/Article/1769041/review-of-parts-purchased-from-transdigm-group-inc-dodig-2019-060/).

²⁹ Federal Acquisition Regulation 15.404-1 (online at www.acquisition.gov/content/15404-1-proposal-analysis-techniques).

³⁰ Department of Defense, Office of the Inspector General, *Review of Parts Purchased from TransDigm Group, Inc.* (Feb. 25, 2019) (online at www.dodig.mil/reports.html/Article/1769041/review-of-parts-purchased-from-transdigm-group-inc-dodig-2019-060/).

V. OPTIONS FOR REFORM

In a letter to the IG, Shay Assad, the former Director of Defense Pricing and Contracting, recommended legislative changes to prevent price gouging by spare parts manufacturers in the future. Mr. Assad wrote:

The reality is that the only true defense against companies that exhibit unconscionable greed is to avoid doing business with those companies whenever possible through competitive means, ensure that there are statutory provisions that address “war profiteering” and price gouging, and ensure the existence of a legislative provision that compels companies to provide cost data when so required.³¹

On November 7, 2007, DOD issued a new policy requiring contracting officers to notify the Director of Defense Pricing and Acquisition Policy of any contracts awarded without obtaining requested cost data.³² The memo was issued in response to an IG recommendation to track and report information about contractors that refused to provide cost data and take appropriate action to address pricing issues related to those contractors.³³

The IG determined that, as of March 2019, DOD’s component offices still had not yet implemented the policies outlined in the 2007 memo. In response to this finding, Kim Herrington, the current Acting Principal Director of Defense Pricing and Contracting, pledged to draft an updated memorandum and incorporate its requirements into federal acquisition regulations.³⁴

On March 22, 2019, Mr. Herrington issued an updated policy memo for DOD acquisition executives. The memo institutes “a quarterly reporting requirement” for all determinations by contracting officials that a contract may be awarded despite the contractor’s refusal to provide data requested by DOD during the negotiation process.³⁵

³¹ *Id.*

³² United States Department of the Navy, *Access to Records with Exclusive Distributors/Dealers* (Dec. 21, 2007) (online at <https://bit.ly/2JZHaJF>).

³³ Department of Defense, Office of the Inspector General, *Procuring Noncompetitive Spare Parts Through an Exclusive Distributor* (Feb. 6, 2008) (online at media.defense.gov/2017/May/08/2001774140/-1/-1/1/D-2008-048.pdf).

³⁴ Department of Defense, Office of the Inspector General, *Review of Parts Purchased from TransDigm Group, Inc.* (Feb. 25, 2019) (online at www.dodig.mil/reports.html/Article/1769041/review-of-parts-purchased-from-transdigm-group-inc-dodig-2019-060/).

³⁵ Department of Defense, Office of the Under Secretary of Defense, *Process and Reporting Requirements Pertaining to Contractor Denials of Contracting Officer Requests for Data Other than Certified Cost or Pricing Data* (Mar. 22, 2019) (online at oversight.house.gov/sites/democrats.oversight.house.gov/files/2019.03.22%20DPC%20Response%20to%20DOD%20IG%20recommendations.pdf).