



United States Government Accountability Office
Washington, D.C. 20548

December 22, 2005

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

The Honorable Duncan L. Hunter
Chairman
The Honorable Ike Skelton
Ranking Minority Member
Committee on Armed Services
House of Representatives

Subject: *Pilot Project to Expand Merchandise Sold in Commissary Stores
Will Likely Have a Negligible Impact on the Exchange Dividend*

The Department of Defense (DOD) has three military exchanges—the Army and Air Force Exchange Service, the Navy Exchange, and the Marine Corps Exchange—that operate retail and other specialty stores. During fiscal years 2000 through 2004, the three exchanges provided more than \$300 million annually, an average of 55 to 70 percent of their profits, in the form of a dividend to support the military services' morale, welfare, and recreation programs.¹ DOD, through the Defense Commissary Agency (DeCA), also operates commissaries that sell groceries and authorized household products at the lowest practical price, charging patrons only for the cost of goods sold plus a 5 percent surcharge. The funds generated by the surcharge are used to construct new and modernize existing commissaries.

The Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005 authorized the Secretary of Defense to conduct a pilot project involving the sale of film, one-time use cameras, and telephone cards in not less than 10 commissary stores for a period selected by the Secretary, but

¹ DOD's morale, welfare, and recreation programs—such as gymnasiums, libraries, and child care centers—provide for the physical, cultural, and social needs and the well-being of servicemembers, their families, and eligible civilians and are intended to provide a sense of community among patrons to make individuals more satisfied with military life and to attract people to military careers.

not less than 6 months.² Previously, these items had only been sold by the exchanges. Concerns were expressed by some associated with the exchanges that allowing the commissary stores to sell these items could adversely affect the exchange dividend, which could reduce the funding for the military services' morale, welfare, and recreation programs. The legislation also included a requirement that we examine that issue. In response to the 2005 act, we determined (1) the status of the pilot project to sell film, one-time use cameras, and telephone cards in select commissaries; and (2) the potential impact that the pilot project could have on the exchange dividend.

We performed our work at the Office of the Under Secretary of Defense (Personnel and Readiness), Arlington, Virginia; Army and Air Force Exchange Service headquarters, Dallas, Texas; Navy Exchange headquarters, Virginia Beach, Virginia; Marine Corps Exchange headquarters, Quantico, Virginia; and DeCA Washington Office, Washington, D.C. To determine the status of the pilot project, we reviewed the memorandum of agreement that instituted the pilot project and interviewed officials at the headquarters of the three exchanges and DeCA. To determine the potential impact of the pilot project on the exchange dividend, we analyzed sales data for film, one-time use cameras, and telephone cards for fiscal years 2003, 2004, and 2005 through September 30, 2005.³ We also reviewed financial reports on the amount of exchange dividends for fiscal years 2000 through 2004. Finally, we obtained data on the percentage of funding for the services' morale, welfare, and recreation programs from the exchange dividend compared to self-generated revenue and appropriated funding for fiscal year 2004. We determined that the data used were sufficiently reliable for purposes of this review. We conducted our review from September through November 2005 in accordance with generally accepted government auditing standards.

Summary

Officials from the three exchanges and DeCA signed a memorandum in November 2005 agreeing to institute a pilot project to sell film, one-time use cameras, and telephone cards at 10 commissaries in the continental United States. DOD implemented the pilot project at one location in November 2005 and plans to implement it at the other nine locations in

² Pub. L. No. 108-375, Section 651 (Oct. 28, 2004).

³ The exchanges operate on the retail fiscal year, which runs from February through January.

December 2005. The pilot project is scheduled to last for 2 years. As designed, the pilot project is a test of convenience. The commissaries will purchase the selected film, one-time use cameras, and telephone cards from the exchanges at the exchanges' retail price and sell the items at the same price as the exchanges. The commissaries will receive a management fee equal to 2 percent of the sale price of the items to offset the costs for handling the pilot project items and will not collect a surcharge on these items.

The pilot project should have a negligible impact on the exchange dividend because of the design of the pilot project and the small percentage of sales from film, one-time use cameras, and telephone cards. The commissaries will purchase all pilot project items from the exchanges, less a 2 percent management fee. Further, based on our analysis of the exchanges' sales data, the sale of all film, one-time use cameras, and telephone cards comprise a very small percentage (less than 1 percent from fiscal years 2003 through 2005) of annual total exchange sales, and the pilot project calls for only selling 8 varieties of these items at 10 locations. Moreover, the exchanges would continue to sell the items at their locations throughout the pilot project. Based on fiscal year 2004 sales and dividend data, we determined that the fiscal year 2004 exchange dividend would have decreased by about \$600,000, or 0.2 percent, if all sales of all varieties of these items were made at the commissaries. Our estimate represents a worst case scenario because it includes the sale of all film, one-time use cameras, and telephone cards, rather than the eight items selected for the pilot project; assumes that all sales of film, one-time use cameras, and telephone cards would occur at the commissaries instead of the exchanges; and assumes that the sales of these items remain the same as when they were only sold in the exchanges.

In written comments on a draft of this report, DOD concurred with the overall report.

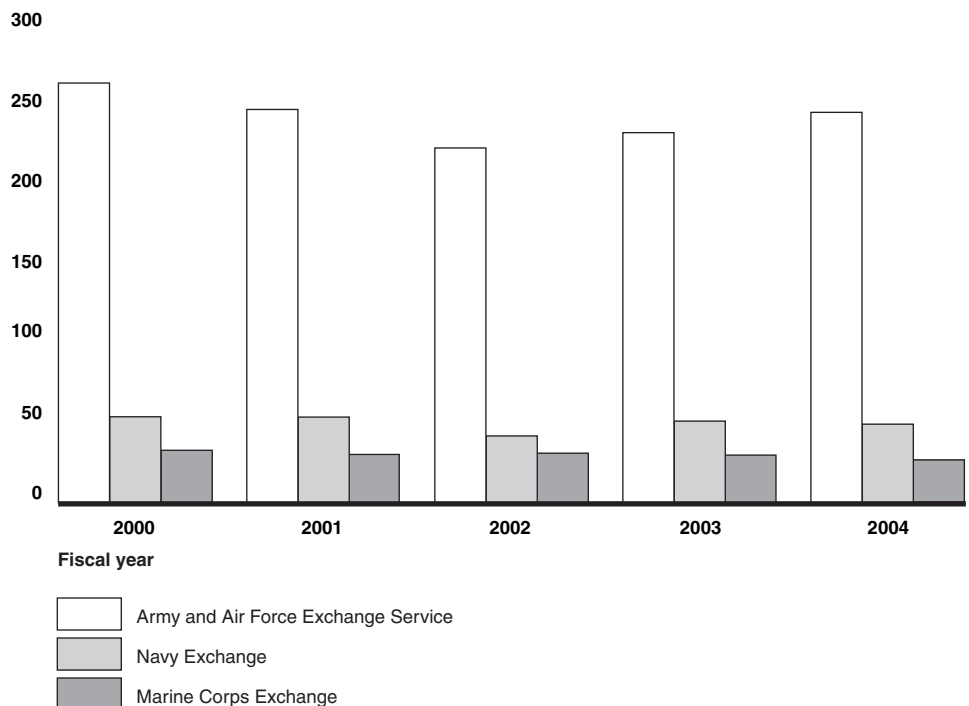
Background

The three military exchanges—the Army and Air Force Exchange Service, the Navy Exchange, and the Marine Corps Exchange—are nonappropriated fund activities that are established by, controlled by, and operated for the benefit of DOD components. The military exchanges have a dual mission of providing (1) authorized patrons with articles of 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.

The exchanges operate retail stores, similar to department stores, and provide a host of other services and specialty stores, including furniture stores, florist shops, barber and beauty shops, optical shops, liquor stores, and fast-food restaurants. For fiscal year 2004, the exchange services had almost \$11 billion in sales. While the exchanges use different methods to determine their dividend, between 55 and 70 percent of the exchange services' profits from sales were allocated to morale, welfare, and recreation activities through the exchange dividend over the past 5 fiscal years and the remaining profits were reinvested in the exchange system and used primarily to build new exchange facilities and related capital improvements.

The exchanges' dividend has fluctuated somewhat over the past 5 years. Figure 1 shows the exchange dividend for each exchange for fiscal years 2000 through 2004.

Figure 1: Exchange Dividend by Exchange for Fiscal Years 2000 - 2004
Dollars in millions



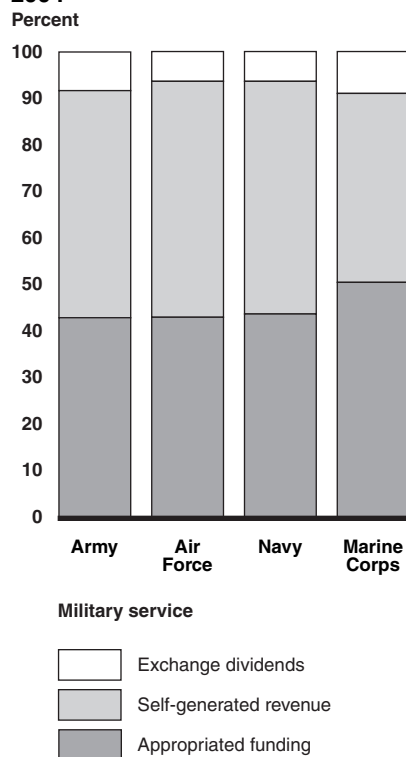
Source: DOD.

Note: The Navy Exchange data do not include the Ships' Stores.

The Army and Air Force Exchange Service's dividend fluctuated from a high in 2000 of \$260.4 million to a low in 2002 of \$220.1 million before increasing again to \$242.2 million in 2004. Similarly, the Navy Exchange's dividend was at its high of \$53.3 million in 2000, at a low of \$41.4 million in 2002, and was around \$50 million in 2003 and 2004. The Marine Corps Exchange's dividend fluctuated from year to year, but remained near \$30 million, with the exception of its lowest year, 2004, when the dividend was \$26.1 million.

The exchange dividend makes up a small portion of the total funding for the services' morale, welfare, and recreation programs—less than 10 percent of each service's total morale, welfare, and recreation funding in fiscal year 2004, as shown in figure 2.

Figure 2: Source of Morale, Welfare, and Recreation Program Funding, Fiscal Year 2004



Source: DOD.

DeCA is DOD's designated agency for managing commissary stores worldwide. DeCA's mission is to provide beneficiaries with groceries and authorized household products at the lowest practical price, charging patrons only for the cost of goods sold plus a 5 percent surcharge. The funds generated by the surcharge are used to acquire (including acquisition by lease), construct, repair, maintain, and equip the physical infrastructure of commissary stores. DeCA ended fiscal year 2004 with 273 stores and sales over \$5 billion.

Pilot Project In Process of Being Implemented

Officials from the three exchanges and DeCA signed a memorandum in November 2005 agreeing to institute a pilot project to sell film, one-time use cameras, and telephone cards at 10 commissaries in the continental United States.⁴ DOD implemented the pilot project at one location in November 2005 and plans to implement it at the other nine locations in December 2005. The exchanges and DeCA selected eight specific items for the pilot project—two types of film, three types of one-time use cameras, and three types of telephone cards.⁵ Exchange officials said that the items selected for the test were the exchanges' best selling items in these categories. The pilot project is scheduled to last for 2 years; however after 1 year the exchange services and DeCA can agree to terminate the pilot project.

As designed, the pilot project is a test of convenience. The 10 commissaries will purchase the pilot project items from the exchanges at the exchanges' retail price and sell the items at the same price as the exchanges. The exchanges will continue to sell the pilot project items in the exchanges. The exchanges will pay the commissaries a management fee equal to 2 percent of the sales price of the pilot project items to offset the cost of

⁴ The 10 commissaries chosen for the pilot project are Andrews Air Force Base, Maryland; Buckley Air Force Base, Colorado; Fort Bliss, Texas; Fort Knox, Kentucky; Fort Lee, Virginia; Norfolk Naval Base, Virginia; Patuxent River Naval Air Station, Maryland; Port Hueneme, California; Quantico Marine Corps Base, Virginia; and Wright-Patterson Air Force Base, Ohio.

⁵ The items included in the pilot project are Kodak 800 speed film, 4 pack; Kodak 400 speed film, 4 pack; Kodak One-time Use Camera, Zoom; Kodak One-time Use Camera, Max Flash; Kodak One-time Use Camera, Funsaver; AT&T 100 Unit Global Phone Card (Army and Air Force Exchange System)/ 150 Unit (Navy Exchange, Marine Corps Exchange); AT&T 200 Unit Global Phone Card (Army and Air Force Exchange System)/ 300 Unit (Navy Exchange, Marine Corps Exchange); and AT&T 550 Unit Global Phone Card.

handling the pilot project items. The commissaries will not collect a surcharge on the sale of pilot project items.

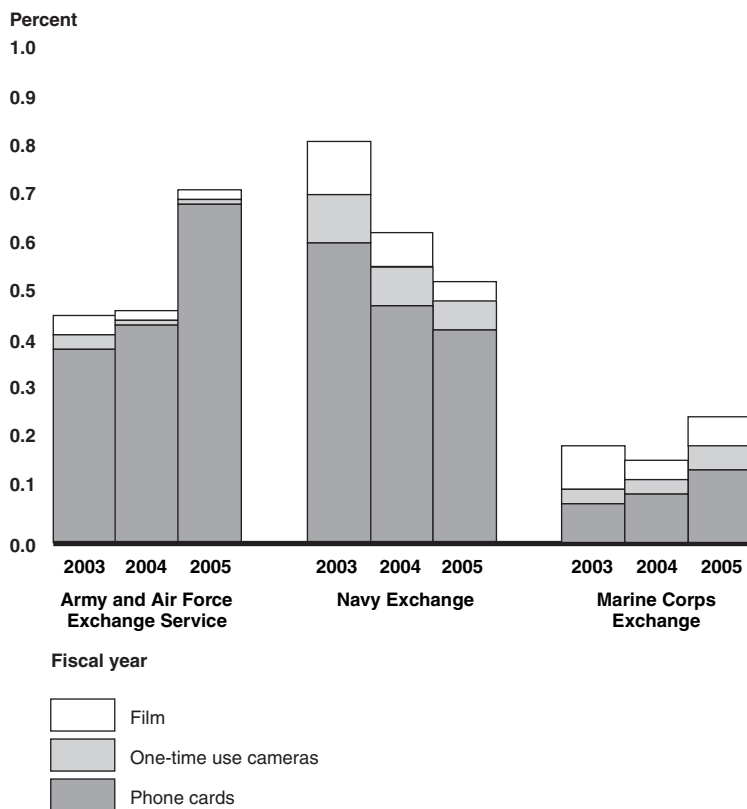
Pilot Project Should Have Negligible Impact on the Exchange Dividend

The pilot project should have a negligible impact on the exchange dividend used to support the military services' morale, welfare, and recreation programs. The exchanges will not lose any sales of film, one-time use cameras, or telephone cards to the commissaries during the pilot project because the commissaries will purchase the items from the exchanges and will continue to sell the items themselves. However, the exchanges will pay DeCA a 2 percent management fee on the sale of these items. In addition, the sales of all film, one-time use cameras, and telephone cards represented less than 1 percent of the total sales for the three exchanges for fiscal years 2003 through 2005.

According to DOD officials, the pilot project was designed to have minimal impact on the exchange dividend. Specifically, as previously mentioned, the 10 commissaries involved in the pilot project will purchase the pilot project items from the exchanges, rather than an outside vendor, and sell the items at the same price as the exchanges. Because the commissaries will purchase all items from the exchanges and the exchanges will continue to sell the items in their locations, the exchanges will not lose any sales of film, one-time use cameras, and telephone cards to the commissaries.

The sales of all film, one-time use cameras, and telephone cards comprised less than 1 percent of total retail sales for the exchanges from fiscal years 2003 through 2005, as shown in figure 3. Telephone cards were the largest proportion of the three categories in terms of dollar sales, ranging from a low of 0.08 percent of sales at the Marine Corps Exchange in fiscal year 2003 to a high of 0.70 percent of sales at the Army and Air Force Exchange System in fiscal year 2005.

Figure 3: Exchange Sales of All Film, One-Time Use Cameras, and Telephone Cards as a Percentage of Total Exchange Sales, Fiscal Years 2003-2005



Source: GAO analysis of DOD data.

Notes: The sales data include the sales of all film, one-time use cameras, and telephone cards, not only those eight items selected for the pilot project. The Navy Exchange data do not include the Ships' Stores.

As previously noted, the pilot project includes eight items and not all the film, one-time use cameras, and telephone cards sold in the exchanges. Comparable data on the sales of only the 8 items and 10 installations included in the pilot project were not available. To show the potential impact on the exchange dividend, we assumed that the commissary stores accounted for the sale of all film, one-time use cameras, and telephone cards. Based on fiscal year 2004 sales and dividend data, we determined that the exchange dividend would have been reduced by about \$600,000, or 0.2 percent, as shown in table 1.

Table 1: Potential Impact of the Pilot Project on the Exchange Dividend Based on Fiscal Year 2004 Data

Dollars in thousands

Exchange	Actual exchange dividend (2004)	Potential decrease in exchange dividend	
		Dollars	Percentage
Army and Air Force Exchange Service	\$242,179	\$370	0.15
Navy Exchange	48,667	203	0.42
Marine Corps Exchange	26,141	22	0.08
Total	\$316,987	\$595	0.19

Source: GAO analysis of DOD data.

Note: The Navy Exchange data do not include the Ships' Stores.

Our estimate represents the worst case scenario because it includes the sale of all film, one-time use cameras, and telephone cards, and not just the 8 items included in the pilot project or the 10 locations selected for the pilot project. In addition, we assumed that the commissaries would account for all sales since we have no basis to determine the extent to which sales would be split between the exchange stores and the commissary stores. In addition, our analysis does not consider whether the overall sales of these items would increase or whether the pilot project could reduce sales of other items at the exchanges due to a loss of foot traffic.

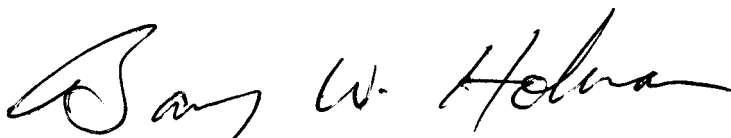
Agency Comments

In commenting on a draft of the report, the official performing the duties of the Principal Deputy Under Secretary of Defense (Personnel and Readiness) concurred with the overall report. DOD also provided technical comments which were incorporated as appropriate. DOD's comments are reprinted in the enclosure of this report.

We are sending copies of this report to the Secretary of Defense; the Under Secretary of Defense (Personnel and Readiness); the Commander, Army and Air Force Exchange System; the Commander, Navy Exchange Command; the Director, Personal and Family Readiness Division, U.S. Marine Corps; the Chairman, Commissary Operating Board; the Director, DeCA, and the Director, Office of Management and Budget. We will make

copies available to others upon request. In addition, the report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

Please contact me at (202) 512-5581 if you or your staff have any questions concerning this report. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Major contributors to this report were Michael Kennedy, Assistant Director; Hilary Murrish; James Nelson; and Alissa Czyz.

A handwritten signature in black ink, reading "Barry W. Holman". The signature is fluid and cursive, with the first name "Barry" being more prominent and the last name "Holman" following in a similar style.

Barry W. Holman
Director
Defense Capabilities and Management

Enclosure

Enclosure: Comments from the Department of Defense



PERSONNEL AND
READINESS

OFFICE OF THE UNDER SECRETARY OF DEFENSE
4000 DEFENSE PENTAGON
WASHINGTON, D.C. 20301-4000



DEC 14 2005

MEMORANDUM FOR DOD INSPECTOR GENERAL
ATTN: TECHNICAL DIRECTOR AUDIT FOLLOW-UP
& GAO AFFAIRS

SUBJECT: DoD Comments on GAO Draft Report GAO-06-256R, "Expansion of Merchandise Sold in Commissary Stores Will Likely Have Negligible Impact on the Exchange Dividend", November 28, 2005 (GAO Code 350751)

This memorandum responds to your request of November 30, 2005, for comments on GAO Report -06-256R. DoD concurs with the overall report. We request that GAO modify the report to reflect the recommended technical corrections attached.

Thank you for the opportunity to comment. Questions may be directed to Ms. Michelle Priester, Resale Activities and NAF Policy, (703) 602-4601.

Gail H. McGinn
Performing the Duties of
the Principal Deputy

Attachment:
As stated

cc:
Commander, Army and Air Force Exchange Service
Commander, Navy Exchange Service Command
Director, Personal & Family Readiness, HQ USMC
Acting Director, Defense Commissary Agency



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