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United States Department of State
and the Broadcasting Board of Governors
Office of Inspector General

Report of Inspection

Review of the Department's Use of Its Defense Export Licensing Watchlist in the Acquisition Process

Report Number SIA-I-08-05, September 2008

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PREFACE

This report was prepared by the Office of Inspector General (OIG) pursuant to the Inspector General Act of 1978, as amended, Section 209 of the Foreign Service Act of 1980, the Arms Control and Disarmament Amendments Act of 1987, and the Department of State and Related Agencies Appropriations Act, FY 1996. It is one of a series of audit, inspection, investigative, and special reports prepared by OIG periodically as part of its oversight responsibility with respect to the Department of State and the Broadcasting Board of Governors to identify and prevent fraud, waste, abuse, and mismanagement.

This report is the result of an assessment of the strengths and weaknesses of the office, post, or function under review. It is based on interviews with employees and officials of relevant agencies and institutions, direct observation, and a review of applicable documents.

The recommendations therein have been developed on the basis of the best knowledge available to the OIG, and have been discussed in draft with those responsible for implementation. It is my hope that these recommendations will result in more effective, efficient, and/or economical operations.

I express my appreciation to all of those who contributed to the preparation of this report.

A handwritten signature in black ink, appearing to read "H. W. Geisel".

Harold W. Geisel
Acting Inspector General

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KEY JUDGMENTS

- The Department's Watchlist for defense export licensing was created to assist licensing officers and compliance specialists when reviewing a party's application for an arms export license, not for the purpose of vetting prospective contractors as part of the acquisition process.
- Officials from the Department of State's (Department) Directorate of Defense Controls (PM/DDTC) have been meeting with Department of Defense (DOD) acquisition experts to develop contract clause language that would allow the use of Watchlist information in the acquisition process.
- Office of Acquisitions Management (A/LM/AQM) officials acted judiciously in identifying and flagging the poor performance of AEY, Inc., and in ceasing activity with the company when it was deemed necessary.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objective of this review was to determine the Department's use of its defense export licensing Watchlist in the acquisition process, with specific focus on AEY, Inc. Reportedly, AEY was put on the Watchlist as early as April 2006, and was subsequently awarded four contracts by the Department, one in December 2006, two in February 2007, and one in June 2007.

This review was conducted through interviews with principals from the Bureau of Political-Military Affairs (PM) and the Bureau of Administration (A). The findings and conclusions of this review were based upon these meetings; reviews of open source documents pertaining to AEY; the Arms Export Control Act (AECA),¹ as amended; testimony given to the House of Representatives, Committee on Oversight and Government Reform on June 24, 2008; and documents provided to OIG by A/LM/AQM and PM/DDTC.

This review was conducted between June 24 and July 10, 2008, (b) (6)
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¹22 U.S.C. § 2778

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BACKGROUND

In 1968, Congress passed the AECA, which requires, inter alia, that companies engaging in the brokering, exporting, or manufacturing of weapons and ammunition be registered, and obtain a license for each transaction. This authority is given to the President, which is delegated to the Secretary, the Under Secretary for Arms Control and International Security Affairs, and then to PM/DDTC. PM/DDTC officials may disapprove a license application and may revoke, suspend, or amend an existing license whenever it deems “...such action to be in the furtherance of world peace, the national security or foreign policy of the United States, or is otherwise inadvisable...”²²

The AECA requires the development of “appropriate mechanisms” to identify persons and entities that are ineligible to receive an arms export license.³ It is for that purpose the Watchlist was created. The Watchlist is maintained by PM/DDTC compliance specialists, who draw from intelligence, law enforcement, and open source information. While some entries, such as criminal violations of the AECA, are clearly determinative as to whether or not an export license will be approved, other entries are more of an informative nature, leaving to the licensing officer’s discretion whether or not to approve the party’s license application.

AEY, Inc., a Florida-based company founded in 1999, received its first U.S. government contract in 2004. Since then the majority of its contracts and purchase orders have been with DOD and the Department for the procurement of weapons, ammunition, and other military equipment. In January 2007, the U.S. Army awarded AEY a \$300 million contract to supply ammunition to Afghan Security Forces. In May 2008, after payments of \$66 million, the Army terminated the contract for cause. In June 2008, a federal grand jury indicted AEY and individuals associated with the company on criminal charges arising from the company’s purchase of ammunition under the contract.

²²U.S.C. § 2778 (g) (1).

³Ibid.

On June 24, 2008, the U.S. House of Representatives, Committee on Oversight and Government Reform, conducted a hearing to examine AEY contracts with the U.S. government. The hearing addressed the failures by AEY to provide weapons and ammunition under contracts to the U.S. government and the deficiencies within the government that allowed AEY to be awarded these and other contracts. Among the noted deficiencies was the U.S. Army's failure to check AEY against the Department's defense export licensing Watchlist prior to awarding the \$300 million contract to supply ammunition to Afghan Security Forces.

FINDINGS

Use of the Watchlist

Paramount to understanding the Department's use of its defense export licensing Watchlist is understanding what the Watchlist is and what it is not. Its purpose is to alert licensing officers and compliance specialists within PM/DDTC regarding potential concerns when reviewing a party's application for an arms export license. According to PM officials, all export license applications are screened against it. The broad range of information contained in the Watchlist, some of which is derived from classified sources, reflects the wide latitude given to licensing officers in granting or denying a license application. But with the exception of certain determinative information that legally bars the issuance of a defense trade license, the presence of a person or organization on the Watchlist does not automatically result in a denial of the license application.

Officials from A/LM/AQM stated that their contracting officers currently do not use the Watchlist in determining the awarding of contracts or the issuance of purchase orders, as much of the information in the Watchlist does not relate to contract performance and, as such, it is ill-suited for use in the acquisition process. Information on the Watchlist that would be determinative in the awarding of a contract or the issuance of a purchase order, such as a company's listing on the General Service's Administration's (GSA) Excluded Parties List (EPLS), is available from other sources, which are used by A/LM/AQM's contracting officers.

It would appear that the Watchlist and the arms export licensing process could be used to indirectly control those contracts and purchase orders that involve the export of arms and munitions by denying the arms export license, thereby preventing the contractor from meeting the terms of the contract or purchase order. But this was found not to be the case. Of the 39 purchase orders the Department⁴ issued to AEY during fiscal years 2004 through 2007 for arms and munitions, the OIG team found only one purchase order that contained a requirement for the vendor to obtain an export license. The majority of the purchase orders that showed a foreign country as the final destination did not specify shipment to the foreign destination, but instead required shipment to a domestic U.S. government location, presumably for transshipment by the U.S. government.

In response to the June 24, 2008, Committee on Oversight and Government Reform hearing regarding AEY and its contracts with the U.S. government, representatives from PM/DDTC have been meeting with DOD acquisition experts to develop contract clause language that would allow the use of Watchlist information in the acquisition process. The contract clauses being discussed would potentially give U.S. government acquisition officials greater insight into and leverage over contractors that run afoul of export laws and regulations. If this effort is successful, the results may be useable for the Department's acquisitions.

AEY Arms Export Licenses and Department Contracts

Between January 2005 and March 2008 AEY submitted 28 arms export license applications, of which 19 were approved. Two of the approved licenses were subsequently revoked, one of which was reapproved after being resubmitted. Five license applications were returned without action, which is typical when the application contains administrative errors, and four license applications were rejected. According to PM officials, each of these applications was carefully reviewed, vetted with appropriate law enforcement officials, and checked against the Watchlist. The OIG team confirmed, as was reported, that AEY and many of its key officers are on the Watchlist. As noted above, only one of the 28 arms export license applications that AEY submitted, one of the approved applications, was for a Department purchase order.

⁴"Department" for the purposes of this review is intended to mean all foreign and domestic Department of State facilities, including all overseas posts.

During fiscal years 2004 through 2007, the Department issued 39 purchase orders to AEY for arms and munitions, totaling approximately \$ 5.9 million. Of these 39 purchase orders, one was cancelled and another was partially cancelled.

Of these 39 purchase orders, 27 were awarded through the FedBid “reverse auction” process. FedBid is operated by a privately owned company whose primary focus is public-sector procurement officials. FedBid is contracted through GSA. Through this on-line process, procurement officials articulate their need for services or products and bidders offer their lowest price or best value for these products or services.

Among the features of FedBid is the ability for procurement officials to flag poorly performing vendors. In February 2006, AEY was flagged by the Department for its inability to deliver according to its bid specifications, and as a result, activity with AEY was temporarily suspended. Activity with AEY was reactivated in March 2006 following discussions between Department and company officials regarding the need to improve the company’s business practices. AEY was again flagged in November 2006, whereupon A/LM/AQM acquisition officials ceased issuing new purchases to the company⁵. In April 2008 AEY was posted on the EPLS, thereby prohibiting it from contracting with any federal agency, by the DOD, based upon evidence that AEY had illegally purchased ammunition for an Afghan Security Forces contract and had made false or misleading statements concerning this ammunition.

⁵A/LM/AQM issued a modification to existing purchase order in February 2007 and a second modification to the same purchase order in March 2007, partially canceling the original purchase order.

It is the opinion of the OIG team that A/LM/AQM acted judiciously in identifying and flagging AEY's poor performance and in ceasing activity with the company when it was deemed necessary. It should be noted, however, that between November 2006, when A/LM/AQM ceased activity with AEY, and April 2008, when AEY was posted on the EPLS, two purchase orders were issued to AEY by overseas posts outside the FedBid process. One was issued in February 2007, and the other was issued in June 2007. A review of the process that allowed these purchase orders to be issued after A/LM/AQM ceased activity with AEY is beyond the scope of this review, but may warrant a subsequent OIG review.

A summary of key events pertaining to AEY is provided in Table 1.

<u>Date</u>	<u>Event</u>
January 12, 2005	AEY registers with PM/DDTC as an exporter.
January 13, 2005	AEY is entered into the Watchlist for law enforcement reasons.
February 2006	AEY is flagged on FedBid; activity with Department is suspended.
March 2006	Activity with Department is reactivated after conversation with AEY senior official.
November 2006	AEY is flagged on FedBid. A/LM/AQM cancels a previously issued purchase order and ceases issuing any new purchase orders to AEY.
March 2008	AEY is debarred by the U.S. Department of the Army.
April 2008	AEY is put on the EPLS.

Table 1 - Key Events Pertaining to AEY

ABBREVIATIONS

A	Bureau of Administration
AECA	Arms Export Control Act
A/LM/AQM	Office of Acquisitions Management
EPLS	Excluded Parties List System
GSA	U.S. General Services Administration
PM	Bureau of Political-Military Affairs
PM/DDTC	Directorate of Defense Trade Controls

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