United States General Accounting Office

GAO

Report to Congressional Requesters

June 1999

DEFENSE ACQUISITIONS

Historical Analyses of Navy Ship Leases

GAO

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GAO/NSIAD-99-125

United States General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-281374

June 25, 1999

The Honorable John Warner
Chairman, Committee on Armed Services
United States Senate

The Honorable Olympia Snowe
Chairwoman
The Honorable Edward Kennedy
Ranking Minority Member
Subcommittee on Seapower
Committee on Armed Services
United States Senate

To acquire 12 Auxiliary Dry Cargo vessels, the Navy recently proposed using long-term leasing rather than outright purchase.[1] Historically, the Navy has purchased its combat ships, but it has used long- and short-term leasing arrangements to acquire certain auxiliary vessels to perform supply and other operational support functions. Although it now appears that the Navy will purchase the dry cargo vessels, it still considers long-term leasing an alternative to purchasing auxiliary vessels.

This letter responds to your request for a historical analysis of the Navy's decisions to lease Sealift tankers, Maritime Prepositioning Ships, T-5 replacement tankers, and Chouest specialized support vessels. Specifically, we (1) determined the basis and support for the Navy's lease decisions, (2) reviewed past concerns regarding those decisions, and (3) identified legislative and regulatory changes that affect current and future leasing decisions. On April 21, 1999, we testified on some historical insights into Navy ship leasing. This report updates the information provided in that testimony.

[1]In 10 U.S.C. 2401, a long-term lease is defined as a lease, charter, service contract, or conditional sale agreement that lasts for a period of 5 years or longer (including options to renew or extend the initial term of the lease), for a period of more than one-half the useful life of the vessel, or for a period of 3 years or longer (including options to renew or extend the initial term of the lease) when certain investment tax credits or depreciation are claimed by the lessor. For the purposes of this report, a short-term lease is any lease, charter, or service contract that does not meet the definition of a long-term lease provided in 10 U.S.C. 2401.

Results in Brief

The primary reason the Navy decided to use long-term leases to acquire auxiliary vessels in the early 1970s and early 1980s was the ability to acquire the vessels without a large, up-front obligation of procurement funds, which were being used to purchase combat ships and meet other Navy procurement priorities. The Navy also cited readiness and industrial base concerns as reasons for entering into the long-term lease arrangements. Cost-effectiveness was not the primary factor in the Navy's decisions. The Navy complied with then-existing requirements to perform lease versus purchase cost analyses, and its analyses concluded that leasing was more cost-effective than purchasing.

When the Navy entered into these long-term leases, concerns arose regarding (1) the budget authority needed to make such large, long-term funding commitments and (2) the cost-effectiveness of such commitments. After entering into the long-term arrangements of the early 1980s, the Navy expressed concerns about the total amount it should record as a firm obligation in the Navy Industrial Fund.[2] Congress was also concerned about whether the Navy Industrial Fund could adequately cover the total obligations that would accrue from these leases. To address these concerns, the Navy requested and received congressional authorization to carry out the acceptance provisions of the long-term leasing contracts and incur obligations in advance of appropriations. The cost-effectiveness of these long-term commitments was also questioned. At the time, there were limited guidelines for conducting lease versus purchase analyses. As a result, cost studies used different assumptions and methodologies in analyzing the alternatives and drew different conclusions about the cost-effectiveness of leasing. In 1983, our report and a congressional staff study questioned the validity of the assumptions used in the Navy's studies and their conclusions.[3] Had the Navy's studies used assumptions that more fully reflected the government's total costs, they would have concluded that purchasing was the cheaper alternative.

Since the long-term leasing decisions of the early 1970s and early 1980s, a number of changes in oversight and cost analyses have occurred that will

[2]At that time, the Navy Industrial Fund was a revolving fund that provided products and services, and it was reimbursed for those products and services by its customers out of operation and maintenance appropriations.

[3]Improved Analyses Needed to Evaluate DOD's Proposed Long-Term Leases of Capital Equipment (GAO/PLRD-83-84, June 28, 1983) and Tax Aspects of Federal Leasing Arrangements, Staff of the Joint Committee on Taxation JCS 3-83 (Feb. 25, 1983).

affect current and future long-term lease decisions. Through legislation, Congress has increased its control over leases lasting 5 years or more and made the leasing decision more transparent. Additionally, budget-scoring guidelines have increased the emphasis on up-front budget authority by providing Congress with a mechanism to assess the cumulative impact of long-term leasing decisions prior to the obligation of funds. Finally, tax benefits, which made leasing an attractive option to the Navy, have been reduced, and more detailed guidelines now require that the Navy perform lease versus purchase analyses that better reflect the government's total cost of long-term leasing arrangements.

Background

The Military Sealift Command is responsible for administering the Department of Defense's (DOD) leases of auxiliary vessels. In the early 1970s and early 1980s, the Navy used long-term leases, called charter and build arrangements, to acquire Sealift tankers, Military Prepositioning Ships (MPS), and T-5 replacement tankers. Under these arrangements, the private sector lessors arranged for the construction, long-term financing, and delivery of the vessels. In return, the lessors, as owners of the ships, receive a return on their investment from the Navy's lease payments, tax benefits, and the residual value of the vessels at the end of the leases. The Navy leased the vessels for 20 to 25 years and agreed that it would pay scheduled termination costs if it canceled the leases. The termination costs ensure that lessors will recover their investment plus a specified rate of return.

In 1972, the Navy entered into contracts with two contractors for the long-term lease of nine Sealift tankers. These tankers were put into service in 1974 and 1975, but are no longer being leased. In 1982, the Navy awarded 13 separate contracts (based on offers received from 3 different companies) for the long-term lease of a total of 13 MPS vessels. Each contract was awarded to a separate special purpose corporation. The first of these 13 vessels was delivered to the Navy in September 1984, and all remain under lease. Also in 1982, the Navy awarded contracts for the long-term lease of five newly constructed T-5 replacement tankers. The first of these tankers was delivered in June 1985, and all remain under lease.

The Navy has used a different type of lease arrangement to acquire the specialized support services of vessels owned and operated by Edison Chouest Offshore. Since 1988, the Navy has used the small- to medium-sized Chouest vessels for transportation services and special missions, such as oceanographic surveillance and research. Generally, these vessels have been leased through short-term leases that consist of a fixed period of 17 months or less followed by multiple option periods of 17 months or less that, when combined, do not exceed 5 years. With 30-days notice, the Navy can cancel these short-term leases during the option period without incurring termination costs. In addition to these short-term leases, the Navy entered into a 5-year, long-term lease for the *Cory Chouest* in 1998. For the long-term lease of the *Cory Chouest*, the Navy's termination costs are limited to redelivering the vessel to its owner in its original condition, with normal wear and tear excepted. Under both the short- and long-term leases of the Chouest vessels, the Navy's lease payments cover the services of the vessel, crew, and its operation and maintenance on a daily use basis.

Since 1969, a DOD instruction has required DOD components to perform economic analyses of lease versus purchase decisions.[4] Following the long-term leasing decisions of the early 1980s, Congress enacted statutory provisions that require specific analyses or determinations to be made prior to entering into certain types of leasing arrangements. These statutes and other guidelines do not apply to the short-term leases of Chouest vessels, and as a result, the Navy is not required to perform lease versus purchase analyses prior to entering into these short-term arrangements.

Basis and Support for Lease Decisions

Cost-effectiveness was not the primary reason for the Navy's decisions to lease auxiliary vessels in the early 1970s and early 1980s. According to Navy officials, the primary reason for proposing long-term lease(s) was the need to devote procurement funds to higher priority combat ships. Long-term leasing allowed the Navy to meet its support requirements without a large, up-front obligation of procurement funds. Had the Navy purchased these vessels, funds would have been obligated from the Navy's Shipbuilding and Conversion procurement appropriation; payments would have been required prior to delivery over the relatively short construction phase; and auxiliary ships would have had to compete with combat ships for procurement funds. By leasing the vessels, the Navy believed it could spread payments over the length of the leases and use its annual Operation and Maintenance appropriations to fund them without incurring an up-front obligation of the total lease amount.

[4] Since 1969, this instruction (DOD Instruction 7041.3) has been revised twice, in 1972 and 1995.

Readiness was an additional factor cited in the Navy's decision to enter into long-term leases for auxiliary vessels. For example, the Navy believed that the MPS vessel program could not fulfill its mission effectively unless all 13 vessels could be acquired in a short period. However, available procurement funds were insufficient to purchase enough MPS vessels to fulfill the Marines' requirement for prepositioned equipment and supplies in three strategic locations around the world. Through the long-term leasing arrangement, the Navy acquired all 13 vessels by 1986—4 years after the contracts were awarded.

Industrial base concerns were another factor in the decision to lease the MPS vessels and T-5 replacement tankers in the early 1980s. At that time, the commercial shipbuilding sector was in decline. A Navy official stated in a 1983 hearing that projects such as the MPS and T-5 replacement tanker programs were needed to prevent the potential closing of several commercial shipyards and to protect the nation's industrial base.[5]

Cost-effectiveness was not the primary reason for the Navy's lease decisions, but the Navy maintained that long-term leasing was a cost-effective way of acquiring the services of auxiliary vessels. Cost studies provided by the Navy, together with historical references to Navy analyses in our 1973 report[6] and in congressional hearings in 1982 and 1983,[7] indicate that the Navy complied with DOD requirements to perform lease versus purchase cost analyses in support of its long-term leasing decisions for the Sealift tankers, MPS vessels, and T-5 replacement tankers. The Navy's analyses showed that long-term leasing would be cheaper than purchasing.

Flexibility and cost-effectiveness are cited as the primary reasons for leasing the Chouest vessels. According to a Military Sealift Command official, flexibility is important because the military requirements for

[5]Federal Leasing Practices Hearing before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives, 98th Congress, First Session, February 28, 1983.

[6]See Build and Charter Program for Nine Tanker Ships (B-174839, Aug. 15, 1973).

[7]See Hearing on Contract Awards for Charter and Conversion of the TAKX Pre-Positioning Ships Program before the Readiness Subcommittee of the Committee on Armed Services, House of Representatives, 97th Congress, Second Session, September 17, 1982; Federal Leasing Practices Hearing before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives, 98th Congress, First Session, February 28, 1983; and Governmental Lease Financing Reform Act Hearing before the Committee on Finance, U.S. Senate, 98th Congress, First Session, July 19, 1983. The TAKX program is now commonly referred to as the MPS program.

special mission vessels, as well as the funding for these requirements, are frequently uncertain. The lease arrangements for the Chouest vessels provide military users the flexibility to obtain commercial vessels for short-term, specific technological and design needs. Military users like short leases because they can return the vessel to its owner rather than retain an asset that they no longer need once a mission is completed or that they can no longer afford once funding is discontinued. While lease versus purchase analyses were not required for the short-term leases of the Chouest vessels, such an analysis was performed before the Navy entered into a 5-year, long-term lease for the *Cory Chouest*. This analysis concluded that it was in the government's best interest to lease this vessel instead of purchasing a similar vessel. The Navy found that the government would save approximately $3 million to $15.4 million by leasing the *Cory Chouest* from 1998 through 2003 rather than purchasing a comparable vessel.

Concerns About Budget Authority and Supporting Analyses

The Navy's decisions to enter into long-term leases raised concerns about whether (1) the Navy had sufficient budget authority to cover the total cost of the leases, especially termination costs if the leases were canceled and (2) the Navy's lease versus purchase analyses adequately reflected the government's costs.

Concerns Regarding Budget Authority

Under the Navy's ship leasing programs, the leases were to cover a base period of 5 years, renewable up to 20 or 25 years at 5-year intervals, with substantial termination costs for failure to renew. After entering into the long-term leasing arrangements with the contractors in the early 1980s, the Navy became concerned about the total amount it should record as a firm obligation in the Navy Industrial Fund once the lease period started, and it requested our legal opinion. Following the request, Congress expressed concern about the adequacy of the Navy's budget authority to cover the total long-term obligations that would accrue from these leases. We[8] concluded that once the Navy, through acceptance of vessel delivery, agreed to commence the lease, it must record the leases as firm obligations in an amount sufficient to cover lease payments for the 5-year base period plus the gross termination expenses should the leases not be renewed at the end of the 5 years. If the Navy Industrial Fund did not have an existing

[8] 62 Comp. Gen. 143, B-174839 (Jan. 28, 1983), Navy Industrial Fund: Obligations in Connection with Long-Term Vessel Charters.

unobligated balance sufficient to cover these costs at the time of the delivery of all the vessels, it would be in violation of the Antideficiency Act.[9] The opinion contained suggested actions the Navy could take to increase its funding authority and avoid such a violation. One option was to obtain specific contract authority from Congress. The Navy subsequently requested and received such authority from Congress to proceed with the leasing arrangements in the absence of an appropriation covering the total potential termination liability.[10] The following year, Congress provided the Navy additional contract authority, which allowed the Navy to proceed with the leasing arrangements in the absence of an appropriation or existing unobligated balance sufficient to cover the total lease payments for all 5 years of the 5-year base period.[11]

Specifically, under these authorities granted by Congress, the Navy was only required to record annually against its industrial fund an amount equal to the estimated lease payments for the then current lease year for the MPS and T-5 replacement tanker leases. With respect to the termination liability, the authority required that the Navy record against its then current fiscal year Operation and Maintenance appropriation an amount equal to only 10 percent of the gross termination costs that would be due for failure to renew the leases. Without these authorities, the Navy would have been required to record the full amount of the gross termination costs and the full amount of the estimated lease payments for the first 5-year base period of the leases. A study conducted on the Navy's behalf in 1983 determined that the highest termination values for the MPS program occurred during the first 5 years; the termination liability for failing to renew the lease after this period was estimated to be 128.1 percent of the lessor's cost to acquire the ship.

Concerns Regarding Cost-Effectiveness of Leasing

The Navy complied with DOD requirements to perform lease versus purchase cost analyses in support of its long-term leasing decisions in the early 1970s and early 1980s. However, guidelines for such analyses at that time were neither detailed nor specific. As a result, the outcomes of these analyses were influenced by the methodologies and assumptions used in

[9]The Antideficiency Act, codified in 31 U.S.C. 1341, prohibits authorizing or incurring obligations or expenditures in excess of amounts available in an appropriation or fund unless authorized by law.

[10]Supplemental Appropriations Act of 1983 (P.L. 98-63).

[11]Appropriations Act of 1985 (P.L. 98-473).

each study. Although the methodologies and assumptions the Navy used showed leasing to be cheaper, our 1983 review of the Navy's decision and a study by the Joint Committee on Taxation used different methodologies and assumptions and found purchasing to be the cheaper alternative. Specifically, the Navy's lease versus purchase cost comparison for the MPS vessels concluded that the government would save $29.3 million per ship by leasing the 13 MPS vessels. However, the MPS study conducted by the Joint Committee staff concluded that outright purchase would be cheaper by $20.8 million per ship. Our 1983 report concluded that it would cost between $11.9 million and $38 million more per ship to lease the MPS vessels. The differences between the studies' conclusions are a result of different methodologies and assumptions regarding (1) tax revenues, (2) residual values, and (3) discount rates.

The majority of the differences between the Navy study and the congressional staff study were attributed to differing assumptions regarding how to account for tax revenue. The Navy study reduced the total cost of the lease to the government by the taxes that would be paid on interest income received by the lenders that financed a portion of the ship's acquisition. The committee staff's methodology did not include these taxes as a source of government revenue. The methodologies and assumptions used in both studies were acceptable under then existing guidelines; however, in our June 1983 report, we supported the committee staff study's decision not to consider these taxes because the Treasury would receive taxes on the income earned from either a lease or a purchase.

Another key difference between the Navy and committee staff studies was the treatment of residual values. The residual value of a vessel is an estimate measure in present value terms of what that vessel could be sold for at the end of the lease term. The Navy's study of the MPS program assumed that the vessels would have no residual value at the end of their 25-year leases, whereas the committee staff assumed that the residual value of the ships would be nearly 60 percent of the original cost of the ships. While it is not clear if a residual value of 60 percent was appropriate, a residual value of zero was not consistent with Internal Revenue Service (IRS) requirements at the time. Had the residual value been assumed to be 20 percent, which would be consistent with the minimum IRS requirements at the time, the cost advantage of leasing identified in the Navy's study would be reduced. In our 1983 review of these studies, we agreed with the staff study's assumption that the vessels would have a residual value at the end of the lease terms.

Determining whether leasing is more economical than purchasing also depends on the discount rate used to adjust the total value of lease payments to recognize the time value of money—the lost opportunity to invest the money and earn interest. A lower discount rate makes purchasing a more economical option, while a higher rate makes leasing more economical. When the lease versus purchase analyses were performed for the long-term leasing arrangements of the early 1970s and early 1980s, there was some flexibility regarding what discount rate to use in the analysis. In prior reports, we expressed concern regarding the discount rates used in the Navy's lease versus purchase analyses. For example, in a 1973 report on the Navy's analysis of the Sealift tanker program, we found that the Navy had inappropriately selected a high discount rate.[12] Had the Navy used the lower and more appropriate rate, it would have found that the cost of leasing exceeded the purchase cost. In our 1983 report, we questioned whether the prescribed Office of Management and Budget (OMB) discount rate was realistic, and in our analysis, we used a discount rate based on the average yield on marketable Treasury obligations, which we believed was a better reflection of the government's true cost of borrowing funds.

Actual lease payment and ship purchase cost data for the MPS vessels, T-5 replacement tankers, and Chouest vessels are provided in appendix I.

Changes That Influence Lease Decisions

Since the long-term leasing decisions of the early 1970s and early 1980s, a number of changes have occurred that will affect current and future long-term leasing decisions by increasing oversight and improving cost analyses. Through legislation, Congress has increased its control over these types of decisions and made them more transparent. Additionally, scoring guidelines now provide Congress with a mechanism to assess the cumulative impact of long-term leasing decisions prior to the obligation of funds. Reductions in tax benefits and changes in how these benefits are treated in lease versus purchase analyses minimize the loss of tax revenue and ensure that such a loss of revenue is more fully considered in the decision. Finally, as part of the decision-making process, more detailed guidelines require that government agencies perform lease versus purchase analyses that better reflect the government's total cost for long-term leasing arrangements.

[12] Build and Charter Program for Nine Tanker Ships (B-174839, Aug. 15, 1973).

Changes to Increase Congressional Control and Lease Decision Transparency

Concerns about the budgetary impact of the leases' long-term funding commitments and uncertainties about their cost-effectiveness led Congress to establish a number of statutory conditions and requirements for entering into long-term leases as part of the fiscal year 1984 Department of Defense Authorization Act (P.L. 98-94) in September 1983. These requirements, now codified in 10 U.S.C. 2401, increased congressional control over certain lease decisions, made lease decisions more transparent, and provided for the development of more detailed guidelines for conducting lease versus purchase cost comparisons.

In general, 10 U.S.C. 2401 requires that[13]

- DOD's long-term leases or charters of vessels and aircraft, or leases or charters with substantial termination liabilities, be specifically authorized by law;
- notice of intent to issue a solicitation for such a lease or charter be given to the Committees on Armed Services and on Appropriations of the Senate and House of Representatives;
- a detailed description of the terms of the lease and a justification for entering into the lease rather than purchase of the vessel be provided to Congress;
- an analysis comparing the costs of leasing to those of purchasing be submitted to Congress with any request for authorization of such a lease;
- such analysis be evaluated by OMB and the Treasury Department; and
- OMB and Treasury jointly issue guidelines for determining under what circumstances DOD may use lease arrangements rather than use direct procurement.

Additionally, Congress established statutory requirements for certain leases lasting less than 5 years. Under these requirements, now codified in 10 U.S.C. 2401a, a Secretary of a military department cannot (1) enter into a leasing arrangement that exceeds 18 months or (2) extend or renew such an arrangement for a term of 18 months or more until the Secretary has considered all costs of such a lease, including the estimated termination

[13]This statute did not apply to any lease or charter agreement entered into before December 1, 1983. The Joint Explanatory Statement of the Committee of Conference stated that "nothing in this section shall impede or affect the ability of the Secretary of the Navy to proceed to acquire the use of thirteen T-AKX class Maritime Prepositioning Ships and the use of five new T-5 tankers in accordance with the long term charter arrangements negotiated by the Navy before the date of enactment of this Act." House Conference Report No. 98-352, p. 246.

liability. The Secretary must also determine in writing that the contract is in the best interest of the government.

Increased Emphasis on Up-Front Budget Authority

At the time the Navy entered into the long-term leases in the early 1970s and early 1980s, Congress' ability to assess the cumulative impact of such arrangements prior to the obligation of funds was limited. Since the Navy entered into these leases, mechanisms for requesting budget authority have been more clearly established, which increases the transparency of these arrangements.

The Balanced Budget and Emergency Deficit Control Act of 1985 (P.L. 99-177), as subsequently amended,[14] established statutory limits on federal government spending by creating spending caps on discretionary spending. To track progress against and compliance with budget enforcement requirements and spending caps, budget scorekeeping guidelines have been established for lease-purchases, capital leases, and operating leases.[15] If the Navy were to now enter into the types of leases it entered into in 1972 and 1982, the current scorekeeping rules would require that the Navy request up-front budget authority for the estimated net present value of the government's total estimated legal obligations over the life of the contract.

Changes That Eliminate Tax Incentives

Under leasing arrangements for the Sealift tankers, MPS vessels, and T-5 replacement tankers that were entered into prior to 1984, the lessors qualified for special tax benefits. These benefits included accelerated depreciation of the ship's cost and deductions on interest payments that lowered the shipowners' taxes. Consequently, shipowners passed some of these benefits to the Navy in the form of lower lease payments, which made leasing a more attractive option to the Navy. However, these tax benefits also represented a loss of tax revenue to the U.S. Treasury. The Deficit Reduction Act of 1984 (P.L. 98-369) modified tax laws and eliminated the benefits available to the owners of assets leased to government entities; the act did not, however, affect prior Navy leasing arrangements.

[14]The Balanced Budget Act of 1997 (P.L. 105-33) extended the discretionary spending caps to 2002.

[15]Preparation and Submission of Budget Estimates, OMB Circular A-11 (July 1, 1998).

More Detailed Guidelines Will Influence Future Cost Analyses

In October 1984, OMB and Treasury issued joint guidelines for DOD's leases. These guidelines required that any special tax benefits conveyed to the shipowner be added to the cost of a lease in a lease versus purchase analysis.[16] Additional OMB guidance was issued in 1992 to prevent lease versus purchase analyses from understating the government's total cost of leasing. Specifically, this guidance, which is to be applied government-wide, prescribes that analyses (1) should add special tax benefits to the cost of leasing and (2) should not subtract the normal payment of taxes on the lessor's income derived from the leases from the total lease costs.[17] Had this guidance been in place when the Navy conducted its analyses of the MPS and T-5 replacement tanker lease programs, the analyses would have concluded that purchasing was cheaper than leasing.

OMB's 1992 guidance also addressed the issue of discount rates. This guidance prescribes that lease versus purchase analyses are to use discount rates that reflect the Treasury's borrowing rate. OMB now annually updates the discount rates to be used in the analyses. Current discount rates as prescribed in the OMB guidance are lower than those used in the past analyses, and lower rates tend to make leasing less attractive today.

Conclusions

The Navy's decisions in the early 1970s and early 1980s to enter into long-term ship leases were based primarily on the decision to acquire ships without a large up-front obligation of procurement funds. The Navy also believed leasing was more cost-effective than purchasing the ships. These decisions were supported by certain assumptions that were used in the absence of clear guidance. Different economic assumptions would have supported purchasing, rather than leasing, these ships. Our legal opinions clarified requirements for such leases, and current budgetary legislation and scoring guidance now emphasize up-front budgeting for such leases. The elimination of tax advantages for leasing, together with more detailed guidelines for conducting lease versus purchase analyses, will make it more difficult to support long-term leasing on a cost-effectiveness basis.

[16] Joint OMB and Treasury Guidelines to the Department of Defense Covering Lease or Charter Arrangements for Aircraft or Naval Vessels (Oct. 31, 1984).

[17] Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs, OMB Circular A-94 (Oct. 29, 1992).

Scope and Methodology

To determine the basis and support for the Navy's decisions to lease instead of purchase selected auxiliary vessels, we interviewed and requested documents from Military Sealift Command, Naval Sea Systems Command, Office of the Assistant Secretary of the Navy (Financial Management Comptroller), Office of the Deputy Chief of Naval Operations (Logistics), and the Center for Naval Analyses officials in Washington, D.C. We also interviewed officials from Edison Chouest Offshore in Galliano, Louisiana; Avondale Industries, Inc., in New Orleans, Louisiana; and the American Shipbuilding Association in Washington, D.C. We also reviewed congressional hearings and previous reports by us, Navy contractors, and others regarding the leasing of vessels by the Navy, and we examined applicable laws and regulations.

To review past concerns regarding the leasing decisions of the early 1970s and early 1980s, we primarily relied upon congressional hearings conducted in the early 1980s and previous reports. We also interviewed Navy and Military Sealift Command officials.

To identify legislative and regulatory changes that affect current and future long-term leasing, we examined applicable laws, legislative histories, and regulations. We also interviewed Military Sealift Command and industry officials.

We did not verify the reliability of the lease payment data provided by (1) the Military Sealift Command from its contract files and accounting systems and (2) in select cases, Edison Chouest Offshore. The Military Sealift Command was unable to provide lease payment data relating to the Sealift tanker program. According to agency officials, the Sealift tanker contracts had been closed out and specific payment records sent to storage, and they could not be located and retrieved within the time constraints of our review. The Military Sealift Command also informed us that because of accounting changes, it would be virtually impossible to obtain a complete and accurate record of how much has been spent on technical or regulatory upgrades and insurance on the four categories of auxiliary vessels covered by our review. Therefore, we did not attempt to replicate the Navy's prior lease versus purchase analyses.

We performed our review between November 1998 and March 1999 in accordance with generally accepted government auditing standards.

Agency Comments and Our Evaluation

DOD did not provide written comments. However, in oral comments on a draft of this report, DOD did not take issue with the information presented in it. DOD suggested certain technical clarifications, and we have incorporated them in the text where appropriate.

We are sending copies of this report to Senator Robert Byrd, Senator Carl Levin, Senator Joseph Lieberman, Senator Ted Stevens, Senator Fred Thompson, Representative Dan Burton, Representative David R. Obey, Representative Ike Skelton, Representative Floyd D. Spence, Representative Henry A. Waxman, and Representative C.W. Bill Young in their capacities as Chairmen or Ranking Minority Members of Senate and House Committees. We are also sending copies of this report to the Honorable William S. Cohen, Secretary of Defense; the Honorable Richard Danzig, Secretary of the Navy; Rear Admiral Gordon S. Holder, Commander, Military Sealift Command; and the Honorable Jacob J. Lew, Director, Office of Management and Budget. Copies will be made available to others upon request. If you or your staff have any questions concerning this report, please call the contacts listed in appendix II.

James F. Wiggins

James F. Wiggins
Associate Director
Defense Acquisitions Issues

Lease Payment and Ship Cost Data

As requested by the Subcommittee, this appendix summarizes actual lease payment data for the Military Prepositioning Ships (MPS) vessels, T-5 replacement tankers, and selected Chouest vessels. For the MPS vessels and T-5 replacement tankers, the lessors' original cost to acquire the ships is also provided; such data are not available for the Chouest vessels.

MPS Vessels and T-5 Replacement Tankers

Actual lease data are available for the MPS vessels and the T-5 replacement tankers, but such data are not available for the Sealift tankers. The data identify the lessors' cost to acquire the ships—the capitalized costs—and the total lease payments of the lease period.[1] However, the data do not reflect all the costs that would be considered in a lease versus purchase analysis. Table I.1 shows the present value as of fiscal year 2000 of the capitalized costs, the total lease payments, and their difference for the MPS vessels and T-5 replacement tankers.

Table I.1: Present Value of Total Lease Payments and Capitalized Costs for MPS Vessels and T-5 Replacement Tankers (in constant fiscal year 2000 dollars)

Type of ship	Number of ships	Length of leases[a]	Present value of total lease payments[b]	Present value of total capitalized costs	Difference
MPS vessels	13	25 years	$4.7 billion	$5.1 billion	$474 million
T-5 replacement tankers	5	20 years	$655 million	$736 million	$81 million

[a]Calculation of total lease payments assumes that the leases will not be terminated prior to the completion of their 20- and 25-year terms.

[b]To do the present value calculations, we used an Office of Management and Budget (OMB) prescribed rate of 2.9 percent. All values have been rounded.

Source: GAO analysis of Military Sealift Command contract data.

Based on this present value analysis, the total lease payments for both the MPS vessels and T-5 replacement tankers are less than the capitalized costs of the ships, which suggests that it was cheaper for the Navy to lease these vessels. However, an analysis that only considers lease payments and

[1]The capitalized cost of a vessel is determined upon the delivery of that vessel and represents the acquisition costs incurred by the vessel's lessor. Included within these acquisition costs are the construction price, interest on interim financing, and other costs associated with the construction and delivery of the vessel.

capitalized costs does not fully account for the government's total costs. Under the leasing arrangements for these ships, the owners qualified for tax benefits, including accelerated depreciation rates, interest deductions on the long-term debt, and amortization deductions for certain elements of vessel cost. These tax benefits, along with the lease payments and residual value, provide the owners with a net return on investment. A portion of these tax benefits was passed on to the Navy in the form of reduced lease payments, which made leasing more attractive to the Navy. These lower lease payments do not fully offset the loss of tax revenue to the U.S. Treasury. The government's total cost for these lease arrangements, therefore, consists of not only the lease payments, but also the loss of tax revenue as a result of the tax benefits that were available to the lessors as shipowners.

Chouest Vessels

Since 1988, the Navy has used short-term leases to acquire the services of 19 Chouest vessels. While the Navy has leased some of these Chouest vessels for a total of 5 or more years under a series of short-term leases, each short-term lease was awarded pursuant to separate, fully competed solicitations. Lease payments for Chouest vessels include not only the services of these vessels, but also their crew, operations, maintenance, and other costs; these costs are not broken out separately. Table I.2 shows the approximate total lease payments for selected Military Sealift Command short-term leases of Chouest vessels from the inception of the initial leases through fiscal year 1998.[2] For example, the *Laney Chouest* was first leased in 1988 for 17 months with two 17-month extension options, then leased again under a new contract in 1992 for the same length of time, and then under a third contract beginning in 1997 for 15 months. In 1998, the *Laney Chouest* was returned to its owner; it is the only vessel in table I.2 that is no longer leased by the Navy. During the 10-year period that the Navy leased the *Laney Chouest* under consecutive, separate short-term contracts, it paid the contractor approximately $42.6 million in lease payments.

[2]Beginning in 1994, the Navy has also leased harbor tugs from Edison Chouest Offshore. Currently, 13 Chouest tugs are operating under Navy leases in California, Florida, and Georgia.

Table I.2: Total Short-Term Lease Payments for Chouest Vessels Through Fiscal Year 1998

Dollars in millions (constant fiscal year 2000)

Vessel	Fiscal year of initial lease	Number of subsequent short-term leases	Total lease payments
Laney Chouest	1988[a]	2	$42.6
Cory Chouest	1989	2[b]	45.4
Dolores Chouest	1990	1	12.9
Carolyn Chouest	1994	0	15.0
Kellie Chouest	1996	0	10.1
Margaret B. Chouest	1996	0	14.6

[a]Lease payment data for the *Laney Chouest* were available for only fiscal years 1989 through 1998.

[b]At the start of fiscal year 1999, the Navy's long-term lease of the *Cory Chouest* commenced. This table does not present the payments associated with this long-term lease.

Source: GAO analysis of Military Sealift Command and contractor accounting data.

On October 1, 1998, the Military Sealift Command commenced a new long-term contract to charter the *Cory Chouest*—an oceanographic surveillance vessel used as a platform for the Surveillance Towed Array Sensor System (SURTASS) and Low Frequency Active (LFA) acoustic detection system. The *Cory Chouest* will be chartered through the year 2003 because of delays in the delivery of the Navy's new T-AGOS 23 vessel, *The Impeccable*. *The Cory Chouest* is currently performing the mission that *The Impeccable* is expected to perform upon its completion. In addition, the *Cory Chouest* will substitute for other surveillance vessels as they are retrofitted with LFA.

The *Cory Chouest* total estimated lease (charter hire) payments for the 5-year contract that commenced on October 1, 1998, range from $24 million to $27 million in constant fiscal year 2000 dollars (based on price economic adjustments). These payments are based on daily rates by fiscal year and do not include estimated port charges, fuel, use of satellite communications, meals for government personnel, and reimbursable items as listed in the contract.

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Acknowledgements

In addition to those named above, Johana R. Ayers, Rosa M. Johnson, Stephanie J. May, and Charles W. Perdue made key contributions to this report.

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