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DEFENSE ACQUISITION

Historical Insights Into Navy Ship Leasing

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Madame Chairwoman and Members of the Subcommittee:

I am pleased to be here today to provide some historical insights into Navy ship leasing. At the request of this Subcommittee, we are reviewing the Navy's decisions in the early 1970s and early 1980s to lease Sealift tankers, Maritime Prepositioning Ships (MPS), and T-5 replacement tankers, and more recently, Chouest specialized support vessels. My remarks today are based on this work and earlier GAO reviews. Specifically, I will discuss the basis and support for the Navy's decisions to lease rather than purchase these vessels, the concerns that surrounded the decisions, and the legislative and regulatory changes that have been implemented which will influence future lease versus purchase decisions. Our report on these issues will be available in July.

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 because available procurement funds were needed for higher priority combat ships, and leasing arrangements allowed the Navy to acquire the support ships without a large, up-front obligation of procurement funds.¹ The Navy also believed that leasing was cost-effective and helped support the industrial base. At the time, the Navy complied with existing requirements to perform lease versus purchase cost comparisons. These comparisons concluded that leasing was cheaper than purchasing.

The Navy's decision to enter into long-term leases in the early 1970s and early 1980s raised concerns regarding the budget authority needed to make such large long-term funding commitments. Congress expressed concern about whether the Navy Industrial Fund could adequately cover the total obligations that would accrue from these leases.² To address this concern, the Navy requested and received specific congressional authorization to carry out the acceptance provisions of the long-term leasing contracts. There were also concerns regarding the cost-effectiveness of these leases.

¹At 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 five 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 three 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.

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

When the leasing decisions were made, there were limited standardized governmentwide guidelines for conducting lease versus purchase analyses. As a result, the studies used different assumptions and methodologies in analyzing the alternatives and drew different conclusions. 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 have occurred that will affect future long-term leasing decisions by increasing oversight and improving cost analyses. Through legislation, Congress has increased visibility of and control over these types of decisions. Additionally, budget-scoring guidelines increase 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. Tax benefits that favored leasing have been reduced. Finally, as part of the decision-making process, more detailed guidelines require that the Navy perform lease versus purchase analyses that better reflect the government's total cost of long-term leasing arrangements.

Background

Traditionally, the Navy has purchased its combat ships but used long-term leases, called charter and build arrangements, to acquire Sealift tankers, MPS vessels, and T-5 replacement tankers. Under these arrangements, the lessors arranged for the construction, long-term financing, and delivery of the vessels. The Navy leased the vessels for 20 to 25 years and agreed that it would pay scheduled termination costs if, for some reason, it canceled the leases.

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 entered into contracts with three separate contractors for the long-term lease of 13 MPS vessels. The first of these was delivered to the Navy in September

³Improved Analysis 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, February 25, 1983.

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. The Chouest vessels have generally been leased on a short-term basis—less than 5 years—for transportation services and special missions, such as oceanographic surveillance and research. Under these leases, the Navy pays for the services of the vessel, crew, and its operation and maintenance (O&M) on a daily use basis. In 1998, the Navy entered into a 5-year lease for one of the Chouest vessels under the same type of daily use arrangement.

The Military Sealift Command (MSC) is responsible for administering the Department of Defense's (DOD) auxiliary ship leases. Since 1969, DOD has required its components to perform economic analyses of lease versus purchase decisions. Lease versus purchase analyses are not required for short-term lease 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 the long-term lease approach was that available procurement funds were needed for higher priority combat ships and long-term leasing allowed it to meet its support requirements without a large, up-front obligation of procurement funds. Under these leasing arrangements, the Navy initially had assumed it could spread payments over the length of the leases and use its annual O&M appropriations to fund them without incurring an up-front obligation of the total lease amount. If, instead of leasing, the Navy had 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 a relatively short construction phase; and the purchases would have had to compete with combat ships for the Navy's procurement funds. The Navy also maintained that long-term leasing was a cost-effective way of acquiring the services of auxiliary vessels. Navy lease versus purchase analyses showed that it was less costly to lease than purchase these vessels.

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.⁴

Flexibility and cost-effectiveness are cited as the primary reasons for leasing the *Chouest* vessels. Since 1988, the Navy has entered into short-term leases that generally consist of a firm period of 17 months or less followed by multiple option periods of 17 months or less that, when combined, do not exceed 5 years. Additionally, in 1998, the Navy entered into a 5-year lease for the *Cory Chouest*. The primary reason cited for these leases is the flexibility they provide because the Navy does not have a defined requirement for the extended use of these vessels. Since the leases are for shorter periods of time, leasing is likely to be more cost-effective than purchasing. A lease versus purchase cost analysis is not required for short-term leases and, therefore, such an analysis was only performed when the Navy decided to enter into a 5-year lease to acquire the services of the *Cory Chouest*.

Concerns About Decisions and 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

After awarding the long-term leases in the early 1980s, the Navy became concerned about how to record total obligations—lease payments as well as potential termination costs—associated with these leases in the Navy Industrial Fund and requested a GAO legal opinion. Congress also expressed concern whether the Navy's budget authority would adequately cover the total obligations that would accrue from these leases. GAO's

⁴Federal 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.

opinion,⁵ issued in response to the Navy's request, concluded that if the Navy Industrial Fund did not have an unobligated balance sufficient to cover these costs upon the delivery of all the vessels, it would be in violation of the Antideficiency Act.⁶ The opinion contained suggested actions, such as obtaining congressional authority, that the Navy could take to prevent such a violation from occurring. The Navy subsequently requested and received authority from Congress to lease the vessels without having sufficient unobligated funds available to cover the government's total obligation under the contracts.⁷

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. However, the guidelines that existed for such analyses when the Navy entered into the leases for the MPS vessels and T-5 replacement tankers were not detailed and specific. As a result, the outcomes of these analyses were influenced by the methodologies and assumptions used in each study. 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. For example, 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 tax revenue should be accounted for. The Navy study

⁵B-174839, January 28, 1983 (62 Comp. Gen. 143), "Navy Industrial Fund: Obligations in Connection With Long-term Vessel Charters."

⁶The Antideficiency Act, codified at 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.

⁷Supplemental Appropriations Act of 1983 (P.L. 98-63).

reduced the total cost to the government of the lease 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. Although the methodologies and assumptions used in both studies were acceptable under the then-existing guidelines, in our June 1983 report, we agreed with the staff study's assumptions 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 of what that vessel could be sold for at the end of the lease term, measured in present value terms. 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 should be used in the analysis. In our prior reports, we expressed concern regarding the discount rates used in the Navy's lease versus purchase analyses. 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.⁸ Had the Navy used the lower and more appropriate rate, it would have found that the cost of leasing exceeded the purchase cost. In

⁸Build and Charter Program for Nine Tanker Ships, (B-174839, Aug. 15, 1973).

our 1983 report, we questioned whether the prescribed Office of Management and Budget (OMB) discount rate was realistic and, in our analysis, 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.

Changes That Will Influence Future Leasing Decisions

Since the long-term leasing decisions of the early 1970s and early 1980s, a number of changes have occurred that will affect future long-term leasing decisions by increasing oversight and improving cost analyses. Through legislation, Congress has increased its visibility of and control over these types of decisions. 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 of long-term leasing arrangements.

Changes to Increase Congressional Visibility and Control

Given concerns about the budgetary impact of the leases' long-term funding commitments and uncertainties about their cost-effectiveness, Congress established a number of statutory conditions and requirements for entering into future long-term leases. These requirements, now codified at 10 U.S.C. 2401, increase congressional visibility and control over certain lease decisions 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:

- 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 purchasing the vessel be provided to Congress;

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- 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.

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, as amended by the Budget Enforcement Act of 1990 and the Omnibus Budget Reconciliation Act of 1993, 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.⁹ 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 entered into prior to 1984, shipowners 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. While not impacting prior Navy leasing arrangements, the Deficit Reduction Act of

⁹OMB Circular A-11, July 1, 1998.

1984 modified tax laws and eliminated the benefits available to the owners of assets leased to government entities.

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.¹⁰ 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 governmentwide, prescribe 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.¹¹ 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, instead of leasing, was the cheaper alternative.

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.

Madame Chairwoman, that concludes my statement. I will be happy to answer any questions you or any Members of the Subcommittee may have.

¹⁰Joint OMB and Treasury Guidelines to the Department of Defense covering Lease or Charter Arrangements for Aircraft or Naval Vessels," October 31, 1984.

¹¹OMB Circular A-94 "Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs," October 29, 1992.

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