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[Maintaining Excess Capacity in DOD Industrial Reserve Facilities Costs the Government Millions of Dollars a Year]. LCD-78-314; B-140389. May 31, 1978. 4 pp.

Report to Secretary, Department of Defense; by Hcbert G. Rothwell (for Fred J. Shafer, Director, Logistics and Communications Div.).

Issue Area: Facilities and Material Management (700).
Contact: Logistics and Communications Div.
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Organization Concerned: Department of the Navy; Department of the Air Force.
Authority: National Industrial Reserve Act of 1948. 10 U.S.C. 2667.

The National Industrial Reserve Act of 1948 authorized the Department of Defense (DOD) to maintain a nucleus of Government-owned industrial plants and a reserve of machine tools and other manufacturing equipment to supply the needs of the Armed Forces in a national emergency. In March 1977, DOD had 131 industrial facilities, 51 Government operated and 80 contractor operated. The Secretaries of the military services can rent the excess production capacity of these plants if, in their opionion, it is advantageous to the Government. Two types of rental agreements can be used: the facilities contract authorized by the Armed Services Procurement Regulation and the nondefense lease. In the case of Government-owned, contractor-operated plants, it is difficult to determine what are adequate rental rates. However, there was some indication that the rental rates at six plants visited were low. At the five Air Force plants surveyed, heavy capital-type rehabilitation of plant and equipment was commonly financed by applying rent for commercial production to the cost as allowed under nondefense leases. The Secretary of Defense, in conjunction with the service Secretaries, should provide guidance as to which type of rental agreement to use in various circumstances, review the reasonableness of rental rates in current agreements, and determine the adequacy of legislative and executive authorization and oversight of capital-type rehabilitation projects in plants under nondefense leases. (RRS)

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

LOGISTICS AND COMMUNICATIONS DIVISION

B-140389

May 31, 1978

The Honorable
The Secretary of Defense

Dear Mr. Secretary:

We surveyed the practices of the Navy and Air Force in renting excess industrial plant capacity for commercial production. Two aspects of these rental agreements should receive further consideration by your office.

The National Industrial Reserve Act of 1948 authorized DOD to maintain a nucleus of Government-owned industrial plants and a reserve of machine tools and other manufacturing equipment to supply the needs of the Armed Forces in time of national emergency. After a period of retrenchment, DOD had 131 industrial facilities by March 1977--51 Government operated and 80 contractor operated. We visited six of the contractor-operated plants producing airframes or aircraft engines: a Navy plant in Texas, and Air Force plants in New Mexico, Kansas, Ohio, and Massachusetts.

The secretaries of the military services can rent the excess production capacity of these plants, if, in their opinion, it is advantageous to the United States. Two types of rental agreements may be used: the facilities contract authorized by the Armed Services Procurement Regulation (ASPR), and the nondefense lease authorized by 10 U.S.C. 2667.

Each of the types of agreement for commercial use of these plants has a different set of advantages and disadvantages for the contractor/operator and the Government. The facilities contract must contain certain terms specified by ASPR. For example, not more than 25 percent of the facilities may be rented for commercial production without approval of the Secretary of Defense, the rental rates for plants and equipment must conform to certain principles and/or percentages of original cost, the contractor pays for the percent of the facilities rented, and the rent receipts are deposited in miscellaneous receipts of the Treasury.

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Use of a nondefense lease, on the other hand, gives the military services much more latitude in negotiating terms and conditions with the contractor. Any amount of plant capacity not needed for military items may be used for commercial production at any time; the contractor pays rent based on the ratio of commercial production to total production periodically. The rental rates are based on different conditions and may be much more complex and varied than the facilities contract rates. The rental period may be as long as 5 years, and the rent due may be applied to the cost of abnormal maintenance performed by the contractor on defense plant and equipment (known as capital-type rehabilitation).

During our review parts of the capacity of 19 Navy industrial plants and 23 Air Force plants were under rental agreements for commercial production. Four of the Navy contracts and 12 of the Air Force contracts were nondefense leases. The following concerns were raised in our survey of rental arrangements at one Navy and five Air Force plants.

ADEQUACY OF RENT FOR COMMERCIAL PRODUCTION

In the case of Government-owned, contractor-operated plants it is difficult to determine, in all circumstances, what are adequate rental rates. Nevertheless, there were some indications at the plants visited that they may be low, particularly in view of today's price level and the improving commerical markets for many of these contractors' products.

At the one Navy plant surveyed, the rental rate under a facilities contract appeared low compared to the rate for other similar plant facilities. The Navy contracting office agreed, and we were informed later that the Navy was preparing its position to negotiate for a higher rate for the next contract.

All five Air Force plants surveyed had nondefense leases for commercial production. Four of the five had been converted from facilities contracts some time earlier. According to Air Force records, the changes were made as a relief to the contractors because their defense work had declined and they had made investments in the plants' equipment in anticipation of new production contracts which did not materialize.

At two of those five Air Force plants the Defense Contract Administration Services Office had reviewed the rents for fiscal year 1972, the first year under nondefense leases after conversion from facilities contracts. That office estimates that because of the conversion the total rents for the two plants had declined from about $575,000 to about $370,000 a year. Its officials recommended that the leases be reassessed and the plants changed again to the rental agreement under facilities contracts. The 5-year leases had expired when we surveyed the plants in 1977, but both had been extended twice for 12- and 15-month periods at the same rental terms.

USE OF RENTAL RECEIPTS FOR CAPITAL-TYPE REHABILITATION

At the Air Force plants we surveyed, heavy capital-type rehabilitation of plant and equipment was commonly financed by applying rent for commercial production to the cost. That is permissible under nondefense leases. The extent of these rent-financed costs is illustrated by the following examples.

At one Air Force plant, for the five calendar years 1972 to 1976, about $2.36 million of major rehabilitation costs were offset against $2.55 million of rent due for commercial production. At a second, about $1 million of such work over 3-1/2 years was paid for from about $1.25 million of rents due. In a third plant, about $440,000 of work was financed from about $578,000 of rent in a 3-1/2 year period. Altogether, over 80 percent of the rents due in these cases was applied to capital-type rehabilitation of the facilities.

The rental method of financing major repairs and rehabilitation is, in effect, a supplement to appropriated funds without having run the full budgetary process. It raises the question of whether or not these rehabilitation projects would have had the same priority for funding, if the rental agreements at the plants were under facilities contracts and the projects had to be financed by appropriated funds. Are these projects subjected to the same consideration as projects requiring appropriated funds, regarding the relative needs of various plants, condition of equipment

among the Government plants, and other factors? Is there oversight of the financing of such projects by the Office of the Secretary of Defense and the pertinent congressional committees?

OBSERVATIONS

Both the military and commercial markets have improved substantially for many of the contractor/operators of defense industrial plants. In the current situation, prior rental terms and the type of agreement for commercial production may not be reasonable for the Government. The rehabilitation of plant and equipment with rents earned should be examined from the standpoint of budgetary controls over the practice, generally, as well as the long-range need for plants under nondefense leases, and the relative rehabilitation needs of all defense industrial plants.

We suggest for your consideration that your office, in conjunction with the service secretaries, provide additional guidance as to which type of rental agreement (facilities contract or nondefense lease) to use in various circumstances, review the reasonableness of rental rates in current agreements, and determine the adequacy of legislative and executive authorization and oversight of capital-type rehabilitation projects in plants under nondefense leases.

We would appreciate your views on our observations and suggestions.

Sincerely yours,

R. G. Rothwell

for F. J. Shafer
Director