REPORT TO

THE CONGRESS OF THE UNITED STATES

LONG-TERM LEASING OF BUILDINGS AND LAND BY GOVERNMENT CONTRACTORS

DEPARTMENT OF DEFENSE

BY

THE COMPTROLLER GENERAL OF THE UNITED STATES

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COMPTROLLER GENERAL OF THE UNITED STATES
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To the President of the Senate and the
Speaker of the House of Representatives

The General Accounting Office has examined into the long-term leasing of buildings and land by Government contractors. Our review of the long-term leasing of buildings and land by one contractor, the Lockheed Missiles & Space Company, has disclosed that Lockheed's use of this method of acquiring facilities is more costly to the Government than would be the case if the contractor had constructed and retained ownership of the property for use on Government work. However, we believe that current provisions of the Armed Services Procurement Regulation provide an incentive for contractors to rent. It is our belief that the pertinent Armed Services Procurement Regulation guidelines should be reconsidered by the Department of Defense.

Our review of this matter disclosed that the Lockheed Aircraft Corporation, in behalf of its Missiles and Space Division, entered into noncancelable leases on property which cost about $27 million, for a 25-year period, which committed it to pay total rentals of about $46 million for the period. Although the cost of the land and interest expense on the contractor's investment in buildings and land would not have been reimbursable under the Government cost-reimbursement contracts in effect, the contractor, through the long-term leasing arrangements, is being reimbursed for all costs of the property. If the use of the facilities continues almost exclusively for negotiated Government work over the initial 25-year period of the leases, the Government will pay, through reimbursement of rental payments, about $19 million more than the cost of the buildings, which would be the amount chargeable to Government contracts as depreciation if the contractor owned the property.

Under these conditions, however, the contractor will save during this same period a substantial amount, which we estimate at about $10 million, in interest expense which it would have incurred to finance ownership of the facilities. Also, the higher leasing costs are included in the cost base in establishing fees or profits on Government contracts.

Furthermore, under the current Armed Services Procurement Regulation guidelines for establishing the source of resources portion of the contract profit allowances, a contractor is allowed the same profit or fee consideration for furnishing the facilities whether they are owned, and the contractor absorbs the financing costs, or whether they are rented, and the contractor passes the rental costs, which would include the owner's financing costs, on to the Government.

Lockheed entered into the leases without seeking Government approval of these transactions and without disclosing details of the lease arrangements until after they had been consummated. Although there was no legal requirement for the contractor to obtain Government approval of its plans, the contractor's work at the time consisted almost entirely of negotiated Government cost-reimbursement-type contracts, and other cost-type contracts were in process of negotiation or definitization. Had the Government been informed of the cost consequences, it would have been in a position to compare the lease arrangement with Government provision and ownership of the facilities.

In commenting on a draft of this report, both Lockheed and the Department of Defense emphasized the risk that Lockheed took by entering into the 25-year noncancelable leases without the assurance that its work under Government contracts would continue during the entire period. However, the Department agreed with our position that the risk is substantially the same whether the contractor purchases the facilities or acquires them through long-term leasing arrangements. The Department stated that it was aware of the magnitude of the leasing costs and that it was not precluded by the Armed Services Procurement Regulation from considering the reasonableness of the costs of leasing in any current or future negotiations. Further, the Department stated that the Armed Services Procurement Regulation Committee would be requested to review the rental cost principle, particularly under noncancelable, long-term leases. The Department also advised that consideration of revisions to the weighted guidelines, which are used in the establishment of profits and fees, would be possible after sufficient data had been obtained under a Department of Defense Profit Review Study. The contractor and agency comments are included as appendixes to the accompanying report.

We are recommending to the Department of Defense that, in its review of the rental cost principle, it consider the alternatives discussed in this report; that is, either to consider the costs of rented buildings and land used by defense contractors to be allowable to the extent that they do not exceed the costs of ownership or to provide a clear distinction between owned and rented facilities in establishing profits or fees. We are recommending also that, in conjunction with consideration of these alternatives, the Department review the matter of a requirement for disclosure of contemplated actions involving special or unusual costs to be incurred by defense contractors.

This report covers our review of plant property rental at only one contractor location. However, we have noted in our reviews a sufficient number of extensive rental arrangements at other defense contractor locations to indicate that the problem discussed may have widespread significance among defense contractors. We plan to include other locations involving such rental arrangements in our continuing reviews.

We are bringing this matter to the attention of the Congress because, in our opinion, under current provisions of the Armed Services Procurement Regulation, there is a strong incentive for contractors to rent, and this condition can be expected to continue to result in higher costs of major proportions to the Government as long as the incentive remains.

Copies of this report are being sent to the Director, Bureau of the Budget; the Secretary of Defense; and the Secretaries of the Navy and Air Force.

Comptroller General
of the United States

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LONG-TERM LEASING OF BUILDINGS AND LAND
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INTRODUCTION

The General Accounting Office has made a review of the long-term leasing of buildings and land used in the performance of Government contracts by Lockheed Missiles & Space Company, Sunnyvale, California, a division of Lockheed Aircraft Corporation, Burbank, California. Our examination was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53); the Accounting and Auditing Act of 1950 (31 U.S.C. 67); and the authority of the Comptroller General to examine contractors' records, as set forth in 10 U.S.C. 2313(b).

Our examination was directed primarily toward a review of the costs which the Government may incur under Lockheed's method of financing plant expansion by 25-year noncancelable sale-leaseback and lease-finance agreements. We compared the costs to the Government under three lease arrangements with the costs which the Government would incur if Lockheed had owned the land and facilities. Our review did not include an evaluation of Lockheed's overall operations.

Although this report covers our review of the rental of plant property by one organizational element of a single defense contractor, we have noted in our reviews a sufficient number of extensive rental arrangements at other contractor locations to indicate that the problem discussed may have widespread significance among defense contractors.

BACKGROUND

Almost all the work of the Lockheed Missiles & Space Company (Lockheed), a division of Lockheed Aircraft Corporation, is performed under negotiated Government prime contracts and subcontracts, the major portion of which are of the cost-reimbursement type. These contracts were awarded primarily by the Navy and the Air Force and pertained largely to design, development, and manufacture of weapons and space systems.

In performance of these contracts, Lockheed uses numerous facilities, consisting of buildings and land, which are leased under three separate 25-year noncancelable sale-leaseback and lease-finance agreements with an insurance company, hereinafter sometimes referred to as the lessor. Two of the agreements were entered into on January 10, 1957, and the third agreement was entered into in August 1958. Under the agreements, Lockheed was required to complete the buildings it had started to construct and to supervise the construction of additional buildings. Lockheed received about $4.6 million from the insurance company for the land and the buildings under construction which were substantially completed at the time of the agreements. This amount included land and certain site improvements covered by two of the lease agreements, which were sold to the insurance company at Lockheed's approximate cost of $339,200. Lockheed was also required to pay the construction costs of the additional buildings, which subsequently amounted to about $22.6 million, and it was reimbursed by the insurance company for these costs. The final cost of the leased buildings and land amounted to about $27.2 million.

The leased buildings, land, and site improvements are located in Sunnyvale and Palo Alto, California, on sites which contain

about 115 and 23 acres of land, respectively, and constitute an important and integral part of Lockheed's plant. There are about 30 buildings leased from the insurance company under these agreements, which have a combined floor space of about 1.4 million square feet. The buildings are generally reinforced concrete with structural steel framing and are designed for research and development, manufacturing, and administrative functions. The estimated total cost of the buildings and land for the two leases for the Sunnyvale complex is about $22 million, and the lease for the Palo Alto complex is about $5 million.

The approximate gross square footage of building space used by Lockheed, primarily in the Sunnyvale area, and the approximate cost of the buildings and land as of the end of 1964 were:

	Square feet		Cost	
	Number (thousands)	Percent	Amount (millions)	Percent
Government furnished	746	19.6	$16.4	20.7
Lease financed	1,368	35.9	27.2	34.3
Other rental space	624	16.3	6.8[a]	8.6
Contractor owned	1,077	28.2	28.9[b]	36.4
Total	3,815	100.0	$79.3	100.0

[a]Estimated by the General Accounting Office on basis of General Services Administration standards.

[b]Includes about $6 million of improvements to the leased buildings.

Lockheed filed applications in December 1955 and February 1956 for Federal income tax benefits under certificates of necessity through accelerated depreciation of the buildings it intended to construct. The estimated cost of the buildings stated in the

applications was about $17 million. The applications were approved by the Office of Defense Mobilization for accelerated depreciation of 60 percent of the estimated cost and were certified to the Commissioner of Internal Revenue in April and May 1956. However, Lockheed did not obtain the tax benefits under the certificates of necessity because of its subsequent decision to sell the buildings and enter into the leasing arrangements.

Under the 25-year lease-finance agreements, the lessor receives a specified rental and Lockheed is required to maintain the buildings and grounds, pay all real estate taxes and assessments, insure the buildings for the benefit of the lessor, pay the costs of building and site improvements, and pay all other operating expenditures normally associated with property ownership. The agreements also provide for five renewal options constituting an additional 25-year period. The agreements do not include purchase options. Annual rental payments amount to about 9 percent of the lessor's gross investment in the property for the first 15 years, 3.5 percent for the next 10 years, and 3 percent for each year thereafter under the renewal options.

The Government's interest in Lockheed's lease-finance agreements arises from the fact that Lockheed Missiles & Space Company's sales, since its inception in 1954, have been almost exclusively to the Government. Of the total Lockheed sales for 1954 through 1964, 95.6 percent were under negotiated Government cost-reimbursement-type contracts and 4.2 percent were under other types of negotiated Government contracts.

Nearly all the costs incurred by Lockheed under these lease-finance agreements are passed on to the Government through overhead allocations to its various contracts. Rental payments to the

lessor currently amount to about $2.5 million a year. Through 1964 the Government had reimbursed Lockheed for about $17 million in rental payments.

In April 1959 the Air Force contracting officer, in negotiating overhead rates for the year 1957, held that the rentals under the lease-finance agreements were unreasonably high. Lockheed appealed this decision to the Armed Services Board of Contract Appeals (ASBCA) and, after hearings, the Board decided in favor of the contractor in 12 of the 19 contracts involved in the dispute.

The Armed Services Procurement Regulation (ASPR), at the time these agreements were entered into, stated that, unless otherwise provided for in a contract, the allowability of costs would be determined on the basis of the general criteria of reasonableness and allocability. In November 1959 section XV of the ASPR was changed to prohibit, where a sale-leaseback is involved unless otherwise provided in a contract, the reimbursement of rental costs in excess of the amount which the contractor would have received had it retained legal title to the facilities. Also section XV was changed to require that, when a contractor uses rented facilities extensively, the determination of allowability of rent may also include a comparison of the amount of such rent with the amount of rent the contractor would have received had it owned the facilities (or ownership costs). This section of the ASPR contains cost principles to be used in the determination and allowance of costs under cost-reimbursement-type contracts and as a guide in the evaluation of cost data in connection with the negotiation of fixed-price-type contracts.

This section of the ASPR also provides that interest on borrowings (however represented), bond discounts, and costs of

financing and refinancing operations, are unallowable. These costs are not allowed for Government contract purposes so that equality of treatment may be provided between a contractor that provides its own capital and a contractor that operates on borrowed capital. With respect to rental costs, in a case involving fiscal years 1957-59 costs, the Armed Services Board of Contract Appeals stated[1] that equality of treatment between a contractor that owns its plant and a contractor that rents is supposed to be accomplished by an adjustment of the negotiated fee or profit, under the theory that a contractor that provides its own plant facilities is entitled to a higher fee or profit than a contractor that uses rented facilities.

However, another part of ASPR, section III, was revised in August 1963 to prescribe the weighted guidelines method of establishing profits or fees. This method requires analysis of the extent of a contractor's dependence on Government financial assistance or material assistance in the form of facilities. To discourage the contractor's reliance on Government resources, a lower profit is provided for such dependence by applying a fee or profit reduction of up to 2 percent (designated in the ASPR as a "Source of Resources Factor") to the fee or profit objectives established under other sections of the guidelines. Commercial facilities rented by the contractor are evaluated the same as contractor-furnished facilities, under these guidelines.

The Government has furnished direct capital assistance to Lockheed in the form of Government-owned buildings and production and test equipment which, as of the end of 1964, amounted to about $57 million, including the Government-furnished buildings shown in

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[1]Sanders Associates, Inc., ASBCA No. 8481, June 30, 1965.

the tabulation on page 3 . The total investment of the Lockheed Missiles & Space Company in buildings and equipment amounted to about $58 million as of the end of 1964, of which about $25 million had been reimbursed to the contractor through depreciation charged to Government contracts.

The Air Force and Navy contracts awarded to Lockheed were administered by the Air Force Plant Representative and the Bureau of Naval Weapons Representative, respectively, located at the contractor's plant. Audit responsibility for all contracts at Lockheed during the period of this review was vested in the Air Force Auditor General's Representative, also located at the contractor's plant.

FINDINGS AND RECOMMENDATIONS

EFFECTS OF LONG-TERM LEASING RATHER THAN OWNING PLANT PROPERTY

Our review of the long-term leasing of buildings and land by a Government contractor, the Lockheed Missiles & Space Company, has disclosed that Lockheed's use of this method of acquiring facilities is more costly to the Government than would be the case if the contractor had constructed and retained ownership of the property for use on Government work. However, we believe that current provisions of the Armed Services Procurement Regulation provide a strong incentive for contractors to rent, and these conditions can be expected to continue to result in higher costs of major proportions to the Government as long as the incentive remains. It is our belief that the pertinent ASPR guidelines should be reconsidered by the Department of Defense.

Our review of this matter disclosed that the Lockheed Aircraft Corporation, in behalf of its Missiles and Space Division, entered into noncancelable leases on property which cost about $27 million, for a 25-year period, which committed it to pay total rentals of about $46 million for the period. Although the cost of the land and interest expense on the contractor's investment in buildings and land would not have been reimbursable under the Government cost-reimbursement contracts in effect, the contractor, through the long-term leasing arrangements, is being reimbursed for all costs of the property. If the use of the facilities continues almost exclusively for negotiated Government work over the initial 25-year period of the leases, the Government will pay, through reimbursement of rental payments, about $19 million more than the cost of the buildings, which would be the amount chargeable to Government contracts as depreciation if the contractor owned the property.

During this same period, however, the contractor will save a substantial amount, which we estimate at about $10 million, in interest expense which it would have incurred to finance ownership of the facilities. Also, the higher leasing costs are included in the cost base in establishing fees or profits on Government contracts. Furthermore, under the current Armed Services Procurement Regulation guidelines for establishing the source of resources portion of the contract profit allowances, a contractor is allowed the same profit or fee consideration for furnishing the facilities whether they are owned, and the contractor absorbs the financing costs, or whether they are rented, and the contractor passes the rental costs, which would include the owner's financing costs, on to the Government.

Lockheed entered into the leases without seeking Government approval of these transactions and without disclosing details of the lease arrangements until after they had been consummated. Although there was no legal requirement for the contractor to obtain Government approval of its plans, the contractor's work at the time consisted almost entirely of negotiated Government cost-reimbursement-type contracts, and other cost-type contracts were in process of negotiation or definitization. Had the Government been informed of the cost consequences, it would have been in a position to compare the lease arrangement with Government provision and ownership of the facilities.

The Government, under current conditions, will apparently continue to pay the indicated amounts over ownership costs; however, neither the Government nor Lockheed will own this property at the end of the 25-year initial period of the lease, and the Government will continue to absorb rental costs for any use of the property on Government work beyond that date.

Effects of the lease-finance agreements

Rental payments under the sale-leaseback and lease-finance agreements are significantly greater than the costs which the Government would have been obligated to pay had Lockheed continued to own the facilities. Under ownership conditions, the Government reimburses a contractor for the construction cost of facilities through charges to contracts for depreciation of the facilities, and the Government also pays a fee or profit on these costs. Neither the cost of the land nor the interest expense incurred by a contractor in the acquisition of buildings and land are allowable contract costs under Department of Defense procurement regulations.

Whereas the maximum depreciation charges under Government contracts would be equal to the cost of the buildings, or $26.5 million, the rental costs under Government contracts projected for the 25-year initial period of the leases would be $45.9 million. Thus, if Lockheed continues to use these facilities almost exclusively on negotiated Government work for the remaining fixed term of the leases, the Government will incur rental payments of about $19.4 million in excess of the costs which the Government would have incurred had Lockheed owned these properties. The Government will also pay profits or fees on the additional costs. Furthermore, the Government would continue to pay rentals for use of the property on Government work during any renewal periods of the leases. Through calendar year 1964, the Government had reimbursed Lockheed for about $17 million in rental payments, or over half the original cost of the land and facilities, and about 17 more years remained in the fixed term of the leases. On the basis of the current rate of reimbursement, the Government, by the end of 1968, will have paid an amount equivalent to the original cost of the buildings and land.

Lockheed benefits substantially from lease-finance agreements

Although Department of Defense regulations prohibit the reimbursement of interest expense and a contractor's investment in land as contract costs, the Government, instead of the contractor, is now paying all costs of the property either as operating expenses or as rental expenses under Government contracts. If the use of the facilities continues almost exclusively for negotiated Government work over the 25-year leases, the contractor will save an amount which we estimate at about $10 million in interest on the funds it would have had to invest to own the property, and would also recover its investment of $0.3 million in the land.

The projected saving of interest expense to Lockheed is computed at a rate of 4.5625 percent which is the approximate rate established for a debenture bond issue that Lockheed sold at about the same time the leases were entered into. In our computation of the projected saving of interest expense, we recognized that Lockheed, had it owned the buildings, may have been permitted to include, as a reimbursable contract cost, depreciation on the buildings under the concept of "true depreciation" which was in effect at the time. Under this concept, where a defense contractor was granted tax benefits under certificates of necessity, application could be made to the military departments for a determination of true depreciation which would be allowed as contract costs.

Our review of the actions taken by the responsible office--the Air Force Emergency Facilities Depreciation Board--indicated that, from its inception in 1953 through October 1960, the Board granted true depreciation allowances at an average of 50.9 percent of the estimated costs of emergency facilities which were included in

applications filed by defense contractors. Therefore, our computation of the interest saving was based on an assumption that Lockheed would have recovered, through depreciation charges, 50 percent of its investment in the buildings during the first 5 years and that the balance would have been depreciated in accordance with Lockheed's normal depreciation policy, as applied to other buildings at Sunnyvale which are owned by the contractor. This policy provides for depreciating the assets over a 25-year period.

Also, the added costs of the rental payments are included in the estimated costs used in the computations of the contractor's fees. In a written statement to the Armed Services Board of Contract Appeals, Lockheed indicated that fee penalties or other disallowances were not imposed on them because of the rental costs by either the Navy or the Air Force at the time major contracts were definitized. The contracts referred to by Lockheed in this statement were the Navy Polaris contract (NOrd 17017) which was definitized on April 19, 1957, and the Air Force Satellite System contract AF 04(647)-97 which was definitized on December 19, 1957. Lockheed further stated to the Board that the Government did not penalize Lockheed during any of the numerous contract price negotiations conducted in 1957, 1958, and 1959.

Lockheed did not disclose the content of its lease arrangements to the Government

Lockheed entered into the long-term leases without disclosing the details of the lease arrangements to the Government and without seeking Government approval of the transactions. Although there was no legal requirement for the contractor to obtain Government approval of its plans, Lockheed's decision to lease the facilities represented a significant change in its position, as evidenced by

its prior commitment to finance facilities expansion; its applications to the Government for tax benefits through accelerated depreciation of the buildings under certificates of necessity; and its initiation of construction on the properties.

When, as in this case, a contractor's sales are over 99 percent to the Government and the Government is reimbursing essentially all the contractor's costs under cost-reimbursement contracts and when letter contracts involving substantial commitments of Government funds are in process of negotiation and other letter contracts are being definitized, we believe that it is reasonable to expect the contractor to inform the Government and to seek Government concurrence before changing a previously stated policy and entering into transactions which will have substantial cost effects on the Government. If the Government had been informed of the cost consequences, it would have been in a position to consider the cost effects of Government provision of the facilities.

We recognize that the ASBCA in rendering its decision on the contractor's appeal concluded that a letter dated August 6, 1956, from Lockheed to the Air Force, together with certain other information, was sufficient to put the Government "on inquiry" in regard to the lease-finance arrangements. Nevertheless, our review of documents submitted in evidence and of the testimony of Lockheed and Air Force officials at the hearing held in 1960 indicates to us that the Air Force officials did not inquire into the matter in depth at the time and were not aware of the scope or financial significance of the leasing transactions until about 5 months after they had been consummated.

In April 1955, about a year after Lockheed established a separate missile systems division, the Commander, Sacramento Air

Materiel Area (SMAMA), requested Lockheed to inform him of its position on financing required plant expansion for fiscal years 1955 and 1956. On May 26, 1955, Lockheed replied to SMAMA's request that, with respect to the Missile Systems Division, Lockheed planned to continue financing plant expansion. The reply stated, in part, that the company had financed and was prepared to continue financing its facilities expansion as required and that, to that date, over 90 percent of the facilities of this division had been contractor financed. The reply further stated that the contractor was not adverse to financing the missile systems division's expansion. Subsequently, Lockheed purchased a large tract of land in Sunnyvale, California, on November 1, 1955, and Lockheed purchased a 99-year lease on a site in nearby Palo Alto, California, on March 1, 1956. Soon thereafter Lockheed started the construction of permanent plant facilities for the Missile Systems Division.

According to information disclosed at the ASBCA hearing, the Missile Systems Division Government programs by July 1956 had been accelerated substantially and it became apparent that plant expansion would also have to be accelerated in order to meet forecasted needs. Lockheed's missile division sales volume increased from $76 million in 1957 to $302 million in 1958 and to $512 and $689 million in 1959 and 1960, respectively. After a review of its financial position and the various alternatives for completing and acquiring plant facilities, Lockheed management concluded that, from a financial standpoint, leasing would be the best method of acquiring facilities. During the period August 1 through 10, 1956, Lockheed presented to three insurance companies a preliminary proposal for the sale-and-leaseback of existing buildings and land and for the construction and leasing of additional buildings.

On August 6, 1956, during the period that Lockheed was contacting these insurance companies, Lockheed notified the Commander, Air Materiel Command, Wright-Patterson Air Force Base (copy to SMAMA), that its previous commitment to SMAMA to finance required facilities expansion through fiscal year 1956 programs could not be extended on a blanket basis to programs being developed for fiscal year 1957 and beyond. The letter stated, with respect to Lockheed's plans for financing future facility requirements, that:

> "Although the company plans to continue to finance an important part of the facilities requirements of the Missile Systems Division, it will be requesting the increased use of Government facilities in its rapidly expanding operation ***."

Although the letter strongly indicated that Lockheed needed financial assistance and that requests would be made for Government aid in acquiring equipment and facilities, no mention was made in this letter of Lockheed's intentions to finance, by means of lease-finance arrangements, the particular buildings referred to in this report, including the sale-and-leaseback of existing Lockheed-owned facilities.

One of the reasons given by Lockheed in the letter of August 6, 1956, for seeking additional Government assistance was that its earnings for the 30 months ended with June 1956 were only $61,000 on sales of $53 million and that a factor contributing to the low rate of earnings had been the Government's policy of disallowing as a contract cost interest on funds borrowed to provide facilities. Lockheed stated in the letter that it had anticipated that the Government would recognize its large expenditures for facilities in the form of higher fee allowances to compensate for the risks involved and to offset interest charges which it was absorbing.

However, according to Lockheed, Government buyers exerted maximum pressure to drive fees lower and the anticipated higher fees were not forthcoming. Lockheed stated that the Corporation had issued $30 million of debenture bonds in 1955 and a second $30 million in 1956 to provide for its overall facilities requirements.

Lockheed submitted its proposal, dated September 28, 1956, to the Air Force for a space satellite system, including an advanced reconnaissance system. A letter contract for the systems was awarded to the contractor on October 22, 1956. This contract was definitized in December 1957 after negotiations which began in November. Lockheed made no mention of its planned sale-and-leaseback arrangements in its proposal for the satellite system in September 1956, although at the time of negotiations on October 5, 1956, covering the facilities provisions of the proposed contract, a Lockheed official stated that "management signals" had been changed with reference to its previous commitment to supply facilities as a capital item. With respect to the particular facilities covered by this report, on October 12, 1956, Lockheed, in a letter to the Office of Defense Mobilization, requested an extension of time within which to complete certain of these facilities that had been started in fiscal year 1956 and requested approval for deferment into fiscal years 1957 and 1958 of other facilities covered by the certificates of necessity.

Government officials did not insist upon full disclosure from Lockheed

Department of Defense officials located at the contractor's plant testified, during the ASBCA hearings in March 1960, that they were not aware of Lockheed's intentions to enter into the first two sale-leaseback and lease-finance agreements until about January 1957, when the first two agreements were executed. However, these officials did not insist upon full disclosure from Lockheed, nor did they take action to inform Lockheed that reimbursement of the costs might be questionable.

In June 1958, about 18 months after the first two leases were entered into, Air Force officials for the first time questioned the allowability of certain costs associated with these leases as part of their 1957 overhead review. At that time the Air Force officials questioned primarily the manner in which the rental was distributed over the total term of the leases at the rate of about 9 percent of the lessor's investment for each of the first 15 years and 3.5 percent for each of the next 10 years. About 2 months after these questions were first raised, the contractor entered into a third long-term lease arrangement with the lessor. Government officials did not take a firm position of the allowability of the costs under this lease at the time it was entered into.

During this time ASPR was not specific as to the allowability as contract costs of rentals under sale-leaseback or other lease-finance arrangements. However, certain guidelines for evaluating the reasonableness of costs resulting from leases existed. In October 1956, the Navy Auditor's Handbook stated that, unless otherwise provided in the contract, rentals under sale-and-leaseback agreements were allowable only to the extent that such rentals did

not exceed the normal cost of ownership. The Air Force, in its reply brief upon conclusion of the ASBCA hearing, stated that, although this publication was not incorporated into Lockheed's contracts, it nevertheless was binding upon the Navy contract negotiators at the time and served as a guideline in the administration of all Government cost-plus-a-fixed-fee (CPFF) contracts.

The ASPR, at the time these agreements were entered into, stated that, unless otherwise provided in a contract, the allowability of costs would be determined on the basis of the general criteria of reasonableness and allocability. ASPR was revised in November 1959 with an effective date of July 1, 1960, to prohibit, unless otherwise provided in a contract, the reimbursement of rental costs in excess of ownership costs where a sale-leaseback is involved and to further indicate that, when a contractor uses rented facilities extensively, the determination of allowability of rent may include a comparison of cost of rent with cost of ownership.

During the ASBCA hearing the Air Force administrative contracting officer testified that he had found out about the first two lease agreements on or about the time these agreements were entered into and that he requested pertinent details on this transaction but did not receive the agreements from Lockheed until about 5 months later. He also testified that he could not recall an overhead forecast that had, according to Lockheed testimony, been submitted to him in October 1956 and which included an estimate of future leasing costs under these agreements. He indicated that, even if he had received the document in question, the significance of certain lease costs reflected therein would not have been of major interest, since he would have been more concerned with the total proposed overhead rate for contract pricing.

One of the procurement contracting officers also testified that he had heard something about these transactions sometime in 1957. He testified that he questioned the administrative contracting officer (ACO) about this and asked whether Lockheed intended to charge those costs to the Government but that the ACO was not familiar with the details. He apparently did not pursue his inquiry further because in December 1957, about a year after the first two lease-finance agreements were entered into, this procurement contracting officer negotiated a major Air Force contract without introducing the matter during the negotiations.

Air Force decision on reimbursement of rent appealed by Lockheed

In June 1958, subsequent to the first two lease-finance agreements with the insurance company, but before the third agreement was signed, the Air Force started negotiations with Lockheed for settlement of final overhead rates for the year 1957. In April 1959, the Air Force contracting officer held that the amount of rent was unreasonably high for the first 15 years of the leases in relation to the last 10-year period and that the annual reimbursable rent should be limited to an amount determined by evenly prorating the total rent for the 25-year period. Lockheed appealed this decision to the ASBCA, and the Government then amended its position by submitting that the costs to be borne by the Government under the contracts in question should not exceed the normal costs of ownership.

In summary, the Board held that the leasing costs were reasonable and properly allocable under 12 of the 19 contracts involved in the dispute but that only normal ownership costs were allocable for the 7 contracts entered into before August 6, 1956, the date of the letter in which the contractor informed the Air Force that its

previous commitment to finance facilities expansion could not be extended to programs being developed for fiscal year 1957 and beyond. The Board concluded that the letter of August 6, 1956, together with certain other information, was sufficient to put the Government "on inquiry" in regard to the leasing transactions and that the rentals under the sale-leaseback charged to contracts entered into subsequent to August 6, 1956, were reasonable and appeared to be comparable to the market rate.

After the ASBCA decision, which was rendered on November 30, 1960, Lockheed and the Department of Defense specifically provided in Lockheed's contracts that rentals under the lease agreements were allowable costs. Therefore, the Department of Defense has continued to reimburse Lockheed for essentially all the rental costs under the lease agreements.

Effect of leasing on contractor fees

It is the policy of the Department of Defense, as stated in the ASPR, that contractors will furnish all facilities required for the performance of Government contracts except under certain conditions. It is also the policy of the Department of Defense that new facilities shall not be provided by the Government where an economical, practical, and appropriate alternative exists. One such alternative specified is to have the contractor rent facilities from commercial sources. Under the current ASPR section III guidelines, which became effective in August 1963 for establishing contract fee or profit allowances, when evaluating the extent of contractors' dependence on Government assistance in the form of facilities, it is specified that rented commercial facilities will be evaluated as contractor-furnished facilities.

The ASPR section III guideline appears to us to be inconsistent with section XV of ASPR, where interest is not allowed as a contract cost, because the contractor would be given the same profit consideration for furnishing facilities whether they are owned, and the contractor absorbs the costs of financing, or whether they are rented, and the Government pays all costs of the property as operating expenses or as rental costs under the contracts. We think that this is particularly inequitable as it affects two competing contractors--one that purchases facilities with funds obtained from stockholders, mortgage notes, bonds or other means of financing and one that rents facilities. Consequently, under these philosophies, it appears that contractors are provided an incentive to rent instead of to own facilities, thereby avoiding the payment of otherwise unallowable interest expense.

Two contracts negotiated in 1964 between Lockheed and Department of Defense activities illustrate the effect of the application of the current ASPR section III guidelines.

Department of the Air Force cost-plus-incentive-fee (CPIF) contract AF 04(695)-545 was definitized in September 1964 in the approximate amount of $50 million to cover Lockheed effort in an Air Force program. In computing the profit objective under the weighted guidelines method, Air Force negotiators assigned a minus 0.5 percent to the source of resources factor in recognition of Government assistance in the form of facilities, special test equipment, and special tooling. In evaluating the source of resources factor, Air Force officials considered the buildings leased from the insurance company as contractor furnished, since this is the treatment prescribed in the ASPR.

Department of the Navy CPIF contract NOw 63-0165 was definitized in March 1964 in the approximate amount of $188 million to cover Lockheed effort in a Navy program. The prenegotiation clearance letter shows that, in computing the profit objective under the weighted guidelines method, Navy negotiators assigned a minus 1.5 percent to the selected factors including the source of resources, in recognition of the Government's large investment in buildings and tools, weekly reimbursements of costs, and financing of development. It was the opinion of the responsible Navy contracting officials that the facilities were the major consideration and that about 0.5 percent of the fee reduction would be attributable to the use of a Government-furnished building, such as the one used in the Polaris program at Lockheed, rather than to the use of a contractor-furnished facility.

A corresponding difference of 0.5 percent in the weight assigned to Lockheed's facility contribution under the Air Force contract referred to would result in an increase of about $232,500 in the profit objective, inasmuch as the percentage is applied to the proposed total target cost. (The target cost under this contract was about $46,500,000.) Such additional fee consideration would accrue to a contractor where the Government absorbed the financing costs through the rentals charged to Government contracts, as well as where the contractor owned the property and the contractor absorbed the financing costs. All the contractor's costs associated with the property would be recovered, and the contractor would still receive the same profit consideration as if it were financing ownership.

We also examined the negotiation records pertaining to selected Air Force and Navy contracts with Lockheed and discussed the

weighted guidelines applications with the responsible contracting officials. We found that a distinction was not made between owned and rented facilities in computing negotiation profit objectives under other provisions of the weighted guidelines method. We found also that the current ASPR section 3-808 which covers the weighted guidelines method of establishing contract profits does not distinguish, apart from the reference under the source of resources factor as discussed, between owned and rented property for purposes of establishing profits or fees.

In addition, we noted that a profit distinction, if applied to the overhead elements of cost under the weighted guidelines method, would not compensate for the difference between rental and ownership costs. For example, a fee differential of 13 percent (2 percent applied to rental costs and 15 percent applied to depreciation), the maximum differential provided for overhead elements under the Armed Services Procurement Regulation Manual for Contract Pricing dated October 29, 1965, would result in a profit objective differential on the total of such costs described in this report of about $3 million, compared with the total excess of rentals over ownership costs of about $19 million. However, the application of the maximum differential appears improbable since the higher fee ranges are prescribed, generally, for engineering labor.

Contractor comments

Lockheed, in its reply to our draft report (see app. I), expressed the belief that it would be detrimental to both the contractor and the Government to attempt to make the Government a participant in management and a party to the type of long-term commitment discussed in this report.

Our proposal that contractors be responsible for disclosing these actions to Government contracting officials did not contemplate that the Government would become a party to such agreements. Disclosure would, however, provide an option to the Government to initiate alternate courses of action, when it is in its interests to do so--for example, the provision of Government-owned facilities. This course was, in fact, taken by the Navy when it decided to provide the Polaris facility, on which construction began in 1957 on land provided by Lockheed, and which cost $16 million. The disclosure we proposed is similar in concept to the disclosure prescribed in section III of ASPR in connection with negotiation of contract costs under cost-reimbursement contracts and other forms of negotiated contracts, where the restraints normally expected under competitive pricing conditions are not present.

The contractor has properly concluded that the changes in regulations proposed in our report reflect our concern that current ASPR regulations may result in undue reliance by contractors on leased facilities. The contractor takes the position that competitive pressures are preferable to regulatory provisions if they will achieve the desired result. We are completely in accord with this position. However, the changes we propose for consideration would affect ASPR section XV or other sections of ASPR which are specifically applicable to those situations where the amount of a contractor's costs and profits are significant elements in the negotiation

of contract prices because the restraints expected under conditions of competition are not present. In our opinion, under current ASPR provisions there is a strong incentive for contractors to rent, and this condition can be expected to continue to result in higher costs of major proportions to the Government as long as the incentive remains. This matter is discussed in more detail on pages 30 and 31.

Agency comments

The Department of Defense, as well as the contractor, devoted a large portion of their comments on our draft report to a discussion of the amount of risk which Lockheed assumed by entering into the noncancelable leases. Their replies to our draft report are included as appendixes I and II. They believed that the draft report did not present a full evaluation of this risk.

We agree that the contractor assumed a substantial risk. However, in his reply (see app. II, p. 5) the Deputy Assistant Secretary of Defense (Procurement) agreed with our position that the risk is substantially the same whether a contractor purchases the facilities or acquires them through long-term leasing arrangements. Although the risk is substantially the same, the respective costs to the Government and the contractor are significantly different under either option. If the facilities were owned, interest or financing charges would not be allowed under the type of contracts which were, and still are, the contractor's principal form of Government business. When a contractor leases, it passes on all costs of the property to the Government as operating expenses or as rental costs under the contracts, but the contractor receives the same profit or fee consideration under the source of resources factor that it would receive if the facilities were owned. The

contractor also receives profits or fees on the higher costs of leasing.

In this connection, the Deputy Assistant Secretary's reference to a shift from cost-reimbursement-type contracts to contracts under which contractors assume greater risk and have incentives to reduce costs warrants comment, in view of the current efforts by the Department to use such other forms of contracts. The volume of advertised fixed-price contracts is still relatively small. Over 80 percent of the dollar amounts of contracts awarded in recent fiscal years, including fiscal year 1965, were various forms of negotiated contracts. The prices of such contracts are, for the most part, cost based. The ASPR section XV cost principles are an important matter for consideration under all of these contracts because they not only make interest and financing costs unallowable for cost-reimbursement-type contracts but also are guidelines for use in the evaluation of costs under negotiated fixed-price contracts. Insofar as risk is concerned, the contractor is compensated by means other than the source of resources profit factor for the additional risks associated with negotiated fixed-price contracts, when such contracts are entered into. Profit guidelines established in the ASPR for various forms of negotiated fixed-price contracts range up to 7 percent higher than those for cost-reimbursement-type contracts.

In our draft report we had proposed that contractors be made responsible for disclosing contemplated actions involving special or unusual costs when the effect, based upon the contractor's current business, is that the Government would bear most of these costs. The Department expressed the opinion that this matter was adequately provided for in the ASPR. The Department pointed out

that the ASPR section 15-107 provides that either the contractor or contracting officer may initiate advance understandings and that the lack of disclosure does not preclude the Government's right to disallow costs if they do not meet the test of reasonableness. The Department stated also that the ASPR section 15-205 reference to ownership costs as a standard of reasonableness provides strong inducement for disclosure of proposed leases.

However, as discussed on page 24, a requirement for disclosure would provide a basis for the Government to consider and initiate alternate courses of action when it is in its interests to do so--for example, the provision of Government-owned facilities. Furthermore, the concepts of both disclosure and ownership costs as a standard of reasonableness are permissive in application under current provisions of the ASPR. The reimbursement of rental expense was not limited to ownership costs at Lockheed and other locations we are aware of. Of course, the Government has long had the right to disallow costs found to be unreasonable after they had been incurred. In the instant case, the matter was resolved by a decision of the Armed Services Board of Contract Appeals. We believe that an advance understanding is clearly preferable to an after-the-fact administrative determination or court decision, after unalterable commitments have been made.

The Deputy Assistant Secretary, in his reply to our draft report, stated that the Department was aware of the magnitude of leasing costs and that the Department was not precluded from reconsidering, in future negotiations, the reasonableness of the leasing costs. However, he did not present the Department's position on the acceptance of leasing costs in excess of ownership costs or on the equal weighting of owned and rented facilities for purposes of

establishing contract profits or fees. He stated that the ASPR Committee would be requested to review the rental cost principle, particularly under noncancelable, long-term leases. He further stated that consideration of revisions to the weighted guidelines, which are used in the establishment of profits and fees, would be possible after sufficient data had been obtained under a Department of Defense Profit Review Study.

The Deputy Assistant Secretary subsequently advised us in another letter dated June 18, 1966 (see app. III), that the Department did not believe that it would be in the Government's interest to negotiate with the contractor for reimbursement of future rental costs based upon the costs of ownership. The reasons for taking this position were that Lockheed "apparently had exhausted its ability to obtain additional public financing" and that there was no limitation in the Defense regulation at the time concerning the allowance of rental costs in sale or leaseback agreements.

The reference to public financing apparently relates to Lockheed's issues of debenture bonds. (See p. 16.) We recognize that we are not able at this time to establish that the contractor could (or could not) have obtained either additional public financing or mortgage loans with the property as the security. Nevertheless, in either event, we believe that it is inequitable for the Government to reimburse the contractor's entire rental costs under Government contracts and still allow the same fees or profits to the contractor which would be allowed if the contractor owned the property and was absorbing the financing costs. This matter is discussed more fully on pages 30 and 31.

In the letter of June 18, 1966, the Department stated also that the ASPR Committee would review the rental cost principle, particularly as it relates to noncancelable long-term costs.

Conclusions

It appears that the Government's interests are not protected where, under circumstances as discussed in this report, a contractor can enter into arrangements which could result in additional costs of about $19 million to the Government without giving the cognizant Government agency the opportunity to review and consider the effect of such decisions. Such review is even more important in decisions where the interests of the parties conflict because they result in significant savings to the contractor. We believe that an advance understanding of the responsibility for the cost consequences of such decisions is clearly preferable to an after-the-fact administrative determination or court decision.

We recognize that the absorption by Lockheed of about $10 million in interest expense would have been of substantial financial significance to this contractor. However, Lockheed, by financing construction under a conventional mortgage arrangement, would have acquired the equity in the property as the financing was liquidated. This equity would accrue to the contractor if the property were disposed of and would also be valuable to the extent of the inherent lower costs, after recovery of the accelerated depreciation, in any future bids for competitively priced Government or commercial work. Under the leasing arrangement, neither Lockheed nor the Government acquires any equity in this property. In addition to rentals on the property, the residual value accrues to the lessor at the end of the lease period.

We recognize also that, at the time the leasing arrangements were made, the probability of continued Government business may not have been certain. However, Lockheed chose this method of financing unilaterally, and Lockheed had essentially the same long-term commitment under either the lease arrangement or the ownership of the facilities, the principal difference being the amount of the respective costs to Lockheed and to the Government.

The ASBCA decision pertained only to rentals included in specific contracts which were in existence in 1957, and is not controlling as to subsequently executed contracts where entirely new and different considerations are involved. The ASPR now designates that, unless otherwise specifically provided in the contract, the excess of sale-and-leaseback costs over ownership costs to be unallowable; and it designates ownership costs to be a matter for consideration under other extensive rental arrangements.

We believe it is evident that large amounts of otherwise unallowable interest expense are being paid by the Government to the contractor in the form of rent. However, under current ASPR guidelines, the contractor that rents and is reimbursed by the Government for all costs of the property receives the same profit consideration by Government negotiators, for provision of resources, as the contractor that owns its facilities and absorbs in its profits either the interest expense or the cost of equity capital in the form of dividends to its stockholders. In addition, the contractor that rents receives profits on the higher costs of renting.

The additional 2 percent profit range presently permissible under the ASPR for contractor provision of resources applied, for example, to the Lockheed Missiles and Space Company's total 1964 contract costs of about $565 million could amount to additional

annual profits of as much as $11 million. This is equivalent to an annual return of 6 percent on an investment of $183 million. We think that this is potentially a considerable inducement to private investment if applied in a discriminating manner. However, we do not believe that contractors should continue to receive the benefits of this inducement equally whether they own or whether they rent, as long as they are permitted to recover all costs associated with rental of property but are not permitted recovery of the financing costs if they buy property.

In our opinion, under current ASPR provisions, there is a strong incentive for contractors to rent, and this condition can be expected to continue to result in higher costs of major proportions to the Government as long as the incentive remains.

To correct this condition, it appears that it would be necessary either to permit recovery only of ownership costs of property or to compensate, through lower profits, for the higher costs to the Government of renting.

We recognize that this report covers our review of plant property rental at only one contractor location; however, we have noted extensive rental arrangements at other defense contractor locations. We plan to include other locations involving such rental arrangements in our continuing reviews.

The Department of Defense has stated that it will review the rental cost principle, particularly as it relates to noncancelable long-term costs. We realize that this is a complex matter involving a number of questions which may not be easily solved.

Recommendations

We recommend, therefore, that the Department of Defense, in its review of the rental cost principle, consider the alternatives

discussed in this report; that is, either to consider the costs of rented buildings and land used by defense contractors to be allowable to the extent that they do not exceed the costs of ownership or to provide a clear distinction between owned and rented facilities in establishing profits or fees.

We recommend also that, in conjunction with consideration of the above alternatives, the Department review the matter of a requirement for disclosure of contemplated actions involving special or unusual costs to be incurred by defense contractors.

APPENDIXES

LOCKHEED AIRCRAFT CORPORATION

BURBANK, CALIFORNIA

January 25, 1966

Mr. James H. Hammond
Associate Director
U. S. General Accounting Office
Washington 25, D. C.

Dear Mr. Hammond:

Your letter of December 28, 1965, requested comments on a preliminary draft of a report to the Congress on the effects of certain long-term leases of buildings and land utilized by Lockheed Missiles & Space Company (LMSC) in the performance of Government contracts. I am happy to furnish comments and trust that they will be of use to you in your further consideration of this matter.

As a general statement on the report, I feel that it does not sufficiently highlight the substantial risk which Lockheed Aircraft Corporation (Lockheed) assumed in 1957 and 1958 by entering into 25-year noncancelable leases requiring payments over the life of the leases amounting to about $46 million. Neither at the time we entered into these leases nor at the present time does the Government assume any obligation to reimburse allocable costs beyond the limits of current contracts. Consequently, reimbursement of full lease costs by the Government is dependent upon complete utilization of the leased facilities in the performance of Government contracts for the entire 25-year term of the leases.

Although this was emphasized in the exit interview with the GAO staff at Sunnyvale, apparently we did not impress them with the full extent of this risk. Let me assure you that it is a very real one. There is no lack of examples of major Government programs which have been suddenly curtailed or canceled because of changing requirements, budgetary limitations, or for other reasons. Knowledge of this factor undoubtedly influenced the first two insurance companies which we contacted in 1956 regarding lease arrangements when they declined to consider the matter on the ground that the undertaking was considerably too risky.

Had cancellation of certain major programs occurred at LMSC to the extent of idling any of the leased facilities, or should this occur during the remaining 17-year lease term, our leases being noncancelable would not afford any relief from lease payments; yet any such payments for the unused facilities would not be reimbursed under continuing Government contracts. Exposure to this type of cost risk is a fact of life in the aerospace industry and must be reckoned with. There is no other single matter which

absorbs as much of my attention and that of LMSC management as assuring that we successfully compete for and perform Government contracts in sufficient volume to keep our facilities and workforce fully utilized. For these reasons, I do not believe that the report properly should indicate that all lease costs will be borne by the Government; there was much less basis for such an assumption in 1957 and 1958 when Lockheed entered into these leases.

The draft report implies that contractors should secure review and approval by the Government before long-term facility leases are utilized. It seems reasonable to suggest that if the Government were to exercise the right of review and approval of long-term agreements governing the operation of a company, with the implied right to require changes as a condition of approval, it should enter into long-term commitments to assume the burdens of such arrangements. Under the present system the Government does not have or exercise the right of approval, and assumes the burden only of those costs which are determined to be reasonable and allocable to Government contracts. I would most strongly urge that this is the preferable approach. Company management continuously makes long-term plans and commitments on matters which seriously affect costs of contract performance. This is done in full recognition of the fact that recovery of any of those costs under Government contracts will depend in many cases on after-the-fact Government review. I cannot conceive that it would be anything but detrimental to both the contractor and the Government to attempt to make the Government a participant in management and a party to this type of long-term commitment.

As to the specific circumstances surrounding the leasing of the LMSC facilities, it is somewhat academic to speculate as to what the effects on our contracts would have been if Lockheed had owned the facilities. The fact of the matter is that in 1956 and 1957 Lockheed's programs were so accelerated, with resultant expansion of facility needs, that it was not possible for us to furnish all the facilities required at LMSC, and long-term leasing was found to be the only practical alternative. Similarly, it is unrealistic to dwell on the theoretical savings to the Government if, prior to our lease negotiations, the Government had been informed "of the cost consequences and been given the opportunity to invest in the facilities," as stated in the report. Actually, it had been made abundantly clear to Lockheed over a period of time before the lease negotiations that Air Force funds were not available to furnish the facilities. In summary of the above point, it appears to us that the projection of savings to the Government even now is too speculative to furnish guidance in similar situations and appears even more so if related back to the situation at the time the leases were entered into--about 8 years ago.

The report, particularly the attached appendix, devotes considerable attention to the question of whether and to what extent the cognizant Government representatives at LMSC were notified of the leasing arrangements covering the facilities. This matter was covered exhaustively in the hearing by the Armed Services Board of Contract Appeals and the attendant briefs and documentary evidence furnished at that time. The Board's decision covered

the matter of notice explicitly and at some length, and it seems that nothing can be gained by undertaking to re-try the factual question of notice as determined by the Board.

Additionally, the report appears to require clarification or amplification with respect to several points. On page 3 the cost figures shown for Government-furnished and contractor-owned buildings at LMSC exclude land improvement and leasehold improvement costs, but these costs are included in the figures relating to facilities covered by long-term leases. These figures would more properly reflect the extent of contractor investment in land, buildings and improvements if the above costs were included by revising these figures as follows:

	Cost	
	Amount (Millions)	Per Cent
Government-furnished*	$16.4	23
Long-term lease	27.2	37
Contractor	28.9	40
	$72.5	100

*Excludes cost of land transferred to Government by Lockheed at no cost.

On page 6 of the report, it is stated that as of the end of 1964 about $31 million had been reimbursed to LMSC through depreciation charges to Government contracts on company-owned buildings and equipment at LMSC, whereas the correct amount which has been reimbursed to us is $24.6 million.

An erroneous impression is also created by the statement on page 24 of the report that the ASPR now designates the excess of sale and leaseback costs over normal ownership costs to be "unallowable, hence unreasonable." ASPR 15-205.34(c) provides: "Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements...are allowable only to the extent that such rentals do not exceed the amount which the contractor would have received had he retained legal title to the facility." (Underscoring added.) This does not expressly designate such costs as unallowable, hence unreasonable, as is stated in the report. Rather, ASPR emphasizes that if a contractor desires to recover rental costs in excess of ownership costs on property covered by sale and leaseback agreements, even though he considers such excess costs to be reasonable, he must have an advance agreement with the Government for such recovery or specific provisions for allowability in each contract. The ASPR makes such provision for allowability of so-called sale and leaseback costs by contractual agreement because the Department of Defense has recognized that many situations

cannot be pure black or white. These long-term leases covering a portion of LMSC's facilities, for example, are for the most part not truly sale and leaseback agreements even though they might appear so on the surface. The majority (approximately two-thirds) of the facilities involved were constructed by the insurance company subsequent to Lockheed's entering the lease agreements with it. This factor, coupled with the fact that the Armed Services Board of Contract Appeals determined the rental rates involved to be reasonable, has formed the primary bases for specifically designating such costs as allowable in Lockheed's cost-reimbursable contracts over the period of years since the decision was rendered. Otherwise, certain of these costs might have inequitably been disallowed despite the ASBCA ruling that they are reasonable.

Under Recommendations, the report includes a statement on page 25 that property under long-term leases, the entire cost of which is being borne by the Government, should be considered the same as Government-furnished facilities when establishing the correct factor for "provision of resources" in the determination of profit or fee. The report also states that the same principle is applicable to short-term rental arrangements where a contractor takes little or no risk during the period of contract performance. This recommendation appears to be ill-founded as to both long-term and short-term leases for the following reasons: Contrary to the statements in the report on pages 6 and 24 that additional profits and fees are allowed for a contractor furnishing his own facilities, ASPR III actually provides a profit or fee reduction of up to 2% if a contractor relies upon the Government for essential resources, primarily facility resources, rather than supplying them himself. The Department of Defense, realizing that past periods of military accelerations had necessitated the Government providing many facilities, designed this profit penalty primarily to obviate additional investments by the Government in facilities. In this regard, ASPR III provides: "The contractor who uses new Government resources for the performance of a contract will be penalized to a greater degree than the contractor who uses existing Government resources." The Department of Defense's reasoning behind this penalty is both clear and logical. In the matter of facilities, as in other contract aspects, the Department desires to shift all possible risks from itself to its contractors. And the risk which is assumed by a contractor by furnishing leased facilities is just as real as that of furnishing owned facilities. The risk which the contractor assumes on long-term leases is outlined at some length above, to which might be added the assumption of obligations to maintain and restore facilities which, like the rental costs, would continue even in the absence of Government or commercial business. Accounting convention requires a disclosure of long-term lease commitments in a company's financial statement in order properly to reflect the very real risk of such liabilities. Short-term rentals may involve similar risks of shorter duration, being used principally to obtain facilities where purchase is impractical or uneconomical, e.g., to meet requirements caused by temporary upsurges in business. The present ASPR provision which gives equal weight in fee computations to owned and leased facilities recognizes these factors.

Mr. Hammond

January 25, 1966

Apparently the changes in regulations which are recommended in the report reflect your concern that current ASPR regulations have resulted in undue reliance by contractors on leased facilities. It is my impression that the highly competitive atmosphere of the aerospace industry has resulted in such stress on reduction of costs that contractors generally have a strong incentive to finance their long-term facility requirements with their own funds if adequate funds are available. This certainly has been our practice at LMSC. Since 1958, when the last of these long-term leases was entered into, Lockheed has spent almost $36 million on facilities and equipment for LMSC. In the same period, the expenditures for facilities and equipment for the entire Lockheed Aircraft Corporation have amounted to about $130 million, which when added to earlier expenditures brought the total corporate investment in facilities and equipment to about $260 million at the end of 1964.

We consider this good and prudent business practice and I believe that the practices of other contractors are comparable. Therefore, it does not appear that the changes in regulations which you recommend are necessary to assure that contractors will invest in their own facilities when it is feasible for them to do so. Competitive pressures are certainly preferable to regulatory provisions if they will achieve the desired result.

I appreciate your giving us the opportunity to comment on the report and your offer to include our reply in the final report.

Very truly yours,

D. J. Haughton
President

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

INSTALLATIONS AND LOGISTICS

CA

8 APR 1966

Mr. James H. Hammond, Associate Director
Defense Accounting and Auditing Division
General Accounting Office
Washington, D. C. 20548

Dear Mr. Hammond:

This is in response to your letter to the Secretary of Defense dated December 29, 1965, wherein you transmitted copies of your draft report to the Congress on the effects of long term leasing of buildings and land by a Government contractor, Lockheed Missiles and Space Company, Sunnyvale, California, (OSD Case #2386).

Your report states that a review of this long term leasing disclosed this practice is more costly to the Government than would be the case if the contractor had constructed and retained ownership of the facilities for use on Government work, or if the Government had purchased these buildings for use by the contractor. You report that the company, in behalf of its Missiles and Space Division, entered into 25-year non-cancelable leases on property which cost about $27.2 million and which committed Lockheed to pay total rentals of about $46 million for the period. If these leased facilities continue to be used primarily for Government work over the 25-year lease period, you report that the Government will pay, through reimbursement of rental payments, about $19 million more than the cost of the property. During this same period, you estimate that the contractor will save approximately $10 million in interest expense (a non-reimbursable item under DOD cost contracts) which it would have otherwise incurred to finance ownership of the facilities, but which the Government now reimburses as an element of rental costs under the contracts. The contractor will also recover a $300 thousand investment in land transferred under sale-leaseback arrangements. You further allege that the contractor will incur additional monetary benefit as a result of the ASPR weighted guidelines

policy whereby a contractor is allowed the same fee for furnishing facilities whether they are owned or whether they are rented.

You recommend that:

1. Reimbursements to contractors of leasing costs in excess of ownership costs be the subject of negotiations under any new contract awards. We understand that this recommendation is intended to apply to future contracts with Lockheed Missile and Space Company.

2. Section 15-107 of the Armed Services Procurement Regulation be made less permissive with respect to disclosure of contemplated actions involving special or unusual costs and require that contractors be responsible for disclosing these actions to designated Government contracting officials when the effect, based on the contractor's current business, is that the Government will bear most of these costs.

You also requested comments on the proposition that property under long term leases, the entire cost of which is being borne by the Government, should be considered the same as Government-furnished facilities when establishing the credit factor under the weighted guidelines in the determination of profit or fee. You believe this principle is also applicable to short term rental arrangements, where a contractor takes little or no risk during the period of contract performance.

It appears that the GAO review and the draft report have not given sufficient weight to the risk which Lockheed assumed in signing the leases. In that connection, it is important to take cognizance of the environment which prevailed in 1955 and 1956 and the circumstances influencing and leading up to the signing of these leases. While it may not be possible to visualize all conditions existing in that period, there are many pertinent conditions referred to in the published opinion of the ASBCA in Case 5705 dated November 1960 which had to be weighed by Lockheed and which undoubtedly influenced Lockheed's decision to sign 25-year noncancelable leases with the insurance company. We are enclosing excerpts from that decision. The telegram dated April 27, 1955 and Lockheed's letter to the Air Force dated August 6, 1956 cited in the ASBCA opinion stress the following points:

> Lockheed's actions in 1955 to obtain $30 million of working capital by the issuance of convertible debentures.

- Lockheed's action in 1956 to obtain more cash for long-term capital improvements by the issuance of additional debentures for $30 million.

- The possibility of the Government furnishing needed industrial facilities.

- The influence which the Government's policy on non-allowability of interest had upon the Corporate decisions.

- The extremely low net earnings which Lockheed had been receiving from its large volume of sales to the Government.

- The contribution which Lockheed's expanded plant facilities could make to the Government's space and missile programs.

There were also certain specific risk factors which Lockheed had to consider before executing the leases. Taking ourselves back to 1957, Lockheed could not, with any degree of assurance, assume that its future contracts with the Government over a 25-year period would be cost reimbursement type contracts under which the Government would pay the rental costs in full. This appears to be one major premise upon which the report bases its conclusions that the leasing practice is more costly to the Government than would be the case if the contractor had constructed or if the Government had invested in these buildings to be used by the contractor. Lockheed could not have foreseen the progress which we have made in switching from CPFF contracts to other types under which contractors assume greater risk.

Tangible evidence of the switch in utilization of different contract types occurred recently with Lockheed when it was the successful bidder for a billion dollar fixed-price incentive type contract for the C5A aircraft. This contract and the concept under which it was executed provides an incentive for Lockheed to reduce costs and contains a specific ceiling on the amounts of costs which the contractor may recover in the event of overruns.

Reflecting upon the permanency of Government programs during the past 10 years, there have been instances where major defense projects were

cancelled either partially or completely due to strategic, budget, or military requirement considerations. As you know, the possibilities of defense programs being terminated are always present. However, Lockheed's obligations are apparently such that any cancellations of defense programs on which these facilities are being used would not alter Lockheed's obligations under the 25-year leases.

Thus, in executing the lease agreements in 1957 Lockheed had to assume the total risk concerning:

- Future sales and profits in a highly competitive industry under various types of contracts including fixed-price types.

- Future availability of company funds for substantial rental payments under noncancelable leases.

- Future and long-term efficient use of specialized facilities.

Based upon the considerations discussed above, we feel that the GAO review and the draft report have not presented a full evaluation of the risk which Lockheed assumed in signing these noncancelable leases.

We are in the process of determining the proper course of action with respect to the first recommendation regarding negotiating reimbursements of Lockheed leasing costs with Prudential under new contracts. We should be in a position to advise you further within the next month. In reviewing this matter, we are mindful of the matter of risk to the contractor in entering into these agreements as discussed above; the fact that the contractor entered into the lease agreements in good faith prior to the publication of definitive guidance to contracting offices in ASPR 15-205.34(c) for the evaluation of sale or leaseback agreements; as well as the ASBCA finding which ruled on the reasonableness of the leasing costs. At the same time, we are aware of the magnitude of the leasing costs in terms of dollars, and the fact that we are not precluded by the ASPR from considering the reasonableness of the costs for leasing in any current or future negotiations. The ASPR Committee will be requested to review the rental cost principle particularly as it relates to noncancelable, long-term lease costs.

We are of the opinion that the second recommendation which would make a contractor responsible for disclosure of contemplated actions involving special or unusual costs, when it is anticipated the Government would bear most of those costs, is adequately provided for in the ASPR. The current regulation on advance understandings in ASPR 15-107, provides that either the contractor or the contracting officer may initiate advance understandings. These understandings should result from the exigencies of a particular situation, and the need for such understandings evaluated on the basis of the circumstances of the individual case. Of course, the lack of disclosure of special or unusual costs prior to settlement does not preclude the Government's right to disallow such costs if they do not meet the test of reasonableness. It is our experience that the possibility of a future disallowance provides adequate incentive to a contractor to disclose "contemplated actions involving special or unusual costs." As far as the type of costs herein involved are concerned, ASPR 15-205.34(c), with its reference to the costs of ownership as a standard of reasonableness, provides strong inducement for disclosure of proposed leases in connection with a request for an advance understanding.

With regard to the risk weight to be given to rental facilities under the weighted guidelines method of establishing a profit or fee objective, we look upon situations such as this case, where the contractor enters into a noncancelable, long-term lease, with no guarantee as to the continuation of programs, to be substantially the same as that where the contractor purchases facilities. In either situation, he assumes the risk of a long term obligation which is not the case where he has Government-furnished facilities. Also, although it would appear that under a short term leasing arrangement, the contractor assumes less risk, there is a sound basis for some short term leasing to meet peak requirements. However, consideration of revisions to the weighted guidelines, including the "Source of Resources" factors to be assigned under ASPR 3-808.5(e)(2), will be possible after sufficient data has been accumulated under the DOD Profit Review Study to permit an intelligent analysis of the effect of weighted guidelines on negotiated profit objectives under Defense contracts.

Two matters contained in the report require clarification.

a. Page 3 comments: The figures are based on building space only and indicate that $59 million has been invested in facilities by both the

Government and the contractor. The figures do not include land and land improvements in the Government-furnished and contractor-owned categories which would provide complete comparability with the leased financed figures. When the land and land improvements are included, the total facilities investment amounts to $72.5 million and breaks down as follows:

	Cost	
	Amount (Millions)	Percent
Government-furnished	$16.4	22.2
Lease-financed	27.2	37.5
Contractor-owned	28.9	40.3
Totals	$72.5	100.0

b. On pages 6 and 24, it is stated that the ASPR provides for additional profits or fees of up to 2% of total contract costs to discourage the contractor's reliance upon Government resources. The correct rule set forth in ASPR 3-808.5(e), provides "... the Source of Resources factor will always be rated from 0 to -2%...." In other words, additional profits, as such, are not provided contractors because they use their own facilities.

We appreciate the opportunity to comment on this draft report.

Sincerely yours,

J. M. MALLOY
Deputy Assistant Secretary
of Defense (Procurement)

Enclosure

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

INSTALLATIONS AND LOGISTICS

CA

18 JUN 1966

Mr. James H. Hammond, Associate Director
Defense Accounting and Auditing Division
General Accounting Office
Washington, D. C. 20548

Dear Mr. Hammond:

Further reference is made to your letter to the Secretary of Defense dated December 29, 1965, transmitting copies of your draft report to the Congress on the effects of long term leasing of buildings and land by a Government contractor, Lockheed Missiles and Space Company, Sunnyvale, California, (OSD Case #2386). Our letter dated April 8, 1966 stated that we would advise you further on the first recommendation with regard to negotiating reimbursements of Lockheed leasing costs under new contracts.

After consideration of all of the facts in this case, we do not feel that it would be in the Government's interest to attempt to conduct negotiations with this contractor on the basis of reimbursing future rental costs on the basis of the cost of ownership. As we pointed out in our previous correspondence, Lockheed in the late 1950's was being called upon to perform increased amounts of Defense work and as a consequence had to develop an expansion program for its Sunnyvale facilities. It apparently had exhausted its ability to obtain additional public financing; there was no limitation in the Defense regulation at that time concerning the allowance of rental costs in sale or lease-back agreements and the financing arrangement with the Prudential Insurance Company was the remaining acceptable source of financing for the needed expanded facilities. Under these circumstances it would be contrary to good conscience and acceptable standards of Government conduct to now refuse to contract with this firm except on a basis which would deny Lockheed the ability to claim in its overhead charges against Government contracts the rental costs that it is committed to pay to Prudential under the existing Lockheed agreements--to the extent that these

charges are considered to be reasonable. We will, however, as a result of your inquiry ask the ASPR Committee to review the rental cost principle, particularly as it relates to noncancellable, long-term costs.

We appreciate the opportunity of commenting on your report and its recommendation.

Sincerely yours,

J. M. MALLOY
Deputy Assistant Secretary
of Defense (Procurement)

PRINCIPAL MANAGEMENT OFFICIALS OF THE DEPARTMENT OF DEFENSE AND THE DEPARTMENT OF THE AIR FORCE RESPONSIBLE FOR ADMINISTRATION OF ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
DEPARTMENT OF DEFENSE		
SECRETARY OF DEFENSE:		
Robert S. McNamara	Jan. 1961	Present
Thomas S. Gates, Jr.	Dec. 1959	Jan. 1961
Neil H. McElroy	Oct. 1957	Dec. 1959
ASSISTANT SECRETARY OF DEFENSE (INSTALLATIONS AND LOGISTICS) (position created in 1961 by combining Assistant Secretaries for Properties and Installations and Supply and Logistics):		
Paul R. Ignatius	Dec. 1964	Present
Thomas D. Morris	Jan. 1961	Dec. 1964
ASSISTANT SECRETARY OF DEFENSE (Supply and Logistics):		
E. Perkins McGuire (position merged with Assistant Secretary, Installations and Logistics January 1961)	Dec. 1956	Jan. 1961
DEPARTMENT OF THE AIR FORCE		
SECRETARY OF THE AIR FORCE:		
Harold Brown	Oct. 1965	Present
Eugene M. Zuckert	Jan. 1961	Sept. 1965
Dudley C. Sharp	Dec. 1959	Jan. 1961
James H. Douglas, Jr.	May 1957	Dec. 1959
Donald A. Quarles	Aug. 1955	Apr. 1957

PRINCIPAL MANAGEMENT OFFICIALS OF

THE DEPARTMENT OF DEFENSE AND THE DEPARTMENT OF THE AIR FORCE

RESPONSIBLE FOR ADMINISTRATION OF ACTIVITIES

DISCUSSED IN THIS REPORT (continued)

	Tenure of office	
	From	To
DEPARTMENT OF THE AIR FORCE (continued)		
ASSISTANT SECRETARY OF THE AIR FORCE (INSTALLATIONS AND LOGISTICS) (formerly Materiel):		
Robert H. Charles	Nov. 1963	Present
Vacant	Oct. 1963	
Joseph S. Imirie	Apr. 1961	Sept. 1963
Philip B. Taylor	Apr. 1959	Feb. 1961
Vacant	Feb. 1959	Mar. 1959
Dudley C. Sharp	Oct. 1955	Jan. 1959
COMMANDER, AIR FORCE LOGISTICS COMMAND (created April 1, 1961, formerly Air Materiel Command):		
Gen. Kenneth B. Hobson	Aug. 1965	Present
Gen. Mark E. Bradley, Jr.	July 1962	July 1965
Gen. William F. McKee	Aug. 1961	June 1962
Gen. Samuel E. Anderson	Mar. 1959	July 1961
Gen. Edwin W. Rawlings	Aug. 1951	Feb. 1959
COMMANDER, SACRAMENTO AIR MATERIAL AREA:		
Maj. Gen. Chester W. Cecil	Dec. 1964	Present
Maj. Gen. George E. Price	July 1962	Nov. 1964
Maj. Gen. Robert B. Landry	Aug. 1960	June 1962
Maj. Gen. George E. Price	Aug. 1956	July 1960

U.S. GAO, Wash., D.C.