

B-181714-O.M., Jan. 3, 1975

UNITED STATES GOVERNMENT

GENERAL ACCOUNTING OFFICE

Memorandum

JUN 28 1974

TO : Comptroller General

B-181714

FROM : Director, FGMSD - D. L. Scantlebury

D. L. Scantlebury

SUBJECT: Use of Military Sealift Command (MSC) ~~Industrial~~
Funds to Augment Appropriated Funds

We request a legal opinion on the propriety of the methods being used by the MSC with regards to its tariff system for billing customers for ocean transportation costs. The MSC operates under the authority of 10 U.S.C. 2208.

MSC's revenue is derived primarily from billings at predetermined tariff rates based on the number of measurement tons moved. MSC's tariffs are based on average anticipated cost to provide services world-wide; the costs are factored for mileage and accumulated by class of service (i.e., cargo, petroleum, etc.). By using a tariff based on average cost, MSC attempts to breakeven in total and does not identify and bill the costs of specific services between points of origin and debarkation. Tariff rates are developed by MSC and must be approved by the Secretary of Defense (OSD).

During FY 1974 MSC's operations were significantly affected by the energy crisis and changing cargo requirements. For example, between July 1, 1973 and April 1, 1974, the cost of fuel went from \$3.85 per barrel to \$14.94 per barrel. As a result of these difficulties MSC will lose about \$80 million in FY 1974.

Because of the increased cost of ocean transportation, OSD granted several increases to the FY 1974 tariff rates. These increases, however, were insufficient to recover costs and on April 15, 1974, MSC through the Comptroller of the Navy, requested additional tariff increases for FY 1974. These increases were not intended to provide a financial breakeven but would have limited the FY 1974 loss to about \$29 million.

On May 13, 1974, OSD disallowed the request for tariff increases. (See Attachment I.) While concluding that MSC's operating losses substantiated the need to increase the tariff rates, OSD stated that no provision could be made in the customer accounts (Navy, Army and

Air Force) to cover the requested increases. Instead, MSC was told to adjust its FY 1975 tariff rates to recoup its losses from FY 1974 and prior periods. In order to continue operations during FY 1974, MSC was allocated \$45 million by the Navy Industrial Fund. We believe that by disallowing the rate increases OSD has in effect augmented without Congressional approval the military services appropriations; primarily the Operation and Maintenance Appropriation which is a single-year fund.

We noted that since FY 1972, MSC has adjusted its tariff rates to recover losses or to return profits of prior fiscal years. For example, in FY 1973, MSC budgeted for a \$16.7 million loss.

We discussed these matters with OSD officials who stated that the House Appropriations Committee was told that their policy over the years has been to maintain insofar as possible a stabilized rate for sealift operations even though application of stabilized rates have at times resulted in losses or gains (see Attachments II and III). The results of MSC's operations during the last seven fiscal years follows:

<u>FY</u>	<u>Profit (Loss)</u> (millions)
1968	\$ 16.3
1969	6.6
1970	(26.3)
1971	15.6
1972	42.0
1973	(34.9)
1974	(80.0) estimated

The pertinent provisions of law and implementing DOD regulations that in our opinion bear on this submission follow:

- 10 U.S.C. 2208(c) "Working - capital funds shall be charged, when appropriate, with the cost of - ... (2) services or work performed; including applicable administrative expenses, and be reimbursed from available appropriations or otherwise credited for these costs..."
- 10 U.S.C. 2208(h) "The Secretary of Defense shall prescribe regulations governing the operation of activities...authorized by this section."
- Section X, paragraph G, of DOD Directive 7410.4, Regulations Governing Industrial Fund Operations "In order to avoid, insofar as practical, the augmentation or overcharging of current customer appropriations, industrial fund activities shall, in

determining the amounts to be reimbursed from customers, seek to minimize annual gains or losses. Rates and prices established for services to be furnished during an operating period should be evaluated and adjusted so as to be compensatory and minimize annual gains and losses. It is recognized that gains and losses will occur, but they should be insignificant in relation to annual revenue."

We are considering a report to the Congress on the tariff problem at MSC. We would therefore appreciate your opinion on the following:

- Must tariff rates recover the cost of specific services furnished between points of origin and debarkation, or is a world-wide rate that recovers the total cost of operations by class of service legally acceptable?
- Is it legal to adjust tariff rates to recover losses or to return profits of prior years?
- Is it legal for MSC to absorb an estimated loss of \$80 million during fiscal year 1974 and thus use industrial funds to finance operations of the military services? Does OSD's disapproval of a valid rate increase represent a circumvention of Congressional appropriation limitations?

Attachments

Indorsement

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Director, FGMSD

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Returned. As you indicate, the language of 10 U.S.C. 2208(c) expressly requires that working funds established under such section shall be charged with the costs of the work or services performed, including applicable administrative expenses, and that such funds shall

"... be reimbursed from available appropriations or otherwise credited for those costs, including applicable administrative expenses and costs of using equipment." (Emphasis supplied.)

The plain statutory language under which working funds are authorized thus expresses with reasonable exactitude the intention of the Congress that reimbursements to those funds shall cover the full costs of furnishing the goods or services provided.

Aside from the plain language of Section 2208(c), it is clear from the legislative history of Section 405 of Public Law 216, 81st Congress, 1st Session, 63 Stat. 579, from which the provisions of Section 2208 were derived, that working capital commercial-type operations must be conducted on a current, full-reimbursement basis.

In the course of the hearings on H.R. 5632, which was enacted as Public Law 216, Mr. W. J. McNeil, Special Assistant to the Secretary of Defense, in explaining the effect of Section 405, stated that working fund authority

"... would have the effect of placing the departments operations on a consumption basis. By that I mean charging appropriations for the material at the time it is used on the job." (Emphasis supplied.)

Hearings on H.R. 5632 before the full House Committee on Armed Services, 81st Cong., 1st Sess. 2669 (1949).

Moreover, Section 2208(f) explicitly prohibits the incurring, by the requisitioning agency, of "cost" greater than the amount of appropriations or other funds available for the purposes. That the term "cost" refers to full actual costs is indicated by the further comment of Mr. McNeil, reported at page 2670 of the hearings, in pertinent part, as follows:

"... We are not able to focus our attention on the cost of the job ...

* * * * *

"... This type of operation would provide that a commercial- or industrial-type operation pay for its labor and material in the same manner as the private manufacturing concern or commercial concern would operate its business. It would cost the job and bill the cost of the job to the organizational division that ordered the work done.

* * * * *

"It is in that way that I feel we are really going to get economies in the Military Establishment by focusing attention on the cost of the work to be done." (Emphasis supplied.)

In reliance upon these representations by that official of the military establishment, the Congress enacted general authority for working fund operations. It is clear, therefore, that so far as is reasonably possible billings by working funds are required by law to reflect the full costs of doing business.

However, we find no conclusive indication in the language or legislative history whether reimbursements must reflect the costs of specific operations or services. It may be taken as a matter of conjecture, on the basis of the general tenor of the discussions during the hearings, that the terminology used in the statute was addressed more to the problems of manufacturing or equipment-servicing functions than to those of providing transportation service. Some such indication is found in the following statement of Mr. McNeil, reported at page 2670 of the hearings on H.R. 5632:

"For example, if the Bureau of Ships ordered the overhaul of a destroyer, the yard would cost the job and bill the cost of the job to the Bureau of Ships. The Bureau of Ships would control the amount to be spent. It would control the amount of work to be done. But it would focus to the attention of the Bureau of Ships that it was costing \$61,000, say, to do this type of job at one yard and that another yard could do practically the same job for \$50,000, and another one for \$80,000."

This statement, and the context in which it appears, lends some support to the view that individual job-costing techniques were anticipated, and are therefore required. We are nevertheless impelled to recognize that the techniques of cost accounting were then more fully developed for manufacturing and selling activities than were techniques for transportation cost finding. At the time of the hearings, little progress had been made in the development of commonly-accepted principles for cost-finding for transportation services; the Interstate Commerce Commission was then still perfecting standard methodology for finding rail costs, and did not publish principles for finding motor carrier costs until some ten years later. No definitive work had then been undertaken for maritime transportation

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cost-finding. It seems probable that the magnitude of future shipping activities of the defense establishment may have been then unforeseen. It is entirely clear, however, that the framers of the statute contemplated accurate estimating and to the extent valid cost-finding techniques are available, they must be used.

It is our view, therefore, that the answer to your first specific inquiry must be couched in terms of the availability of feasible cost-finding and data-gathering techniques. Although we understand, from informal discussions, that appropriate methodology for developing specific cost factors has not yet been developed and that documentation relating to past shipping activities of the Military Sealift Command may be inadequate for developing specific costs, we are aware of no insurmountable obstacles to adapting techniques such as those used by the Interstate Commerce Commission in developing specific cost factors for modes under regulation by that agency to the task of developing cost factors for finding specific costs of MSC activities. Whether the utility of such information, if available, would warrant the costs and effort entailed in its development would, of course, be largely determinative of the question whether it is required. Even if it should prove to be the case that development of cost factors for precise ascertainment of the costs of specific services may be prohibitively expensive, we are nevertheless of the view that the statute requires something more accurately reflective of true costs than merely fixing a worldwide rate that recovers total costs of operations by class of service. In the absence of precise methodology for assigning costs on a job-order basis, the rate structure should return full costs of particular patterns of traffic or elements of service, as a minimum acceptable requirement.

With regard to your second and third questions there is for consideration the nature and purpose of an industrial fund.

An industrial fund is a working capital fund and a revolving fund. It is designed so that industrial and commercial type activities may be operated and managed like similar activities in private industry. As a revolving fund it is used to provide payment for materials and services which are later billed to applicable appropriations. The working capital feature of industrial funds is intended to eliminate the many sources of funds that would be needed to finance day to day functions of the activities.

The industrial fund is also a revolving fund inasmuch as the working capital is continuously being replenished by reimbursements from the ordering agencies' budgetary appropriations, thereby permitting an industrial fund activity to finance a continuing cycle of operations in which orders are placed by more than one agency and are reimbursed from more than one appropriation.

Generally speaking, as a means by which Congress controls the amount of money spent by the military departments for services provided by working capital funds, 10 U.S.C. § 2208(f) prohibits a requisitioning agency from incurring any greater cost for work or services performed by activities than the amount of appropriations available for such purposes.

While theoretically an industrial fund should experience neither a gain or a loss from its operations, section X of DOD Directive 7410.4 recognizes the impossibility of such result stating that--

"In order to avoid, insofar as practical, the augmentation or overcharging of current customer appropriations, industrial fund activities shall, in determining the amounts to be reimbursed from customers, seek to minimize annual gains or losses. Rates and prices established for services to be furnished during an operating period should be evaluated and adjusted so as to be compensatory and minimize annual gains and losses. It is recognized that gains and losses will occur, but they should be insignificant in relation to annual revenues."

This feature of working capital funds has been recognized by the Congress in legislation establishing certain working capital funds in that provisions are specifically contained therein requiring that profits or earnings in excess of specified amounts be deposited into the Treasury as miscellaneous receipts. See, for example, the funds established pursuant to 49 U.S.C. § 1657(j); 22 U.S.C. § 2684; 15 U.S.C. § 278(b); and 31 U.S.C. § 1033.

Accordingly, and since 10 U.S.C. § 2208 contains no provision requiring earnings to be transferred to miscellaneous receipts, we believe DOD properly may adjust its rates periodically so as to recover losses or to offset profits of prior periods. Furthermore, an examination of the DOD appropriations hearings held subsequent

to the enactment of the industrial fund legislation discloses numerous instances in which DOD explained to the House Committee on Appropriations that the rates charged customers of industrial funds, including the Army and Air Force industrial funds, were periodically revised so as to take care of previous profits or losses as the case might be.

It thus is inherent in a working fund operation that the rate charged for the services will not always reflect the actual costs of the services provided and thus to the extent that services are provided at a price other than actual cost, the using agency's appropriation is either augmented or overcharged. However, as long as the rates charged are reasonable so as not to constitute an abuse of such implied authority we cannot say that such appropriations are either improperly overcharged or augmented.

Both of these aspects of an industrial fund operation were discussed during the House Hearings on DOD Appropriations for 1972. See page 345 of part 4 of those hearings wherein the discussion is reported as follows:

"NAVAL INDUSTRIAL FUND

"PROFIT AND LOSS PROJECTIONS

"Mr. Sikes. I note that the Navy industrial fund sustained a loss of \$30,631,000 in 1970. What causes this loss?

"Admiral Moore. Most of the fiscal year 1970 loss relates to military sealift operations. Sealift tariffs were established July 1, 1970, which anticipated a break-even operation. However, during fiscal year 1970, the maritime industry experienced unanticipated wage escalation which resulted in a sharply increasing loss trend in the MSC operations. Losses were compounded as a result of shipping delays caused by stevedore strikes as fiscal year 1970 progressed.

"Mr. Sikes. You project a profit of \$25,833,000 in 1971 and you anticipate breaking even in 1972. Considering the loss in 1970, how will you make this recovery?

"Admiral Moore. As indicated in my answer to the previous question, unanticipated losses were incurred during fiscal year 1970 on our Sealift operations. It became evident about March 1970 that an increase in tariff rates was required to meet increased expenses and recover losses incurred. However, in the interest of achieving a stabilized tariff rate, it was considered desirable to plan recovery of these losses over a 16-month period ending 30 June 1971. Accordingly, our fiscal year 1971 industrial fund estimates are projected at a net gain sufficient to recover the fiscal year 1970 Sealift losses.

"Mr. Sikes. When there are profits in some years and losses in other years, does this not constitute in effect subsidization of the direct appropriation accounts?

"Admiral Moore. Yes, sir. To the extent we incur losses in our industrial fund operations in any one fiscal year there is, in effect, a subsidization of that fiscal year's appropriation accounts. As previously indicated, though gains and/or losses at times have taken place, the overriding consideration has been the stabilization of Sealift tariff rates in order to provide sounder and more stable financial management of the appropriation expenditures for ocean transportation services. The net effect of stabilized tariff rates provides a more even flow of expenditures for ocean transportation, which causes no overall additional cost to the Government. In this respect, the Navy Industrial Fund is anticipated to achieve a cumulative net gain of only \$3.4 million for the period 1950 to June 30, 1971." (Emphasis added.)

Furthermore, as noted in your memorandum and as illustrated by attachments II and III thereto together with the above-quoted 1972 hearings, the House Committee on Appropriations has been fully informed of MSC's policy in establishing and maintaining stabilized rates for sealift operations over a period of months, sometimes extending into the next fiscal year even though they at times result in losses or gains.

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In view of the nature of industrial funds and the disclosures that have been made to the House Committee on Appropriations with respect to the sealift operations, your second question is answered in the affirmative.

While in our opinion it is thus legal for MSC to absorb a loss during a fiscal year without improperly having augmented applicable appropriations, any flagrant abuse of such authority should be reported to the Congress. Under the circumstances existing at the time the deficit for fiscal year 1974 was incurred, we are not inclined to view MSC's or OSD's action as constituting an unreasonable exercise of the authority relating to industrial fund operations.

Paul G. Dembling

Paul G. Dembling
General Counsel

Attachment

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DIGEST

1. In so far as is reasonably possible, billings by working funds established under 10 U.S.C. 2208 are required by law to reflect the full costs of doing business.
2. The nature of industrial fund operations under 10 U.S.C. 2208 and the fact that appropriate Congressional committees are advised annually of fund profits or losses suggests that it is legal to adjust Military Sealift Command tariff rates to recover losses or return profits of prior years.