REPORT TO THE COMMITTEES ON APPROPRIATIONS HOUSE OF REPRESENTATIVES AND UNITED STATES SENATE

RELEASED

Plan To Acquire Commercial Aircraft For The Naval Reserve

B-175251

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

JUNE 21, 1972

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-175251

To the Chairmen of the Senate and
House Appropriation Committees

This is in reply to the February 14, 1972, letter from you requesting that we review a Navy proposal to acquire transport aircraft for its Reserve forces under a unique contracting arrangement. The Secretary of the Navy proposed to your Committees that a selected airline would transfer ownership of 12 used jet transport aircraft to the Navy at no charge in return for a contract to modify, maintain, and support the aircraft.

The contract would be for 1 year with options to renew the agreement for 9 succeeding years at a fixed annual charge. Before transferring the aircraft to the Navy, the airline would perform modifications estimated to cost $30 million. This cost would be amortized over the 10-year life of the agreement as a part of the fixed annual charge. The contract would be funded from the Navy Operations and Maintenance appropriation, unless the Government failed to exercise an annual option. In that event the unamortized cost of initial modifications would be paid to the contractor from the Navy Procurement of Aircraft and Missiles appropriation.

Your letter listed 15 specific aspects of the Navy's proposal that you wished us to cover in our review. These aspects have been phrased as questions and answered in appendix I in the same order in which they appear in your letter. You also requested that we cover any other matters which we believed might be of interest to the Congress. These are also discussed in appendix I.

Our basic findings regarding the proposed acquisition of aircraft are as follows:

1. The Navy's calculations of requirements for these aircraft appear to be logical if all the assumptions upon which its calculations are based are valid. The Office of the Secretary of Defense is of the opinion that the Navy needs only six aircraft instead of the 12 which the Navy calculates to be its requirement. (See app. II.)

2. Our principal findings with respect to the legal aspects of the proposed contracting arrangement are as follows:

   --There is no legal basis for funding the modification and start-up costs of the proposed contract with operations and maintenance funds because the arrangement is really an acquisition of a capital asset.

   --The proposed transfer of ownership from the selected airline to the Navy does not constitute a gift.

   --Authorizing legislation would be required before entering into the proposed contract.

3. The proposed arrangement is the cheapest way of acquiring modern four-engined fan-jets. There is some possibility, however, that 12 new two-engined fan-jets could be acquired at a lower lifetime cost than 12 used aircraft of the type contemplated. If it were buying new aircraft, the Navy would prefer two-engined to four-engined aircraft to meet its requirement.

4. On the basis of our analysis of operating costs experienced by commercial airlines, we believe that the $7.5 million informally proposed by one airline is a reasonable annual price for the maintenance, training, and support to be provided. There is a possibility, however, that the feature of the proposed arrangement whereby the contractor would transfer aircraft to the Navy without charge may prove unattractive to the airlines when they are actually required to make firm commitments.

5. The Navy estimate of $30 million for initial modifications to the aircraft is subject to a high degree of error because the Navy has little, if any, prior experience on which to base its estimate.

6. The present Naval Reserve transport fleet of C-118 aircraft is old and unreliable. This type of aircraft is no longer in production, and the acquisition of spare parts sometimes causes

delays in putting aircraft in an operational status again. Although these aircraft do not have to be replaced immediately, some type of replacement aircraft will be required if peacetime Naval Reserve activities are to continue.

7. At the present time it appears that maintenance of the aircraft proposed for acquisition can be performed more cheaply by contract than by the Navy. Navy repair facilities cannot presently accommodate the tail sections of the type of aircraft contemplated.

8. Under the proposed level funding of the contract (i.e., $10.5 million annually), the contractor may not have sufficient incentive to perform adequately in the later years of the contract period because costs would probably be higher in the later years.

- - - -

We have not obtained formal agency comments on the matters included in this report, but we have discussed with Navy representatives the factual matters set forth in the appendixes.

We plan to make no further distribution of this report unless copies are specifically requested, and then we shall make distribution only after your agreement has been obtained or public announcement has been made by you concerning the contents of the report.

If we can assist you further in this matter, please let us know.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

The Honorable Allen J. Ellender
Chairman, Committee on Appropriations S 300
United States Senate

The Honorable George H. Mahon
Chairman, Committee on Appropriations H 300
House of Representatives

COMMITTEE QUESTIONS AND GAO RESPONSES CONCERNING PROPOSED ACQUISITION OF TRANSPORT AIRCRAFT FOR THE NAVAL RESERVE

1a. Does a valid military requirement exist for these aircraft in the Naval Reserve?

We reviewed the manner in which the Navy calculated the need for these aircraft. With the exception of certain matters discussed below, the Navy calculations seem logical. We are unable to determine, independently of the Navy calculations, whether or not these aircraft are needed by the Naval Reserve.

There is a difference of opinion between the Navy and the Office of the Secretary of Defense concerning the number of aircraft which should be acquired. The Navy justifies the acquisition of 12 aircraft by reference to wartime needs. The Office of the Secretary of Defense views the proposed acquisition of jet aircraft as being justifiable by the need to replace obsolete aircraft with a quantity of newer aircraft which would provide the same capability.

The Assistant Secretary of Defense (Installations and Logistics) advised us that it was the position of the Office of the Secretary of Defense that modernization of the Naval Reserve airlift capability could be accomplished with no more than six fan-jet aircraft. (See app. II.) This position is in accordance with data made available to us which shows that 12 fan-jets of the type contemplated would have over twice the airlift capability of the present Reserve fleet of 30 propeller-driven C-118 aircraft.

The Navy has calculated its requirement for the 12 jet aircraft in two ways. In both cases the requirement is based on wartime rather than peacetime needs. Peacetime use of Reserve transport aircraft is regarded by the Navy as a secondary benefit. Both calculations are predicated on tactical or intratheater (short haul) airlift needs rather than on strategic or intertheater (long haul) needs. We have been advised that Navy strategic airlift requirements in both peacetime and wartime are met by the Air Force's

Military Airlift Command. In wartime the strategic capabilities of the Military Airlift Command are augmented by commercial aircraft under the Civil Reserve Air Fleet program.

The two Navy requirements calculations are described below.

FIRST METHOD

The Navy has advised us that it considers its first method of calculation to be the more valid of the two. This method is based on a mobilization contingency for the North Atlantic Treaty Organization. This contingency was selected by the Navy because it presents a more severe requirement than any other.

This requirements calculation is based on the present tactical airlift utilization within the 6th Fleet. One shortcoming of this calculation is that the present airlift within the 6th Fleet area of operations involves a certain amount of relatively low priority cargo and passenger movement that in wartime would not be moved by air. We have not been able to establish the amount of this low-priority movement, but the Navy concedes that it exists.

One factor considered in this calculation concerns the increased amount of time the fleet would stay at sea in wartime (30 days a month rather than 13, or a factor of 2.3). We believe that this causes an overstatement of requirements since the fleet requires tactical airlift support even when in port, although to a considerably lesser degree than when at sea. Therefore the factor used should be some figure less than 2.3.

This requirements calculation is based on airlift needs for any 30-day period following mobilization. We believe that requirements should be calculated as a function of time following mobilization and for a considerably longer period than 30 days, because airlift requirements (and, to a lesser extent, airlift capability as well) decrease gradually following mobilization. This weakness is overcome in the second method described below.

SECOND METHOD

The second method of calculation used to demonstrate the need for the 12 aircraft is not based on any particular wartime contingency. Its starting point is the peacetime tactical airlift utilization of the regular Navy, worldwide rather than in just the 6th Fleet. Also this calculation considers requirements for the period of 1 year beginning with mobilization day.

There are, in our view, three significant shortcomings in this requirements calculation. First, the calculation is not based on any particular wartime contingency. Secondly, the wartime requirement is derived by multiplying peacetime utilization by an estimated factor that is not subject to verification. We were advised that this factor was derived from discussions with Navy personnel experienced in airlift operations. Finally, this calculation shares the shortcoming, noted in the first method, of being based on the assumption that the composition of cargo and the type of passenger carried during peacetime would remain the same in wartime.

1b. Are there other, more suitable aircraft available?

The Navy anticipates that it would obtain some version of the four-engined Boeing 707 or McDonnell Douglas DC-8 aircraft under the proposed arrangement. It would prefer to acquire twin-engined medium transports similar to those being acquired for the regular Navy. Five new twin-engined transports in a passenger/cargo convertible configuration are being purchased for delivery to the regular Navy in fiscal years 1973 and 1974. These aircraft will be C-9Bs, a military version of the McDonnell Douglas DC-9. Under current Navy plans, 33 aircraft of this type will be procured through fiscal year 1977. As discussed below in response to questions 2 and 3, these smaller, twin-engined aircraft are considerably cheaper to purchase, maintain, and operate than the four-engined type. The Navy advised us that none of the airlines was willing to transfer ownership of a smaller type aircraft (two- and three-engined) in return for a maintenance contract.

2. Will the aircraft to be provided under the agreement be obtained at less cost, all factors considered, than the cost to procure new aircraft?

3. Will it be more economical to obtain used aircraft than to purchase new aircraft?

The purchase price of 12 new 707 or DC-8 aircraft would be over $100 million, assuming that they were purchased in their commercial configuration and at the same price paid by the airlines. The Navy has not prepared an estimate of what it would cost to maintain new aircraft either by contract or by using its own facilities. Nevertheless if the price to acquire, modify, and support the 12 used aircraft for 10 years under the proposed arrangement is reasonably near the $105 million proposed informally by one airline, the cost of purchasing new aircraft configured to military requirements and maintaining them for 10 years clearly would cost more.

As stated previously the Navy has indicated that, if it were acquiring new aircraft, it would prefer to have a smaller aircraft than the 707 or the DC-8; e.g., the twin-jet Boeing 737 or McDonnell Douglas DC-9. The purchase price of a 737 or DC-9 is approximately half the price of a 707 or DC-8. Fuel, oil, and maintenance costs are also much cheaper. Commercial airline cost experience shows the DC-9 or 737 to be about 35 percent cheaper in terms of fuel, oil, and maintenance.

We believe that the Navy should compare the cost of buying, maintaining, and operating new twin-engined jets, such as the 737 or DC-9, with the cost of maintaining and operating used four-engined aircraft under the proposed transfer arrangement. Such a comparison should take into consideration the lesser maintenance which the new aircraft would require, as contrasted to that for used aircraft. It should also take into consideration the fact that the lesser fuel and maintenance costs of the smaller aircraft become increasingly significant the longer the aircraft are kept in the inventory.

4. Does the Navy need authorization approval, regardless of the appropriation from which funds are used, to introduce additional aircraft into the inventory under the Armed Forces Authorization Act (Section 412(b)) of Public Law 86-149, as amended?

The cited law forbids the appropriation of funds for the procurement of certain items, including aircraft, without prior authorizing legislation. In our opinion, the acquisition of 12 aircraft from a commercial airline by the means proposed is no less a procurement of aircraft, within the context of the law, than if the usual practice of outright purchase with funds authorized and appropriated for the procurement of aircraft were followed. Reduced to bare essentials, the proposed arrangement constitutes a bilateral contract with benefits flowing both ways, the end result of which is the acquisition by the Navy of title to a capital asset.

In our opinion, the aircraft would in reality be procured even though, if otherwise proper, such procurement were effected through the use of funds appropriated for operations and maintenance. Section 412(b) draws no distinction between the procurement account and the operations and maintenance account in requiring that authorization be enacted before appropriations are made for procurement of aircraft. Although section 412(b) technically has application only to the appropriation process of the Congress, it is our view that the acquisition of the aircraft in question without prior authorizing legislation would constitute a violation of the intent of section 412(b).

5. Which airlines were involved in the proposal? What was the origin of the proposal? What were the circumstances under which the proposal was made? What were the elements of competition, if any, involved?

Late in 1970 the Navy was considering ways to acquire transport aircraft for its Naval Reserve program. Particular attention was being given to ways of acquiring these aircraft which would not entail funding through the procurement appropriation, Procurement of Aircraft and Missiles, Navy (PAMN). In November 1970 the Deputy Chief of Naval Operations (Air Warfare) met with a captain in the Naval Reserve

to discuss this problem. The Deputy Chief asked the Reserve captain to explore informally, with the airline and the aircraft manufacturing industries, ways to acquire aircraft which would not involve PAMN funds.

During the 5 months following the meeting with the Deputy Chief, the Reserve captain contacted 12 airlines and three aircraft manufacturers, including Boeing Aircraft Company and McDonnell Douglas, and suggested to each company the transferring, or giving, of surplus transport aircraft to the Naval Reserve in return for a maintenance, training, and support contract.

Of the 15 airlines and aircraft manufacturers contacted, six airlines indicated interest in the type of arrangement suggested. Three airlines, American, Pan American, and Eastern, submitted informal proposals. American's proposed price was lower although it was based on providing maintenance for more flight-hours. Furthermore, unlike the Pan American and Eastern proposals, the American proposal was based on the transfer of aircraft equipped with fan-jet engines. According to the Navy, fan-jet-equipped aircraft are essential to the requirement.

The American proposal, as revised, offered 12 Boeing 707-720/B aircraft in return for a maintenance and support contract for $10.5 million annually. The proposal was predicated on a Naval Reserve usage of 14,400 flight-hours annually. It should be noted that American in April 1970 had offered to sell surplus Boeing 707-720/B aircraft to the Naval Reserve at a price of $1.7 million to $1.75 million each.

The Pan American proposal was based on transferring 12 Boeing 707-321/331 aircraft and on 10,000 flight-hours annually rather than 14,400 flight-hours. Pan American estimated the annual charge under the maintenance and support contract to be $15 million. The Eastern proposal was predicated on the transfer of 12 McDonnell Douglas DC-8-21 aircraft and on 10,000 flight-hours. The estimated annual price to the Government was $13.3 million.

6. Is the informal airline cost proposal for maintenance, training, and other services valid?

As mentioned in response to question 5, American Airlines informally suggested the lowest price, $10.5 million a year. Actually American's written proposal was for $9.95 million a year. We were advised that the differences between these two figures were due to changes in the services that the Navy wanted. These changes were communicated to American verbally, and American's response was verbal also. Of the $10.5 million yearly charge, $3 million represents amortization of the cost to perform initial modification of the aircraft, leaving $7.5 million a year for maintenance, training, and other services.

The Navy prepared its own estimate of the cost to obtain by contract the services included in the airline's proposal. The Navy estimate was $11.9 million a year, exclusive of $3 million a year for amortization of initial modification costs, and was based primarily on Air Force cost experience under its C-9A maintenance and support contracts. The C-9A is a military version of the twin-engined McDonnell Douglas DC-9.

As indicated above the American Airlines proposal of $7.5 million a year for all services except initial modification was based on 14,400 flight-hours a year for the 12 aircraft. The charge thus would be about $520 a flight-hour. We compared this hourly cost with the cost reported by the Air Force to maintain its four-engined C-135 and KC-135 aircraft. These aircraft are military versions of the Boeing 707. Maintenance costs of the C-135s and KC-135s were reported to be $511 and $497 an hour, respectively. Generally these figures represent maintenance performed internally by the Air Force, although some contract maintenance is involved.

The maintenance costs of DC-8 and 707 aircraft flown by the domestic airlines in trunk service contrast sharply with the Air Force maintenance costs. From the operating costs reported by the airlines for a recent year, we subtracted all costs which clearly were not applicable to the comparison. The nonapplicable costs were primarily depreciation, flight crew, insurance, and fuel and oil. The remaining hourly

cost, which was primarily maintenance and rework cost, was only about $250 for either type of aircraft.

This latter comparison does not consider all cost factors. The winning contractor will be required to establish certain limited support capabilities at each of the four bases where the aircraft will be stationed. More importantly, if a contractor is to commit itself to providing maintenance and support for a period of 10 years at a fixed price, it must provide for future economic inflation and, in all probability, include a contingency in its price to cover non-scheduled maintenance. Finally, an amount must be included in the price for profit. The airlines cost data includes flight-line maintenance but, under the proposed arrangement, this work will be performed by military personnel. Despite these shortcomings in the comparison, we believe that it is sufficiently valid to indicate that a charge of $7.5 million a year, based on 14,400 flight-hours, could provide the selected contractor with a financial benefit, at least in the early years.

In the last analysis, however, we think that it cannot be determined at this time whether the proposed arrangement can be effected at an annual contract charge of $7.5 million, exclusive of charges for initial modification. The feature of the proposed arrangement, whereby the contractor would transfer aircraft to the Navy without charge, may prove unattractive to the airlines when they are required to make firm commitments.

7. Is the cost estimate for modifications to the 12 aircraft valid?

As part of the required effort under the proposed contract, the Navy plans to have various modifications made to the aircraft before they are delivered. These modifications pertain to such things as passenger/cargo convertibility, increased fuel capacity, military communication and navigation systems, life improvement changes, and changes necessary for Federal Aviation Administration certification of airworthiness.

The informal proposal by American Airlines includes $30 million for the cost of initial modifications. The Navy

would pay $3 million each year toward the amortization of this cost. The Navy's independent estimate for all services under the proposed contract was $14.9 million a year. This estimate was mentioned in the Secretary of the Navy's letter to the chairman of the Appropriations Committees dated February 7, 1972. The Navy estimate includes $3 million a year for initial modification costs ($30 million total), or the same amount as that proposed by American Airlines.

We found that the personnel who prepared the Navy estimate arrived at a figure of $44.3 million for the total cost of initial modifications rather than $30 million. Higher Navy echelons changed the estimate to the lower figure on the basis of their general judgment. The original estimate also was primarily based on judgment, since there was little, if any, prior cost experience for the type of work under consideration. The Navy customarily acquires new aircraft already configured to military requirements.

In view of the lack of prior cost experience, all estimates of initial modification costs under the proposed arrangement must be considered subject to high degrees of error.

8. What is the fair market value of the aircraft to be obtained by the Navy?

The value of used commercial aircraft varies enormously depending on their condition. The time since overhaul and the status of modification work required to maintain Federal Aviation Administration certification are particularly important. Used aircraft of the type contemplated could vary in value between $0.5 million and $2.5 million each. In April 1970 American Airlines informally offered to sell 707-720/B aircraft to the Navy at a price of $1.7 million to $1.75 million each.

9. What is the condition of the aircraft to be replaced? and do they require replacement for current Naval Reserve activities to continue?

The 28 C-118s currently in the Naval Reserve (two more will be transferred from the active Navy in the near future) have an average age of 18.9 years and an average flying time of 24,500 hours. The planned useful life of C-118 airframes is 31,200 hours. In recent months these aircraft have been averaging 85 flight-hours a month. At this rate of use the aircraft will reach 31,200 hours in approximately 6.5 years. Aircraft can be used after they reach their programmed useful lives; however, they must first undergo an expensive aircraft service life extension program. Information available for a recent quarter-year period indicates that these aircraft were not operationally ready for significant amounts of time. We were advised that these aircraft no longer were in production and that obtaining replacement parts for them sometimes involved long delays, during which time the aircraft were not in flying status.

A way of ascertaining the condition of these aircraft would be to compare the maintenance per flight-hour being performed on them currently with the maintenance per flight-hour performed several years ago. We were advised, however, that the Navy did not keep maintenance data long enough to make a valid comparison.

The C-118s would not have to be replaced in the near future for current peacetime Naval Reserve activities to continue. There is a possibility, however, that the decreasing reliability of these aircraft might require placing operating restrictions on them prior to expiration of their planned service lives. Such restrictions could reduce airlift capability. Also the decreasing reliability, in itself, could result in decreased capability.

10. Will the aircraft to be obtained be used exclusively for Naval Reserve operations? or will they be used in any way for active naval operations?

In the table below we have compared the planned peacetime usage of the 12 jet transports with the actual usage of the C-118 aircraft they would replace.

C-118 actual use (fiscal year 1970)	Percent	Jets, proposed use	Percent
Training	31	Training	5
SECNAV-CNO-DOD (note a)	7	SECNAV-CNO-DOD	10
Weekend airlift	12	Weekend airlift	15
Direct fleet support	6	Direct fleet support	10
Directed airlift	34	Directed airlift	55
Station support	10	Station support	5
Total	100		100

[a]Secretary of the Navy, Chief of Naval Operations, Department of Defense.

Support for active naval operations falls under the category of direct fleet support. Station support refers to the use of Reserve aircraft to perform missions for the bases where they are stationed. This time can also be considered as spent in support of the active Navy; however, unlike flying in the direct fleet support category, it normally does not involve airlift in direct support of naval operations at sea.

The other categories of usage shown in the table above are concerned with Naval Reserve activities. Training refers to Reserve flight training. SECNAV-CNO-DOD is applicable largely to various types of flights for public relations purposes. For example, civilians are transported to locations where they can board ships for so-called civilian orientation cruises. Another example involves transporting Reserve members to national meetings of the Reserve Officers Association. Weekend airlift refers to transporting Naval reservists to their weekend drill sites. Transporting reservists to active duty sites is the primary type of flying under directed airlift.

11a. What is the responsibility of the Naval Air Reserve for air logistics operations?

In peacetime the Naval Reserve provides air logistics support to the active Navy in two ways. Each year the various Reserve units, including the logistics squadrons,

have active duty periods. During these periods the Reserve units become integral parts of the active Navy and perform essentially the same functions as the same types of units in the regular Navy. Likewise in wartime the Naval Reserve Organization becomes a part of the regular Navy. In fiscal year 1971 about one third of the ton-miles flown by Reserve transport aircraft in support of the regular Navy were flown during active duty periods.

Reserve air logistics capability is also used throughout the year in support of the regular Navy. This support takes the form of individual flights undertaken voluntarily by Reserve flight crews. These flights are performed at the request of regular Navy commands. In fiscal year 1971 about two thirds of the ton-miles flown by Reserve transport aircraft in support of the regular Navy were flown in this manner.

11b. Would the aircraft probably be effectively and efficiently used?

The Navy plans to fly the 12 jets, if they are acquired, a total of 14,400 hours each year in peacetime. The present Reserve transport fleet of propeller-driven aircraft were flown approximately 32,000 hours in fiscal year 1970 and only 23,000 hours in fiscal year 1971. The 12 jets, flying 14,400 hours, have over twice the ton-mile capability of the present fleet flying 32,000 hours and over three times the ton-mile capability of the present fleet flying 23,000 hours. The Navy has not indicated how it intends to use the additional capability it would acquire with the 12 jets. Thus in one sense--i.e., percentage of available capacity used--the jets may not be used in peacetime as effectively and efficiently as the propeller-driven aircraft have been.

12. Is this contract proposal unique? and has a contract of this type ever been used previously?

Our discussions with officials in the military services and the Office of the Secretary of Defense have indicated that an arrangement of the type proposed by the Navy to acquire these airplanes has never been effected, at least not within the Department of Defense. (See our answer to question 13 for a discussion of a procurement method relied on by the Navy as a precedent for the proposed contract.)

13. What is the statutory authority for the contract proposed?

The Navy cited to us a 1921 Comptroller General decision (8 Comp. Gen. 654) as a precedent for the type of contractual arrangement proposed. This case concerned an annually renewable 25-year contract for water services to a veterans' hospital by a municipality. Because it was necessary for the municipality to construct a waterline to the hospital to provide water service, the contract was drawn so that the Government agreed to pay a cancellation charge to the municipality roughly equal to the unamortized cost of construction of the waterline in the event it was determined that the option to renew would not be exercised at the end of any fiscal year.

The Comptroller General's decision held that this arrangement satisfied the statutory requirement that contracts be made "under appropriations adequate to their fulfillment and not in excess of the amount appropriated for the fiscal year" in view of the annual renewal option feature. The decision stipulated, however, that the appropriation for water service for any given fiscal year must contain a reserve sufficient to pay the cancellation charge should the Government elect not to exercise its option at the end of any fiscal year.

Arrangements similar to those described above have been approved by the Comptroller General on several occasions since 1929. It should be noted that, under those arrangements, however, the Government did not obtain title to any capital assets and funds were required to be reserved annually in amounts sufficient to cover the Government's contingent cancellation liability. Such arrangements have been approved only for the provision of utilities or similar services which the Government otherwise could not acquire in a reasonable manner and, to our knowledge, have not been extended to obtain ownership of capital assets as now proposed and which, as indicated in your letter, would be contrary to the principle of full funding for capital items.

This aspect is discussed in the Comptroller General's decision of 1957 (37 Comp. Gen. 155, 159), wherein it is stated that:

"The situation not infrequently arises in the case of requirements for water, gas, electricity, or other utilities that there is only one reasonable source of supply and the furnishing of the service needed requires the construction of a new line to the Government project. This appears to have been the situation involved in the case of the East Tennessee Natural Gas Company contract mentioned in your letter. Under such circumstances, and where the contractor is unwilling to build the required new line at its own expense without assurances that it will be able to recover the capital cost involved, we have approved arrangements similar to those in the contract proposed in the present case. See, for example, 8 Comp. Gen. 655. In such cases, the alternatives open to the Government aside from construction and ownership of the new facility by the Government often are (1) payment to the contractor of the cost thereof at the beginning of the contract, with or without rebates from subsequent bills for services, or (2) contract provisions for cancellation charges contingent upon failure to renew the contract from year to year. Where only these alternatives are available to the Government, the course most advantageous to the Government ordinarily should be chosen, subject, of course, to the condition that an amount equal to the maximum contingent liability of the Government is always available for obligation from appropriations current at the time the contract is made and at the time renewals thereof are made."

Furthermore, even assuming that the contemplated arrangements are otherwise proper, we see no basis on which any part of the modification costs (estimated by the Navy to be $30 million) may properly be charged to the appropriation for operation and maintenance. It is a capital investment item, required to be financed from the procurement appropriation.

14. Does the proposed transfer of 12 jet aircraft at no charge constitute a gift? and does statutory authority exist for the acceptance of such a gift by the Navy?

We believe that the value of the proposed contract to the selected contractor, consisting of the annual fee and any ancillary benefits flowing to the contractor (e.g., keeping maintenance personnel and facilities fully utilized, the loan value of the proposed contract, etc.), represents adequate legal consideration for the aircraft. The fact that the Navy, for funding purposes, might attempt to ensure through an appropriately worded warranty clause that no funds, other than those actually required for modification and maintenance, will be included as part of the contract consideration cannot be said to change the nature of the transaction. It goes without saying, we think, that no airline would be willing to transfer title to the aircraft in question without receiving the modification-maintenance contract. We therefore are of the opinion that the proposed transfer does not constitute a gift.

The Navy does not have statutory authority to accept a gift directly; however, the acceptance of gifts by the Administrator of General Services for a particular defense purpose is authorized by the United States Code (50 U.S.C. 1151-1156).

15. Are the Navy-owned industrial facilities presently being utilized, or will they be utilized in the future, to an extent which would preclude their use for the repair, overhaul, and maintenance of the aircraft to be obtained under the proposed agreement?

Currently there are seven naval air rework facilities that do maintenance work on Navy aircraft. We have been informed that, at present, 78 percent of such work is done by the rework facilities, 20 percent is contracted out to commercial contractors, and 2 percent is done by the Army and Air Force.

A Navy official advised us, in regard to maintaining the proposed aircraft, that they would be too large to be accommodated by any of the current rework facility maintenance hangers. He stated that the DC-9s and Boeing 737s were preferred and were comparable in size to the Lockheed Electra (P-3) which was the largest aircraft being reworked by the rework facilities. The Navy, however, plans to contract, rather than provide in-house capability, for the maintenance and support of the twin-engined medium transports which will be acquired for the regular Navy. (See the response to question 1b.)

The official said that the Navy had no equipment or capability to accommodate Boeing 707s or McDonnell Douglas DC-8s, and industry had. He stated that the Navy would need more personnel billets and a training program in addition to new equipment. He estimated that, even under the best of conditions, it would take a minimum of 3 years for the Navy to ready itself to carry out this function. He could not give us a realistic dollar estimate but said that it would cost about $20 million to equip an activity to support F-4s or A-7s.

The Navy plans to operate the repair facilities at 85 percent of capacity over the next 5 years. We were informed that adding 707s or DC-8s to the work load would necessitate contracting out work now done in-house as well as meeting the other requirements discussed above.

16. What other matters relative to the proposed arrangement should be brought to the Committees' attention?

The Navy proposes to negotiate a maintenance and support contract for 1 year with options for 9 more years at the same fixed annual charge (assuming that flight-hours each year do not exceed 14,400). This fixed-price feature means that the contractor would probably make relatively high profits in the early years and relatively low profits in the remaining years. This situation would be caused by inflation and the higher maintenance and support efforts which would be required as the aircraft become older.

Certain officials in the Navy have suggested to us that, toward the end of the 10-year period, the contractor may not have sufficient incentive under the proposed contract to perform adequately. The Government's only recourse for poor performance would be either to terminate the contract or not to exercise the next annual option; yet by doing this the Government would merely relieve the contractor of responsibility for the less profitable part of the 10-year effort. Furthermore the Government could be without maintenance and other support until a contract to another company could be awarded, an untenable position. One way to minimize the possibility of poor performance would be to include a cost incentive feature in the contract, which would reward or penalize the contractor according to the quality of its performance.

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D.C.

3 APR 1972

INSTALLATIONS AND LOGISTICS

Honorable Elmer B. Staats
Comptroller General of the United States
Washington, D.C. 20548

Dear Mr. Staats:

This refers to your letter B-175251 dated March 8, 1972 regarding review of an airplane acquisition proposal made by the Secretary of the Navy to the Chairmen of the House and Senate Appropriations Committee.

The Navy's original proposal envisioned modernization of the Naval Reserve Aviation program through replacement of 30 propeller-driven aircraft with fan-jet transports. The Navy's proposal was reviewed in detail over a period of several months. The uniqueness of this method of acquisition through a maintenance/training/supply annual contract and the lack of precedent for it prompted the Navy, with approval of the Department of Defense, to seek congressional review of this unprecedented approach. I wish to emphasize that the basic purpose of presenting the proposal to the committees was to obtain their views on the proposed method of acquisition. The number of aircraft to be acquired was not to be addressed since addressal of a specific number was not considered necessary in assessing the method of acquisition. Assuming the validity of the Naval Reserve VR program, we are seeking modernization of the aircraft involved in it by a replacement of obsolete C-118 transports with modern fan-jet equipment. It is the position of the Office of the Secretary of Defense that this modernization program can be accomplished with no more than six fan-jet aircraft.

Our response to the questions you posed and views expressed in your letter is provided in the attachments. I trust this letter provides the information you requested.

Sincerely,

(Signed Barry J. Shillito)
BARRY J. SHILLITO
Assistant Secretary of Defense
(Installations and Logistics)

Attachments

How did the Navy determine that these aircraft will fit into the overall military requirements?

The Military Airlift Commands responsibility with respect to airlift is quoted in DoD Regulation 4500.32R as, "The Military Airlift Command (MAC) is responsible for air cargo from the time of acceptance of the shipment into the MAC terminal until released for onward movement at the destination air terminal. Theater Commands are responsible for the operation of the Theater Airlift System, which provides air logistic support within the theater." Title 10, United States code, Section 5012 states "...Naval Aviation consists of combat and service and training forces, and includes land based Naval operations...". The Mission of the Naval Air Reserve was amplified by Public Law 90-168 stating that the reserve forces will be structured in a manner that will provide compatability with the active forces in the event of mobilization. Hence, the desire to acquire jets with which the reserves would become familiar. The 30 C-118's currently being operated by the Naval Reserve provide air transport essential for Naval operations and theater lift to Naval forces. The fan-jet transport would replace the C-118's.

What are the Department of Defense views on the need for these aircraft to provide this increased airlift capability?

We are not basically seeking "increased airlift capability": we are seeking modernization of Naval Reserve transport equipment and this proposal seemed to offer a unique possibility of acquiring such modernization. The authorized mission of Naval aviation and the Naval Air Reserve is to provide air transport essential for Naval operations. Currently the Naval Air Reserve is operating 30 C-118 transports in performance of its mission. Assuming the validity of need for those aircraft, the same need could then be assumed to exist for the fan-jets which would replace these obsolescent transports.

If additional airlift capability is needed, does the Department of Defense consider the Navy proposal to be the most economical means of obtaining such capability, giving consideration to alternative means of fulfilling these needs?

The purpose of the Navy's original proposal was to seek replacement of 30 propeller driven aircraft with fan-jet transports. The Navy considered that 12 aircraft were required to provide a practicable approximation of the service being provided by the 30 propeller aircraft being replaced. Our review indicated that six fan-jet transports would provide replacement of the existing capability. Accordingly, the Navy was authorized to seek Congressional approval of this method of acquisition. We did not perform a review based on providing additional airlift capability to the Naval Reserves. We assumed an approximate equal replacement of capability, and the cost data provided by the Navy suggested that this method of acquisition was sufficiently economical to pursue it. This method of acquisition could be judged on a comparative cost basis with other methods only after receipt of a firm proposal from a contractor. When and if this acquisition method meets with Congressional approval, such a comparison would be made and would be subject to DOD approval before the Navy would be authorized to proceed with contract award. We would not approve contracting if the proposal were found to be uneconomical.

Are there legal bases for the transaction proposed by the Navy?

The following statement represents the legal bases for the transaction as prepared by the Navy:

On February 7, 1972 the Secretary of the Navy presented a proposal to the Honorable George H. Mahon, Chairman of the Committee on Appropriations of the House of Representatives which would provide for the replacement of the present Navy Air Reserve fleet of old propeller-driven aircraft with modern fan-jet aircraft presently owned by various airlines. As stated in the proposal presented, the planes of the airlines would be transferred to the Navy for their use without any cost for the fan-jet aircraft itself, provided that the Navy on an annual basis obtains the maintenance, support and modification of the planes with options to continue this arrangement over ten years, subject to a declining cancellation charge if the option is not exercised in any year. The question has been raised as to the legality of the proposed arrangement which permits the Navy to obtain the aircraft through the use of its maintenance and operation appropriation.

Basically, the aircraft as currently used by the airlines will be conveyed to the United States subject to the continued maintenance, support and modification that the aircraft would have received had the airlines continued to operate the aircraft over the next ten-year period. This pattern of maintenance, support and modification is consistent with the standards of maintenance, support and modification established by the manufacturer of the aircraft for their safe and economic use throughout the life of the aircraft. In addition, the planes will be modified to meet the requirements peculiar to their military use as a part of the Naval Air Reserve Fleet Logistics Support squadrons.

The aircraft will be delivered to the Navy for their use either in modified form or subsequently modified depending upon what the modification requirements are at the time of delivery. The payment for the modifications will be amortized on a straight-line basis as a part of the annual charge provided in the maintenance, support and modification agreement. Such amortization will be accomplished over a ten-year period. If the Navy does not renew the agreement in any particular year, then the unamortized modification costs will be reimbursed to the airlines in the form of a cancellation charge.

The Comptroller General ruled on a proposal similar in purpose and legal aspects to the proposed arrangement with the airlines. In 8 Comp. Gen. 654 it is stated that the United States Veterans Bureau requested a decision on a proposal covering an annual contract for water service from the Town of Lexington, Mass. which had options renewal for 25 years. To furnish this service, the town was required to make certain installations of equipment to be financed by a bond issue to be amortized over a 25-year period. A minimum usage of service was prescribed. If there was a failure to renew the service contract, then the Veterans Bureau would be required to pay the unamortized debt service to the Town of Lexington as a "cancellation" charge.

The Comptroller General stated that "there appears no legal prohibition to entering into the agreement, provided the appropriation under which expenditure for the water may lawfully be made is adequate to permit the setting aside of a sum sufficient to meet the obligation which would arise under the agreement in the event the option to renew should not be exercised, it being understood that the proposed arrangement is based upon the needs of the hospital for the water, and that the town can not be required to furnish the same without being insured a proper return on its expenditure."

The arrangement contemplated with the airlines is similar to the arrangement made with the Town of Lexington. The airlines must keep their maintenance and training organizations at operating levels well above current airline operations as pointed out in the letter to Mr. Mahon. To effectively employ their maintenance and training organizations, they are prepared to transfer aircraft to the Navy provided that such aircraft are serviced by their organizations. No charge will be made for the aircraft except for modifications necessary for Navy use. The airlines will not transfer the aircraft which are related in structure and required maintenance practices to their existing organizations unless they will be assured of their continued employment as a part of a sustained operating level over a period of years. Spreading the modifications costs over a ten year period on a level basis as a part of a maintenance and support contract provides an incentive to continue to use their maintenance and training facilities provided that a cancellation charge for unamortized costs can be charged in the event the contract is not renewed.

The current appropriation available to the Navy for the operation and maintenance of aircraft is the appropriation "Operation and Maintenance, Navy". In addition to being available for operation and maintenance, it is also available for modification of aircraft.

In addition, the appropriation "Procurement of Aircraft and Missiles, Navy" is also available for modification of aircraft. The modification obtained through an annual service contract would appear to be lawfully available to pay the annual level charge for modification to the transferred aircraft. The cancellation charge, if necessary, could be paid from the Operation and Maintenance, Navy appropriation or from the Procurement of Aircraft and Missiles, Navy appropriation if the reprogramming requirements of the Committees are met.

The aircraft will be transferred to Navy as a part of the maintenance and support effort. This will introduce aircraft into the Navy for use by the Reserve Forces without using the procurement appropriations which require authorization to appropriate under the annual Armed Forces Appropriation Authorization Act (Section 412(b) of Public Law 86-149). The maintenance and support contract is the means by which the Navy gains the ownership and use of the aircraft without any cost of acquisition being assigned to the price being charged for the work to be done under the contract. The contract is not a lease-purchase arrangement since no part of the annual price charged is allocated to acquisition of aircraft. Unlike a lease-purchase arrangement, title to the aircraft passes to the Navy at the time of delivery. This title obtained at no cost which is much less than the cost of leasing the aircraft from the airlines. The cost of leasing any aircraft is payable from the same appropriation available for the maintenance and operation of aircraft.

Within the concepts accepted under 8 Comp. Gen. 654, there appears to be no legal prohibition to entering into the maintenance, support and modification arrangement as proposed.