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

DIVISION OF FINANCIAL AND
GENERAL MANAGEMENT STUDIES

JUL 1? 1975

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The Honorable
The Secretary of Defense

Dear Mr. Secretary:

We evaluated the tariff rate structure used by the industrially funded Military Sealift Command (MSC) to determine whether the rates charged customers were commensurate with the cost of services provided. We limited our survey to the tariff structure used for recovering costs for sealifting cargo.

Our observations of the MSC tariff structure are similar to those discussed in our report to the Congress entitled "Increased Use of Financial Data and An Improved Tariff System Needed by the Military Airlift Command (MAC)" (B-133025, January 5, 1972). In this report, we pointed out that MAC was not charging its customers for channel airlift services rendered on the basis of their cost and that this cost information was needed to prudently manage and use airlift services. After we issued the report, your office requested the Air Force to revise airlift tariffs so that revenues produced by each airlift channel would approximate the cost of providing that channel's service.

Details of our observations on the MSC tariff structure follow.

THE INDUSTRIAL FUND AS
A MANAGEMENT TOOL

Industrial funds have been established to encourage better management by creating an environment similar to that of private industry. Under the industrial fund concept, customers pay for the services received as they would when buying from commercial firms; they are thus motivated to order only those items and services for which there is a real need.

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Industrial fund managers are expected to control and account for the costs of services furnished. The law (10 U.S.C. 2208) provides that working capital funds shall be charged with the cost of services or work performed and shall be reimbursed from available appropriations or shall be otherwise credited for these costs. Further, Department of Defense Directive 7410.4 states that industrial funds should

> "* * *provide meaningful bills to ordering agencies, clearly relating the goods and services furnished by a performing activity to the charges rendered, causing the ordering agencies to assess their procurement practices and specifications in full awareness of costs involved."

To insure that the amounts charged to customers approximate the cost of services, industrial fund managers must periodically determine the cost of services provided and adjust the charges accordingly.

MSC TARIFF RATES ARE NOT COMMENSURATE WITH THE COST OF SERVICES PROVIDED

Although MSC tariff rate schedules quote different rates on a traffic-area-to-traffic-area basis, the rates are not commensurate with the cost of services provided by route.

In a September 24, 1974, letter to us the Assistant Secretary of Defense (Comptroller) indicated that the MSC accounting and billing system was not structured to identify the costs of specific shipments to various parts of the world. The Assistant Secretary further stated that the MSC tariff structure tried to approximate route operating costs through using distance/cost and commodity/cost factors. We found, however, that these factors were not adequate for approximating costs by route.

In establishing tariff rates for its cargo operations, MSC attempts to recognize the relationship between distance and cost by using a graduated mileage rate computation table. The figures in the table, however, are not based on cost data, but have been arbitrarily established using a base rate of $.0 per mile for the first 100 miles. The base rate is then reduced for longer distances so that a shorter voyage never costs more than a longer voyage, while providing for lower per mile costs for longer voyages. The rate computation table thus represents only a mathematical relationship and is not supported by costs.

The rate based on distance is adjusted by commodity cost factors which have been developed in an attempt to reflect in the tariff rates the difference in cost of moving various commodities, such as ammunition and household goods.

In a report issued December 3, 1974, the Naval Audit Service pointed out that the rate structure by commodity should be revised because the commodity cargo mix had changed. Our analysis of the cargo mix confirmed an appreciable change since the commodity cost factors' latest revision in August 1972, as shown below.

Changes in Commodity Mix for Shipments from Fiscal Year 1972 to 1974

Commodity	Percent of Cargo 1972	Percent of Cargo 1974	Relative change in percent
Bulk	15.1	6.4	- 57.6
Privately-owned vehicles	5.4	10.8	+100.0
Reefer	2.7	4.4	+ 63.0
Ammunition	8.6	8.4	- 2.3
Household goods	6.0	5.1	- 15.0
General	43.8	48.5	+ 10.7
Special	16.4	15.8	- 3.6
Miscellaneous	2.0	.6	- 70.0
	100.0	100.0	

Because the mileage rate computation table is not supported by costs and because the commodity cost factors are outdated, we believe that the tariff rates used do not adequately approximate operating costs between specific traffic areas. This may result in revenues for total service over a particular traffic route that are considerably greater or less than the cost of providing services.

Furthermore, military service officials, in requesting transportation services, are not aware of the full cost to the Government. For example, during fiscal year 1973 MSC made more than 50 voyages over a route which starts at Cape Kennedy, provides for stops at Caribbean Island installations, and returns to Cape Kennedy. Using available cost data, we estimate that it cost about $650,000 to provide this service; the amount billed the customer by MSC, based on the published tariff rates, was about $250,000--a $400,000 difference.

Our report to you on transportation activities in Europe (B-181719, September 3, 1974) further illustrates this problem. The report describes a case in which an Air Force nonappropriated fund activity shipped wine from Portugal to Turkey. MSC paid freight charges of over $3,900 for the shipment. Using the tariff rate, MSC billed the Air Force nonappropriated fund activity $970--a loss of $2,900.

MSC officials informed us that they were interested in operating on a break-even basis at the service class level (e.g., cargo, petroleum, and passenger service) and that they were not concerned that some route operations cost more than the revenues generated.

The law (10 U.S.C. 2208) provides that working capital funds shall be reimbursed from available appropriations for the cost of services or work performed. Our legal analysis of this section and its legislative history indicates that tariffs are required which more accurately reflect true costs rather than merely fix a world-wide rate that recovers, by class of service, total operating costs.

During the hearings on the bill enacted as Public Law 216, 81st Congress, from which the provisions of 10 U.S.C. 2208 were derived, a representative of the Office of the Secretary of Defense stated that a working capital commercial-type operation must pay for its labor and material in the same manner as would a private manufacturing or commercial concern, should evaluate the job's cost, and should bill the cost to the organization that ordered the work. This official believed that in this way the Department of Defense would be able to economize by focusing attention on the cost of the work to be done.

When 10 U.S.C. 2208 was enacted, the techniques of cost accounting were more fully developed for manufacturing and selling activities than were techniques for costing transportation services. It is clear, however, that the Congress contemplated accurately estimating the cost of goods and services; therefore, when valid cost-finding techniques are available, they must be used. We believe that in the absence of precise methodology for assigning costs on a job-order basis, the MSC rate structure should return recoverable cost of particular traffic patterns or service elements as a minimum acceptable requirement.

According to officials of the Federal Maritime Commission, private carriers doing business with MSC are required to make available to the Commission actual cost data by traffic route. These officials told us that to insure equitable costing and to assist the carrier in identifying his traffic route costs, the Commission has devised accounting procedures and policies governing cost measurement and allocation.

NO ATTEMPT MADE TO DETERMINE COSTS BY TRAFFIC ROUTE

MSC has not made a detailed study to determine the feasibility of accumulating costs by traffic route. MSC officials stated that they were not concerned that some route operations cost more or less than revenues recovered through using tariff rates, as long as total revenues equal total costs incurred by class of service. They also said that as the single manager for ocean transportation, MSC is generally required to provide sealift services whenever and wherever the customer desires, regardless of cost.

Although military requirements may be the overriding factor in deciding to provide specific sealift services, evaluating and considering cost is necessary for effective management, which is one of an industrial fund's primary objectives. MSC management should know the cost of providing customer services over specific traffic routes and the customer should be fully aware of the cost consequences of his decisions. Further, since MSC provides services as required, those services bearing excessive costs should be identified so that your office can take action to reduce costs.

In this connection we noted that after issuing our report on MAC, your office took the following position in a memorandum to the military services dated June 21, 1972.

> "In our view the optimum method by which the current proliferation of channel service can be ameliorated while still recognizing the military essentiality of some special channel services is to make each channel cost-effective so that each Military Department can make its own determination to request and pay for that special airlift service it considers essential and to forego that specialized service not really required. It is expected that if MAC tariffs are revised so that the revenues produced by each channel closely approximate if not precisely equal the cost of providing that channel service, the Military Departments will have a sound basis for management decision * * *."

Our report on the MAC tariff system received congressional attention. The Special Subcommittee on Transportation of the House Armed Services Committee held hearings in August 1972 to discuss the MAC tariff system. These hearings grew out of questions from previous hearings held by the Subcommittee in March 1972. A major issue in the March 1972 hearings was that MAC's specific airlift service charges to the Army were not commensurate with the cost of providing these services.

CONCLUSIONS

MSC's tariff rates are not commensurate with the cost of services provided on a route basis. As a result (1) customers are not aware of the costs incurred in satisfying their requirements and (2) MSC management and your office are not provided adequate cost information regarding sealift route services.

We are not taking a position that customer billings must equal costs for each voyage. We believe, however, that 10 U.S.C. 2208 requires that MSC's tariffs be more in line with actual costs on a route basis.

RECOMMENDATIONS

We recommend, therefore, that you direct the Navy to establish a task force to identify and evaluate alternative approaches and methods for developing rates which are reasonably commensurate with the cost of providing sealift services on a traffic route basis. This task force should consider the potential applicability of the Federal Maritime Commission cost accounting standards to MSC operations.

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We would appreciate receiving your comments and being advised of any actions taken or planned concerning the matters discussed in this report. We will be glad to discuss these matters with you or your representatives.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House and Senate Committees on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

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We are sending copies of this letter to the Senate and House Committees on Appropriations, Government Operations, and Armed Services; and to the Subcommittee on Defense of the Senate Appropriations Committee. Copies are also being sent to the Director, Office of Management and Budget; the Administrator, General Services Administration; the Assistant Secretary of Defense (Comptroller); the Assistant Secretary of Defense (Installations and Logistics); and the Secretaries of the Navy, Army and Air Force.

Sincerely yours,

D L Scantlebury

D. L. Scantlebury
Director