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**Testimony**

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Subcommittee on Legislation and National Security  
House of Representatives

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**ENVIRONMENTAL  
CLEANUP**

**Unresolved Issues in  
Reimbursements to DOD  
Contractors**

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Mr. Chairman and Members of the Subcommittee:

I am here today to discuss Department of Defense (DOD) reimbursements to contractors for their environmental cleanups. Specifically, I am providing updated information from our work on cleanup costs for the largest defense contractors and issues related to our case studies of reimbursements to three contractors.

### RESULTS IN BRIEF

Before I discuss the specifics of our work, I will give you an overview of the key issues.

- First, 15 of DOD's largest contractors estimate that their future environmental cleanup costs will total \$2.1 billion. Much of this amount could apply to non-government business, but DOD's liability could be substantial. Because DOD does not routinely collect information on its projected costs from these contractors, it cannot properly budget for future costs of DOD's contracts for products and services.
- Second, although DOD has said that contractors do not receive profits on their reimbursements, in some cases DOD has included such profits.
- Third, DOD is also beginning to pay for contractors' cleanup costs directly. In one case, the Navy agreed to indemnify contractors for cleaning up hazardous material. The Army has similar clauses in other contracts, thus creating the potential for additional cleanup cost liabilities.

### CLEANUP COSTS AND DOD REIMBURSEMENTS AT THE TOP 15 DEFENSE CONTRACTORS

Defense contractors responsible for cleaning up sites used for the production of military goods may be able to pass some of the cleanup costs to DOD. These costs may cover activities like site investigations, site cleanups, remediation, mitigation of existing damage, capital purchases, and legal counsel. The 15 largest contractors have developed estimates of past and future costs for their cleanups. These estimates represent costs for both government and nongovernment business activities.

The 15 contractors' individual estimates of past costs ranged from \$5.4 million to \$423 million and totaled \$995 million. The 15 contractors' individual estimates of future costs range from \$1.1 million to \$710 million and total \$2.1 billion. We reported in our June 1992 report,<sup>1</sup> that 10 of these contractors had

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<sup>1</sup>DOD Environmental Cleanup: Information on Contractor Cleanup Costs and DOD Reimbursements, GAO/NSIAD-92-253FS, Jun. 26, 1992.

estimated about \$300 million in past cleanup costs, and 9 had estimated about \$1 billion in future costs. Because estimates of future cleanup costs may be affected by changing environmental laws, cleanup standards, and technology, they generally cover only 2 to 4 years. Four of the contractors estimated cleanup costs of \$285 million over terms of 20 to 30 years.

Seven of the 15 contractors reported that they had asked DOD to reimburse them \$133 million for their cleanup costs. In June we reported that four of the 15 contractors had requested a \$59 million reimbursement. Although the other eight contractors have not yet asked DOD to reimburse them, two said they planned to seek reimbursement, and the other six have not ruled out the possibility that they will also seek reimbursement.

### INCONSISTENT INTERIM REIMBURSEMENT PRACTICES

In our October 1992 report<sup>2</sup> we discussed four of the nation's highest priority sites to be cleaned up under the Comprehensive Environmental Response, Compensation, and Liability Act, commonly known as Superfund. In these four cases, DOD's decisions on environmental cleanup reimbursement claims varied on whether and how much to reimburse contractors. In particular, we noted inconsistencies in the way DOD determined allowability of costs. For example, the contracting officer investigated potential violations of federal or state environmental laws and regulations in one case but not in the others.

The U.S. Environmental Protection Agency (EPA) is charged with implementing Superfund. Under this legislation, a party who contributes to the pollution of a site may be fully responsible to clean up the site whether or not it committed wrongdoing or was only one of many polluters. The parties that can be held liable for cleanups are present or past owners or operators of the contaminated sites, generators of hazardous wastes found on the sites, or transporters of hazardous wastes to such sites. Although neither Superfund nor the Federal Acquisition Regulation (FAR) specifically addresses cleanup costs incurred by government contractors, the FAR permits reimbursement of ordinary and necessary business expenses if the expenses are allocable, reasonable, and comply with contract terms and federal procurement regulations.

Of the four sites we reviewed, two were contractor-owned and -operated manufacturing sites, and the other two were disposal sites operated by third parties. Aerojet-General Corporation's

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<sup>2</sup>Environmental Cleanup: Observations on Consistency of Reimbursements to DOD Contractors, GAO/NSIAD-93-77, Oct. 22, 1992.

rocket testing and manufacturing site in Sacramento, California, and Lockheed Corporation's aircraft manufacturing site in Burbank, California, were contractor owned. The two Boeing Company sites--Western Processing and Queen City Farms--were owned and operated by third parties near Seattle, Washington.

### Sacramento Site

Aerojet is cleaning up soil and groundwater contamination caused by the use, storage, and disposal of hazardous substances at the site as far back as the 1950s. As of November 1991, Aerojet had spent \$75 million on site investigation and other preliminary cleanup activities. According to EPA estimation models, final cleanup could cost many times that amount. The cleanup should begin in 1996 and continue into the next century.

Under the standard for reasonableness of claims, the contracting officer for the Sacramento site denied Aerojet's claim for reimbursement of cleanup costs. The officer believed the standard required a contractor to comply with federal and state environmental laws and regulations for cleanup costs to be allowable. The contracting officer investigated the company's compliance and found evidence that Aerojet had violated state discharge permits.

Aerojet appealed the contracting officer's findings. During this appeal process, the Air Force negotiated a settlement with the company. The Air Force agreed to reimburse \$29 million of the \$62 million claimed through June 1989 for cleanup-related activities. According to the Air Force's trial attorney, notwithstanding Aerojet's alleged violation of state discharge permits, the Air Force agreed to this payment because of potential government liability. Among issues considered were whether Aerojet had been required to use hazardous substances under DOD contracts and whether Aerojet had been indemnified for environmental damage. The parties remain in litigation for costs after June 1989. The company believes that DOD should pay all cleanup expenses.

Furthermore, Aerojet received over \$5 million in cleanup cost reimbursements as a subcontractor with Martin Marietta, even though as a prime contractor Aerojet's claim for the same period was denied. Aerojet included cleanup costs as an overhead charge, which was accepted pending final determination of allowability under the prime contractor's DOD-approved purchasing system.

Aerojet obtained insurance reimbursements for legal and related fees. A claim for payment of cleaning costs went to court, where the jury found that Aerojet should not be reimbursed because it should have expected that its past disposal practices were causing pollution. Aerojet has appealed the decision.

## Seattle Area Sites

About \$101.3 million had been spent through mid-1992 to clean up soil and groundwater contamination caused from 1954 to 1977 at two off-site waste disposal and treatment sites used by Boeing and others. Studies are still in process at one site, and cleanup is about three-fourths complete at the other. Cleanup and monitoring efforts for the two sites are expected to continue into the next century. Boeing's current estimate of the future cleanup cost is about \$78 million.

The contracting officer for the Seattle area disposal sites did not independently investigate Boeing's reimbursement requests as was done for the Sacramento site. However, for early requests, he determined that the requests were for fines and penalties that by law or regulation could not be paid. Costs resulting from violations of federal, state, or local laws and regulations are unallowable, except when incurred as a result of contract compliance or written instructions from a contracting officer.

After additional inquiry regarding later reimbursement requests, including receipt of a copy of EPA consent decrees, which stated that Boeing's cleanup costs were not fines or penalties, the contracting officer agreed in 1987 that interim reimbursement would be appropriate. To date, DOD has reimbursed Boeing \$11 million to \$13 million<sup>3</sup> of the \$101.3 million. DOD's interim payments included an additional factor for profit because the cleanup costs were considered normal business expenses and were charged to certain overhead expense categories. The amount of profit paid would be difficult to calculate because the reimbursements related to a number of contracts and reflected the percentage of Boeing's overall government business.

Boeing sued its insurers and obtained partial coverage of cleanup costs. However, a 1990 court ruled that because Boeing "expected or intended" pollution to occur at the Western Processing site in 1971, but continued to use the site until 1977, Boeing and its insurance companies were jointly liable for cleanup costs. The Defense Contract Audit Agency (DCAA) notified Boeing that some of the 1971-77 costs may not be allowable, based on this ruling. Boeing protested this decision, stating that it was following accepted industry practices in using the disposal site and that several other businesses and federal agencies also used the site during the period. The contracting officer has not yet decided on this issue.

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<sup>3</sup>Boeing estimated federal payments at \$11.1 million through June 1992, while DCAA estimated those payments at \$13 million for the period 1984 through August 1992. According to DCAA officials, the difference in the estimates appears to be due primarily to assumptions about the mix of contract types.

## Burbank Site

As of May 1992, Lockheed had spent \$9 million to clean up soil and groundwater contamination at its Burbank facility. The contamination was caused over several decades through the use, storage, and disposal of hazardous materials used in manufacturing aircraft. Lockheed has completed site investigation work and is beginning to construct facilities to remove the contaminants from the groundwater. The cleanup of both groundwater and soil is estimated to be completed by the turn of the century and to cost about \$263 million.

The DOD contracting officer for Lockheed has not yet authorized an interim payment but has agreed to allocate allowable cleanup costs as general and administrative costs in overhead. In effect, the contracting officer has agreed to allow Lockheed to seek reimbursement but has reserved judgment on the allowability of the costs.

The Air Force had raised the issue of allocation of costs as a result of Lockheed's decision to move the major division working at the Burbank site to Georgia. The current agreement between the Air Force and Lockheed would allocate Burbank cleanup costs to all Lockheed business segments. DCAA, however, has stated in this case that the segment responsible for the contamination should absorb the costs of cleanup because that would more fairly allocate costs.

The contracting officer did not independently investigate potential wrongdoing with regard to the Burbank site and did not require Lockheed to pursue reimbursement from its insurers prior to submitting a claim for reimbursement to DOD. He intends to reduce Lockheed's claim for anticipated insurance recoveries.

The Burbank facility is located in an area of relatively high land values. Lockheed officials state that buyers have indicated interest, but that there are no active negotiations for purchase of the property.

## STATUS OF COST ALLOWABILITY GUIDANCE

The inconsistent practices followed in the above cases appear to be largely attributable to the lack of specific policy guidance on how to handle cost reimbursements for environmental cleanup. Contracting officers rely on general cost principles, statutes and regulations to determine the allowability of contractors' requests for reimbursement.

In the absence of specific provisions dealing with this subject, an environmental cost principle proposed by the FAR Council may provide guidance. This principle was developed by two FAR subcouncils comprised of representatives of defense and civil

government agencies. The principle would generally allow expenses to prevent pollution, but costs to correct damage would be unallowable unless a contractor demonstrated that it (1) performed under a government contract that contributed to the pollution; (2) acted prudently, complied with then-existing environmental laws and regulations, and followed generally accepted industry practices; (3) acted promptly to minimize the damage and costs; and (4) exhausted or was diligently pursuing such sources as insurance and other responsible parties to defray the cleanup costs. Like other cost principles, this draft primarily covered general considerations.

Although approved by the FAR Council's Defense Acquisition Regulation Council and the Civilian Agency Acquisition Council, the cost principle has not been released for public comment. A moratorium on new federal regulations was imposed by former President Bush in February 1992 and has continued under the current Administration.

DCAA gave its auditors additional guidance dated October 14, 1992, including the Director of Defense Procurement's determination that environmental costs should be treated as normal business expenses. The guidance states that such costs are generally allowable if they are reasonable and allocable, but not if the cleanup resulted from contractor wrongdoing, and discusses how to address insurance recovery and potential wrongdoing. The guidance to DCAA auditors was also provided as information for the DOD acquisition community on October 22, 1992.

#### MAJOR OPEN ISSUES REGARDING DOD REIMBURSEMENTS FOR CONTRACTOR ENVIRONMENTAL CLEANUPS

Three major issues raised in our prior reports dealt with the need for cleanup cost information, the allowability of profits for contractors seeking reimbursement for cleanup costs, and the consideration of all cleanup costs as ordinary business expenses.

#### Need for Data on Contractors' Cleanup Costs

In September 1992 DOD responded to our June 1992 report that it does not maintain centralized data on contractors' environmental costs. DOD said such data are not necessary or even helpful for properly determining the allowability of such costs.

Our report did not recommend specific DOD actions but stated that substantial amounts of cost data were available to DOD. We agree that determining allowability of individual claims does not require knowing total past and estimated future liabilities. However, our report emphasized the value of this information for management and oversight purposes. Data on past and future reimbursements of cleanup costs to contractors is important because of their



potential impact on product or service contract costs. Without this information, DOD and the Congress do not have complete information on the costs of systems or services procured.

#### Allowability of Profits for Contractors' Cleanups

DOD took exception to our reporting that Boeing received a factor for profit on its reimbursements for environmental cleanup costs and to our questioning whether Superfund reimbursements should permit allowances for profit. DOD said cleanup costs are normally accounted for as general and administrative expenses, which have not been fee-bearing, and thus did not allow a profit, under DOD's guidelines since 1987. Thus, DOD said such expenses have been explicitly excluded from consideration under its guidelines for developing profit objectives on negotiated contracts.

Our further analysis disclosed that Boeing and 6 of the 13 largest defense contractors currently charge prior-year cleanup costs to overhead accounts other than general and administrative expense. According to information provided by contracting officers, these costs include a factor for profit. In four cases, the contractors had reported reaching agreement with DOD on final cost settlements that included these costs.

In October 1992, DCAA issued its first specific instructions on accounting for cleanup costs in audit guidance to its field offices. The guidance calls for assigning the cleanup costs from contamination caused in prior years to the non-fee-bearing account cited by DOD. DCAA's program manager, Accounting Policy Division, said that one contractor has already questioned DOD's guidance and that if contractors decide not to comply, the issue will end up as a contract dispute to be settled by the Board of Contract Appeals.

#### Consideration of Cleanup Costs

DCAA's October 14, 1992, memorandum stated that the Director of Defense Procurement has determined that environmental costs should be treated as normal business expenses. According to DOD officials, payments in the selected case studies were treated as normal business expenses allocated to overhead.

However, we believe it is not clear that cleanup costs from contamination caused in prior years constitute normal business expenses. These costs often do not have any relationship to the products in current contracts and are often the result of strict liability provisions of environmental law, meaning that contractors may be liable for cleanup costs whether or not they were determined to be at fault. As a result, determining whether a contractor's cost can be reimbursed by the government can require considerable research.

In addition, in some instances, contractors' cleanup costs are not being paid through allocations to overhead, but are instead being considered for payment under contract terms which indemnify contractors for unusually hazardous risks. According to DOD's reports to the Congress, these indemnifications are intended for claims involving death, injury, or property damage arising from nuclear radiation; the use of high energy propellants; or other risks not covered by the contractor's insurance. DOD needs to expand its guidance to fully describe the types of situations that qualify for indemnification.

DOD officials told us that they knew of no cases where DOD had indemnified contractors for environmental cleanup and that such cases would be unusual. However, we found one case where the Navy agreed in advance to assume contractors' environmental cleanup costs. Also, the Army in some cases dealing with its ammunition plants has included indemnification clauses that could similarly result in DOD's assuming liability for contractors' environmental cleanup costs.

The Navy has agreed to pay claims under an indemnification clause in remediation of a low-level-radioactive waste disposal site at Maxey Flats, Kentucky. In that case, three Navy contractors were among parties who may be held liable for remediation of contamination at the disposal site. Navy officials stated that accurate cost data were not available but that potential liability is currently estimated at \$8 million to \$10 million. DOD officials stated that this action was not reported in DOD's 1992 report to the Congress because the exact amount had not been determined.

In a memorandum dated August 3, 1992, the Assistant Secretary of the Navy for Research, Development, and Acquisition determined that "it is appropriate to provide relief under the indemnification clauses of the contracts by assuming the contractors' share of the remediation." The memorandum states that the Navy has taken the place of the three contractors in negotiations with the Environmental Protection Agency.

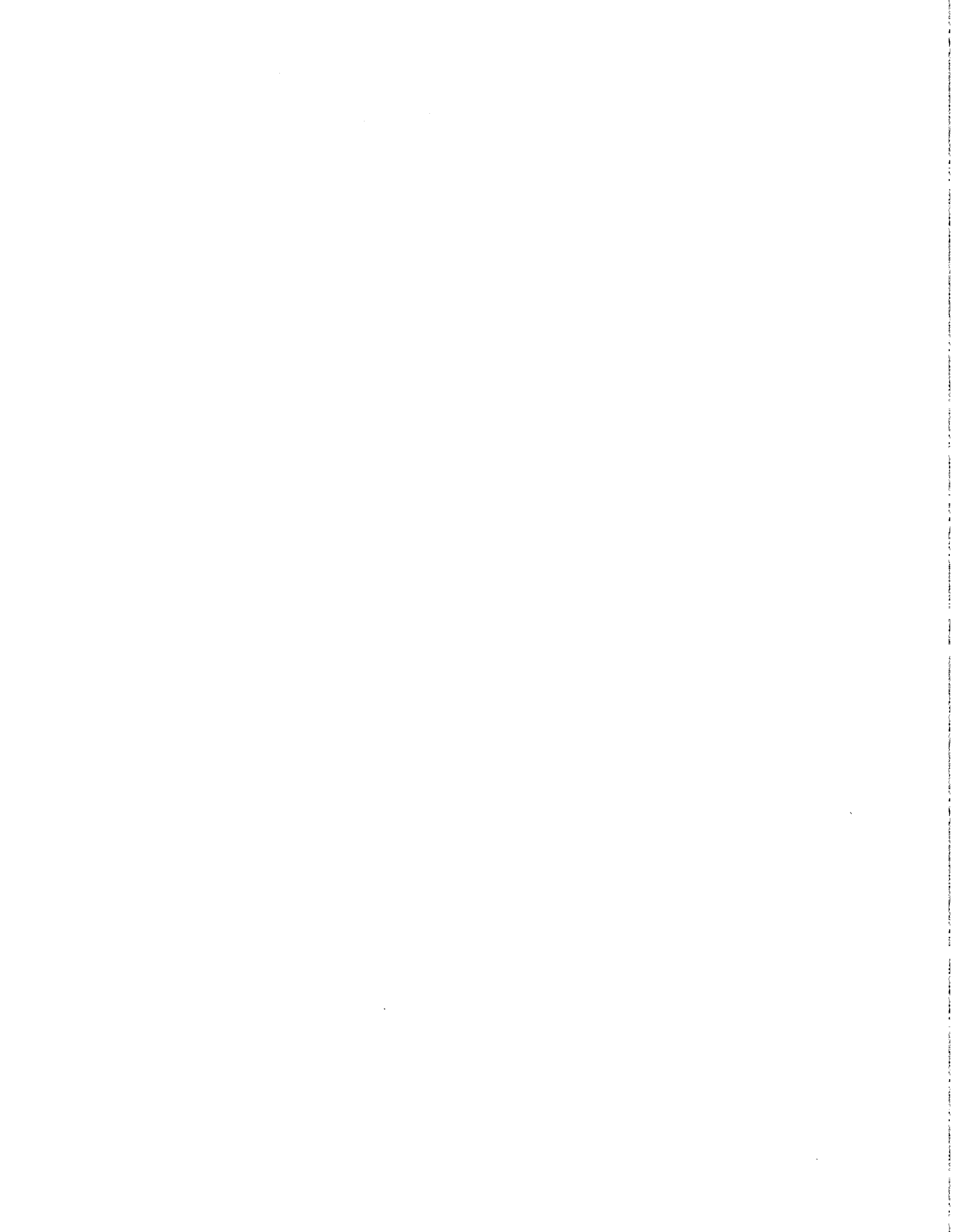
## CONCLUSION

In summary, I want to stress that reimbursement to contractors could represent substantial costs to DOD. However, DOD has not taken steps to gather estimates of these potential costs to assist in developing program budgets and to provide DOD managers and the Congress an idea of the future funding liabilities that may result from cleanup costs.

Also, DOD needs to develop and implement specific guidance on reimbursements to contractors for these costs including whether profits can be included for contractor cleanup costs. In addition DOD needs to expand its guidance to fully describe the types of

situations that warrant indemnification of contractors for environmental cleanup costs.

This concludes my statement, I will be glad to address any questions.



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