

September 1996

DEFENSE RESTRUCTURING COSTS

Projected and Actual
Savings From
Martin-Marietta
Acquisition of GE
Aerospace





United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-272422

September 5, 1996

The Honorable Strom Thurmond
Chairman
The Honorable Sam Nunn
Ranking Minority Member
Committee on Armed Services
United States Senate

The Honorable Floyd Spence
Chairman
The Honorable Ronald V. Dellums
Ranking Minority Member
Committee on National Security
House of Representatives

Section 818 of the National Defense Authorization Act for Fiscal Year 1995 (P.L. 103-337) restricts Department of Defense (DOD) payments of restructuring costs¹ associated with defense contractor business combinations. Specifically, it prohibits the payment of restructuring costs until a senior DOD official certifies in writing that projected savings from the restructuring are based on audited data and should result in overall reduced costs to DOD. In response to section 818, DOD issued interim regulations, effective December 29, 1994, on the allowability of restructuring costs.²

The act also calls for our office to periodically report on the implementation of these DOD regulations. We have already issued two reports on the subject.³ This report discusses the 17 restructuring projects proposed for payment by Martin Marietta Corporation,⁴ as a result of its

¹Restructuring costs cover a wide range of expenses, such as personnel relocations, severance pay, early retirement incentives, equipment relocations, plant rearrangements, and facility closings.

²DOD published the final regulation on restructuring costs in the Federal Register dated April 18, 1996. Differences between the interim and final regulations have no bearing on the matters discussed in this report.

³Defense Restructuring Costs: Payment Regulations Are Inconsistent With Legislation (GAO/NSIAD-95-106, Aug. 10, 1995) and Defense Contractor Restructuring: First Application of Cost and Savings Regulations (GAO/NSIAD-96-80, Apr. 10, 1996).

⁴Martin Marietta Corporation and Lockheed Corporation merged operations on March 15, 1995, to form the Lockheed Martin Corporation. We are using the former name—Martin Marietta Corporation—in the report because the merger with Lockheed Corporation had not taken place at the time the General Electric business segments were acquired.

acquisition of General Electric Company's aerospace business segments.⁵ DOD has certified 8 of the 17 projects. We reviewed in detail the first five projects certified, and our review indicated the other three projects are similar. The objectives of our review were to determine whether (1) the certification process for the five projects was carried out in accordance with the regulations, (2) the savings were in line with the original estimates, and (3) the restructuring resulted in lower DOD contract prices.

To avoid the disclosure of proprietary data, we do not discuss specific dollar amounts applicable to Martin Marietta Corporation's restructuring.

Results in Brief

Our review indicated DOD's actions to review and certify the first five projects complied with the restructuring regulations. As required by those regulations, the contractor submitted restructuring proposals for the projects, which were then audited; a senior DOD official certified that the audited projects should result in overall reduced costs to DOD; and finally, advance agreements⁶ were executed on the projects.

Documented savings from business combinations have not always been as great as initially expected. In the case of Martin Marietta Corporation's acquisition of the General Electric business units, estimated restructuring savings for the eight certified projects are less than half of the contractor's initial rough-order-of-magnitude estimates. This difference exists primarily because the contractor lowered its estimated savings at the time it prepared detailed restructuring proposals and DOD negotiated reductions in the proposed savings during the certification process.

Although certified savings are less than initially estimated, the contractor's overhead costs are lower as a result of savings from these projects. Consequently, the government official responsible for negotiating overhead costs and rates provided procuring activities with lower overhead rates for use in pricing DOD contracts.

Background

The Defense Contract Management Command (DCMC) has lead responsibility for implementing DOD's restructuring regulations and is currently tracking 32 defense contractor business combinations. For three

⁵The acquisition also included General Electric's government services operations.

⁶The advance agreements contain pertinent information about restructuring projects, including a description of the projects, estimated restructuring savings and costs, and the way that restructuring costs will be charged to contracts.

of these combinations,⁷ the Under Secretary of Defense (Acquisition & Technology) has certified an estimated net DOD savings of \$390.4 million. The Defense Contract Audit Agency (DCAA) has completed audits of restructuring proposals for three additional business combinations and is reviewing proposals submitted for four other combinations.

Martin Marietta Corporation entered into formal discussions with General Electric Company on October 30, 1992, to acquire its aerospace and certain other business operations. The acquisition was effective April 2, 1993, and combined two of the nation's leading aerospace research and development organizations. After the acquisition, Martin Marietta Corporation began restructuring the new organization by establishing 17 projects, which ranged from consolidating corporate headquarters in Bethesda, Maryland, to relocating and consolidating selected operations at its facilities in Orlando, Florida.

Of the original 17 projects, DOD eliminated 3 from consideration under section 818 because they involved normal internal downsizing efforts, unrelated to the business combination, or were not applicable to defense work. The Under Secretary of Defense (Acquisition and Technology) issued a certification of net benefit for five projects on September 19, 1995, and for three additional projects on February 14, 1996. At the time we completed our review, six projects remained to be certified.

DOD Actions Complied With Interim Regulations

Martin Marietta Corporation started its restructuring before the interim regulations were issued; nonetheless, DOD's actions to review and certify the five restructuring projects complied with the regulations. The regulations direct the administrative contracting officer, for example, to require the contractor to submit a restructuring proposal, request an audit of the proposal, and negotiate an advance agreement between the government and contractor. The regulations also require a senior-level DOD official to issue a certification of net benefit for the restructuring.

For the five projects we reviewed, Martin Marietta Corporation submitted proposals showing restructuring savings would result in a net reduction of projected overhead costs⁸ for the applicable business segments. DCAA reviewed the proposals and issued audit reports in March 1995. Through

⁷The three business combinations are United Defense, Martin Marietta Corporation-General Electric Aerospace (8 of 14 projects), and Northrop-Grumman.

⁸Costs such as facilities and equipment, general office support, and supervisors' salaries are typically classified as overhead costs, or indirect costs, because they are not directly assignable to a specific contract but benefit more than one contract.

negotiations with the contractor, the administrative contracting officer obtained agreement on most of the restructuring costs and savings DCAA questioned and recommended the net benefits be certified. On September 19, 1995, the Under Secretary of Defense (Acquisition and Technology) certified the net benefit for the five projects. After certification, the administrative contracting officer executed advance agreements for the projects containing the negotiated restructuring costs and savings, cost ceilings, and other pertinent information.

Savings Were Less Than Originally Projected

As part of the public announcements of new business combinations, defense contractors generally provide a rough-order-of-magnitude estimate of restructuring savings. Such estimates were discussed in congressional hearings leading up to enactment of section 818. The Deputy Secretary of Defense, for example, testified before a congressional subcommittee in mid-1994 that early estimates from four recently announced business combinations indicated that projected savings ranged from one and a half to seven times the projected cost. Later in those hearings, however, the Deputy Secretary told the subcommittee that savings on future business combinations could range from four to seven times the projected costs. In other words, for every dollar DOD invests in restructuring costs, it could realize savings of \$1.50 to \$7.00. Savings achieved on the two business combinations we reviewed fall on the low side of the Deputy Secretary's projection.

Restructuring savings resulting from Martin Marietta Corporation's eight certified projects are less than its initial rough-order-of-magnitude estimates. In its initial restructuring projection for the eight projects, Martin Marietta estimated that \$1.00 in restructuring costs would reduce overhead costs by \$2.73 for the first five projects and \$76.84 for the last three projects. These projected reductions in overhead included both the contractor's and DOD's share.

After the projects were certified, \$1.00 in restructuring costs was projected to reduce overhead costs by \$2.41 for the first five projects and \$8.02 for the last three projects. These reductions also included both the contractor's and DOD's share. Certified savings for the first five projects were therefore about 88 percent of the contractor's original estimates, but certified savings for the last three projects were only about 10 percent of the original estimates.

When considering all eight projects together, \$1.00 in restructuring costs was originally projected to reduce overhead costs by \$5.24. After certification, \$1.00 in restructuring costs was projected to reduce overhead costs by \$2.57, which represents only about 49 percent of the contractor's original projection.

Projected savings are lower than initially estimated because the contractor reduced its projection of savings when it prepared detailed restructuring proposals for the projects. Also, DOD negotiated reductions in the contractor's proposed restructuring savings during the certification process. For example, the government negotiator did not categorize the elimination of General Electric's corporate overhead costs as restructuring savings in the project where the contractor proposed to do this because the elimination resulted from the business combination itself and not from actions taken after the combination. The contractor agreed to the negotiator's categorization on a nonprecedence-setting basis in order to proceed with the certification process.

This project comprised \$2.42, or about 46 percent, of the \$5.24 reduction in overhead costs the contractor initially projected for the eight projects, but it comprised only \$0.04, or about 2 percent, of the \$2.57 certified reduction in overhead costs. While most of the proposed savings from this project were not accepted by the government as restructuring savings, the contractor contended the government would still realize savings from the elimination of General Electric's corporate overhead.⁹

The history of the first eight projects certified, coupled with the fact that the United Defense restructuring¹⁰ achieved savings of less than 15 percent of the original estimate,¹¹ shows that certified savings have been considerably less than initially estimated. These results are consistent with the Federal Trade Commission staff's conclusion that mergers do not

⁹The amount of government savings from eliminating General Electric corporate overhead would depend on a number of factors, including the number of contracts transferred to Martin Marietta that were fixed price versus cost, length of the remaining performance periods of the contracts, and the amount of government sales at the business segments where the contracts were transferred. The contractor agreed these factors would reduce the amount of savings the government would realize. Neither we nor DCAA estimated the impact of these factors because the savings were not categorized as restructuring savings.

¹⁰We reported on the United Defense business combination, the first to be officially certified for payment, in *Defense Contractor Restructuring: First Application of Cost and Savings Regulations* (GAO/NSIAD-96-80, Apr. 10, 1996).

¹¹Several factors accounted for the difference between the original and certified estimate of restructuring savings in the United Defense business combination, including the use of different cost elements for estimating purposes, different time periods for savings, and a rough-order-of magnitude estimate versus a detailed cost proposal.

consistently produce the predicted efficiencies. The Commission's staff reached this conclusion after examining the empirical literature on the results of mergers in general.¹²

Restructuring Contributed to Lower Contract Prices

Although restructuring savings are less than initially estimated, the contractor's projected overhead costs are lower at the business segments where the five restructuring projects are being executed. For every dollar in restructuring costs for these projects, the contractor reduced DOD's share of projected overhead costs by \$2.01.¹³ The reduction in projected overhead costs is reflected in lower overhead rates for these business segments, and the lower overhead rates have been provided to procuring activities for use in pricing DOD contracts. When the procuring activities use the lower rates, DOD's contract prices will be lower than they would have been had it not been for the restructuring under these five projects.

Agency Comments

In commenting on a draft of this report, DOD concurred with the report. DOD suggested several clarifications in the report, and we have incorporated them in the text where appropriate. DOD's comments are presented in their entirety in appendix I.

Scope and Methodology

We made a detailed examination of the first five certified restructuring projects because they were the only projects certified when we began our review. Also, these five projects are representative of the other three projects that were certified after we initiated our work. In addition, the other three projects were subjected to the same certification process as the five projects we reviewed in detail, and DOD's actions complied with the same four major elements of the process.

To determine whether the process for the first five projects certified was carried out in accordance with DOD's interim regulations, we used a twofold approach. For those actions taken before the regulations were issued, we determined whether the actions met the intent of the regulations. For actions that had not taken place, we compared the execution of the actions with the specific requirements of the regulations. In doing this work, we examined the restructuring proposals, audit

¹²Anticipating the 21st Century: Competition Policy in the New High-Tech, Global Marketplace, Federal Trade Commission Staff, May 1996.

¹³DOD's share of restructuring savings will vary between the project and business segment based on the total dollar value of DOD's contracts in relation to the total dollar value of all other contracts, including commercial and direct foreign sales.


reports, negotiation memorandums, advance agreements, correspondence, the net benefit certification, and other related documents and records.

To determine whether the projects resulted in lower DOD contract prices, we traced the savings in the contractor's overhead cost proposals and determined that proposed overhead costs were lower than they would have been had the restructuring not occurred. We also determined that the recommended overhead pricing rates were based on the lower overhead costs and that the lower rates were provided to procuring activities for use in pricing DOD contracts. In making these determinations, we examined the contractor's overhead costs proposals, the results of DCAA's audits of the proposals, the recommended overhead pricing rates, and other related documents and reports.

We discussed various aspects of the restructuring activities with officials from Martin Marietta Corporation, the Office of the Director of Defense Procurement, DCMC, and DCAA. We performed our review between December 1995 and June 1996 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Chairmen of the Senate Committee on Government Affairs, the House Committee on Government Reform and Oversight, and the Senate and House Appropriations and Budget Committees; the Secretaries of Defense, the Army, the Air Force, and the Navy; the Commander, DCMC; the Director, DCAA; and the Chief Executive Officer, Lockheed Martin Corporation. We will provide copies to others upon request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. The major contributors to this report were John K. Harper, George C. Burdette, and Stacey E. Keisling.



David E. Cooper
Associate Director
Defense Acquisitions Issues

Comments From the Department of Defense



ACQUISITION AND
TECHNOLOGY

DP/CPF

OFFICE OF THE UNDER SECRETARY OF DEFENSE

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July 25, 1996

Mr. David E. Cooper
Associate Director, Defense Acquisitions Issues
National Security and International
Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Cooper:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report GAO/NSIAD-96-191 "DEFENSE RESTRUCTURING COSTS: "Projected and Actual Savings from Martin-Marietta Acquisition of GE Aerospace," dated July 3, 1996 (GAO Code 705127, OSD Case 1184).

The DoD concurs with the report, with the following exceptions concerning the section entitled "Savings Were Less Than Originally Projected." In the first paragraph of the section, the report states that the Deputy Secretary of Defense testified at a congressional hearing leading up to enactment of Section 818 that restructuring savings could range from four to seven times projected restructuring costs. This statement is incorrect. According to the official opening statement dated July 27, 1994 (copy attached), the Deputy Secretary of Defense said "Based on the rough data we have seen so far in four restructurings occurring after an acquisition or merger, the projected savings range from one and a half to seven times the projected costs" (emphasis added). In other words, for every dollar DoD invests in restructuring costs, it could realize net savings from \$1.50 to \$7.00. When compared to the Deputy Secretary's official statement, the reported estimated net savings of \$1.57 (\$2.57 gross savings) for every dollar DoD invests in restructuring costs resulting from the eight projects of the Martin Marietta acquisition of GE Aerospace falls within the range of anticipated savings.

In the last paragraph of the section, the report refers to the prior GAO report on restructuring costs for the United Defense business combination and states that certified savings were less than 15 percent of the original UDLP estimate. This statement is irrelevant to the subject Martin Marietta review and should be eliminated or, if included in the final report, it should be clarified by providing the reasons for the difference.



Appendix I
Comments From the Department of Defense

We believe the GAO conclusion that documented savings from business combinations have not always been as great as expected is misleading (as stated in paragraph two of "Results in Brief" section). The conclusion is based on a comparison of cost and savings data provided in contractors' detailed restructuring proposals at the time of certification versus their initial rough-order-of-magnitude projections. Section 818 of PL 103-337 required that projections of future cost savings resulting for DoD from the business combination be based on audited cost data and should result in overall reduced costs to DoD. We believe that the restructuring advance agreements certified to date are in full compliance with statutory requirements and are resulting in the savings expected at the time those certifications were made.

Sincerely,



Eleanor R. Spector
Director, Defense Procurement

Attachment

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