

REPORT BY THE

RELEASED

Comptroller General

OF THE UNITED STATES

Improved Analysis Needed To Evaluate DOD's Proposed Long-Term Leases Of Capital Equipment

This report responds to congressional concerns about DOD's long-term leasing of capital type equipment, such as noncombatant ships and aircraft. Specifically, this report addresses the

- magnitude and apparent increase in long-term leasing,
- reasons the services would rather lease than purchase this equipment,
- potential effect of long-term leasing on military capabilities,
- adequacy of the lease versus purchase economic analyses,
- need for full disclosure of long-term leasing costs, and
- need for legislative and administrative changes to improve congressional oversight of long-term leasing programs.

GAO recommends that permanent legislation be enacted which requires an agency to provide key congressional committees with an economic analysis based on prescribed criteria. The analysis should show the total cost to the Government--not just the cost of leasing or purchasing to the acquiring agency. GAO also recommends that the agency obtain congressional authorization before entering into long-term leasing programs financed with working capital funds.



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

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The Honorable Jack Brooks
Chairman, Committee on Government Operations
House of Representatives

The Honorable Charles B. Rangel
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

The Honorable Ted Stevens
Chairman, Subcommittee on Defense
Committee on Appropriations
United States Senate

The Honorable William Proxmire
United States Senate

You requested that we review the practices and procedures followed by the Government in its long-term leasing of capital equipment. ^{1/} As arranged with representatives of your offices, we limited our efforts to those long-term leasing programs the Navy and Air Force have announced for noncombatant auxiliary cargo (TAKX) and tanker (T-5) ships and trainer (CT-39 replacement) and Tanker Transport Bomber (TTB) aircraft. The specific questions you asked us to address and our responses are synopsized below. Further details on these matters are discussed in appendix I.

Question

What is the magnitude of long-term leasing of capital assets in the Federal Government?

GAO response

Information on the magnitude of long-term leasing was not readily available for the Federal Government as a whole. However, the Department of Defense (DOD) plans to increase long-term leasing of assets, such as ships and aircraft, over the

^{1/}The terms long-term leasing and capital equipment have not been specifically defined. We consider long-term leases to be those leases covering 5-years or more, including option periods, and capital equipment to be major end items of equipment used to carry out an agency's mission. In this report, we consider the term "lease" as covering all contracts for the hire of capital equipment to include all vessel charters.

next few years. The planned TAKX and T-5 ships and CT-39 replacement aircraft leases and the TTB aircraft leases under consideration will cost about \$7.9 billion over the life of the leases, which range from 8 to 25 years.

The Air Force has not leased aircraft on a long-term basis. On the other hand, the Navy does lease ships and had 70 ships under lease as of February 1983. The length of the leases for 38 ships ranged from 5 to 10 years. For 12 ships, the leases ranged from one trip to 1 year. Information about the cost or length of leases for the other 20 ships was not readily available. According to Navy officials, the lease costs for the 20 ships would be minimal. However, for the 50 ships for which the information was available, lease payments will total about \$1.1 billion over the length of the leases. (See app. I, p. 3.)

Question

What are the reasons for leasing as opposed to purchasing the ships and aircraft?

GAO responses

The Navy and Air Force would rather lease than purchase these types of assets because of the perceived inability to obtain procurement funds for noncombat ships and aircraft. We agree that monies to purchase noncombatants are more difficult to obtain, because at various budget review levels the tendency has been to delete requests for funds to purchase noncombatants.

Other reasons given by the services for wanting to lease rather than purchase include the need to maintain industrial base capability for mobilization purposes and significant concessions granted by labor unions.^{2/} With respect to maintaining an industrial base capability, the Navy believes that it has a responsibility to rely on the merchant marine industry, to the extent possible, to provide cargo carrying services. Furthermore, the Navy contends that leasing rather than purchasing the TAKX and T-5 ships will enable certain shipyards to remain open and will create or retain numerous

^{2/}The maritime labor unions agreed to a reduction in ship crew sizes, a freeze on labor rates for a 2-year period, and a reduction in crew member vacation time from 6 months to 3 months. The shipyard labor unions agreed to a freeze on wage rates, certain work rule changes that allowed more cross-crafting, and redefined overtime periods.

merchant marine and shipyard jobs. In our opinion, if the ships were purchased, the same industrial base capability and labor concessions would probably have been realized.

The services have also represented leases as cost-effective ways to acquire the use of these assets. We have reviewed the cost-benefit analyses performed for the Navy's TAKX program by Coopers and Lybrand; Argent Group, Ltd.; and the Institute for Defense Analysis and concluded that the methodologies used in these analyses do not consider all pertinent costs. As a result, the analyses did not give managers the proper total cost of leasing versus purchasing, because they included certain costs that should have been excluded and conversely. Therefore, instead of leasing resulting in a savings, it would actually cost many millions of dollars more than if the equipment were purchased. (See app. I, p. 5.)

Question

What effect does long-term leasing have on military capabilities?

GAO response

Our major concern about the effect of long-term leasing on military capabilities is the degree of control over the use of civilian and contractor personnel in time of mobilization or hostilities. This issue is being debated by the services and is the subject of an ongoing GAO review. This issue is equally applicable to military-owned equipment being operated and maintained by contractor or Government civilian personnel.

Service officials express the opinion that they do not anticipate any problems with using contractor or civilian personnel in times of mobilization or hostilities. They point to the lack of problems in past conflicts as evidence for their position. The Navy also points out that contract clauses in the TAKX and T-5 ship programs specifically allow them to replace a crew for non-performance. However, to do so could be a time-consuming process. Under the contract, the crew can be replaced once the contractor has been notified and given 20 days to correct the problem. The Navy's answer to this is that if need be, it would charter another ship and crew willing to perform the mission.

In our opinion, as the military's dependency on these personnel increases, so does the potential adverse impact on military capability if these people cannot be counted on to perform in a hostile or potentially hostile environment. (See app. I, p. 7.)

Question

Were the lease versus purchase analyses adequately performed by Coopers and Lybrand; Argent Group, Ltd.; the Institute for Defense Analysis; and the Joint Committee on Taxation?

GAO response

Except for the analysis performed by the Joint Committee on Taxation, we do not believe the other analyses adequately show the true lease versus purchase costs. The analyses performed for the Navy used some different assumptions than we and the Joint Committee in their lease versus purchase analyses. The Navy studies assumed (1) a 10-percent discount rate based on constant dollars, (2) the ships had no residual value at the end of the lease period, and (3) a tax revenue flow to the Treasury from taxes paid by investors on interest income or return on equity. In our analysis we (1) used a variety of discount rates to illustrate the effect or series of effects of the discount rate factor on the analysis, (2) considered the ship's residual value, and (3) did not include the tax flow from investors because such flow would occur regardless of whether the ships were purchased or leased. Our analysis showed that because of the above factors, instead of leasing resulting in a savings to the Government, each ship could cost the Government from \$11.9 to \$38 million more, over the 25 year lease period, than if it were purchased. These added costs represent a range of from 7 to 21 percent more than the cost to purchase the ship. Likewise, the Joint Committee's analysis also showed that leasing was more expensive than purchasing. The Joint Committee estimated that leasing would cost 12 percent or about \$20.8 million per ship more than purchasing.

The major difference between the methodology used by Argent and the methodology used by the Joint Committee and also us concerned the treatment of tax revenue flow from investors in the leasing company.

The Argent analysis included, as a tax revenue to the Treasury, taxes on interest income received by the lenders in

the lease transaction. Including this revenue had the effect of reducing the total cost to the Government.

In the Joint Committee's analysis as well as ours, this "so called" tax flow was not considered. Our rationale for this is that such revenue flow would also occur under a purchase alternative. Under the purchase alternative, the ship would be financed by tax revenue or by debt, or some combination of both. In either case, the Treasury's tax revenues are affected by the taxes on the interest income earned by these creditors (holders of the Government obligations). Thus, whether the creditors are creditors of the leasing company or the Government, the Treasury will receive taxes on the income earned by the creditors.

Whenever a long-term leasing program provides for leasing an asset for its useful life, leasing will generally be more expensive than purchasing the asset. The reason is that in a leasing arrangement, a third party--the lessor--is involved; whereas, in a procurement arrangement, only two parties--the purchaser and the manufacturer--are involved. Thus, it would be expected that the third party in a leasing arrangement will require a return on his investment and this will be passed on to the lessee as an added expense. In any lease versus purchase analysis, if the lessor's required rate of return exceeds the Government's discount rate--the yield on Government securities ^{3/}--leasing will be more expensive. Again, this is as would be expected, because a lessor would not be willing to accept a lower rate of return than he could earn by investing in Government securities. (See app. I, p. 8.)

Question

Is there a need to provide full disclosure of long-term leasing costs?

GAO response

As a legal matter, long-term leasing contracts, once in effect, must be recorded against available funds to the full extent of the Government's firm obligation. See our decision B-174839, January 28, 1983. Lease arrangements financed with

^{3/}The rate the Government would have to pay for the money it borrowed if it purchased the asset.

working capital funds will appear in the annual operations and maintenance budgets of customer agencies as services are performed and thus are subject to the authorization and appropriations process at that time. However, there may be limited congressional awareness of the total obligation actually incurred. Thus, the Congress may not have overall information on a particular leasing program's cost or the cumulative cost impact of long-term leases. We believe that when the Congress makes these important funding decisions, it should know what the total program costs are expected to be so that necessary trade-off decisions can be made concerning what programs should or should not be funded.

We also believe that permanent legislation is needed which would require an agency to fully disclose to the Congress its long-term leasing proposals. The agency should provide an economic analysis, based on prescribed criteria, which considers the total cost to the Government for these leasing programs. This approach would allow the Congress to decide whether to approve the program, as well as the means of funding the program. The need for permanent legislation is further discussed in the following section. (See app I, p. 18.)

Question

Is there a need for legislative and administrative changes to improve congressional oversight of long-term leasing programs?

GAO response

We have previously reported ^{4/} and still believe that the Congress should consider permanent legislation that would require agencies to obtain congressional approval before entering into long-term leases that are financed with working capital funds. Although a temporary measure has been enacted, this measure only applies to Navy ships and funds appropriated for fiscal year 1983. We believe that a permanent provision is necessary to fulfill the need for increased congressional oversight of leasing arrangements, such as the TAKX. We have suggested language to meet this need. (See app. II, p. 19.)

^{4/}"Build and Charter Program for Nine Tanker Ships" (B-174839, Aug. 15, 1973).

Our suggested language would prohibit long-term leasing projects from being financed from working capital or other revolving funds without specific statutory authority. There are a number of other possibilities, ranging from a notification requirement to a requirement that such projects be funded directly with appropriated funds. We are currently examining this last possibility in connection with an ongoing review of DOD working capital funds. Direct funding would have the added benefit of subjecting such programs to full visibility and congressional action through the budget and appropriations process.

In addition to legislative changes, we believe that there is a need for administrative guidance to agencies considering long-term leases. Our suggested statutory language includes some general requirements for agencies to conduct a complete lease versus purchase comparative cost analysis when considering long-term leases. More specific guidelines, however, should be promulgated by the Office of Management and Budget (OMB), and in a letter dated May 19, 1983, we suggested that the Director issue such guidance. (See app. VII.)

Question

Is it proper to use the Navy Industrial Fund for long-term leasing, and does leasing circumvent the Buy American Act and other contracting requirements.

GAO response

We are still in the process of examining whether the use of Navy Industrial Funds for long-term leasing programs is a proper use of these funds. We plan to address this issue in detail in an upcoming review of working capital funds being performed for the House Committee on Appropriations. With regard to whether long-term leasing arrangements are able to circumvent contracting restrictions such as Buy American and labor surplus requirements, we have concluded that such restrictions are generally not circumvented by leasing. There are no indications that the Labor Surplus Program was only intended to apply to purchases. In addition, we have previously concluded that the restrictions of the Buy American Act apply to products acquired by lease as well as those purchased. Certain service contracts, however, are not subject to Buy American Act restrictions. (See app. I, p. 20.)

CONCLUSIONS

The Navy and Air Force have embarked on major leasing programs for ships and aircraft that will cost about \$7.9 billion over the life of the leases. Lease versus purchase analyses performed for or by the services showed that it was less costly to lease than purchase the assets. Our analysis of the TAKX lease and that performed by the Joint Committee showed just the opposite. The difference between our analysis and the other analyses was due to different assumptions regarding discount rates, residual value, and tax revenue from investors.

In general, a long-term leasing program that provides for leasing an asset for its useful life will be more expensive than purchasing the asset because a third party--the lessor--is involved; whereas, in a procurement arrangement, only the purchaser and the manufacturer are involved. Thus, it would be expected that the third party will require a return on his investment and this will be passed on to the lessee as an added expense. If the lessor's required rate of return exceeds the Government's discount rate, the yield on Government securities, leasing will be more expensive than purchasing. The reason is that a lessor would expect to earn a higher rate of return on his investment that he could earn by investing in Government securities and his added expense is passed on to the lessee.

Evaluation of the various lease versus purchase analyses showed a lack of prescribed criteria on how these analyses should be performed or what factors should be included or excluded. Consequently, there can be vast differences in the results of such analyses even for the same program. Our May 19, 1983, letter to OMB suggested ways to improve the analyses. These suggestions dealt with discount rates, current as opposed to constant dollar methodology, and the effect of not considering tax revenue implications. (See app. VII.)

Leases financed with working capital funds are reimbursed by the using agency from annual operation and maintenance funds as services are performed. As a result, the Congress only sees the annual funding for these leases and does not have the best information available to judge the merits of these programs in relation to other programs for which the services are requesting funds. We have previously suggested and continue to believe permanent legislation is needed to require agencies to fully disclose to the Congress the impact of long-term leases and the economic impact resulting from leasing rather than purchasing.

RECOMMENDATIONS TO THE CONGRESS

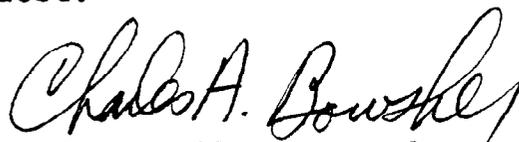
We recommend that permanent legislation be enacted which requires an agency to provide the key congressional committees with a lease versus purchase analysis that is based on prescribed criteria. Such an analysis should consider total cost to the Government. We also recommend that the legislation require the agency to obtain congressional authorization before entering into long-term leasing programs financed with working capital funds.

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Navy and Air Force officials generally agreed with the matters discussed in this report. However, the Navy did not agree with the manner in which we treated the tax revenue flow from investors in the leasing company. As discussed above, we believe that such tax flows should not be considered in the analysis because whether the asset is leased or purchased by the Government, the Treasury will receive tax revenue from the investors in the leasing company or the holders of the Government obligations in the case of a purchase. This is essentially the same position taken by the Joint Committee on Taxation in its analysis of the TAKX program.

As requested by representatives of the Committee on Government Operations, we did not obtain official comments on our report. However, we did discuss the matters in this report with Navy and Air Force officials, and we have incorporated their comments where appropriate.

As arranged with your Offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time, we will send copies to interested parties and make copies available to others upon request.


Comptroller General
of the United States

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ABBREVIATIONS

ACRS	accelerated cost recovery system
DAR	Defense Acquisition Regulation
DOD	Department of Defense
IRS	Internal Revenue Service
ITC	investment tax credit

LONG-TERM LEASING PRACTICES
AND PROCEDURES NEED TO
BE IMPROVED

BACKGROUND

As far as individual Federal agencies are concerned, long-term leasing is an attractive alternative to procurement for several reasons. First, it allows agencies to spread the cost of the asset over a long time period as opposed to the large capital outlays in the initial years of purchase. Second, contract obligations are often recorded against working capital funds and lease payments are made over a period of years from operation and maintenance funds rather than procurement funds. Consequently, lease proposals are not subjected to the same level of scrutiny as procurement requests are. Third, leasing will almost always appear less costly because part of the total cost of acquiring the use of the asset is shifted from the agency's budget to the U.S. Treasury in the form of reduced tax revenue.

The latter point also makes a leasing arrangement attractive to lessors. Under current tax laws, lessors can claim a 10-percent investment tax credit (ITC) and can essentially write off the cost of the asset in 5 years using accelerated cost recovery system (ACRS) deductions. In theory, these benefits are passed on to the lessee in the form of reduced lease payments.

Obviously, the same reasons that make long-term leasing arrangements attractive to lessors and lessees can make such arrangements less attractive to the Government. The reason is that the tax benefits claimed by the lessor reduces the revenue to the Treasury. In effect, the result is that part of the cost of acquiring the use of an asset is diverted from the using agency to the Government as a whole.

Because of increasing Federal budget deficits, the loss or potential loss of tax revenues has spurred an increased interest in these types of leasing arrangements, particularly when the Federal Government is a party to such arrangements. The question of whether Federal agencies should enter into arrangements where part of the cost is subsidized in the form of reduced tax expenditures can only be resolved by the Congress. However, it should be noted that the Federal Government has been involved in long-term leasing arrangements for many years. For the most part,

these leases have been for buildings and automatic data processing and communications equipment. Furthermore, in some cases, long-term leasing may be more advantageous than purchasing the asset, particularly where state-of-the-art technology or obsolescence factors are important. For these reasons, it is not possible to generalize as to whether long-term leases are good or bad for the Government. Each potential acquisition should be evaluated on its own merits.

OBJECTIVE, SCOPE, AND METHODOLOGY

At the request of four congressional requesters (see app. III to VI), we reviewed various aspects of DOD's long-term leasing of ships and aircraft. Although the specific areas of concern varied among the requesters, collectively the concerns focused on the

- magnitude of long-term leasing in DOD,
- reasons the services would rather lease than purchase noncombatant ships and aircraft,
- potential adverse effect of long-term leasing on military capabilities,
- adequacy of the lease versus purchase analyses performed for or by the services,
- need for full disclosure of long-term leasing costs,
- need for legislative and administrative changes to improve congressional oversight of long-term leasing programs.

As agreed with representatives of the requesters' offices, we limited our review primarily to the Navy and Air Force recently announced long-term leasing programs for TAKX and T-5 ships and CT-39 replacement and TTB aircraft. No Army programs were identified.

We held discussions with Navy and Air Force officials at the Assistant Secretary level and their respective staffs. We also reviewed the present value analysis performed on the Navy's TAKX program. We did not perform a detailed review of the CT-39 replacement aircraft or T-5 ship programs. However, we noted that the same assumptions and methodology were used for the T-5 program as were used in the TAKX analysis.

We also performed a present value analysis on one of the TAKX ship leases. This ship was also the subject of other present value analyses performed for the Navy as well as an analysis performed by the Joint Committee on Taxation. Because of the similarities of the leasing contracts for all of the TAKX ships, we believe the analysis for the one ship is representative for all the TAKX ships. The purpose of our analysis was to compare assumptions and methodologies of the other analyses and to explain the reasons where differences existed.

We performed our review from February to April 1983. Except for not obtaining formal agency comments, the audit was performed in accordance with generally accepted Government audit standards. As arranged with representatives of the Committee on Government Operations, we did not obtain official comments on our report. However, we did discuss the matters in this report with Navy and Air Force officials and we have incorporated their comments where appropriate.

MAGNITUDE OF LONG-TERM LEASING

Identifying the magnitude of long-term leasing throughout the Federal Government is difficult because such information is not centrally collected either on a Government-wide basis or on an individual agency basis. The reason for this is that leases are categorized in a variety of ways, such as equipment leases, or service leases, or purchase of personal services. The manner in which the leases are categorized determines where the detailed information is maintained. As arranged with representatives of the requesters, we limited our work on identifying the magnitude of long-term leasing to the Department of Defense (DOD) and more specifically the Navy and Air Force. We did not identify any Army ongoing or planned long-term leases involving the types of equipment being leased by the Navy and Air Force.

The Navy plans to lease 13 TAKX and 5 T-5 ships for 25 years and 20 years, respectively. The Air Force plans to lease 120 aircraft to replace its CT-39 fleet and is considering leasing 202 TTB training aircraft for 8 years and 20 years, respectively. These Navy and Air Force leases are estimated to total \$7.9 billion as shown in the following table.

<u>Equipment</u>	<u>No. leased</u>	<u>Lease period</u> (years)	<u>Estimated payments during the lease period</u> (million)
TAKX	13	a/ 25	\$5,399.88
T-5	5	20	618.20
CT-39 replace- ment	120	8	529.20
TTB	202	20	<u>1,389.76</u>
Total			<u><u>\$7,937.04</u></u>

^{a/}Lease period is for 5 years plus four option periods of 5 years each.

In addition, the Air Force plans to lease three C-140B aircraft for 12 to 18 months and then buy the three aircraft plus eight others. Because the Air Force only plans to lease these aircraft for a short period and plans to issue one contract for both the lease and procurement of the aircraft, we did not include the costs in the above schedule.

Although the Air Force has not previously leased major end items of equipment on a long-term basis, the Navy has leased ships for many years. As shown below, the Navy, as of February 1983, had 70 ships under lease for varying lengths of time. However, the total lease payments during the length of these leases are relatively small in comparison to the \$6 billion that will be spent on the TAKX and T-5 ship leases.

<u>No. of ships leased (note a)</u>	<u>Years (note a)</u>	<u>Estimated payments during the lease period</u> (millions)
8	<u>b/ Spot</u>	\$ 13.76
4	1	13.99
25	5	984.26
<u>13</u>	10	<u>130.18</u>
Total <u>c/ 50</u>		<u>\$1,142.19</u>

a/The leases and associated costs are categorized by the length of the basic charter plus any options that have been exercised. Also, unlike the TAKX and T-5 ships, none of the above leases include a monetary penalty for not exercising an option period.

b/Lease is for one trip.

c/Does not include 20 ships for which leasing costs were not readily available. Navy officials advised that these costs are minimal.

REASONS FOR LEASING
RATHER THAN PURCHASING

The Navy and Air Force would rather lease than purchase the previously mentioned ships and aircraft for several reasons:

- According to Navy and Air Force officials, at the Assistant Secretary level, the type of assets they plan to lease would not successfully compete with other higher priority programs for procurement funding. For that reason, their perception is that leasing is the only other alternative.
- The Navy believes that it has a responsibility to rely on the merchant marine industry to the extent possible, to provide cargo carrying services.

--The Navy points to the need to maintain an industrial base surge capability. The Navy's concern is that two or three key shipyards would go out of business if it did not lease the ships. A related factor cited by the Navy is that by leasing the ships, 750 Merchant Marine and about 12,000 shipyard jobs would be created or retained.

--Because of dire economic conditions, the Merchant Marine and shipyard labor unions granted significant concessions in order to induce the Navy to go forward with the ship programs. These concessions included such things as (1) reducing ship crew size, (2) freezing labor rates for 2 years, (3) reducing vacation time for merchant mariners from 6 months to 3 months, (4) allowing more cross-crafting in the shipyards, and (5) redefining overtime periods for shipyard workers.

--The completed lease versus purchase analyses showed that it was less costly to lease rather than purchase the ships and aircraft.

Of all of the above reasons, Navy and Air Force officials attribute the inability to obtain procurement funds and their desire not to compete with the merchant marine industry as the major reasons for leasing rather than purchasing the respective ships and aircraft. It is understandable that with a finite amount of procurement funds available, a ranking of priorities is necessary to determine what will be procured. However, it would seem that certain end items of equipment that the Navy plans to lease--particularly the TAKX ships--should be able to compete for procurement funds with other end items, because the TAKX ships are an integral part of the Maritime Prepositioning Program. This program entails about \$1.2 billion of equipment--much of which has already been purchased--which will be placed on-board the TAKX ships that will be prepositioned throughout the world in order that the Marine Corps can meet its global missions.

In a later section of this report, we discuss the need for increased congressional oversight of agency proposals to enter into long-term lease arrangements. The oversight process should include presentation by the agency of information that would allow the Congress to assess the importance of the item to be leased in relation to other items for which funds are being requested.

EFFECT OF DOD'S LEASING
ON MILITARY CAPABILITIES

Our major concern about the effect of long-term leasing on military capability is the degree of control that DOD could exercise over the use of equipment that is manned by contractor personnel or Government civilians during mobilization or hostilities. This matter is being debated in many quarters and is a subject we are currently reviewing. The Military Sealift Command, as of February 1983, had contractor personnel manning 73 ships and Government civilians manning 37 ships. However, the matter does not just apply to leased equipment. It is equally applicable to an increasingly wide range of other Government owned systems for which the Government relies on contractor personnel to maintain and operate.

According to service officials, they do not anticipate any problems with using contractor personnel and Government civilians during mobilization or hostilities. They said these types of personnel have been used extensively during past conflicts without problems. In further support of their position, the Navy points out that contract clauses in the TAKX and T-5 ship programs specifically allow them to replace a crew for non-performance of duty. However, to exercise the contractual right could be a time-consuming process. Under the contract, the crew can only be replaced once the contractor has been notified and given 20 days to correct the problem. The Navy's answer to this is that if need be, it would charter another ship and crew willing to perform the mission.

The Air Force also does not anticipate any problems using civilian personnel during mobilization or hostilities. For one thing, the leased CT-39 replacement and TTB aircraft will be military manned.

Regardless of the optimism expressed by the services, their legal counsels have expressed the opinion that contracts requiring civilian personnel to perform in hostile or potentially hostile environments are not enforceable. Thus, the services could be in an untenable position. Although highly dependent on civilians to meet certain mission requirements, the services cannot force them to perform the mission. Alternatives, such as requiring the personnel to be members of the reserves or making them subject to Uniform Code of Military Justice, have been suggested for dealing with the problem. However, these alternatives have not been adopted and the matter will require further study.

LEASE VERSUS PURCHASE
OF TAKX SHIPS

Our analysis of the merits of leasing the TAKX ships as opposed to an outright purchase showed that leasing was more expensive than purchasing. In fact, leasing cost from \$11.9 million to \$38 million more. We compared our analysis and results to prior TAKX leasing studies prepared by Coopers and Lybrand, the Argent Group, the Institute for Defense Analysis, and the Joint Committee on Taxation. In our analysis as well as the others, we considered only the capital hire portion of the lease payment--that portion of the leasing arrangement pertaining to requisition of the ship. The operating costs for personnel and maintenance are not a part of the lease versus purchase decision. These costs are included in the operating hire portion of the leasing arrangement and would be the same whether the ship is leased or purchased.

The Air Force performed a lease versus purchase analysis of the CT-39 replacement aircraft. The analysis showed that it was less costly to lease than to purchase. The analysis, however, only considered the cost to the Air Force and not the total cost to the Government.

The Air Force subsequently performed another analysis that compared the lease costs with the cost of retaining the existing CT-39 aircraft. As an alternative, they also compared the lease costs to the purchase costs of the replacement aircraft. In both cases, the Air Force considered the total costs to the Government. The analyses showed it was cheaper to lease than to retain the existing aircraft or to purchase replacement aircraft.

We did not perform a detailed review of the Air Force analyses nor did we validate the data used in these analyses. Therefore, we are not in a position to say whether the analyses represent the true cost of leasing or purchasing or retaining the existing fleet of aircraft.

However, we did note that the analyses were based on the Office of Management and Budget's (OMB's) criteria for making such comparisons.

As discussed in our May 19, 1983, letter to OMB we urged the Director to issue guidance for performing present value analyses using a discount rate based on the average yield for marketable Treasury obligations with remaining maturities comparable to the

period of the analysis. We also suggested that present value analyses be based on current dollars as opposed to constant dollars.

It is our policy to use a discount rate based on the average yield on marketable Treasury obligations with remaining maturities comparable to the period of the analysis. This rate is readily available, contains an implicit change in price levels, and can be applied to the current dollar expected expenditure streams to arrive at the estimated present value. For most programs on which a present value analysis would be performed, the current dollar expenditure stream has already been estimated. For example, budget requests are generally stated in current dollars, as is DOD's 5-year defense program. Thus, using this discount rate with the built-in price change rate and applying it to current dollars assures that like items are compared when discounting to present dollar values.

Generally, when acquiring the use of an asset for its useful life, leasing will be more expensive than a direct purchase. Under a leasing scenario, an extra party--the leasing company--is involved in the transaction. On the other hand, when purchasing an asset, only the asset user and the manufacturer enter into the transaction, thereby eliminating the third party and the costs associated with his participation. However, there may be circumstances where leasing is a viable alternative. For example, leasing of transportation equipment for a specific trip would be cheaper than purchasing the equipment.

In comparing long-term Government lease costs to the purchase alternative, we believe certain tax aspects must be included in the analysis of Government costs. For some years, the lessor's tax deductions may exceed his taxable revenues thus resulting in a negative taxable income and tax liability. The lessor then uses the excess deductions of the particular lease transaction to offset taxable income from other sources. The value of these tax aspects in terms of lost revenue to the Treasury in some years or gains in other years should properly be attributed to the cost of leasing.

In the analysis of the TAKX which follows, we identify what we believe are appropriate total costs to the Government. The total Government costs include not only the annual lease payment, for which the Navy is liable, but also the foregone revenue to the Treasury resulting from ITC and ACRS. Our analysis is generally consistent with that of the Joint Committee on Taxation's

and at the points where our analysis differs from any of the other analyses, we identify the reasons.

Identifying the parties
and costs of a particular TAKX ship

The data used by us and the Joint Committee in analyzing one TAKX cargo ship relates to the Agreements to Charter as signed by the Navy and Maersk Transport Company for Maersk Vessel #3. The total costs as stated in the agreement are shown in the following table. However, were the Government to purchase the ship, some of the legal, consultant, insurance, and financing fees would be eliminated. This reduces the Government purchase price to \$178,230,000. Further, under the Government purchase alternative, the ship is paid for upon delivery rather than in a series of progress payments. For this reason, we include the \$20,865,000 cost of interim construction loans as a cost. 1/

1/In our analysis we have used these numbers merely as a guide for the sensitivity analysis reported in the table on page 16. For example, using the rent payments stipulated in the contract, we arrived at a Government cost virtually identical to the estimate of the Joint Committee on Taxation. Methodologically, we differ from the contract only by assuming payments in advance rather than arrears and by assuming a constant lease payment. Both of these differences have minimal effect on the total Government cost since both payments and savings are considered in advance and the constant lease payment is considerably less than the average in a stepped lease. In fact, discounted at the rate of return, the present value of the two lease payment streams are equal.

		<u>Cost of Maersk Vessel</u> (in thousands)	
Fixed costs	\$ 30,500		
Conversion	117,920		
Inspection & supervision	647		
	<u>\$149,067</u>		
Other costs subject to changes (max)			
Legal fees	1,740	Interim loan counsel	200*
		Contractor counsel	20*
		Permanent financing counsel	500*
		IRS ruling counsel	20*
		Equity counsel	1,000*
Other	9,789	Prepositioning expense	717.2
		Consulting fee	500*
		Financing advisory fee	200*
		Spare parts	328
		Containers	2,252.1
		Loan administration fee	20.5
		Insurance for delay or non-delivery	200*
		Changes fund	5,000
		Equity commitment fee	365.8*
		Equity placement fee	205.5*
Costs subject to adjustments			
Cost of interim construction loans	20,865		
Debt placement fee	411*		
Permanent loan commitment fee	549*	(0.5 percent of debt)	
Total	<u>182,421</u>		

*Denotes costs excluded with Government purchase option. They total \$4.191 million. Thus, actual purchase option costs are \$178.230 million.

The following table shows the revenue flow for the parties in the leasing arrangement. The Navy's position is easiest to outline. Throughout the 25 year lease the Navy makes rent payments to the lessor. To accurately compare the lease with the purchase alternative, we assume that the Navy buys the ship at the end of the lease. ^{2/} Of all the other studies, only the Joint Committee considered the residual value of the ship. The Coopers, Argent, and Institute for Defense Analysis analyses assumed that the ship had no value at the end of the lease.

The lessor has a more complicated cash flow than the Navy. The lessor receives rent payments from the Navy as well as the proceeds from the sale of the ship at the end of the lease. The lessor makes periodic payments of principal and interest on the money borrowed to finance the purchase of the ship. The lessor also pays taxes. The lessor's taxable income is simply defined as revenues minus expenses. Revenues include rent payments received and any earnings from a sinking fund the lessor may establish to amortize debt or pay future taxes. At the end

<u>Inflow</u>	<u>Navy</u>	<u>Revenue Flows of Lease</u>		<u>Treasury</u>	
	<u>Outflow</u>	<u>Inflow</u>	<u>Outflow</u>	<u>Inflow</u>	<u>Outflow</u>
	Rent (or capital hire)	Rent (or capital hire)	Payment on debt	b/Taxes (can be + or -)	
	Cost to purchase ship at end of the lease	Sale of ship at end of lease	a/Taxes (+ or -)		Return to equity holders

^{a/} Taxable income to lessor equals capital hire minus ACR minus interest expense on loan minus amortization of other expenses plus earnings on sinking fund.

Taxes are 46 percent of taxable income minus ITC plus 46 percent of recapture at end of the lease. This could be negative especially in the first years of the lease.

^{b/} Taxes to the Treasury include the taxes the lessor pays as well as the taxes the investors pays. Taxes by the investor, however, would be paid even if Government purchased i.e., debt financed or retired debt.

^{2/} Alternatively, we could reduce the purchase price by the present value of the ship at the end of the lease period to obtain a comparable cost of using the asset throughout the lease period.

of the lease, the lessor must include in taxable income any recapture of depreciation deductions arising from the sale of the ship as well as any capital gains on the excess of the sale price over depreciation. From these revenues the lessor can deduct ACRS depreciation of the ship, the interest paid on the debt used to finance the ship, and other expenses.^{3/} Taxes paid by the lessor equal 46 percent of taxable income less any ITC that may be available when the asset is new. In the first years of the lease, when ACRS deductions are taken, taxable income is negative, thus implying a tax refund on the ownership of the ship. That is, the lessor is likely to have taxable income from other sources against which he can apply the excess deductions.^{4/}

The Treasury's position is that of tax collector. Taxes collected or foregone represent an inflow or outflow to the Treasury. Taxes flow into the Treasury from the lessor, although in the early years of the lease there is an outflow from the Treasury in terms of reduced revenue.

Turning to the investor's position, recall that the analysis centers on the differences between leasing and purchasing. While investors receive either interest income or a return on their equity (perhaps in the form of dividends) and pay taxes on their earnings, such earnings are no different than those occurring under the purchase alternative. That is, under a purchase alternative, whether the ship is financed through the issuance of new debt or retiring less current debt than planned, the investors (lenders to the Government) receive returns to their investments and pay taxes on those returns. Thus, since investors receive taxable investment income under the lease or the purchase, the revenues to the Treasury from the tax on investor earnings should

^{3/}Other expenses are defined here as legal fees and other financing costs which are not part of the depreciable base. Generally, these costs must be amortized over the life of the lease.

^{4/}We assume the lessor is a profitable firm and pays taxes at the top 46 percent tax rate. Since the rental payments and the analysis critically depend on the lessor receiving the full tax benefits of the lease, we feel confident that only lessors in the 46 percent tax bracket would enter into such leasing arrangements.

be ignored in comparing the lease costs to the purchase costs. Both the Argent and the Institute for Defense Analysis analyses incorrectly reduced the total cost to the Government of a lease by the tax revenue to the Treasury from the taxation of the interest income on the debt to finance the ship. ^{5/}

The relative costs
of leasing as opposed
to purchasing

We compared the total Government cost of leasing to that of an outright purchase under a variety of economic scenarios. In the cases we examined, it was more expensive to the Government to lease rather than purchase the asset for \$178.23 million. (See Table 1 for details).

We used a present value analysis that places future outlays in current dollar terms. The computer program we developed calculates the Navy's rent payment for any set of assumptions about the interest rate on borrowing, the tax consequences to the lessor such as the availability of ACRS and ITC, and the required rate of return for the equity investors. Thus, if the ITC is unavailable, the rent to the Navy increases. Such a result is consistent with the tax indemnification clauses of the contract, which essentially guarantee the lessor a required rate of return.

^{5/}The Argent and Institute for Defense Analysis method is particularly inappropriate when the OMB pre-tax discount rate of 10 percent is used to state future cash flows in terms of current dollars. If the tax liabilities incurred by the investors--equity and debt owners in the leasing company--were subtracted from the Government costs, the discount rate would be the after-tax discount rate computed as one minus the tax rate times the pre-tax discount rate. Since we do not know the tax rate of the investors, we discount at the pre-tax discount rate and ignore the taxes on investor income in our analysis. Notice also that these studies do not consider the taxation of the return to the equity holders. If we use an after tax discount rate, the revenue from the taxation of the return to equity should also be included. Further, OMB Circular A-94 prescribes a real rate of 10 percent, while the figures used in all the studies analyzed are nominal.

Unlike the other studies, we assume annual debt service and rent payments rather than semi-annual payments. This approach results in only minimal differences. Further, we assume that the lessor is 100 percent current in the payment of taxes in all cases except one.

Certain assumptions are common to all scenarios. In all cases we assume the ship qualifies for a 5 year tax life under the ACRS tax depreciation rules and only in scenario number 7, do we assume there is no ITC. ^{6/} For the cases in which ITC is assumed, we reduce the depreciable base (for tax purposes) by one-half the ITC prescribed by the Tax Equity and Fiscal Responsibility Act of 1982. We also assume that the lessor's debt is in the form of a mortgage bond with a constant payment throughout the 25 year lease and no prepayments. Further, the lessor's tax rate in our analysis and the other studies equals the top corporate marginal tax rate of 46 percent. The assumption is that only profitable or marginally profitable firms would undertake investment in leasing since unprofitable firms could not take full advantage of the tax benefits.

To calculate the residual value of the ship at the end of the lease, we use recent econometric estimates of economic depreciation. The estimates are based on the market value of used ships and indicate an annual rate of decline in value of 7.5 percent (inflation adjusted and measured on a declining balance basis). We then inflate this value annually by an implicit annual rate of inflation. We calculate the implicit inflation rate as the difference between the discount rate and 4 percent, the historical average real rate of return on assets.

The data in Table 1 indicate the effects on the total costs to the Government of any changes in economic assumptions. Scenario 1 is the base case in which we assume an 11.34 percent after tax (corporate tax) rate of return on equity (or 21 percent before tax), an 11 percent loan interest rate, an 11 percent Government discount rate, and a 7 percent reinvestment rate of the lessor sinking fund. We also assume that 43 percent of the project is equity financed. We use this base case only as a

^{6/}The lessor provides operating hire services to permit the contract to qualify as a service lease rather than a property lease. A service lease entitles the lessor to ITC. The Internal Revenue Service IRS has yet to rule on the eligibility of the ship for ITC and the validity of the ship lease qualifying as a service contract.

point of reference for the analysis. We do not mean to imply that the assumptions in this base case are any more or less realistic than the assumptions in some of the other scenarios.

We found that the present value of total Government costs of leasing in the base case was \$190.7 million compared to the \$178.2 million purchase price. Thus, under the base case conditions, the Government pays 7 percent more to lease than to purchase.

TABLE 1
COST COMPARISONS TO
PURCHASE COST OF \$178.23 MILLIONS

Scenario	Assumptions	Result (\$000)				
		Navy rent per year	FV of total Navy costs (note a)	FV of total gov't costs (note b)	Per- cent over pur- chase cost	Increased cost of leasing
1*	Base Case	\$15,008	\$151,555	\$190,725	7	\$12,495
2	discount rate 10%	15,008	160,904	198,171	11	19,941
3	discount rate 10%, loan interest rate 13%	16,675	177,558	216,238	21	38,008
4	reinvestment rate 11%	14,664	148,237	180,398	c/1	2,168
5	reinvestment rate 11%, return on equity 11%	14,560	147,360	179,871	c/1	1,641
6	reinvestment rate 11%, return on equity 11% percent equity 20	11,639	120,259	181,200	c/2	2,970
7	no investment tax credit	17,948	179,028	194,006	9	15,776
8	10% deferral of taxes - 90% current	15,008	151,555	190,133	7	11,903

* Denotes base case where the after tax rate of return on equity is 11.34 percent, loan interest rate is 11 percent, discount rate is 11 percent, reinvestment rate is 7 percent, and the project has 43 percent equity.

a/Column represents the present value of 25 years of Navy rent plus the present value of the ship's value at the end of the lease period.

b/Column represents the total Navy cost plus the present value of the Treasury account.

c/These scenarios are included to illustrate the fact there is very little cost difference when the lessor's reinvestment rate and return on equity rate approximates the Government discount rate—yield on Treasury obligations. In actuality, lessors would probably not enter into leasing arrangements unless they could earn more than what they could earn by investing in Treasury obligations.

Generally, we found the additional costs to the Government as a result of leasing as opposed to purchasing are sensitive to the economic assumptions used. When we lowered the discount rate to 10 percent, the leasing alternative was 11 percent more expensive than a purchase. Keeping the discount rate at 10 percent and raising the loan interest rate to 13 percent (scenario 3) (a scenario close to that portrayed in other studies) made leasing 21 percent more expensive. Raising the reinvestment rate for sinking fund balances to 11 percent (scenario 4) implied that leasing was only 1 percent more expensive than purchasing. When the return on equity, loan interest rate, reinvestment rate, and Government discount rate were all 11 percent (scenario 5), the difference between leasing and purchasing is less than 1 percent. Further, when all rates are 11 percent and the equity is reduced to the 20 percent minimum required by IRS, (scenario 6), the direct purchase of the ship is still only about 2 percent less expensive. Leasing is 9 percent more expensive than purchasing when the ITC is disallowed (scenario 7). Finally, when the lessor is assumed to be 90 percent current in his taxes (as opposed to 100 percent in the other scenarios), leasing is approximately 7 percent more expensive than purchasing.

For the scenarios we examined, we found that as long as the lessor's required rate of return exceeded the Government's discount rate, leasing was more expensive. Further, on a long-run basis, there is no reason a lessor would be willing to accept a rate of return less than the yield on Government securities (i.e., the Government's discount rate). Both the Institute for Defense Analysis and Argent analyses, because they included the tax on the investor's income and excluded the residual value of the equipment in the Government costs, came to a different conclusion. Interestingly, scenarios 5 and 6, which assume all interest rates and discount rates are equal, yield leasing costs closest to the cost of purchasing.

Obviously, in some cases, the total leasing costs to the Navy are less than purchasing since it is able to pass some of their costs to the Treasury in the form of tax expenditures (reduced revenue). While ACRS and ITC are tax expenditures designed to stimulate private investment, their applicability to property used by the Government is an issue subject to question. In other words, should tax expenditures be used as a means to subsidize an agency's acquiring the use of an asset. Our analysis indicates that leasing or other such methods of using tax expenditures for acquiring the use of assets is inefficient, and that the cost to the Treasury would be reduced if the

Government were to give a direct subsidy to an agency to enable it to directly purchase the asset. Alternatively, the subsidy would be less than the lost tax revenue.

FULL DISCLOSURE OF
LONG-TERM LEASING COSTS

The Congress needs to have an accurate measurement of budget resources and spending in order to set appropriate national goals and allocate scarce resources.

The current method of funding long-term leasing projects through the working capital fund does not provide the Congress with the information needed to make these choices. The reason is that long-term leases are often financed through working capital funds, which are reimbursed over a period of years by operation and maintenance funds. For example, in the TAKX program, the leases are funded and obligations are recorded against available funds ^{7/} for 5 years plus termination costs after 5 years by the Navy Industrial Fund and are not subject to the annual budget and appropriations process at the time the contracts are entered into. Thus, the Congress does not have the information necessary to scrutinize total program costs and is not in the position to assess the merits of the project in relation to other projects for which funds are being requested. Furthermore, without this information the Congress cannot assess the cumulative impact of long-term leasing programs.

To remedy this situation, we believe that there is a need for permanent legislation that would require an agency to fully disclose its long-term leasing proposals. At the same time, the agency should provide an economic analysis, based on prescribed criteria, which considers the total cost to the Government. The need for permanent legislation is further discussed in the next section.

^{7/}Long-term leasing contracts, once in effect, must be recorded against available funds to the full extent of the Government's firm obligation. (See our legal decision B-174839, Jan. 28, 1983.)

LEGAL ISSUES: NEED FOR
LEGISLATIVE AND ADMINISTRATIVE
CHANGES TO LONG-TERM LEASING

In 1973, ^{8/} we suggested that the Congress consider legislation that would require agencies to notify and obtain congressional approval before entering into long-term lease arrangements for capital assets such as ships. At that time, we suggested that the Congress consider legislation similar to that which requires congressional committee approval prior to the appropriation of funds for building leases of over \$500,000 a year. See 40 U.S.C. §606.

Section 303 of the fiscal year 1983 Defense Authorization Act ^{9/} requires the Navy to notify the House and Senate Committees on Appropriations and on Armed Services before entering into long-term leases. However, this requirement only applies to funds appropriated under authority of the fiscal year 1983 Defense Authorization Act, it does not cover the leases proposed in future years. In addition, it only applies to the Navy's leasing of ships, and not the other services.

In addition, the present provision simply requires the Navy to notify the appropriate congressional committees. The Navy may proceed after 30 days regardless of the views of these committees.

It is, in our view, still appropriate for the Congress to consider increased congressional oversight of long-term leasing arrangements, such as the TAKX program. Long-term leasing arrangements are often financed through the unobligated balances of working capital funds, reimbursed by the operations and maintenance accounts of customer agencies throughout the life of each lease. The lease arrangements will appear in the operations and maintenance budgets of the customer agencies as services are performed, and consequently will receive congressional review through the authorization and appropriations process at those times. This review, however, is really after-the-fact. At the time the actual obligations are created, congressional oversight

^{8/}"Build and Charter Programs for Nine Tanker Ships", (B-174839, Aug 15, 1973).

^{9/}Public Law 97-252, Department of Defense Authorization Act, 1983.

is limited. At present, oversight is limited to that required by section 303 of the Defense Authorization Act. Although the Antideficiency Act requires the obligations to be recorded at the beginning of the project, (see B-174839, Jan. 28, 1983), these funds (the unobligated balances of working capital funds) are often not included in the annual authorization and appropriations process.

The suggested language shown in appendix II is intended to fill the need for increased congressional oversight of lease arrangements such as the TAKX program.

Other legal issues

There are certain other legal issues that we have examined, or are in the process of examining, in connection with long-term leasing programs. One of these is the propriety of using the Navy Industrial Fund for long-term leasing programs. We plan to address this issue in detail in an upcoming review of working capital funds which is being performed for the House Committee on Appropriations.

Another issue is whether long-term leasing arrangements are able to circumvent contracting restrictions, such as Buy American and labor surplus requirements.

The Buy American Act

The Buy American Act states that unless the head of the agency concerned determines it to be inconsistent with the public interest or the cost to be unreasonable,

"only such unmanufactured articles, materials, and supplies as have been mined or produced in the United States, and only such manufactured articles, materials, and supplies as have been manufactured in the United States substantially all from articles, materials, or supplies mined, produced, or manufactured, as the case may be, in the United States shall be acquired for public use.* * *"
41 U.S.C. § 10a (1976) (Underscore added.)

We have previously held that the restrictions of the Buy American Act apply to products obtained by lease as well as those purchased. (See 46 Comp. Gen. 47, 49 (1966) leasing of Post Office vehicles.) We noted in our decision that the intent of the

Congress in enacting the Buy American Act was to protect the American manufacturer and worker and to ensure that American-made products are used in Government procurement where possible. We held the act to be applicable to leasing even though a later amendment used the term "purchase" instead of "acquire."

The provisions of the Defense Acquisition Regulation (DAR) implementing the Buy American Act also make it clear that it is applicable to leases. DAR § 6-100 provides, in pertinent part:

"This Part implements the Buy American Act (41 U.S.C. § 10a-d) and the policies set forth in Executive Order 10582, dated 19 December 1954, with respect to supply contract and to services which require the furnishing of end items (e.g., leasing of equipment). * * *" (Underscore added.)

While Buy American Act restrictions apply to the acquisition of products through leasing, there remains the question of whether such restrictions apply to acquisition by a contractor of equipment used in the performance of services to the Government. Our position is that the Buy American Act applies to service contracts only to the extent that such contracts result in the furnishing of end products to the Government. (See 56 Comp. Gen. 18, 20 (1976); 56 Comp. Gen. 102, 104, (1976).) This view also is consistent with DAR. (See DAR § 6-100.) Consequently, an agency could, by using a service contract instead of a lease or purchase, avoid Buy American requirements, unless it is apparent that the principal purpose of the contract in question is the acquisition of articles or equipment, rather than services. (See 56 Comp. Gen. 18, 20 (1976).)

Labor surplus requirements

The Labor Surplus Program, originally an administrative policy, was given a statutory basis in an amendment to the Small Business Act. (See 15 U.S.C. 644 (d).) That act requires that priority be given to the awarding of contracts and the placement of subcontracts to small business concerns within the high unemployment (labor surplus) areas. The statutory language and the provisions of DAR, which implement the program, refer broadly to contracts and subcontracts. There is no indication in the language of the statute or its legislative history, or in the language of DAR, that the program was only intended to apply to

purchase contracts. It should be noted that DAR defines "contracts to mean all types of agreements and orders for the procurement of supplies and services" (DAR § 1-201.4) (emphasis added), and further defines procurement as including "purchasing, renting, leasing, or otherwise obtaining supplies or services" (DAR § 1-201.13).

Other Federal contracting restrictions

Besides the Buy American and Labor Surplus Program restrictions, there are a number of other Federal contracting restrictions that apply to leases and service contracts as well as to purchases. For a summary description of many of these restrictions, see chapter 5 of the GAO Office of General Counsel publication "Government Contracts Principles" (1978). Certain of these restrictions apply only to service contracts. see e.g., which applies to "* * * all Federal contracts, the principal purpose of which are to furnish services in the United States through the use of service employees." (DAR § 12-1002.11.)

Many other contracting restrictions, however, are applicable to all Government contracts. See the Anti-Kickback Act, 41 U.S.C. § 51 et seq., which applies to all negotiated contracts. Such restrictions apply regardless of whether the contracts in question may be classified as a purchase, lease, or service contract.

Administrative Changes

At present, there are no prescribed criteria for determining what factors and rates should be included or excluded in lease versus purchase analyses. As a result, analyses differ widely on the same project and decisionmakers may get conflicting information. Therefore, we believe administrative guidance should be given to agencies that are considering long-term equipment leases. Our proposed statutory language includes a requirement that agencies submit a detailed lease proposal to the appropriate congressional committees. The proposal would include a comparative analysis of the cost of leasing--including total cost to the Government considering the tax effects--versus the cost of purchasing the equipment.

We recognize that these are general guidelines and believe that it would be appropriate for OMB to implement specific guidance, perhaps in the form of a circular. Such guidance should prescribe criteria for performing a lease versus purchase

analysis and set forth the manner in which the discount rate should be calculated.

In a letter dated May 19, 1983, to OMB, we made a series of suggestions for improving the usefulness of OMB Circulars A-94 and A-104 analyses which provide guidance for conducting cost-benefit. First, we suggested that instead of using 10 percent and 7 percent discount rates for performing a present value analysis, that OMB use a rate that approximates the average yield on outstanding marketable Treasury obligations with remaining maturities comparable to the period of the analysis. Our rationale is that investments must be viewed from a Government-wide perspective, and interest is a cost related to all Government expenditures. Additionally, since most Government funding requirements are met by the Treasury, the estimated cost to borrow (or conversely, savings from not having to borrow) is a reasonable basis for establishing the discount rate to use in present value analyses.

Second, we suggested that present value analyses be based on current rather than constant dollars. The use of constant dollars discounted by the true cost of money exclusive of inflation or deflation, not the OMB prescribed 10 or 7 percent discount rate, would yield satisfactory results. However, neither the true cost of money nor the constant dollars are generally readily available. For that reason we use current dollars and a discount rate based on the average yield on marketable Treasury obligations in our present value analyses. This rate contains an implicit change in price levels. For most programs or activities on which a present value analysis would be performed, the estimated current dollar expenditures stream has already been projected. Thus, the use of a discount rate with a built-in price change rate is much easier than trying to adjust the current dollar value for inflation or deflation before discounting it to present dollar value.

Third, we suggested that cost benefit and lease versus purchase analyses consider the tax implications--particularly the revenue implications of ITC and ACRS. Our position is that tax implications should be considered when comparing acquisition alternatives such as single versus multiyear contracting or lease versus purchase. Not considering these implications seriously misstates the true cost of the acquisition and results in a cost comparison based only on the cost to the user, not the total cost to the Government.

In today's environment of large Federal deficits, excluding the ITC and ACRS revenue implications from a lease versus purchase analysis can significantly affect the basis for comparison and can result in an erroneous evaluation of the acquisition costs. Thus, the tax implications should be attributed to a leasing program and should be included in the analysis.

PROPOSAL FOR SUGGESTED LANGUAGE
REQUIRING CONGRESSIONAL APPROVAL
OF CERTAIN LONG-TERM LEASES

§ _____ REQUIREMENT FOR CONGRESSIONAL APPROVAL [NOTIFICATION TO THE CONGRESS] OF CERTAIN LONG-TERM LEASES

(a) No working capital fund or other revolving fund may be obligated or expended by an agency for the long-term lease of major capital equipment, as defined herein, or for the solicitation of a contract proposal therefore, unless--

- (1) a detailed lease proposal has been transmitted to the appropriate Committees of the Congress, as specified in section paragraph (c); and
- (2) the proposed lease has been specifically authorized in an Act of the Congress.

[(2) (alternate) a period of 30 days of continuous session of Congress has expired after receipt of such lease proposal. For the purpose of this subsection, a continuous session shall be one not broken by adjournment sine die. In addition, there shall be excluded in determining the 30-day period any day on which either House of Congress is not in session because of an adjournment of more than 3 days to a day certain.]

(b) The detailed lease proposal required by paragraph (a)(1) shall include, at a minimum,--

- (1) a description of the capital equipment to be acquired by long-term lease and the purposes for which the equipment will be used;
- (2) a complete analysis of the costs of the proposed lease, examining the total cost to the Government, including tax effects, and comparing such costs to those that would be incurred if the capital equipment was purchased instead of leased; and
- (3) a statement of justification for leasing, rather than purchasing the capital equipment in question.

(c) The appropriate Committees of the Congress referred to in paragraph (a)(1) are--

- (1) the Committees on Appropriations of the Senate and the House of Representatives; and

- (2) the Committees of the Senate and the House of Representatives that have jurisdiction over the activities of the procuring agency.
- (d) The following definitions shall apply for the purpose of this provision:
- (1) as used herein, the term "lease" includes (A) agreements for the acquisition of major capital equipment other than by purchase, and (B) agreements for the provision of services through use by the contractor of major capital equipment, if such equipment is used predominantly for services to the Government.
 - (2) "major capital equipment" means (A) any vessel or aircraft; or (B) any other article of equipment with a fair market value at the time of the lease proposal of \$ _____ or more [but not including automatic data processing equipment];
 - (3) a "long-term" lease agreement is one with a term exceeding 5 years, including any option for contract renewal or extension for which the failure to exercise such option will subject the Government to liability.
- (e) This provision shall not apply to any contract in effect at the time of its approval.

EXPLANATION: The suggested language set out above is a permanent funding limitation. While a similar provision could be attached as a rider to an appropriation or authorization bill, we believe that a permanent enactment is necessary. Such a provision could be enacted for inclusion in title 31 of the U.S. Code or in titles 40 (Public Property) or 41 (Public Contracts), or title 10 (Armed Forces) if limited to military departments.

The provision is worded to be applicable to all agencies (defined in 31 U.S.C. § 101).

The provision is limited to working capital or other revolving funds, as the use of such funds is subject to the least amount of congressional oversight. At the same time, we would encourage agencies to apply comparative cost analyses such as those detailed in subsection (b), to any long-term lease proposal, whether financed through revolving funds or not. We have some concerns about the use of other types of funds (for example, no-year appropriations) for long-term leases. The Congress may wish to consider applying similar limitations to other funding sources.

The provision has been written to require specific congressional authorization of the use of working capital funds for these types contracts. Another alternative, in fact one more akin to 40 U.S.C§ 606, would require specific committee approval of lease proposals prior to the appropriation of funds by the Congress to cover such leases. There are several other alternatives, one of which is set out in brackets in the draft language above. The bracketed language sets out a committee notification alternative, one that specifically delineates the applicable notification period in terms of days in session. Another possibility (not shown) would premise the authority to use working capital funds for long term leases on the specific approval of congressional committees. Such a provision, however, might be subject to challenge on the grounds that it constitutes a legislative veto of an agency program without action by the full Congress. It should be noted, however, that the Congress has previously enacted provisions restricting the use of funds unless specific committee approval has been obtained. See, e.g, section 311 of the fiscal year 1982 Department of Transportation Appropriation Act, P. L. No. 97-102, § 311, 95 Stat. 1442, 1460 (1981).

One final possibility would be to require long-term leasing projects to be funded directly with appropriated funds. Such a requirement would subject such projects to full visibility and positive congressional action through the budget and appropriations process.

The "appropriate Committees of the Congress" are described in a manner intended to require approval by the principal oversight committees of the procuring activity.

"Lease" is defined in a way that is intended to cover not only those agreements that are labeled as such, but also those that appear in the form of service contracts or other types of agreements. The language is intended to cover all agreements where the principal purpose is to provide the Government with the use of major capital equipment other than through a purchase.

Because of the TAKX program and the proposed leasing of CT-39 aircraft, vessels and aircraft are the types of equipment most closely associated with the problems of long-term leasing by the Government. The suggested oversight provision recognizes this by specifying the... articles as "major capital equipment." The definition, however, also includes broad language in anticipation of other types of leasing proposals. It would cover, for example, the possible sale and lease-back of Weather Service satellite equipment. We have left it to the Congress to determine the minimum valuation of equipment to be included under this definition. Bracketed language excluding automatic data processing equipment is based on the fact that rapid changes in the state-of-the-art of such equipment often renders impracticable its purchase.

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U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C. 20515

SUBCOMMITTEE ON OVERSIGHT

February 14, 1983

Charles A. Bowsher
Comptroller General
General Accounting Office
441 G Street, N. W.
Washington, D. C. 20548

Dear Mr. Bowsher:

The Subcommittee on Oversight of the Committee on Ways and Means will be holding a hearing on the impact of recent Federal leasing practices on Monday, February 28, 1983. The hearing will be held in Room 1100, Longworth House Office Building beginning at 10:00 a.m. As Chairman of the Subcommittee, I request that you or your designated representative appear as a witness at this hearing. Enclosed is a copy of the Subcommittee's press release announcing the hearing.

The initial focus of this hearing will be the recent decision of the Department of the Navy to lease rather than purchase 13 TAKX ships. The Subcommittee will also examine the use of leveraged leasing by Federal agencies, state and local governments and other non-taxable entities as a means of financing major projects. Therefore, the Subcommittee would like your testimony to address the Department of the Navy transaction and consider the three general policy issues outlined in the press release.

In addition, the Subcommittee would be particularly interested in your comments on the following issues in connection with the GAO's Report to the Congress titled "Build and Charter Programs for Mine Tanker Ships" (B-174839) and other related work undertaken by the GAO.

(1) A brief summary of the GAO's Report and discussion of the issues involved.

(2) A discussion of the recommendations GAO made to the DOD and the Congress.

(3) A discussion of any changes the DOD or other agencies made in response to your report.

(4) A discussion of why Federal agencies have indicated that they prefer to lease rather than purchase.

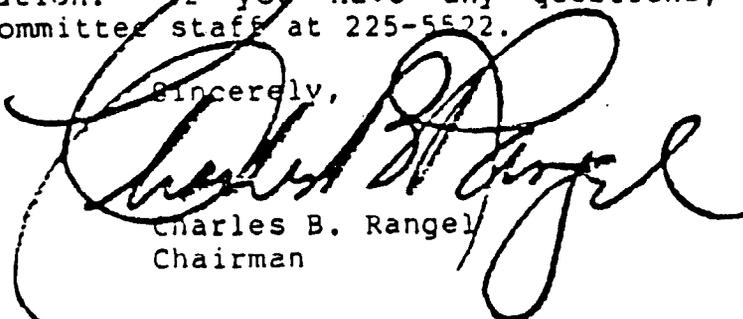
(5) Legislative and administrative options that should be considered to insure that the total costs to the government are appropriately considered when an agency makes the decision to lease rather than purchase.

(6) The extent to which the GAO has found that Federal agencies are switching from direct acquisition to leasing.

It will be necessary for Members to review your written statement prior to the hearing day, therefore I must request that 25 copies of your written testimony be delivered to the Subcommittee offices, Room 1101 Longworth House Office Building, no later than close of business, February 23, 1983. An additional 75 copies should be delivered to the Subcommittee office, Room 1101 Longworth House Office Building on the day of the hearing for distribution to the public. Since your entire written statement will be included in the Subcommittee's hearing record, I urge you to limit your oral statement to 10 minutes. This will provide the Subcommittee with the opportunity to ask each witness questions.

I look forward to your appearance at the hearing and appreciate your cooperation. If you have any questions, please contact the Subcommittee staff at 225-5522.

Sincerely,



Charles B. Rangel
Chairman

CBR/bklv

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Congress of the United States

House of Representatives

COMMITTEE ON GOVERNMENT OPERATIONS

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February 7, 1983

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Honorable Charles A. Bowsher
 Comptroller General
 U.S. General Accounting Office
 Washington, D.C. 20548

Dear General:

It has come to my attention that the Department of Defense has either leased or is considering leasing, rather than purchasing, equipment considered important to our national defense. Your office reported on this practice in August 1973 (Build and Charter Program for Nine Tanker Ships, B-174839) and raised serious questions about the tax and budget implications of such arrangements.

The Navy has recently signed contracts to charter 13 ships to be used for prepositioning equipment. These contracts commit the Government to billions of dollars in lease payments for as long as twenty-five years or subjects it to enormous penalties in the event the contracts are terminated. I understand the Navy also plans to lease several tankers and possibly a hospital ship under similar arrangements. In addition, the Navy has announced that it may lease several aggressor aircraft and the Air Force is considering leasing up to 124 administrative support aircraft.

Such leasing raises a number of serious questions which I would appreciate the General Accounting Office examining for the Subcommittee.

- 1) How do the issues GAO raised and the findings and conclusions it reported in the 1973 review of the Navy's build and charter proposal apply to the current leases?
- 2) Will these lease arrangements be less economical to the Government than outright purchases? How accurate were the lease-versus-purchase analyses used by the Navy to justify leasing? Was the general methodology and the discount rate used to establish present value in these studies reasonable?
- 3) How will short-term and long-term leasing arrangements, which require non-procurement funding, affect the budgetary process? What congressional actions will be required?

Honorable Charles A. Bowsher
February 7, 1983
Page 2

4) How are congressional approval and oversight responsibilities affected when DOD chooses to lease rather than purchase?

5) In what way could the use of leased equipment operated by contract personnel affect our ability to mobilize in the event hostilities commence?

6) Does this type of lease program effectively circumvent any "Buy American" requirements which would be applicable if the acquisition process were used?

Other pertinent issues that should be addressed may arise during the course of the review. The Subcommittee wishes to be kept informed on a regular basis as the review progresses.

I would appreciate it if work on this project could begin as soon as possible in order that the Subcommittee might have the benefit of your findings by the end of April 1983.

With best wishes, I am

Sincerely,



JACK BROOKS
Chairman

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United States Senate

COMMITTEE ON APPROPRIATIONS
 WASHINGTON, D.C. 20510

February 3, 1983

The Honorable Charles A. Bowsher
 Comptroller General of the United States
 U.S. General Accounting Office
 441 G Street, N.W.
 Washington, D. C. 20548.

Dear Mr. Bowsher:

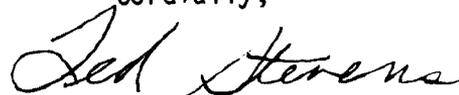
Your staff recently completed an excellent short study concerning the USAF's CT-39 replacement program. However, the "total government" funding aspect of such programs need to be explored further.

Recognizing that full programmatic details may not be available for the CT-39 program, would you prepare a report which examines in a general way the entire cost to the government of this or any other equipment leasing program wherein federal tax revenues may be lost. Clearly, the answer in each case is different. However, a generalized study, possibly using representative or illustrative funding profiles which develop rules of thumb or formulas for estimating the "total government" costs, would be helpful. This study should not be restricted only to tax and contingent liability considerations.

I would appreciate it if your staff could provide a briefing on your preliminary results to the Defense Appropriations Subcommittee staff within 45 days, followed by a written report. Necessary coordination should be made with Dick Ladd of the committee staff on 224-7296.

With best wishes,

Cordially,



TED STEVENS
 Chairman
 Subcommittee on Defense

(4) A discussion of why Federal agencies have indicated that they prefer to lease rather than purchase.

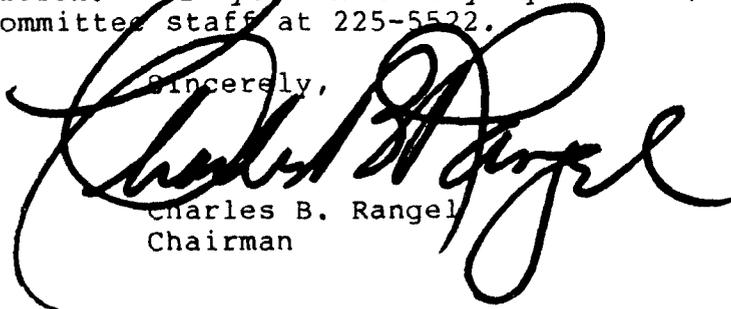
(5) Legislative and administrative options that should be considered to insure that the total costs to the government are appropriately considered when an agency makes the decision to lease rather than purchase.

(6) The extent to which the GAO has found that Federal agencies are switching from direct acquisition to leasing.

It will be necessary for Members to review your written statement prior to the hearing day, therefore I must request that 25 copies of your written testimony be delivered to the Subcommittee offices, Room 1101 Longworth House Office Building, no later than close of business, February 23, 1983. An additional 75 copies should be delivered to the Subcommittee office, Room 1101 Longworth House Office Building on the day of the hearing for distribution to the public. Since your entire written statement will be included in the Subcommittee's hearing record, I urge you to limit your oral statement to 10 minutes. This will provide the Subcommittee with the opportunity to ask each witness questions.

I look forward to your appearance at the hearing and appreciate your cooperation. If you have any questions, please contact the Subcommittee staff at 225-5522.

Sincerely,

A large, stylized handwritten signature in black ink, which appears to read "Charles B. Rangel". The signature is written over the typed name and title.

Charles B. Rangel
Chairman

CBR/bk1v

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WASHINGTON, D.C. 20510

February 1, 1983

The Honorable Charles A. Bowsher
Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Bowsher:

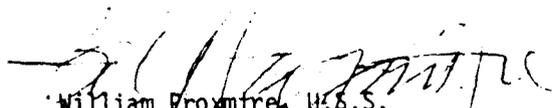
In the past Congress the Senate and House Appropriations and Armed Services Committees took testimony concerning the Navy's charter and conversion/TAKX Maritime Prepositioning Ships Program. Much of that testimony centered on the findings contained in two studies: one titled "Analysis of the Convert and Charter Program" authored by the accounting firm Coopers and Lybrand (February 11, 1982) and another titled "TAKX Maritime Prepositioning Ships: Relative Financing Costs of Charter and Purchase" produced by the Argent Group Ltd. (August 19, 1982).

Both of these studies compared the relative costs of charter and purchase of ships for the U.S. Navy and to a lesser extent the net costs to the federal government. Both studies relied heavily on a few alternately optimistic and questionable assumptions (particularly with respect to the discount rate and tax sheltering).

Therefore, it is requested that the General Accounting Office undertake an analysis of the validity of the findings contained in the two above-mentioned studies with particular attention paid to how those findings are influenced by the studies' economic conditions and lesser financial requirement assumptions (discount rate, long-term interest rates, lesser expected rate of return, tax sheltering, etc.). In addition, it is asked that the General Accounting Office undertake an analysis of the net costs of the Navy's charter and conversion/TAKX Maritime Prepositioning Ships Program to the federal government--taking into consideration all tax losses, opportunity costs, and other financial considerations such as long-term effects on the deficit.

I would hope that the study could be completed in time for the FY 84 Defense Appropriations Bill.

Sincerely,


William Proxmire, U.S.S.
Ranking Minority Member
Senate Banking, Housing and
Urban Affairs Committee



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

19 MAY 1983

The Honorable David A Stockman
Director, Office of Management and
Budget
Washington, D.C.

Dear Mr. Stockman:

In recent hearings before the Subcommittee on Oversight, House Committee on Ways and Means, Mr. Donald Sowle, Administrator of the Office of Federal Procurement Policy testified that OMB Circulars A-94 and A-104 had been identified as candidates for updating and revision. He also expressed an interest in receiving any suggestions for specific improvements that may be needed in those Circulars.

We are also in the process of providing Mr. Sowle our suggestions for improving OMB Circular A-76 in a separate letter. We appreciate the opportunity for offering specific suggestions for improving the Circulars A-94 and A-104. These suggestions deal with:

- the discount rate that should be used in present value analyses.
- the use of current dollars as opposed to constant dollars in these analyses.
- the need to recognize tax revenue implications in cost benefit and lease versus purchase analyses.

As you know, Circulars A-94 and A-104 prescribe the use of a 10 percent and 7 percent discount rate respectively for performing a present value analysis. We believe that a more realistic discount rate is one that approximates the average yield on outstanding marketable Treasury obligations with remaining maturities comparable to the period of the analysis. We have decided to use this basis because we believe investments must be viewed from a Government-wide perspective, and interest is a cost related to all Government expenditures. Additionally, since most Government funding requirements are met by the Treasury, the estimated cost to borrow (or conversely, savings from not having to borrow) is a reasonable basis for establishing the discount rate to use in present value analyses.

A matter closely related to the discount rate is whether present value analyses should be based on constant or current dollars. As you are aware, OMB Circulars prescribe that such analyses be based on constant dollars.

We believe the use of constant dollars discounted by the true cost of money exclusive of inflation, not the OMB Circulars required 10 or 7 percent, could yield satisfactory results. However, neither the true cost of money nor the constant dollars are generally readily available.

It is our policy to use a discount rate based on the average yield on marketable Treasury obligations with remaining maturities comparable to the period of the analysis. This rate is readily available, contains an implicit change in price levels, and can be applied to the current dollar expected expenditure streams to arrive at the estimated present value. For most programs or activities on which a present value analysis would be performed, the current dollar expenditure stream has already been estimated. For example, budget requests are generally stated in current dollars, as is DOD's five year defense program. Thus, using this discount rate with the built-in price change rate, and applying it to current dollars assures that like items are compared when discounting to present dollar values.

In response to questions about the existence of OMB policies concerning the tax consequences of leasing transactions, Mr. Sowle pointed out that Circulars A-94 and A-104 require all benefit analyses be performed using pre-tax data. He went on to say that the pre-tax analyses do not account for the loss of tax revenue as a result of the Accelerated Cost Recovery System (ACRS) or the Investment Tax Credit (ITC). While Mr. Sowle did not agree during the hearings that these tax consequences should be considered, he did ask for advice on factors to be considered in revising the OMB Circulars.

We believe the tax implications should be considered when comparing acquisition alternatives such as single versus multi-year contracting or lease versus purchase. Not considering the tax implications seriously misstates the true cost of the acquisition and results in a cost comparison based only on the cost to the user, not the total cost to the Government.

In today's environment of large Federal deficits, excluding the ACRS and ITC tax implications from a lease versus purchase analysis can significantly affect the basis for comparison and can result in an erroneous evaluation of the acquisition costs. Hence, tax implications are factors that should be attributed to a leasing program and should be included in the cost analysis.

We appreciate this opportunity to suggest improvements to the OMB Circulars. We believe our suggested improvements would make the Circulars more realistic and enhance their usability in achieving the purposes for which they were designed.

If you ave any questions or would like to further discuss the above matters, please call Werner Grosshans on 275-6504.

Sincerely yours,



Comptroller General
of the United States

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