LETTER TO DONALD H. RUMSFELD

July 30, 2002

BY FACSIMILE

The Honorable Donald H. Rumsfeld
Secretary
Department of Defense
The Pentagon
Washington, D.C. 20301

Dear Secretary Rumsfeld:

Last year, during conference negotiations on the Department of Defense Appropriations Act for Fiscal Year 2002, the Senate Appropriations Committee inserted into the bill unprecedented language to allow the U.S. Air Force to lease 100 Boeing 767 commercial aircraft and convert them to tankers, and to lease four Boeing 737 commercial aircraft for passenger airlift to be used by Congressional and Executive Branch officials. You will recall that Congress did not authorize these leasing provisions in the Fiscal Year 2002 National Defense Authorization Act, and in fact, the Senate Armed Services Committee was not advised of this effort by the U.S. Air Force during consideration of that authorization measure.

Again this year - without benefit of authorization committee debate or input - the Senate Appropriations Committee has added funding in the Fiscal Year 2003 Department of Defense Appropriations bill for $30.6 million to cover the leasing costs for the four Boeing 737 VIP transport aircraft noted above. Furthermore, additional language in the bill modifies a provision that the Administration carefully negotiated with appropriators last year that may permit the Air Force to circumvent standard leasing arrangements and, with respect to the four Boeing 737 VIP aircraft and 100 Boeing 767 tanker aircraft, may allow the Air Force to extend the termination liability costs over the full term of the lease.

Secretary Rumsfeld, I am concerned that the impact of these provisions has not been adequately scrutinized, and the full cost to taxpayers has not been sufficiently considered. In fact, after review of the Air Force's proposed lease for the four 737s and its comparison of leasing and purchase options for these aircraft, it appears that certain leasing costs are being hidden to make the leasing option appear more cost-effective.

For example, although the Department of Defense (DoD) self-insures its equipment and would not take out an insurance policy if it purchased these 737s, the Air Force's comparison of the leasing and purchase options assesses more than $17 million in insurance costs to the purchase option, thereby inflating the estimated purchase price significantly. In addition, the proposed leasing arrangement includes provisions requiring the Air Force to pay to insure the four 737 VIP aircraft and, in the event of loss or destruction of an aircraft, requiring the Air Force to pay a lease cancellation charge equal to one-year's worth of lease payments, or $10 million. These provisions add not only the cost of insurance, but also another $10 million to the leasing costs that would not be incurred under a traditional purchase arrangement and have not been disclosed up-front in discussions with OMB or Congress. In another example, although the contractor, Boeing, is not required to ensure that the aircraft and related modifications are fully certified to FAA standards prior to delivery to the Air Force, the proposed lease stipulates that the Air Force must return the aircraft to Boeing at the end of the lease in a configuration that is fully certified to FAA standards, including applicable Airworthiness Directives and Regulations, and must remove any Air Force modifications - all at the taxpayers' expense. Under a leasing arrangement, the government also will incur costs for supplemental rent; contractor storage; all fees, penalties, and other charges for registration, recording, financing, and refinancing of the lease; and all taxes imposed by any domestic or foreign tax authority related to the lease. These examples of hidden costs illustrate the lack of transparency of this transaction and strongly suggest that the Air Force's analysis of the $3.9 million advantage to leasing over purchase is illusory.

But you do not have to take my word for it. Rather, in a July 23 letter to Representative Curt Weldon, Congressional Budget Office Director Dan Crippen advised that the Air Force's estimated purchase price of the four 737s may be too high and that "small adjustments in the assumed purchase price, residual value, or insurance cost would reduce the projected savings from leasing the aircraft or make the purchase alternative the less expensive option." In its analysis, CBO notes that the cost of the purchase option is estimated and not based on any negotiation between the Air Force and Boeing. Significantly, CBO states,

"Just as Boeing and the Air Force negotiated a lower lease-price from Boeing's initial offer, CBO believes it might also be possible for the Air Force and Boeing to negotiate a lower purchase price for the aircraft, if the Air Force were a willing buyer. CBO estimates that the Air Force would only need to negotiate a purchase price about $1 million less per plane than Boeing's initial estimate in order for the cost of the purchase option to be equal to the cost of the lease option, in net present value terms. . . . Using Air Force data and a model for calculating commercial lease payments, we estimate that a purchase price of $249 million (rather than the $269 million price used in the Air Force's analysis) would be consistent with the lease terms. . . . We estimate that, if a purchase price for the four aircraft could be negotiated for $249 million or $5 million less per aircraft, then the purchase alternative would save about $15 million compared to the lease."

OMB Director Mitch Daniels has indicated his preference to maintain scrutiny of government leasing practices out of regard for U.S. taxpayers. Just last year, in a letter to Senator Kent Conrad, Mr. Daniels cautioned against eliminating rules intended to reduce leasing abuses. His letter emphasized that the Budget Enforcement Act (BEA) scoring rules "were specifically designed to encourage the use of financing mechanisms that minimize taxpayers' costs by eliminating the unfair advantage provided to lease-purchases by the previous scoring rules. Prior to the BEA, agencies only needed budget authority for the first year's lease payment, even though the agreement was a legally enforceable commitment to fully pay for the asset overtime." Mr. Daniels continued by explaining that this loophole had permitted the General Services Administration to agree to 11 lease-purchase agreements with a total, full-term cost of $1.7 billion, but to budget only the first year of lease payments. He said, "[t]he scoring hid the fact that these agreements had a higher economic cost than traditional direct purchases and in some cases allowed projects to go forward despite significant cost overruns. . . ."

I ask you to continue your strong oversight of government leasing practices, and request that you respond by August 1 to the following questions regarding the proposed Air Force lease with Boeing of four 737 aircraft for VIP transport:

1. The information in Attachment 7 gives the Air Force the option to purchase the four Boeing 737s at the end of the lease for an additional $102 million; this option to buy strongly suggests this is a capital lease rather than an operating lease. Given the language in Attachment 7 of the proposed lease between the Air Force and Boeing, please explain whether this is an operating lease or a capital lease, and why. If you conclude that it is a capital lease, please discuss your opinion of such lease-purchase deals, which Mr. Daniels has previously indicated routinely cost the government much more than anticipated.

2. A GAO report released in April 2000 to Senate Appropriators Barbara Boxer and Tom Harkin concluded that DoD did not define adequately or validate its VIP airlift requirements. Nonetheless, if the Air Force, by its request for these four 737s, is indicating that such a requirement currently exists, it is logical to assume that this requirement will remain in five years at the end of the lease. If this requirement still exists in five years and these new aircraft are expected to have a service life of 30 years, please discuss whether this proposed lease is in fact a lease-purchase deal (i.e., capital lease) and whether it might be more cost-effective to pursue instead a long-term strategy to purchase the aircraft and negotiate a fair purchase price.

In your response, please consider that in the Senate version of the Fiscal Year 2003 Department of Defense Appropriations bill, the Appropriations Committee rejected the Administration's proposal to purchase 60 additional Boeing C-17 airlift aircraft at a rate of 15 per year via an incremental funding proposal that would have allowed DoD to request only the amount of funding needed each year to start production of 15 aircraft and to finance the balance of the cost over several years. Instead, the Committee said, "[t]his financing scheme runs counter to the 'full funding' principles which guide Federal Government procurement practice and thus creates a future liability for the Air Force and Congress." The Committee then increased the President's budget request by over half a billion dollars to fully fund the purchase of these Boeing aircraft.

3. As noted above in the discussion of the CBO's letter, the Air Force did not attempt to negotiate on a purchase price for the four Boeing 737s. In addition, the Air Force did not attempt to compete its leasing concept for the VIP airlift aircraft. Please explain why the Air Force did not compete this leasing proposal, given the many manufacturers, financing entities, airlines, or any other entities that could have offered competitive proposals.

4. The Air Force has advised that OMB has concurred with this proposed leasing concept for the four Boeing 737 VIP aircraft. Please provide your analysis of how the Air Force determined or developed the leasing amount, purchase price, discount rate, and aircraft residual value, and DOD Comptroller Dov Zakheim's rationale for concurring with the Air Force's leasing proposal.

5. Financing experts advise that to evaluate whether leasing is the preferable option as compared to purchase of aircraft, one month's lease payment should be equal to approximately 1% of the total cost of the aircraft. In GAO's current analysis, on which I have been briefed, GAO contends that the Air Force's proposed lease with Boeing for the 737 VIP aircraft is $32 million more than the above-noted leasing norm. Please compare the proposed Air Force-Boeing lease with the industry standard to determine whether the Air Force's lease payments are too high.

6. In my view, this leasing proposal for Boeing 737 VIP aircraft - not requested in the President's budget - puts the Air Force at risk of being unable to procure higher priority items that have been discussed at length and presented in formal testimony at hearings in the Committee on Armed Services, the President's budget request, the Air Force Chief of Staff's Unfunded Priority List, and the Air Force's long-term procurement plan. Please describe the immediate requirement for these aircraft in consideration of other higher priority procurement items in the Administration's budget request needed to fight our nation's war on terrorism.

7. Please evaluate the policy of leasing major defense acquisition programs, including the Air Force-Boeing 737 VIP aircraft, as compared to the traditional defense acquisition process.

Secretary Rumsfeld, in view of the Senate's impending vote on its version of the Fiscal Year 2003 Department of Defense Appropriations bill and DoD's only recently submitted reprogramming request to fund this lease, I greatly appreciate your prompt consideration of my letter and your continued close review of this important matter. The American taxpayers are counting on you.

Sincerely,

John McCain
U.S. Senator