
June 21, 2006



Acquisition

Contracting and Funding for the
C-130J Aircraft Program
(D-2006-093)

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Acronyms

AFAA	Air Force Audit Agency
FAR	Federal Acquisition Regulation
IG	Inspector General
MYP	Multiyear Procurement
PBD	Program Budget Decision
SPO	System Program Office



INSPECTOR GENERAL
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June 21, 2006

MEMORANDUM FOR ASSISTANT SECRETARY OF THE AIR FORCE
(FINANCIAL MANAGEMENT AND COMPTROLLER)
NAVAL INSPECTOR GENERAL

SUBJECT: Report on Contracting and Funding for the C-130J Aircraft Program (Report No. D-2006-093)

We are providing this report for your information and use. The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) provided comments. We considered management comments on the draft of this report when preparing the final report. The complete text of the comments is in the Management Comments section of the report.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Rudolf Noordhuizen at (703) 604-8959 (DSN 664-8959) or Lisa E. Novis at (703) 604-8967 (DSN 664-8967). See Appendix C for the report distribution. The team members are listed on the inside back cover.

A handwritten signature in black ink that reads "Richard B. Jolliffe".

Richard B. Jolliffe
Assistant Inspector General
Acquisition and Contract Management

Department of Defense Office of Inspector General

Report No. D2006-093

June 21, 2006

(Project No. D2005-D000AB-0214.000)

Contracting and Funding for the C-130J Aircraft Program

Executive Summary

Who Should Read This Report and Why? Congressional, civilian, and military personnel involved in managing acquisition programs should read this report to obtain information about commercial item acquisition and contract management. This report discusses problems associated with commercial acquisition, contractor performance, contract modifications, and contract termination of the C-130J aircraft.

Background. The C-130J performs the intratheater portion of the airlift mission and is a platform for dropping troops and equipment into hostile areas. The Air Mobility Command, Theater Commands, Air National Guard, Air Force Reserve, Air Force Special Operations Command, Marine Corps, and Coast Guard use the C-130 aircraft fleet in peace and war missions. The C-130J aircraft is a medium-range, tactical aircraft and is the newest upgrade to the C-130 fleet.

The DoD Program Budget Decision (PBD) 753, December 23, 2004, called for the termination of the procurement of C-130J aircraft for the Air Force and the accelerated procurement of the remainder of the KC-130J aircraft for the Marine Corps in FY 2006.

On May 10, 2005, the Secretary of Defense determined that it was in the best interest of DoD to complete the multiyear contract based on the estimated costs to terminate the contract.

We performed this audit in response to four allegations made to the Defense Hotline concerning the C-130J Program. The first allegation was that the C-130J termination cost estimate was inaccurate; further, if the estimate was valid, there was a potential for an Antideficiency Act violation. The complainant also alleged that the Government misused funds to support the C-130J commercial venture, the Government funds spent on contract modification P00020 did not relate to new Air Force work requirements, and that the contracting officer did not appropriately evaluate the contractor's performance against contract default provisions.

Results. We substantiated the allegation that the C-130J termination cost estimate was unsupported, and that had the estimate been valid, there was a potential for an Antideficiency Act violation. Specifically, the Air Force acquisition personnel could not support the cost estimate to terminate the C-130J aircraft multiyear procurement contract. As a result, the Secretary of Defense did not have sufficient termination cost information to determine the cost-effectiveness of continuing or terminating the C-130J MYP contract. In addition, the FY 2006 President's Budget did not include sufficient funds to terminate the Air Force C-130J aircraft procurement and accelerate the Marine Corps KC-130J aircraft procurement if the unsupported cost estimate was valid. We did not

substantiate the allegations that the Air Force C-130J System Program Office misused funds to support the C-130J commercial venture and that the funds for modification P00020 were not used for new work. We substantiated the allegation that the C-130J System Program Office contracting officer did not appropriately evaluate the contractor's performance against contract default provisions. The last three allegations discussed relate to a finding in a prior report and are addressed in Appendix B.

Management Comments and Audit Response. Although no comments were required, the Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) stated that the PBD 753 implementation cost estimate was based on information that was available at the time the estimate was submitted. Because the C-130J aircraft were procured under Federal Acquisition Regulation Part 12, the contractor was not required to provide certified cost data. The Air Force also stated that there was no potential for an Antideficiency Act violation because the Air Force would have been allowed to fund the program within its Total Obligation Authority. The Air Force acknowledged that the allegation was partially accurate. The Air Force stated that they did not terminate the C-130J contract for default because they were actively working with the contractor to address shortfalls in meeting the commercial specification that was on contract.

We agree that the Air Force PBD 753 implementation cost estimate was based on the information that was available at the time the estimate was submitted. However, as we stated in the report, because the C-130J aircraft were procured under Federal Acquisition Regulation Part 12, the Air Force did not have cost and pricing data needed to perform a valid cost estimate. If PBD 753 had been implemented at the termination cost amounts the Air Force estimated, the FY 2006 President's Budget would not have had sufficient funds to pay for the termination. Though we agree that the Air Force would have been allowed to fund the implementation of PBD 753 within its Total Obligation Authority to avoid an Antideficiency Act violation, the Air Force should not have entered into a contract that could cost almost as much to cancel as to complete. Also the Government should require the contractor to deliver an aircraft compliant with the contract model specification, yet ten years after the first award in 1995, the contractor was still delivering non-compliant aircraft. The Air Force's acceptance of the deficient aircraft for such a long period limited its options in enforcement of the contract. This was compounded because the Air Force chose an inappropriate acquisition strategy and used ambiguous and vague contracting language.

A discussion of the management comments is in the Finding section and Appendix B of the report, and the complete text is in the Management Comments section.

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Background

We performed this audit in response to four allegations made to the Defense Hotline concerning contracting and funding for the C-130J Program.

Congressional Authorization and Appropriation. Congress authorized and appropriated about \$7.5 billion for the acquisition of the C-130J aircraft for FYs 1994 through 2006. About \$2.9 billion of the \$7.5 billion was in the form of congressional increases to the Services' budget requests. In 2003, DoD submitted a request for approval of a multiyear procurement (MYP) contract for the C-130J aircraft. The 2003 Authorization Conference Report 107-772 authorized MYP authority for the C-130J aircraft program.

C-130J Aircraft. The C-130J performs the intratheater portion of the airlift mission and is a platform for dropping troops and equipment into hostile areas. Air Mobility Command, Theater Commands, Air National Guard, Air Force Reserve, Air Force Special Operations Command, Marine Corps, and Coast Guard use the C-130 aircraft fleet in peace and war missions. The C-130J aircraft is a medium-range, tactical aircraft and is the newest upgrade to the C-130 fleet. Specialized versions of the aircraft include the C-130J Stretch in which the cargo floor length of the aircraft is increased from 40 to 55 feet, the WC-130J that performs weather reconnaissance missions, the EC-130J that performs electronic warfare missions, the KC-130J that performs air-refueling missions, and the HC-130J that performs search and rescue missions. In this report, all aircraft will be referred to as the C-130J unless the discussion relates to a specific aircraft version.

C-130J Program Information. The Under Secretary of Defense for Acquisition, Technology, and Logistics designated the C-130J Program as an Acquisition Category IC program and assigned the Air Force acquisition executive as the milestone decision authority.* The Air Force C-130J System Program Office (SPO) contracting officer determined that the C-130J aircraft was a commercial item that would meet the Government's needs with minor modifications. Lockheed Martin developed and produced the C-130J aircraft by using a commercial aircraft model performance specification. Lockheed Martin initiated the C-130J aircraft and managed the program development, developmental testing, and production process. Because the Air Force C-130J SPO contracting officer determined that the C-130J aircraft was a commercial item, the Air Force did not apply the normal milestone decision process to this program.

Based on the congressional authority to purchase C-130J aircraft, the Air Force decided to buy the aircraft in the quantities authorized. Because of the contracting officer's decision to designate the aircraft as a commercial item, Federal Acquisition Regulation (FAR) Part 15, "Contracting by Negotiation," which allows Government access to contractor cost and pricing data as well as other Government oversight, did not have to be applied to the C-130J procurement. On

* Acquisition Category IC programs are Major Defense Acquisition Programs with expenditures for research, development, test, and evaluation of more than \$365 million or procurement of more than \$2.190 billion. The milestone decision authority is the Component head, or Service acquisition executive.

March 14, 2003, the Air Force C-130J SPO awarded, as authorized, an MYP contract to Lockheed Martin. The contract was for the procurement of 60 aircraft: 40 C-130J aircraft for the Air Force and 20 KC-130J aircraft for the Marine Corps. Since program inception, the Air Force C-130J SPO has contracted for 117 C-130J aircraft for the Air Force, Marine Corps, and Coast Guard at a cost of \$7.45 billion. As of December 31, 2005, the Air Force C-130J SPO had accepted 73 C-130J aircraft.

Program Budget Decision 753. The DoD Program Budget Decision (PBD) 753, December 23, 2004, proposed terminating the procurement of C-130J aircraft for the Air Force and accelerated procurement of the KC-130J aircraft for the Marine Corps in FY 2006.

Congressional Letter. On January 10, 2005, 24 members of the U.S. Senate wrote a letter to President George Bush stating that the DoD proposed termination of the C-130J MYP contract was ill-advised and untimely given the operational shortfalls facing our military and the threats facing our Nation.

Conversion to Noncommercial Acquisition. During an April 13, 2005, meeting, the Chairman of the Senate Subcommittee on AirLand, Committee on Armed Services, the Acting Secretary, and Chief of Staff of the Air Force agreed that the aircraft procurement should be converted from a commercial acquisition to a negotiated procurement under FAR Part 15.

Secretary of Defense Letter. On May 10, 2005, the Secretary of Defense wrote a letter to the Honorable Ted Stevens, Chairman for the Defense Subcommittee, Committee on Appropriations in which he stated that it was in the best interest of DoD to complete the MYP contract based on the estimated costs to terminate the C-130J MYP contract.

Objectives

The audit objective was to determine whether the Defense Hotline allegations on the C-130J program had merit. Specifically, the audit evaluated:

- the costs to terminate the C-130J contract for convenience and potential Antideficiency Act violations;
- the potential misuse of Government money to support the C-130J commercial venture;
- whether money spent for contract modification P00020 appropriately related to new work requirements of the Air Force; and
- whether the contracting officer appropriately evaluated the contractor's performance against contract default provisions.

The report finding discusses the costs to terminate the C-130J contract for convenience and potential Antideficiency Act violations. Appendix B addresses the potential misuse of Government money to support the C-130J commercial

venture; whether money spent for contract modification P00020 appropriately related to new work requirements of the Air Force; and whether the contracting officer appropriately evaluated the contractor's performance against contract default provisions. See Appendix A for a complete discussion of the audit scope and methodology as well as prior coverage.

Managers' Internal Control Program

We did not review the managers' internal control program because the audit focused on whether the allegations on the C-130J Program had merit.

Termination Costs for the C-130J Program

The Air Force acquisition personnel provided the Secretary of Defense with an unsupported cost estimate to use in deciding whether to terminate the C-130J aircraft MYP contract. This occurred because the Air Force included ambiguous language in the contract and did not have cost and pricing data needed to develop an accurate cost estimate. As a result, the Secretary of Defense did not have sufficient termination cost information to determine the cost-effectiveness of continuing or terminating the C-130J MYP contract. In addition, the FY 2006 President's Budget did not include sufficient funds to terminate the Air Force C-130J aircraft procurement and accelerate the Marine Corps KC-130J aircraft procurement if the unsupported cost estimate was valid.

C-130J MYP Contract

C-130J/KC-130J MYP Contract. On March 14, 2003, the Air Force C-130J SPO contracting officer awarded an MYP contract to Lockheed Martin. The contract was for the procurement of 60 aircraft: 40 C-130J aircraft for the Air Force and 20 KC-130J aircraft for the Marine Corps. Table 1 shows the number of aircraft by Service and fiscal year.

Table 1. MYP Aircraft by Service and Fiscal Year

	<u>Air Force C-130J</u>	<u>Marine Corps KC-130J</u>	<u>Total Aircraft</u>
FY 2003	0	4	4
FY 2004	4	0	4
FY 2005	11	4	15
FY 2006	9	4	13
FY 2007	9	4	13
FY 2008	<u>7</u>	<u>4</u>	<u>11</u>
Total	40	20	60

The C-130J MYP contract included 60 aircraft at a price of \$4.05 billion. Table 2 shows the funding by Service and fiscal year.

**Table 2. MYP Aircraft Funding by Service and Fiscal Year
(in Millions)**

	<u>Air Force C-130J</u>	<u>Marine Corps KC-130J</u>	<u>Total Aircraft</u>
FY 2003	\$70.0	\$279.6	\$349.6
FY 2004	369.1	40.0	409.1
FY 2005	733.9	277.6	1,011.5
FY 2006	567.7	277.6	845.3
FY 2007	567.7	277.6	845.3
FY 2008	<u>351.6</u>	<u>237.6</u>	<u>589.2</u>
Total	\$2,660.0	\$1,390.0	\$4,050.0

Program Budget Decision 753. DoD PBD 753, December 23, 2004, terminated the procurement of C-130J aircraft after FY 2005 for the Air Force and accelerated procurement of the remainder of the KC-130J aircraft for the Marine Corps in FY 2006. PBD 753 would have reduced the MYP contract by 25 aircraft from 60 to 35 aircraft. Table 3 shows the number of aircraft by Service and fiscal year under PBD 753.

Table 3. MYP Aircraft by Service and Fiscal Year Under PBD 753

	<u>Air Force C-130J</u>	<u>Marine Corps KC-130J</u>	<u>Total Aircraft</u>
FY 2003	0	4	4
FY 2004	4	0	4
FY 2005	11	4	15
FY 2006	0	12	12
FY 2007	0	0	0
FY 2008	<u>0</u>	<u>0</u>	<u>0</u>
Total	15	20	35

Criteria

Federal Acquisition Regulation. FAR clause 52.217-2, "Cancellation Under Multi-Year Contracts," October 1997, defines cancellation as

the Government canceling its requirements for all supplies or services in program years subsequent to that in which notice of cancellation is provided. Cancellation shall occur by the date or within the time period specified in the Schedule, unless a later date is agreed to, if the contracting officer notifies the contractor that funds are not available for contract performance for any subsequent program year. If cancellation under this clause occurs, the contractor will be paid a cancellation charge not over the cancellation ceiling specified in the schedule as applicable at the time of cancellation. The cancellation

charge will cover only costs incurred by the contractor and/or subcontractor; reasonably necessary for performance of the contract; and that would have been equitably amortized over the entire multi-year contract period but, because of the cancellation, are not so amortized; and a reasonable profit or fee on the costs.

United States Code. Section 1341, title 31, United States Code, “Limitations on Expending and Obligating Amounts,” forbids obligating, expending, or authorizing the use of funds exceeding the amount available in an appropriation or fund. Section 1517, title 31, United States Code, “Prohibited Obligations and Expenditures,” forbids the overobligation and overexpenditure of appropriations.

Air Force Estimated Termination Costs

PBD 753 proposed terminating the procurement of C-130J aircraft after FY 2005 for the Air Force and accelerated procurement of the remainder of the MYP KC-130J aircraft for the Marine Corps in FY 2006. Assistant Secretary of the Air Force, Acquisition personnel, the Air Force C-130J SPO, the Air Force F/A-22 SPO, and Marine Corps personnel developed the Air Force estimate to implement PBD 753. The Air Force estimated the cost to implement PBD 753 at \$1.78 billion, as shown in Table 4.

Table 4. Air Force Estimated Costs to Implement PBD 753

<u>Cost Component</u>	<u>Cost (in billions)</u>
Cancellation Ceiling	\$0.44
Equitable Adjustment	0.72
KC-130J Procurement Acceleration	0.42
F/A-22 Overhead Cost Increase	<u>0.20</u>
Total	\$1.78

Cancellation Ceiling. The C-130J MYP contract included a cancellation ceiling clause in case the Government terminated the contract for the convenience of the Government. For purposes of determining the cancellation cost, the contract assumes full funding by November 15 of each fiscal year. The contract stated that if the contract cancellation occurred after November 15, the Government and the contractor would negotiate an equitable adjustment to the cancellation values. The equitable adjustment was to be limited to a reasonable amount necessary to account for the additional contract performance required after November 15 and until the actual date of cancellation. No adjustment was to be made to the cancellation ceiling unless the actual date of cancellation occurred after November 15 of the affected fiscal year. The C-130J MYP contract established the contract cancellation ceilings as shown in Table 5.

Table 5. MYP Cancellation Ceiling Amounts by Fiscal Year

<u>Fiscal Year</u>	<u>Cancellation Ceiling Amount</u>	<u>Assumed Date of Cancellation</u>
FY 2003	\$110,000,000	November 16, 2003
FY 2004	\$474,200,000	November 16, 2004
FY 2005	\$439,700,000	November 16, 2005
FY 2006	\$383,300,000	November 16, 2006
FY 2007	\$347,300,000	November 16, 2007
FY 2008	\$0	-

The Air Force estimate to terminate the C-130J contract used the FY 2005 cancellation ceiling of \$439,700,000 (rounded up to \$440 million) that was provided in the contract. The Air Force stated that the cancellation ceiling covered contractor commitments to subcontractors and long-lead items. However, the Air Force C-130J SPO contracting officer could not provide any documentation to show how the ceiling cost was derived and what items were included in the ceiling amount. Under the terms of the cancellation clause, the C-130J SPO was not obligated to pay the full cancellation ceiling amount. The cancellation clause in the contract allowed the contractor to receive only an equitable adjustment or otherwise allowable cost resulting from the termination. In estimating the amount to pay the contractor, the Air Force should have considered that they had already paid advanced procurement for long-lead items, and PBD 753 did not cancel the Marine Corps aircraft procurements. The C-130J SPO contracting officer should only make payments to the contractor that are allowable by the contract cancellation clause and that the contractor can support. Assistant Secretary of the Air Force, Acquisition personnel stated by definition, a contract cancellation ceiling should represent the Government's maximum liability.

Equitable Adjustment. Air Force C-130J SPO personnel stated that the C-130J MYP contract included significant contingent liabilities beyond the contract cancellation ceiling. Air Force C-130J SPO personnel stated that in addition to the contract ceiling clause, an equitable adjustment clause in the contract states:

If the contract is terminated for the Convenience of the Government and the total quantity of aircraft procured is reduced to less than 60, an equitable adjustment shall be made to the unit price reflected in the schedule. All payments made, or to be made, will be adjusted to reflect the new unit price.

However, the contract does not provide a methodology for determining the equitable adjustment, new unit prices, or a new contract price for procuring fewer than 60 aircraft. The equitable adjustment clause was separate from the cancellation provisions. The contract did not state whether these costs were included as part of the cancellation ceiling. Assistant Secretary of Air Force, Acquisition personnel stated that because the equitable adjustment clause was not contained in the cancellation provisions, but rather in the multiyear funding provision, it would not be included in the contract cancellation ceiling. In addition, the equitable adjustment wording did not provide any pricing

methodology, so the Air Force acquisition personnel stated that they believed it was reasonable to assume that these words represented an open-ended liability risk to the Government.

The Air Force estimated that the additional price for the 23 delivered C/KC-130J aircraft would be \$32 million per aircraft (\$720 million total). However, the Air Force C-130J SPO personnel did not have supporting documentation or a methodology for how they arrived at the additional amount. Because the C-130J MYP contract was awarded as a commercial contract, the Air Force C-130J SPO personnel had no cost or pricing data to determine increased aircraft costs related to procuring 25 fewer C-130J aircraft. In addition, the cancellation clause stated that if the Government cancels the contract, the contractor will be paid a cancellation charge no more than the cancellation ceiling specified in the cancellation ceiling clause.

The ceiling should be the limit for reimbursement of allowable cost, but costs should only be allowable to the extent those costs could be supported. Therefore, a supportable equitable adjustment to increase C-130J aircraft costs should be allowed up to the cancellation ceiling amount.

KC-130J Procurement Acceleration. PBD 753 also accelerated procurement of the remainder of the KC-130J aircraft for the Marine Corps in FY 2006. Air Force C-130J SPO personnel stated the Government would have additional costs if the KC-130J aircraft procurement was accelerated to buy 12 KC-130J aircraft instead of 4 KC-130J aircraft and 9 C-130J aircraft in FY 2006. Air Force C-130J SPO personnel stated that the cost per aircraft would increase due to a break in the production line. In addition, Air Force C-130J SPO personnel stated that long-lead items were purchased for four KC-130J aircraft and nine C-130J aircraft, not for the additional eight KC-130J aircraft to be procured under PBD 753. Air Force C-130J SPO personnel stated that there would be an 8- to 11-month break in the C-130J production line and estimated that the procurement acceleration would increase the price per aircraft by \$35 million (\$420 million total) to procure 12 KC-130J aircraft in FY 2006. However, the Air Force C-130J SPO personnel did not have supporting documentation or a methodology to show how they arrived at the additional amount. The Marine Corps acceleration did not change the number of the KC-130J aircraft to be acquired as part of the MYP contract; it only changed the timing of the purchase. In addition, the Government was buying only one less aircraft overall in FY 2006; rather than 4 KC-130J aircraft and 9 C-130J aircraft, the Government was buying 12 KC-130J aircraft. Air Force C-130J SPO personnel did not provide any analysis of what C-130J long-lead items might be usable for the KC-130J aircraft. Only a supportable equitable adjustment should be allowed within the ceiling amount.

F/A-22 Overhead Cost Increase. Lockheed Martin manufactures both the C-130J aircraft and the F/A-22 aircraft at its production facility in Marietta, Georgia. Assistant Secretary of the Air Force, Acquisition personnel stated if the C-130J aircraft was no longer produced at the facility in Marietta, Georgia, the cost of the F/A-22 program would grow, primarily because of increased overhead rates. The briefing to the Secretary of Defense showed the F/A-22 overhead increase as \$200 million. Further refinement by the F/A-22 Program Office brought the estimated cost down to \$175 million. The F/A-22 Program Office

and the Air Force Cost Analysis Agency performed a detailed, documented analysis of the impact of PBD 753 on the F/A-22 Program. The analysis showed an increase to the F/A-22 program of \$175 million from FY 2006 through FY 2008 if the Air Force terminated the procurement of C-130J aircraft after FY 2005 and accelerated procurement of the remainder of the KC-130J aircraft for the Marine Corps in FY 2006. The Institute for Defense Analysis validated the F/A-22 cost-estimation process. The F/A-22 Program Office was able to perform a detailed supported cost estimate because, unlike the C-130J Program, the F/A-22 Program was procured under a FAR Part 15 negotiated contract; therefore, the program office had validated cost and pricing data necessary to accurately estimate the effect on the F/A-22 overhead rates.

Total Estimated Cost to Terminate. The Air Force estimated it would cost \$1.78 billion to terminate the procurement of the C-130J and accelerate the procurement of the KC-130J aircraft. However, \$1.1 billion was not supported and another \$440 million was supported only to the extent that it represented the ceiling amount in the contract. In addition, PBD 753 funding of the C-130J termination was not adequate to cover the Air Force estimate to terminate the C-130J MYP contract if the unsupported cost estimate was valid.

Air Force Budgeted Termination Costs

If PBD 753 had been implemented at the termination cost amounts the Air Force estimated, the FY 2006 President's Budget would not have had sufficient funds to pay for the termination. Based on figures provided by the Assistant Secretary of Air Force, Acquisition personnel, DoD budgeted \$650 million in PBD 753 for the termination of the Air Force procurement of C-130J aircraft and the accelerated procurement of the remainder of the KC-130J aircraft for the Marine Corps in FY 2006. The initial cancellation cost amounts budgeted for in the FY 2006 President's Budget that Assistant Secretary of Air Force, Acquisition officials provided were based on lower estimates. The Air Force estimated the cost to implement PBD 753 at \$1.78 billion. Because only \$650 million was budgeted to implement PBD 753, the Air Force would have had a budget shortfall of \$1.13 billion and the potential for an Antideficiency Act violation if PBD 753 had been implemented. However, Assistant Secretary of Air Force, Acquisition personnel stated that if the C-130J MYP contract termination had been implemented, funding would have been included in the FY 2007 budget request to cover the full termination cost, and avoid an Antideficiency Act violation.

Air Force MYP Contract

Air Force C-130J SPO contracting officer clouded the terms and conditions of the MYP contract by modifying standard FAR clause 52.217-2, "Cancellation Under Multi-Year Contracts."

FAR Clause 52.217-2. The Air Force C-130J SPO contracting officer modified FAR clause 52.217-2, "Cancellation Under Multi-Year Contracts," October 1997, and did not include an explanation of what the cancellation ceiling amount would cover. Instead, the C-130J MYP contract stated, "in the event of contract

cancellation, as defined in paragraph 23.a of this clause, the contractor would submit a commercial cancellation proposal to the Government.” In addition, the contracting officer deleted FAR clause 52.217-2 paragraphs that explained what the contractor’s claim may include, what the claim would not include, and how to deal with option clauses if included within the contract. The contracting officer also did not make clear how the equitable adjustment clause for termination would interact with the cancellation ceiling clause. The contract did not discuss accelerated deliveries. Although the Air Force C-130J SPO contracting officer left portions of the contract unclear and clouded the meaning of the FAR clause, the clause still required the contractor to provide sufficient support of incurred costs to substantiate payments to the contractor and that amounts would only be allowed under the ceiling to the extent the costs were supported.

C-130J MYP Contract Cost and Pricing Data

The Air Force C-130J SPO personnel did not have C-130J cost and pricing data necessary to determine termination costs for the C-130J MYP contract. Because the Air Force C-130J SPO contracting officer determined that the C-130J aircraft was a commercial item, the SPO adopted a commercial acquisition strategy. Therefore, the Air Force C-130J SPO personnel did not have cost or pricing data for the C-130J aircraft procurement to develop an estimate of the additional contractor costs related to the C-130J procurement reduction and acceleration of the KC-130J procurement.

Decision Not to Terminate the C-130J MYP Contract

The price to complete the aircraft deliveries under the C-130J MYP contract for FY 2006 through FY 2008 is \$2.3 billion. The Air Force estimate to implement PBD 753 was \$1.78 billion. Accordingly, the difference between implementing PBD 753 and completing the C-130J MYP contract was \$520 million.

On May 10, 2005, the Secretary of Defense wrote a letter to the Defense Subcommittee, Committee on Appropriations in which he stated it was in the best interest of DoD to complete the multiyear contract based on the additional costs estimated to terminate the C-130J MYP contract.

Conclusion

The Air Force estimated it would cost \$1.78 billion to implement PBD 753 to terminate the procurement of the C-130J and accelerate the procurement of the KC-130J aircraft. However, the Air Force did not have support for \$1.1 billion of its cost estimate and only supported an additional \$440 million to the extent that it was the ceiling amount included in the contract. The Air Force C-130J MYP cancellation ceiling amount was taken from the MYP contract. By definition, a contract cancellation ceiling represents the Government’s maximum liability. However, conflicting statements and ambiguities in the contract limited the Air Force’s ability to assess the Government’s liability and resulted in a significantly higher estimate to implement PBD 753. PBD 753 was only a partial program

cancellation; it canceled only the Air Force aircraft procurement, not the Marine Corps aircraft procurement. Instead of attempting to determine incurred costs that would be allowed up to the ceiling amount, the Air Force C-130J SPO personnel used the total ceiling price in its cost estimate. In addition, the Air Force C-130J SPO contracting officer could not provide documentation to show how the ceiling cost was derived and what items would be allowable under the ceiling. The language in the MYP contract also allowed for an equitable adjustment if less than 60 aircraft are purchased. The contract did not include the equitable adjustment in the cancellation provision; therefore, it is not clear whether the equitable adjustment should have been limited to the cancellation ceiling. In addition, the equitable adjustment clause should have included a pricing methodology to allow the Government to know its liability. Because the C-130J MYP contract was designated as commercial, the Air Force C-130J SPO personnel had no cost or pricing data needed to perform a valid cost estimate for the C-130J procurement reduction or the KC-130J procurement acceleration. The contract did not discuss equitable adjustments for accelerated deliveries. The increase in overhead to the F/A-22 program caused by the cancellation is the only cost supported with a detailed methodology and documentation. As a result, the cost estimate used by the Secretary of Defense to reinstate the C-130J Program was incomplete and did not provide reliable information for making an informed decision. Had the Air Force's cost estimate been closer to the original amount included in the PBD, the decision may have been different.

We are making no recommendations in this report because the problems within the C-130J Program were the result of the Air Force C-130J SPO contracting officer adopting a commercial acquisition strategy and using ambiguous contract language. Our previous report, DoD Inspector General Report No. D-2004-102, "Contracting for and the Performance of the C-130J Aircraft," July 23, 2004, addressed this issue. In addition, during an April 13, 2005, meeting, the Chairman of the Senate Subcommittee on AirLand, Committee on Armed Services, the Acting Secretary, and Chief of Staff of the Air Force agreed that the aircraft procurement should be converted from a commercial acquisition to a negotiated procurement under FAR Part 15. The Air Force is in the process of making that conversion. An undefinitized contract action was issued on February 10, 2006, to convert the FY 2006 through FY 2008 portion of the C-130J MYP contract to a FAR Part 15 negotiated contract.

Management Comments and Audit Response

Although not required to comment, the Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) provided comments on the report. For a full text of the comments, see the Management Comments section of the report.

Management Comments. The Air Force stated that the PBD 753 implementation cost estimate was based on information that was available at the time the estimate was submitted. The Air Force, along with the Office of the Secretary of Defense (Program Analysis and Evaluation), developed a rough order of magnitude cost estimate based on the Government's interpretation of the contract terms and conditions, along with potential operational and programmatic impacts. There were no discussions with the C-130J contractor. The Air Force

considered termination costs, cancellation costs, equitable adjustments required by express contract terms, C-130J/KC-130J operational impacts, and facility impacts based on overhead rates. Because C-130J aircraft were procured under FAR Part 12, the contractor was not required to provide certified cost data. The Air Force also stated that there was no potential for an Antideficiency Act violation because the Air Force would have been allowed to fund the program within its Total Obligation Authority.

Audit Response. We agree that the Air Force PBD 753 implementation cost estimate was based on the information that was available at the time the estimate was submitted. However, as we stated in the report, because the C-130J aircraft were procured under FAR Part 12, the Air Force did not have cost and pricing data needed to perform a valid cost estimate. By definition, a contract cancellation ceiling should represent the Government's maximum liability. However, conflicting statements and ambiguities in the contract limited the Air Force's ability to assess the Government's liability and resulted in a significantly higher estimate to implement PBD 753. As a result, the cost estimate used by the Secretary of Defense to reinstate the C-130J Program was incomplete and did not provide reliable information for making an informed decision. The Air Force estimated the cost to implement PBD 753 at \$1.78 billion but only \$650 million was budgeted, leaving the Air Force with a budget shortfall of \$1.13 billion and the potential for an Antideficiency Act violation. Though we agree that the Air Force would have been allowed to fund the implementation of PBD 753 within its Total Obligation Authority to avoid an Antideficiency Act violation, the Air Force should not have entered into a contract that could cost almost as much to cancel as to complete.

Appendix A. Scope and Methodology

We performed the audit to examine four allegations made to the Defense Hotline regarding contracting and funding for the C-130J Aircraft Program.

We reviewed the operational requirement document and contract files for the C-130J Program dated from September 1995 through March 2006. We reviewed DoD policies for commercial acquisitions, contract terminations, and contractor performance. We discussed the allegations with the complainant. We also reviewed the Program Budget Decision and the documentation supporting the cost analysis. We interviewed officials in DoD, the Air Force, the Navy, the Marine Corps, and the Defense Contract Management Agency.

We performed this audit from June 2005 through March 2006 in accordance with generally accepted government auditing standards.

Use of Computer-Processed Data. We did not use computer-processed data to perform this audit.

Government Accountability Office High-Risk Area. The Government Accountability Office has identified several high-risk areas in DoD. This report provides coverage of the DoD weapons acquisition process and contract management and oversight high-risk areas.

Prior Coverage

During the last 5 years, the DoD Inspector General (IG) and the Air Force Audit Agency (AFAA) have issued two reports discussing the C-130J Program. Unrestricted DoD IG reports can be accessed at <http://www.dodig.mil/audit/reports>.

DoD IG

DoD IG Report No. D-2004-102, "Contracting for and the Performance of the C-130J Aircraft," July 23, 2004

AFAA

AFAA Report No. F2005-0008-FC3000, "Acquisition Management of the C-130J Program," September 28, 2005

Appendix B. Summary of Allegations

We substantiated the allegation that the Air Force provided an unsupported cost estimate to terminate the C-130J aircraft MYP contract, and that if the Air Force termination cost estimate was valid there was a potential for an Antideficiency Act violation. This allegation was addressed in the Finding section of this report.

The other three allegations and our results are addressed below.

Allegation. The Government misused funds to support the C-130J commercial venture.

Audit Result. We did not substantiate that the Air Force misused Government funds to support a commercial venture. However, the Air Force's flawed commercial item determination and mismanagement caused the Air Force to contract for the C-130J aircraft even though the contractor did not have the ability to make a specification-compliant aircraft. Furthermore, the Air Force continued to accept C-130J aircraft for delivery even though the aircraft had deficiencies and did not meet the commercial model specification. In addition, the Air Force issued additional contracts for more aircraft at increasing prices without taking decisive action to obtain a compliant aircraft.

Allegation. Government funds spent on contract modification P00020 did not relate to new Air Force work requirements.

Audit Result. We did not have enough information to substantiate the allegation that modification P00020 was used to fund work that was not for new Air Force requirements. The Air Force accepted a vague commercial model specification and awarded a commercial contract. The contract model specification was ambiguous, which made it difficult to determine which requirements were part of the contract model specification and which requirements were outside of the specification but needed for operational missions. The contract model specification was so difficult to interpret that the Air Force and the contractor formed a Blue Ribbon Panel to determine which party was responsible for reported deficiencies and for funding the corrections.

Block Upgrade 5.4 is a major upgrade to the C-130J Program and is made up of three separate phases. Contract modification P00020 was the third phase. Block 5.4 is supposed to bring the aircraft up to the new operational requirements. The cost of Block Upgrade 5.4 was about \$58 million.

Because of the ambiguous C-130J contract model specification and the commingling of new requirements and corrections to bring the aircraft into compliance with the contract model specification, not enough information was available to determine if Government funds were only used for the new work requirements in Block Upgrade 5.4.

Allegation. The contracting officer did not appropriately evaluate the contractor's performance against contract default provisions.

Audit Result. We substantiated that the contracting officer did not appropriately evaluate the contractor's performance against contractor default provisions. The Air Force did not take decisive actions to improve contractor performance or pursue contractor default provisions primarily because the Air Force's own actions contributed significantly to the poor performance and the inability to obtain a mission-capable aircraft for approximately 10 years.

The Air Force issued three consecutive contracts for the C-130J aircraft even though Lockheed Martin had not delivered a specification-compliant aircraft. The Air Force could not easily terminate the C-130J MYP contract for cause when the Air Force continued to contract for additional aircraft and conditionally accept deficient aircraft.

The C-130J Program Office also issued contractor performance assessment reports that provided an unrealistic and inflated contract rating for the C-130J Program. Contractor performance assessment reports are prepared by the Government to rate contract performance.

The contracting officer stated that the Air Force did not consider termination for default as a viable option for the C-130J contract. The Air Force stated that because Lockheed Martin is the sole source for the C-130J aircraft, terminating the C-130J contracts with Lockheed Martin would have been useless. The Government had no other entity that could supply the C-130J aircraft. In a non-sole-source environment where the Government had another avenue to procure C-130J aircraft and related support, the Air Force could have terminated the contract for cause if the Contractor defaulted on the contract and procured the aircraft from another source. Additionally, the Air Force stated that if the courts found that the Air Force termination for default was incorrect, the termination of the contract would have become a termination for the Government's convenience.

In addition, Assistant Secretary of the Air Force, Acquisition personnel stated that it would not have been legally permissible to terminate the MYP contract for default while canceling the Air Force procurement but accelerating the Marine Corps procurement.

We believe that although the contract was sole source, the Air Force should not have ruled out a contract termination for cause if the contractors' performance failed to meet contract requirements. In addition, contractor performance assessment reports should have been accurate.

Management Comments. The Air Force acknowledged that the allegation was partially accurate. The Air Force stated that they did not terminate the C-130J contract for default because they were actively working with the contractor to address shortfalls in meeting the commercial specification that was on contract. Therefore, the Air force decided that the benefits of continuing the program with a planned strategy to use a Blue Ribbon panel to mediate ambiguous contract language and disposition outstanding deficiencies to fix the performance issues were in the best interest of the Government.

Audit Response. The Air Force stated that termination is always an option, but was not considered because of the performance challenges. The Air Force issued

three consecutive contracts for the C-130J aircraft even though Lockheed Martin had not delivered one aircraft that met the contract model specification. The C-130J Program began in 1995, with the first C-130J non-compliant aircraft delivered in 1999. The Government should require the contractor to deliver an aircraft compliant with the contract model specification, yet ten years after the first award, the Air Force was still accepting non-compliant aircraft. The performance challenges in the contract were created by the Air Force actions on acquisition strategy and contract formation. As a result, the Air Force limited its options to forcefully enforce the contract because they chose an inappropriate acquisition strategy and compounded the problem by using ambiguous and vague contracting language.

Previous Report. The problems within the C-130J Program were the result of the Air Force C-130J SPO contracting officer determining that the C-130J aircraft was a commercial item and adopting a commercial acquisition strategy. Our previous report, DoD IG Report No. D-2004-102, "Contracting for and the Performance of the C-130J Aircraft," July 23, 2004, addressed this issue. In addition, during an April 13, 2005, meeting, the Chairman of the Senate Subcommittee on AirLand, Committee on Armed Services, the Acting Secretary, and Chief of Staff of the Air Force agreed that the aircraft procurement should be converted from a commercial acquisition to a negotiated procurement under FAR Part 15. The Air Force is in the process of making that conversion. An undefinitized contract action was issued on February 10, 2006, to convert the FY 2006 through FY 2008 portion of the C-130J MYP contract to a FAR Part 15 negotiated contract.

Appendix C. Report Distribution

Office of the Secretary of Defense

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Director, Acquisition Resources and Analysis
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Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
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Naval Inspector General
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Department of the Air Force

Assistant Secretary of the Air Force for Acquisition
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Director, Air National Guard
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Committee on Government Reform
House Subcommittee on National Security, Emerging Threats, and International
Relations, Committee on Government Reform

Office of the Assistant Secretary of the Air Force (Acquisition) Comments



DEPARTMENT OF THE AIR FORCE
WASHINGTON DC

OFFICE OF THE ASSISTANT SECRETARY

19 MAY 2006

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL
ATTN: DEPUTY INSPECTOR GENERAL FOR AUDITING

FROM: SAF/AQ

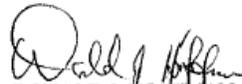
SUBJECT: Report on Contracting and Funding for the C-130J Aircraft Program
(Project Number D2005-D000AB-0214.000)

The Air Force appreciates the opportunity to review and comment on this draft DoD IG report. Although no recommendations were provided under this report regarding the four allegations made to the Defense Hotline, we would like to provide management comments for your consideration as you finalize your report on the two allegations that you stated you have substantiated.

The Air Force believes that the C-130J termination cost estimate was supported with the information that was available at the time the estimate was submitted, and that there was no potential for an Antideficiency Act Violation under 10 U.S.C. § 2306b. Once PBD 753 was issued, the Air Force, along with OSD (PA&E), started the process of evaluating the impacts of PBD 753 direction. As part of the process, a cost estimate was developed that assessed the termination and cancellation cost risks associated with stopping the Air Force C-130J procurement and accelerating the procurement of Marine KC-130J. This estimate yielded a range of values. The process resulted in a cost estimate reflecting what was understood by Air Force and DoD officials to be a rough order of magnitude of the costs, based on the government's interpretation of the contract terms and conditions, along with potential operational/programmatic impacts. As part of the estimate, the Air Force considered: termination costs, cancellation costs, equitable adjustments required by express contract terms, C-130J/KC-130J operational impacts, and facility impacts based on overhead rates. The cost impact was provided to OSD(PA&E) for their consideration in assessing the executability of PBD 753. In addition, since C-130J aircraft were procured under FAR Part 12 procedures, which do not require the contractor to provide certified cost data, the government estimate was a "best effort" with the information known at the time.

Regarding your allegation concerning the potential for an ADA violation, we note that 10 U.S.C. § 2306b expressly provides that "The costs of cancellation or termination may be paid from -- (1) appropriations originally available for the performance of the contract concerned; (2) appropriations currently available for procurement of the type of property concerned, and not otherwise obligated; or (3) funds appropriated for those payments." Based on the above statute, the Air Force would have been allowed to fund the program within our Total Obligation Authority thus avoiding any potential ADA violation.

The allegation that the Air Force did not consider termination for default as a viable option and was actively working with the contractor to address shortfalls in meeting the commercial specification that was on contract is only partially accurate. Termination for default is always an option when the Air Force is faced with poor contractor performance. In this case, however, in recognition of the performance challenges associated with the C-130J, a "Blue Ribbon" panel was formed in 2002 to mediate ambiguous contract language and provide a disposition of which organization would be responsible for fixing outstanding deficiencies. Therefore, the Air force decided that the benefits of continuing the program with a planned strategy to fix the performance issues were in the best interest of the government.



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