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Leasing Combat Support Equipment: Lessons From the Maritime Prepositioned Ship (MPS) Experience

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May 18, 2005



Policy Perspective

- The Current Legislative and Regulatory Environment for the Federal Government Effectively Eliminates “Leasing” As a Financing Option.
- Is This Appropriate in the GWOT Context in 2005?



MPS Experience

- 13 LoLo/RoRo Ships to Support 3 Marine Expeditionary Brigades for 30 Days of Combat Were Leased by the Military Sealift Command (MSC) in 1983 – 1984
- These MPS Have Been Important Assets to the Navy for More Than 20 Years, Including Crucial Service in Operation Desert Storm



MPS Experience (Continued)

- This (TAKX) Program Would Not Have Been Possible If the Navy Had Been Required to Buy the Ships
- Use of the Ships Was Arranged Through 25 Year Leases (Five, Five-year Periods) From Private Investors Who Actually Own the Ships



History of Navy Leasing

- There Is a Long History of the Navy Deploying Leased Ships to Augment Military Capability in Times of War:
 - 450 Ships in World War II
 - 200 Ships in the Korean Conflict
 - Navy Refueling Tankers in the Vietnam War
- The Navy Also Regularly Leases Commercially Available Equipment:
 - Storage Batteries on Nuclear Submarines
 - Reduction Gears on Surface Warfare Ships
 - Medical Equipment for Navy Hospitals



The End of Leasing

- But, the Ability to Lease Significant Assets (\$ Billion Investments) Ended in 1985 in a Strong Congressional/Treasury/OMB Reaction Against the \$2.6 Billion TAKX Program
- “Never Again” for Major Acquisitions Via “Long Term Leases” Was the Washington Response After the TAKX Program Was Begrudgingly Approved



The MPS Deal

There Were Four Important Advantages of “Leasing” Over “Purchase” for the MPS:

- 1) “Design to Launch” in 2 Years Versus 5 to 7 Years
- 2) Substantial Savings Per Ship by Use of Commercial Construction Standards (\$182M Versus \$217M)
- 3) The Choice Was “Lease Versus Do Without,” Not “Lease Versus Purchase”
- 4) Leasing Was Substantially Cheaper to the Government, Measured by the Present Value of All Cash Flows Over the Life of the Leases, Including the Impact on Treasury Department Revenues



Comparing Purchase to Three Different Viewpoints on the Net Total Cost to the Government from Leasing (5% semiannual discounting=10.25% per year) (in millions)

	<u>AGL</u>	<u>JCT</u>	<u>SSS</u>
Ship Cost if Purchased	(182.4)	(178.2)	(182.4)
Tax revenue from interest on Treasury Bonds used to finance the purchase			2.5
Net PV of Purchase	(182.4)	(178.2)	(179.9)
Present value of 25 years of capital hire payments by the Navy	(135.1)	(135.1)	(135.1)
Residual value payment by the Navy at termination, net of tax	(1.7)	(1.7)	(1.7)
Lost tax revenue from the amortization deductions	(.7)	(.7)	(.7)
Tax payments by the lessor on capital hire payments received (46% tax rate)			
Return of capital component	22.0	22.0	22.0
Interest component	39.7		
Lost tax revenue from depreciation deduction	(72.4)	(72.4)	
Total PV with Leasing	(148.2)	(187.9)	(115.5)
Leasing benefit versus purchase	34.2	(9.7)	64.4



Politics and Polemics of the MPS Deal

- But, Leasing Bypasses the Conventional Process for Defense Acquisitions:
 - Design (ORD)
 - Authorization/Appropriation/Expenditure
- Those Persons and Groups Who Believe Strongly in That Conventional Process Made Sure the TAKX Program Was a One-time Aberration and NOT a Trend!



Current Legislative Context

Four Overwhelming Impediments to Long-term Leasing Today Are:

- 1) Taxation – Disallowance of the Depreciation Tax Shelter Advantages of Leasing for All Assets Leased to the Federal Government
- 2) Financial Justification – Disallowance From Consideration in Leasing Proposals of Any Impact on Treasury Department Revenues, Regardless of What That Impact Might Be
- 3) Cash Flow Budgeting – Congress Requires That All Contractual Financial Obligations Over the Terms of a Lease, Including Termination Penalties, Must Be Fully Encumbered in the Navy Working Capital Fund Before the Lease Begins. This Totally Defeats the Purpose of Leasing Which Is to Spread Out the Cash Flows Over the Period of Use
- 4) Pre-review and Approval – No Leasing Proposal May Go Forward Without Prior Review and Approval By OMB and the Treasury, Both of Which Are Clearly Opposed to Any Circumvention of the Conventional Acquisition Processes Via Lease



Conclusion

- It Can Be Argued That, As in Earlier Wartime Periods, Leasing Could Be a Valuable Tool Today to Augment Military Capability in the Midst of Our “GWOT,” Without Curtailing Other Approved Weapons Programs
- It Is in the Power of Congress and the Administration to Eliminate the Impediments Created in the Mid-1980’s, If They So Choose



The Big Question?

Which Is More Important to National Security in the Overall Context of 2005:

- 1) Full Compliance With the Conventional Appropriations Process, or
- 2) Allowing the Possibilities of Leasing, Under Certain Circumstances, Which Circumvents Much of the Conventional Process.

