

Fuel Fiasco Costs Lockheed Martin \$2 Million

Written by Nick Sanders
Thursday, 02 April 2015 00:00

On March 27, 2015, the U.S. Department of Justice [announced](#) that Lockheed Martin had agreed to pay \$2 million to settle allegations that it overbilled the government for fuel.

According to the DoJ press release—

Between 2006 and 2013, Lockheed manufactured C-130s for the U.S. Air Force at its Marietta facility. Pursuant to the underlying contracts, the Government provided Lockheed with up to 22,000 gallons of fuel (characterized as government furnished property or ‘GFP’) per aircraft, which could be used for the engine runs, fuel operations and test flights necessary to manufacture C-130s. Once Lockheed exhausted its 22,000 gallon allotment on a particular aircraft, Lockheed, not the Government, was financially responsible for any additional fuel.

However, the Government’s investigation indicated that between 2006 and 2013, Lockheed routinely used fuel in excess of the 22,000 gallons, but failed to reimburse the government for the excess. Additionally, the evidence suggests that Lockheed used the fuel on other unrelated projects, where the government was either not a party, or had not agreed to furnish fuel.

Two million dollars is not a large settlement, as these things go. Two million dollars is a small settlement compared, for instance, to the \$27.5 million settlement between Lockheed Martin Integrated Systems and the U.S. Government announced on December 19, 2014. In fact, a settlement of \$2 million is rather trivial and hardly compensates the taxpayers for the “tireless investigative efforts of DCIS agents working closely with our Air Force OSI partners,” who “sifted through and unwound dense and complicated data to reveal the overcharges.” We suspect that the executives at Lockheed Martin consider the settlement a victory rather than a loss.

So if it’s so trivial, why are we writing about it?

Well, we were interested in the cost accounting aspects of such a fungible commodity as fuel.

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Think about it.

The Department of Defense gives Lockheed Martin 22,000 gallons of fuel per aircraft. That is to say, Lockheed agrees not to include fuel prices into the cost of its aircraft and the Pentagon agrees to provide Lockheed with the fuel it needs, up to 22,000 gallons per aircraft under contract. Some aircraft will need more fuel; others will need less. But any needs beyond 22,000 would be on Lockheed's dime.

How would you account for that?

First thing would be to account for the incoming fuel. Fuel, of course, is a fungible commodity in that each gallon is indistinguishable from every other gallon. So we assume Lockheed has a great big fuel tank where the fuel is stored. The government "deposits" 22,000 gallons of fuel into that tank each time a new aircraft is ordered.

But Lockheed has fuel needs beyond just the 22,000 per C-130 aircraft. It has commercial sales and IR&D projects and who knows what else going on. It might need more fuel because, in some circumstances, 22,000 gallons will be insufficient for its C-130 needs. What should it do? Does it set up a separate fuel tank for each project, or does it do the smart thing and just put all the fuel in one big tank, knowing that so much is GFP fuel and the rest is its fuel.

We would hope that all the fuel would be commingled together and used as necessary. That's what makes the most business sense, and it avoids the need to build separate fuel tanks for each need—the cost of which would be allowable overhead to be passed on to government customers. If we were Lockheed, we would put all the fuel into one big tank. The tank would have both GFP fuel and fuel we purchased on our own dime. Then when we fueled-up our aircraft, the C-130s would get whatever amount they needed and any "extra" fuel above the planned 22,000 gallon amount would have been paid for by us. Similarly, as we drew fuel for IR&D and commercial needs, that would be our fuel as well. We'd buy the fuel on overhead since we could get a volume discount (versus buying fuel one program at a time) and because it would be very difficult to estimate how much fuel might be used (and by whom) ahead of time. Much easier to buy the fuel on overhead and simply make it a cost of production.

But apparently somebody had a problem with that approach (assuming that's what Lockheed

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did). We suspect the argument went something like this:

When Lockheed Martin commingled all its fuel together, it lost accountability for the GFP fuel. It drew fuel as needed, so that nobody knows whether it used more, or less, fuel than was provided to it by the DoD. Nobody knows whether there is left-over fuel that is still the property of DoD, so DoD cannot value any fuel for purposes of getting clean financial statements. More to the point, Lockheed has been accepting 22,000 gallons of fuel for each C-130 aircraft, but there is no way to tell if that was the correct amount. Maybe Lockheed only needed 20,000 gallons of fuel, and it used the extra 2,000 for its own nefarious purposes. How can we tell? And how can Lockheed Martin prove it didn't divert the GFP fuel since it's all commingled together?

If a single C-130 aircraft needed more fuel than its allotment of 22,000 gallons, shouldn't Lockheed have charged the cost of the additional fuel directly to the benefitting contract? Did it do so, or did it just charge its fuel needs to overhead? Because if you think the excess fuel costs should have been direct-charged and that those direct charges would have been non-reimbursable by contract terms, then shifting those costs to overhead would have looked like an attempt to avoid a contract loss by shifting unallowable direct costs into an allowable overhead charge.

Which might have been perceived as being fraud and resulted in a tireless investigation that tried to distinguish fungible fuel costs by cost object, a difficult undertaking in the best of circumstances.

Now the foregoing is quite a lot of suppositions and assumptions, and it's probably presumptuous of us to create such a hypothetical from such a paltry lack of information. Nevertheless ...

The lesson here is that, sometimes, what makes good business sense does not work out well in government contract cost accounting. The lesson is true even if we've gotten our facts mixed up and built a chain of suppositions into a completely wrong hypothetical. Regardless of the validity of the facts which we've essentially created out of nothing, it would make good business sense – and result in cost avoidance – to commingle fuel. But when that fuel was drawn and used, it would require a certain degree of diligence in identifying where that fuel was being used. Failure to maintain an accurate usage log, and appropriately allocate fuel costs to the users based on that log, could lead to downstream problems.

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When business people encounter government contract cost accounting rules for the first time, they tend to react poorly. The rules are not logical. They are not self-consistent. And they can sometimes penalize, instead of reward, innovation and cost avoidance. Thus, the real lesson here is that management decisions need to be first vetted with subject matter experts in relevant areas. In this case, before Lockheed Martin decided to commingle fuel, government accountants and property administrators should have been consulted to see if there were any risks or additional steps that needed to be taken. It might have seemed like an obviously smart move to save money by commingling fuel, but it ended-up costing Lockheed Martin \$2 million plus an unknown amount of legal fees.