

Another Charge for the KC-46A

Written by Nick Sanders

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There was a time, 20 or 30 years ago, when awarding a firm, fixed-price development contract was against the law. The rationale for that position was easy to discern: how can you establish a firm, fixed-price for something that hasn't been designed yet? You can't, as the government kept learning over and over, to its chagrin.

It's not sufficient to say "Hey, FFP! All the cost risk is on the contractor—so who cares how much the contract overruns?" For one thing, some of those contracts had authorized progress payments, so those contractors were getting paid for trying really hard. For another thing, change orders baby. You find yourself falling behind, you're going to start looking for what's changed since your proposal.

Finally: bailout. As Airbus experienced with its supply chain during the last global financial crisis, it's sometimes better to reform the contract (at a higher price) than it is to put your suppliers into bankruptcy. The cost of finding another supplier is higher than bailing out the supplier you've got. For an example closer to home, remember that, in 1971, the U.S. Government gave Lockheed \$250 million in guaranteed loans to bailout the contractor after cost overruns on a Navy contract threatened to bankrupt the company and put thousands of Americans out of work.

So the government learned its lesson: you cannot put all the financial risk on the contractor, simply because the contractor cannot shoulder all that financial risk. And then, after a decade or two (or three), the government forgot that lesson and decided that fixed-price contracting was the way to go, even for development programs where nobody knew how to price the work.

We have elsewhere recounted the story of how Boeing came to win the KC-46A aerial refueling plane development contract—now dubbed "the Pegasus." We have also noted, from time to time, that the program is experiencing delays and mounting cost growth. For example, the last such article is [here](#).

Now we are back, roughly a year later, to note that Boeing has taken another charge against earnings related to its Pegasus program.

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In its Third Quarter financial analysis, Boeing noted that it had recorded another \$329 million in charges related to the program. The charges were split between commercial and defense businesses, with defense taking \$73 million and commercial taking the rest. A year ago, Boeing's rationale for the 2016 charge cited, among other things, "concurrency between late-stage development testing and initial production." A year later, Boeing's rationale for the 2017 charge cited, "... incorporating changes into initial production aircraft as we progress through late-stage testing and the certification process"—which seems to us to be the same rationale year-over-year.

For those keeping score, Boeing is now at "roughly \$2.9 billion" (according to one report) in pre-tax charges associated with cost growth on the \$4.8 billion fixed-price-incentive-fee development contract whose point of total assumption was reached long ago. (Our math says \$2.4 billion, not \$2.9 billion, but who knows? The point is, it's a big number. In fact, the overrun recognized to date is equal to at least 50% of the total contract value.)

Further, at least one KC-46A supplier has also recorded reserves associated with cost growth. In February 2017, Cobham recorded a \$187 million charge associated with the program, citing "an onerous commercial arrangement" with Boeing.

As we said in 2016—

There are not very many defense contractors that could have afforded to fund nearly half the development cost of a new aircraft. Fortunately for all concerned, one of them is Boeing.

Tell us again why fixed-price development contracts are preferred these days?

We stand by those words today, a year later.