

Cost Problems Already for Boeing's KC-46 Tanker

Written by Nick Sanders
Tuesday, 19 July 2011 00:00

When last we checked-in, Russia had submitted a late proposal, leaving the U.S. Air Force with a clear choice between EADS/Airbus and Boeing. Then there was that little procurement integrity kerfuffle, when the Air Force sent sensitive ratings to the wrong bidders. But everybody got through that and by now it should be old news that [Boeing won](#) , beating out EADS.

At the time, the Washington Post (link above) reported—

‘... in the end, Boeing won on price,’ said Loren B. Thompson, a defense policy analyst for the Arlington-based Lexington Institute. ‘Price consists of the cost of producing the plane, plus the cost of operating it over 30 years. The Airbus plane is so much bigger and burned over a ton more fuel per flight hour. Multiply that by 179 planes, times 30 years of service life and it becomes very big.’

‘These are fixed-price contracts,’ [U.S. Air Force Secretary] Donley said. The decision ‘reflects our efforts to deliver better value to the warfighter . . . in a budget process that we realize is not going to give us more money every year.’

And that seemed to be the end of that. Boeing won on price and was awarded a \$35 billion fixed-price-incentive-fee (FPIF) contract for a boatload of aerial tankers. Moreover, according to [this Bloomberg report](#) , USAF Secretary Donley promised that, “The U.S. Air Force won’t allow changes to Boeing Co.’s air refueling tanker contract of more than \$30 billion without ‘high-level’ review from Pentagon leadership.” The Bloomberg article reported—

Donley said today that he is drafting a memorandum that will spell out Pentagon leaders’ involvement in reviewing any changes to the contract. He also said the Air Force has discussed the issue with Boeing.

Altering the program may increase manufacturing costs, so Boeing has ‘the same interest’ as

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the Air Force in avoiding changes, Donley told reporters at a roundtable in Washington.

Boeing agreed to perform in accordance with its winning bid. Bloomberg reported—

‘Our commitment is to perform to schedule and on cost and that is what we intend to do,’ William Barksdale, a spokesman for Boeing’s tanker program, said in an e-mailed statement.

Issues are sure to arise, he said, ‘and as they arise, we will work closely with the Air Force to resolve them. We expect minimal contract change activity on this program.’

It looked to all observers that the relationship between Boeing and the USAF was on to a great start.

Hold on. Not so fast there, folks.

In late June, 2011, [reports](#) began to emerge that Boeing may have “bought-in” to the competition, intentionally submitting a price that it knew to be lower than its projected costs. Which is perfectly legal and fine—so long as the bidder stays “bought-in” to its prices. DODBuzz (link above) reported, “Boeing believes it could encounter as much as a \$300 million cost overrun on its KC-46A tankers, but everyone involved — the company and the Air Force — understand the company will bear that and any other extra costs.”

In mid-July, 2011, articles such as [this one](#) reported that, “Boeing has bumped up costs for its \$4.4 billion

Air Force tanker deal up to the ceiling price of \$4.9 billion

. The company has to fund 40 percent of the increased costs, and be responsible for 100 percent of any further expenses.”

[Another article](#) reported—

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Boeing Co's winning bid for the U.S. Air Force's fiercely contested tanker development deal means it likely will show no profit in the program's first phase and shift \$600 million in development costs to taxpayers, new government figures showed.

Boeing could be on the hook for \$700 million in development costs of its own, according to a compilation of figures provided by the government and a congressional source.

Boeing's below-cost bid for the contract was part of a carefully crafted strategy to deny the deal to Europe's EADS, parent of rival commercial jet builder Airbus SA. ...

The Air Force, in a written reply to queries from Reuters, said on Monday that Boeing's target cost had been \$3.9 billion to develop the aerial-refueling plane ... 'For every dollar the program costs above target cost of \$3.9B, the government pays \$0.60 and the contractor pays \$0.40, until the total amount paid to Boeing reaches \$4.9 billion,' at which point Boeing assumes all further costs, the service said. Under this formula, taxpayers would pick up \$600 million up to the \$4.9 billion ceiling. Boeing would cover the other \$400 million plus any ceiling overrun. ...

Boeing told the Air Force on April 25 that it projected that it would spend more than the ceiling price for the development phase of the contract, Miller said. The ceiling is set at 125 percent of the target cost. Boeing's potential profit under the deal likewise was built in and would have totaled 12.5 percent, or about \$500 million, if the target were hit. The company would break even if the development phase is completed at the ceiling.

The Air Force said it was neither improper nor uncommon for a company to bid a development price that is below actual cost in a competition.

The Air Force and Department of Defense 'will now tightly control' the program's execution to make sure Boeing delivers on its promises within negotiated cost, schedule and performance baselines, said Miller, the Air Force spokesman.

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Yeah, about that "tight control" which is what the Air Force promised Congress and the taxpayers back in April and now promises Congress and the taxpayers yet again, three months later....

Senator McCain thinks the current situation is "completely unacceptable," according to [this report](#).

The Arizona Senator sent Dr. Ashton Carter, Under Secretary of Defense (A,T&L), a letter in which he also stated, "This is gravely wrong and creates an incentive, particularly on very large programs, for contractors to low-ball a contract knowing that the taxpayers will subsidize at least some of the overruns that will be needed to actually complete the work."

The article reported—

McCain wrote ... 'I can assure you that Congress and taxpayers will find a \$600 million subsidy of a low-ball bid by Boeing is something they feel they should not have to pay. Boeing fully understood that up to 60 percent of any cost overrun up to \$1 billion over the target cost' of \$3.9 billion 'would be borne by the taxpayer. On a program that you found to be low-to-moderate risk, the extent of exposure to the taxpayer here appears excessive.'

Dr. Carter, for his part, dismissed concerns about unacceptable cost growth on the nascent aircraft program. According to this [Reuters report](#) —

The Pentagon's top weapons buyer dismissed concerns on Friday that Boeing is projecting huge cost overruns in developing a new Air Force refueling tanker, saying it was a fixed-price contract and company losses were 'not our problem.'

Defense Undersecretary Ashton Carter said Boeing had made a commercial decision to offer a below-cost bid for development of the aircraft in hopes of making up its losses during production of 179 of the aircraft through the 2020s. ...

Carter, answering questions about defense procurement at the Brookings Institution think tank on Friday, dismissed reports of Boeing's cost overruns, saying, 'It's not our problem because it's

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a fixed-price contract and it was written with ... protections for the taxpayers.'

He said the issue was the value of the contract at its ceiling price.

'The fact that Boeing decided that it would lose money in the development phase, presumably in the hopes of making money in the production phase, was a decision that they made, and that's not a problem from the Defense Department's point of view,' Carter added.

Well, we readers know that, in fact, Boeing did not sign a firm, fixed-price contract, as Dr. Carter stated. A FPIF contract is significantly different from a FFP contract, and we would expect Dr. Carter to understand that difference—given his position in DOD's procurement policy-making hierarchy.

The thing is—and there's really no way to get away from it—is that Boeing has taken just about everything (monetarily speaking) from the Air Force that it can and, absent requirements changes, is stuck at the FPIF ceiling and now has to perform to that amount. In essence, the company has announced that it's going to overrun the development phase and will hope to make up the loss during production. Whether or not the Pentagon will permit Boeing to "get well" on the prices of production aircraft remains to be seen.

What is clear, however, is that the company is now (along with Lockheed Martin's JSF program) now centered in the cross-hairs of Congressional critics and taxpayer advocates. Boeing's credibility has been undercut and the only way out is to perform on schedule, on budget, and meet technical specifications. We can't see much incentive for the Air Force to let Boeing slide any further