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UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

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STATEMENT OF  
ROBERT F. KELLER  
DEPUTY COMPTROLLER GENERAL  
BEFORE THE  
HOUSE ARMED SERVICES COMMITTEE *HSE 00500*  
ON  
DEPARTMENT OF DEFENSE PROPOSAL TO USE  
PUBLIC LAW 85-804 TO SETTLE  
SHIPBUILDERS' CLAIMS

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Mr. Chairman and Members of the Committee:

We are pleased to appear here today to discuss the action which the Department of Defense proposes to take to provide financial relief to four shipbuilders under 11 ship construction contracts. Public Law 85-804 is cited by the Department as authority for this action.

Deputy Secretary of Defense, Clements, pointed out in his formal letter of notification to this Committee on April 30, 1976, that prolonged confrontations between the Navy and contractors over ship claims threaten major combatant ship construction projects and "constitute a major threat to the national defense." He stated that unanticipated inflation was the transcending cause of many of these claims and that he intended to use the authority of P.L. 85-804 to bring about early remedial action. Later, in testimony before this Committee, the Navy stated its intention to modify the 11 contracts by substituting a revised escalation clause in place of the original clause and reprice the contracts from the award date through completion. In exchange for this action, the Department hopes to liquidate claims against these contracts totaling \$1.9 billion, at an estimated cost of between \$500 million and \$700 million.

In connection with this matter you asked us to provide you with the following:

- the legal authority of the Deputy Secretary to implement P.L. 85-804,
- the Department's compliance with its own regulations and other related requirements and restrictions concerning P.L. 85-804,
- the support for the Department's estimate of \$500 million to \$700 million needed to settle the claims,
- the profit or loss conditions of the contractors involved and the effect of the Department's proposed action on the profits or losses,
- the reasonableness of the Department's contention that unrecoverable losses due to inflation are the causes of shipbuilders' claims, and
- the relationship between repricing the 11 contracts and pending and future claims.

#### LEGAL AUTHORITY

Public Law 85-804 enacted on August 28, 1958, provides that the President may authorize any department or agency of the Government which exercises functions in connection with the national defense to enter into contracts or into amendments or modifications of contracts, without regard to other provisions of law relating to the making, performance, amendment or modification of contracts, whenever it is determined that such action will facilitate the national defense. Although the use of extraordinary contractual relief to keep contractors who are in a loss position from going out of business is one means of facilitating the national defense, neither P.L. 85-804 nor its implementing

regulations require such a showing as a prerequisite for its use.

The Act is an extraordinary relief measure, broad in scope, and is generally used in instances where no other authority is available. A grant of relief to a contractor under the Act is to be allowed or denied at the discretion of designated officials.

Public Law 85-804 has been implemented by Executive Order 10789, as amended, which grants authority to the Department of Defense, among other agencies, to use the Act.

In November 1973, Congress amended P.L. 85-804 to provide that the Act may not be utilized to obligate the United States in any amount in excess of \$25 million, unless the Committees on Armed Services of the Senate and House of Representatives have been notified in writing of such proposed obligation, and neither House of Congress adopts a resolution disapproving such obligation within 60 days of continuous session of Congress following the date of transmission of the written notice.

The 60 day period given to either House of Congress to adopt a resolution disapproving a proposed obligation of funds in excess of \$25 million is explained by the Act as follows:

"\* \* \* For purposes of this Section, the continuity of a session of Congress is broken only by an

adjournment of the Congress sine die, and the days on which either House is not in session because of an adjournment of more than 3 days to a day certain are excluded in the computation of such 60 day period."

Thus, it appears that all working and nonworking days of a continuous session of Congress that do not fall within "an adjournment of more than 3 days to a day certain" are counted toward the 60 day period.

Over the years most of the cases involving the use of P.L. 85-804 have dealt with relatively small contract amounts. The only ones which concerned large contracts occurred in 1971 when the Lockheed contracts for the C-5A and the Cheyenne helicopter were restructured under this authority at estimated costs of \$500 million and \$123 million respectively. Also, in March 1973 pursuant to the provisions of P.L. 85-804 the Navy and Grumman agreed that the last three production options for the F-14 fighter would not be exercised. Additional contracts for F-14 fighters were later entered into increasing the original contract amounts by more than \$25 million. This is the first proposed use of the Act to obligate the United States in an amount in excess of \$25 million since the Act was amended in 1973.

The legislative history of the 1973 amendment of P.L. 85-804 does not indicate the type of information Congress had in mind with respect to the Act's notice requirement. However, we think a reasonable interpretation is that an agency should furnish sufficient information at the time of the notice to enable Congress to make an informed decision regarding the

proposed use of the authority. This is a subjective judgement for Congress to make based on the facts in the individual case.

COMPLIANCE WITH REGULATIONS AND  
OTHER RELATED REQUIREMENTS AND  
RESTRICTIONS

Section 17 of the Armed Services Procurement Regulation implements P.L. 85-804, as amended. This regulation authorizes the Secretaries of Defense, the Army, the Navy, and the Air Force to utilize P.L. 85-804 and prescribes the standards, limitations, and review incident to its use. It separates the relief authorized by P.L. 85-804 into two categories. The first category, set out under part 2 of section 17 of the regulation, deals with "Contractual Adjustment" and includes amendments without consideration, correction of mistakes and formalization of informal commitments. Part 2 of section 17 requires that contractors initiate requests for relief and that the Secretaries of the services act on the request.

The second category, "Residual Powers," is set out in part 3 of section 17 of the regulation. "Residual Powers" are described by section 17-300 of the regulation as including all the authority under the act except that classified as "Contractual Adjustment" and the authority to make advance payments. Proposals for the exercise of residual powers need not be contractor initiated.

In this instance, the Deputy Secretary of Defense initiated the action to implement P.L. 85-804 and established

a special board under his direction to develop factual data supporting proposed relief. We understand that the authority to exercise "Residual Powers" set out in part 3 of section 17 of the regulation is being relied on to support the proposed use of P.L. 85-804. However, even if the "Contractual Adjustment" authority covered by part 2 section 17 of the regulation is used, we see no legal problem with the Deputy Secretary's actions. In this regard, section 17-001 of the regulation authorizes deviations from its terms upon the approval of the Secretary of Defense. Also, as a general rule, waiver of procedural regulations not adversely affecting contractors is generally permissible. The Deputy Secretary has determined that the proposed action is in the interest of national defense, he has deemed other legal authority to be inadequate, and notification has been given to the House and Senate Committees on Armed Services of his intention to use P.L. 85-804. In our opinion, these actions are within the authority conferred by P.L. 85-804. Also, since the contracts which the Deputy Secretary intends to revise under P.L. 85-804 were not initially formally advertised, the restriction in the law related to negotiated procurement after cancellation of a formally advertised solicitation is not applicable.

DOD'S ESTIMATE OF COST  
TO IMPLEMENT NEW ESCALATION  
CLAUSE UNDER P.L. 85-804

In previous testimony, Mr. Clements remarked that he planned to reprice the 11 contracts with a new escalation

clause. The principal differences between the new and old clause in applying escalation are:

- the new clause provides for payments based on actual cost incurred whereas the old clause provides for payment based on estimated cost,
- the new clause provides for payments to the date of actual ship delivery whereas the old clause provides for payments to ship delivery date established in the contract,
- the new clause provides for payment to contract ceiling price whereas the old clause provides for payment to contract target price.

Mr. Clements further stated that repricing the 11 contracts with a new escalation clause would cost the Navy from \$500 million to \$700 million. We were told by the Navy it plans to revise the escalation provisions of 9 of the 11 contracts and that the claims under the remaining two will be settled without changing the escalation provision.

The Navy estimates that the repricing action for the nine contracts would cost an estimated \$566 million, they also pointed out that this estimate is based on a number of contingencies and it could climb to as much as \$747 million if the contracts were completed at the designated ceiling price. It should be pointed out that if the rate of inflation increases more than is anticipated by the Navy, the amount could be even greater than \$747 million.

Additional cost  
to settle claims

We also learned that of the \$1.9 billion in claims as of May 1, 1976, the Navy plans to settle about \$427 million



through the normal claims settlement procedures and through other means rather than the use of P.L. 85-804.

Thus, it is conceivable that the Navy's current plans to settle the \$1.9 billion in claims could cost more than the upper limit of the \$500 to \$700 million range estimated by Mr. Clements.

ANTICIPATED PROFIT/  
LOSS ON CONTRACTS

The profit and loss information we are providing has been obtained from published corporate financial reports, as well as schedules and internal management reports and documents, supplied by the contractors and the Navy. Our investigation did not include an examination of the accounting records or underlying books and records from which the supplied information was prepared. The estimated profit or loss of the contracts, if they are repriced with the new escalation clause, is contingent upon the accuracy of the Navy and contractor estimates of costs to complete work under the contracts, projection of the escalation rate, and the period of time during which the rate will be applied to the costs incurred.

On May 14, 1976, the Navy estimated that a \$566 million increase granted under the new escalation clause would turn an overall estimated \$463 million loss under the 11 contracts into an overall \$103 million profit. The result of this action would be to:

- reduce the losses under some of the contracts,
- change some of the loss contracts into profitable contracts, and
- increase the existing profits under other contracts.

The Navy estimates of profits and losses of the 11 contracts with the old escalation clause differ significantly from the contractors' estimates. The Navy estimates that contractors' losses with the old clause would total \$462 million, whereas the contractors estimate losses of \$947 million--a difference of \$485 million.

INFLATION AS A  
CAUSE OF CLAIMS

There are currently \$1.9 billion in outstanding and anticipated claims on the 11 shipbuilding contracts designated by Secretary Clements. The Navy has received claims on seven of these contracts which represent the Navy's current shipbuilding claims backlog of \$1.4 billion. Four anticipated claims comprise the remaining \$471 million in claim amounts.

It is not possible to state with any degree of certainty the amounts in outstanding and anticipated claims representing costs due to inflation that were not compensated under the old escalation clauses, but we were able to obtain estimates of these amounts from some of the shipbuilders. Navy officials could not provide an estimate of these costs because all documentation supporting the

claims has not been received nor has the Navy's claim analysis progressed far enough to make such an estimate.

Ingalls Shipbuilding has informed us that \$173 million of its \$505 million claim against construction of LHA vessels is attributable to inflation.

National Steel has indicated none of its claim is due to inflation.

Newport News Shipbuilding could not estimate the amount attributable to inflation in its six claim submissions. However, the deferred work portion of the claim for delay represents the increased cost of performing original contract work in a later and more expensive time period than originally planned. Contractor officials estimate that the deferred work portions of these claims totaling \$126 million, is inflation.

Details of the anticipated claims from General Dynamics on the contracts for the SSN 688 and from Ingalls on the DD 963 have not been received by the Navy. Estimates of claim elements or amounts attributable to inflation are unknown at this time.

For the \$1.4 billion in Navy claims on hand, we identified \$298 million, or about 21 percent, of the claim amounts due to inflationary costs not covered by the old escalation clause.

RELATIONSHIP BETWEEN P.L. 85-804  
AND FUTURE CLAIMS

Although repricing these contracts using a new escalation clause will, as a minimum, reduce losses, the claims planned to be settled with this technique are not based solely on

inflation. We have reported some of the causes of claims in prior reports to the Congress as follows:

- late and inaccurate lead-yard working plans,
- inadequate specifications,
- defective, and late delivery of, Government-furnished equipment and technical information,
- unanticipated increases in quality assurance requirements,
- indiscriminate use of oral constructive change orders,
- seriously underpriced contracts,
- inappropriate use of firm fixed-price contracts which involved too many uncertainties and cost risks,
- potential problems not identified and settled at an early stage, resulting in unsupportable claims for cost increases, and
- contractors' inefficiencies resulting in additional costs.

In addition, we are currently reviewing the practices and procedures used by the Navy to settle claims. It appears based on early results of this work that some delays in claims settlements are being caused by contractors submitting unsupported claims.

At this time, there is no guarantee that the present claims will be dropped in part or in whole if relief is granted. This will depend on the terms of the agreements entered into between the Navy and the contractors. Furthermore, there is no guarantee that claims based on future events will not be filed.

## CONCLUSION

The question as to whether Public Law 85-804 should be used to settle these claims is difficult to answer. An argument can be made that there are adequate legal procedures for the settlement of the claims through decisions by the contracting officers, by the Armed Services Board of Contract Appeals, and subsequently by the Court. However, past history has shown this is a long drawn out procedure and, of course, such decisions would be made on the existing terms of the contracts involved without consideration of changed economic conditions. The Deputy Secretary of Defense has taken the position that to follow normal claims procedures or to attempt to modify the contracts on a quid pro quo basis will not yield an adequate remedy in reasonable time or eliminate the adverse relationship between the Navy and the contractors. The Deputy Secretary has found the situation to be such that it constitutes a major threat to national defense.

Based on our limited work we cannot conclude that the contractors will be unable to complete their contracts if no relief is granted, although one contractor has serious financial problems. Balanced against this is the viability of the contractors for future defense business. And, of course, it is unknown the extent of additional costs which would be incurred by the Navy if Public Law 85-804 is used rather than the normal claims procedure. We assume there would be some additional costs but this cannot be quantified with any degree of accuracy.

Mr. Chairman, this concludes our statement. However, we have additional information on the individual claims and the financial conditions of the contractors involved which is considered to be confidential by the Navy or proprietary business information by the contractors. We would be glad to discuss this information in executive session of the Committee.

EXECUTIVE SESSION

UNITED STATES GENERAL ACCOUNTING OFFICE

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SUPPLEMENTARY INFORMATION

FURNISHED BY

ROBERT F. KELLER

DEPUTY COMPTROLLER GENERAL

BEFORE THE

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DEPARTMENT OF DEFENSE PROPOSAL

TO USE

PUBLIC LAW 85-804 TO SETTLE

SHIPBUILDERS' CLAIMS

Much of this information was obtained independently from the Navy or the contractors and is considered confidential by each. Thus, this material should not be released to the other party or to the public. Unauthorized disclosure may also violate 18 U.S.C. 1905 which prohibits the unauthorized disclosure of information relating to the identity, confidential statistical data, amount or source of any income, profits, losses, or expenditures of any person, firm, partnership, corporation or association.

EXECUTIVE SESSION

Much of the following information on profits or losses on the four contractors is either company confidential or confidential Navy estimates. The net income is before income taxes. Information on net income after taxes was not available for the shipbuilding divisions or subsidiaries.

We also have included two attachments which show Navy and contractor estimates by contractor if P.L. 85-804 relief is granted. The third attachment shows the amount in current claims identified as inflation, and the fourth attachment shows the cash needs of Ingalls.

#### General Dynamics

Electric Boat is a division of General Dynamics Corporation. The net income of General Dynamics Corporation for the years 1971 through 1975 totaled \$357 million. Over \$70 million of this income was earned by the Electric Boat Division.

Electric Boat is dependent upon Government work. During these years over 98 percent of its sales was to the Government.

Electric Boat has estimated that it will lose \$142 million on the two SSN 688 contracts. The Vice President of General Dynamics advised us that Electric Boat could not complete the contracts without relief but that General Dynamics could if it had enough other business and can borrow the necessary funds. The Vice President also said the decision would be up to the Board of Directors.

#### Ingalls Shipbuilding (Litton Industries)

Ingalls is a division of Litton Industries. However, financial data is available for the division and the Ingalls



March 1976 balance sheet indicates that liabilities exceeded assets by \$18 million. As of that date, Ingalls Shipbuilding had received cash advances of almost \$160 million from Litton Industries.

Ingalls can only continue operating by the constant availability of cash from Litton Industries. Ingalls Shipbuilding cannot borrow cash from banks, based on its own financial credit. Litton cannot indefinitely continue to advance Ingalls operating cash because of limitations on Litton's ability to borrow additional cash--this was confirmed by an independent study made for the Navy in late 1975 by Haskins and Sells.

The net income of Litton Industries for the years 1971 through 1975 totaled \$623 million. Over \$3 million of this income was earned by the Ingalls Division. However, their profits do not reflect anticipated profits on the DD 963 contract after 1973 nor the anticipated large losses on the LHA contract after 1972.

Navy and contractor estimates of cash needed by Ingalls to complete the LHA and DD 963 contracts indicate that the cash needs will exceed payments under the contracts. The Navy estimates cash shortages of \$439 million and Litton estimates shortages of \$857 million. Even the proposed payments under P.L. 85-804 which are estimated at \$239 million would not be adequate to meet these large cash needs.

Newport News Shipbuilding  
and Drydock

Newport News Shipbuilding and Drydock Company is a wholly owned subsidiary of Tenneco Corporation. The net net income of Tenneco for the years 1970 through 1975 totaled \$3.2 billion. Over \$110 million of this income was earned by Newport News. In its fiscal year 1975 financial statement, Newport News reported a net income before taxes of over \$30 million--the highest in its 89 year history.

Contractor officials did not comment on its ability to complete the contracts without relief under P.L. 85-804. However, the Executive Vice President said that if Newport News gets no relief it will get out of the Navy shipbuilding business.

National Steel and  
Shipbuilding Company

National Steel and Shipbuilding Company (NASSCO), is wholly owned by Kaiser Industries Corporation and Morrison-Knudsen Company; each owns 50 percent. The net income before taxes for the years 1973 through 1975 totaled about \$228 million for Kaiser Industries and \$46 million for Morrison-Knudsen. Over \$24 million of this income was earned by NASSCO.

NASSCO does both commercial and Government work. Contract 0227 was the only Government new ship construction contract performed by NASSCO during the 1973 through 1975 time frame. On December 15, 1975, NASSCO was awarded a contract for two Destroyer Tenders.

As of April 30, 1976, contract 0227 was 93 percent complete, with an estimated loss of \$1.1 million. NASSCO officials stated that the company would have no difficulty in completing the contract if financial assistance is denied under P.L. 85-804. Based on the financial data presented, and through discussions with NASSCO officials, we do not believe contract performance is dependent on financial relief under P.L. 85-804.

Provided to GAO on 5/14/76

NAVY ESTIMATES OF CONTRACTOR'S PROFITS UNDER CURRENT CONTRACTS  
VERSUS PROFITS ON THOSE CONTRACTS WITH REVISED ESCALATION CLAUSES

Contractor	Estimate of Current contract prices	Proposed increase to current contracts	Estimate of Modified contract prices	Estimate of Total contractor's cost	Estimate profit (loss)*		Under Modified Contract	Percent of Base Cost
					Under Current Contract	Percent of Base Cost		
Electric Boat Division, General Dynamics Corporation								
Total	<u>\$1,893.7</u>	<u>\$178.3</u>	<u>\$2,072.0</u>	<u>\$2,028.4</u>	<u>\$(134.7)</u>	Loss	<u>\$43.6</u>	3.22
Ingalls Shipbuilding Division, Litton Systems, Incorporated								
Total	<u>\$3,953.9</u>	<u>\$239.0</u>	<u>\$4,192.9</u>	<u>\$4,150.9</u>	<u>\$(197.0)</u>	Loss	<u>\$42.0</u>	1.45
Newport News Shipbuilding and Dry Dock, Company ** Tenneco Corporation								
Total	<u>\$2,258.4</u>	<u>\$144.9</u>	<u>\$2,403.3</u>	<u>\$2,389.8</u>	<u>\$(131.4)</u>	Loss	<u>\$13.5</u>	.73
National Steel and Ship- building Company	<u>\$68.8</u>	<u>\$3.7</u>	<u>\$72.5</u>	<u>\$68.3</u>	<u>\$.5</u>	.84	<u>\$4.2</u>	7.98
GRAND TOTAL	<u>\$8,174.8</u>	<u>\$565.9</u>	<u>\$8,740.7</u>	<u>\$8,647.4</u>	<u>\$(462.6)</u>	Loss	<u>\$103.3</u>	1.68

\* These profits would result from re-pricing action under P.L. 85-804 only. Any other action by the Navy in settling these claims, or parts of these claims, by other means would further reduce these losses or increase these profits. Base cost represents estimated total costs less escalation.

\*\* Two of the contracts included in these totals are not planned to be modified with the new escalation clause. However, the Navy plans to settle these claims through other measures.

BEST DOCUMENT AVAILABLE

CONTRACTOR ESTIMATES OF PROFITS UNDER CURRENT CONTRACTS  
VERSUS PROFITS OF THOSE CONTRACTS WITH REVISED ESCALATION CLAUSES

ATTACHMENT II

<u>Contract</u>	<u>Estimate of Current Contract Price</u>	<u>Estimated Increase in Current Contract With New Escalation Clause</u>	<u>Estimate of Modified Contract Price</u> (\$ in millions)	<u>Estimate of Cost to Complete</u>	<u>Estimated Profit (loss)*</u>			
					<u>Under Current Contract</u>	<u>Percent of Base Cost</u>	<u>Under Modified Contract</u>	<u>Percent of Base Cost</u>
Electric Boat Division, General Dynamics Corporation	<u>\$1,886.4</u>	<u>\$200.0</u>	<u>\$2,086.4</u>	<u>\$2,028.4</u>	<u>\$(142.0)</u>	Loss	<u>\$58.0</u>	<u>4.16</u>
Ingalls Shipbuilding Division, Litton Systems, Incorporated	<u>\$4,025.6</u>	<u>\$228.0</u>	<u>\$4,253.5</u>	<u>\$4,569.0</u>	<u>\$(543.4)</u>	Loss	<u>\$(315.5)</u>	Loss
Newport News Shipbuilding and Dry Dock Company (Tenneco)	<u>\$2,253.5</u>	<u>**</u>	<u>**</u>	<u>\$2,513.8</u>	<u>\$(260.3)</u>	Loss	<u>-</u>	<u>-</u>
National Steel and Ship- building Company	<u>\$68.7</u>	<u>\$6.6</u>	<u>\$75.3</u>	<u>\$69.8</u>	<u>\$(1.1)</u>	Loss	<u>\$5.5</u>	<u>9.24</u>

\* These profits would result from re-pricing action under PL 85-804 only. Any other action by the Navy in settling these claims, or parts of these claims, by other means would further reduce these losses. Base cost represents estimated total costs less escalation.

\*\* Newport News could not provide estimates of the increase in the current contract with the new escalation clause.

BEST DOCUMENT AVAILABLE

CONTRACTOR CLAIMS WITH AMOUNTS  
IDENTIFIED AS INFLATION

<u>CONTRACTOR</u>	<u>SHIP TYPES</u>			<u>CLAIM TOTAL</u>	<u>AMOUNT IN</u>	<u>% OF INFLATION</u>
	<u>NO</u>	<u>CLAIM</u>	<u>AT</u>	<u>(MILLIONS)</u>	<u>CLAIM IDENTI-</u>	
				<u>PRESENT</u>	<u>FIED AS</u>	<u>TO TOTAL CLAIM</u>
					<u>INFLATION</u>	
					<u>(MILLIONS)</u>	
GENERAL DYNAMICS CORP. - ELECTRIC BOAT DIVISION						
LITTON SYSTEMS, INC. INGALLS SHIPBUILDING DIVISION		LHA		\$ 504.8	\$172.5	34.2%
NEWPORT NEWS SHIPBUILDING AND DRY DOCK COMPANY TENNECO		CVNs; CGNs; SSNs		894.3	125.9	14.1%
NATIONAL STEEL AND SHIPBUILDING COMPANY		AOR		20.7	-0-	-
TOTAL				<u>\$1,419.8</u>	<u>\$298.4</u>	<u>21%</u>

ADDITIONAL CASH REQUIRED BY INGALLSTO COMPLETE LHA AND DD CCNTRACTS

<u>LHA</u>	<u>Ingalls estimate</u>	<u>Navy estimate</u>
	(\$ in millions)	
Additional cost to complete	\$553.7	\$386.0
Less payments to be received	<u>121.1</u>	<u>121.1</u>
Cash needed by Ingalls to complete	<u>\$432.6</u>	<u>\$264.9</u>
<u>DD 963</u>		
Additional cost to complete	\$1,128.7	\$878.3
Less payments to be received	<u>863.8</u>	<u>863.8</u>
Cash needed by Ingalls to complete	<u>\$264.9</u>	<u>\$14.5</u>
Total cash needed by Ingalls	<u>\$697.5</u>	<u>\$279.4</u>
<u>Litton Industries</u>		
Cash advances from Litton to Ingalls	<u>\$159.6</u>	<u>\$159.6</u>
Total potential cash exposure by Litton	<u>\$857.1</u>	<u>\$439.0</u>