

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

FOR RELEASE ON DELIVERY  
EXPECTED AT 10:00 A.M.  
DECEMBER 18, 1972



STATEMENT OF  
ELMER B. STAATS, COMPTROLLER GENERAL OF THE UNITED STATES  
BEFORE THE  
SUBCOMMITTEE ON PRIORITIES AND ECONOMY IN GOVERNMENT  
JOINT ECONOMIC COMMITTEE

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

AS REQUESTED IN YOUR LETTER OF DECEMBER 7, 1972, MY  
STATEMENT TODAY WILL COVER FIVE TOPICS:

1. OUR INVESTIGATION INTO THE CHARGES MADE BY MR. HENRY M.  
DURHAM CONCERNING CERTAIN ASPECTS OF LOCKHEED'S MAN-  
AGEMENT OF THE C-5 AIRCRAFT PROGRAM.
2. PROGRESS PAYMENTS PRACTICES ON THE C-5 AIRCRAFT PROGRAM.
3. OUR ASSESSMENT OF ARMY "SHOULD-COST" STUDIES.
4. OUR REVIEW OF THE IMPLEMENTATION OF THE EMERGENCY  
LOAN GUARANTEE ACT (PUBLIC LAW 92-70).
5. THE STATUS OF SHIPBUILDING CLAIMS.

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December 18, 1972; [Reponses to Various Questions Regarding Military Contracts]

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INVESTIGATION OF  
CHARGES BY MR. HENRY M. DURHAM

THIS SEGMENT OF OUR STATEMENT CONCERNS OUR INVESTIGATION AT YOUR REQUEST OF OCTOBER 12, 1971, OF THE CHARGES MADE BEFORE YOUR SUBCOMMITTEE BY MR. HENRY M. DURHAM, A FORMER EMPLOYEE OF LOCKHEED AIRCRAFT CORPORATION, REGARDING LOCKHEED'S MANAGEMENT OF THE C-5 AIRCRAFT PROGRAM.

THE GENERAL ACCOUNTING OFFICE HAS GIVEN PARTICULAR ATTENTION TO THE FOLLOWING MATTERS RELATING TO MR. DURHAM'S CHARGES:

1. THE CONTRACTOR'S AWARENESS OF THE PROBLEMS CITED BY MR. DURHAM AND THE TIMELINESS AND EFFECTIVENESS OF THE ACTION TAKEN.
2. THE COMPARISON OF LOCKHEED'S EXPERIENCE ON THE C-5 AIRCRAFT WITH ITS PAST EXPERIENCE AND WITH THAT OF OTHER MAJOR AIRCRAFT COMPANIES IN PRODUCING NEW AIRCRAFT SYSTEMS.
3. THE AWARENESS OF AND THE ACTIONS TAKEN BY THE AIR FORCE IN RESPECT TO THESE MATTERS.

WE ALSO OBTAINED LOCKHEED AND AIR FORCE COMMENTS ON MR. DURHAM'S CHARGES IN LETTERS DATED MAY 26 AND JULY 13, 1972, RESPECTIVELY.

MR. DURHAM PROVIDED A SET OF 23 EXHIBITS IN SUPPORT OF HIS CHARGES OF UNSATISFACTORY MANAGEMENT PRACTICES IN THE ASSEMBLY OPERATIONS AT THE MARIETTA, GEORGIA, PLANT AND IN THE FABRICATION PLANT AT CHATTANOOGA, TENNESSEE. THE PRINCIPAL PROBLEMS CITED BY MR. DURHAM AT THESE TWO PLANTS, ALONG WITH OUR FINDINGS, ARE SUMMARIZED BELOW AND ARE PRESENTED IN DETAIL IN THE REPORT PREVIOUSLY FURNISHED TO YOUR SUBCOMMITTEE.

LOCKHEED-GEORGIA COMPANY, MARIETTA, GEORGIA

MR. DURHAM CHARGED THAT THERE WAS MISMANAGEMENT OF ASSEMBLY OPERATIONS IN PRODUCING THE C-5 AIRCRAFT AT THE MARIETTA PLANT. HE CHARGED, IN PART, THAT (1) ASSEMBLY RECORDS WERE INACCURATE, (2) PARTS HAD BEEN REMOVED WITHOUT AUTHORIZATION, HAD BEEN SCRAPPED BY MISTAKE, AND HAD BEEN UNNECESSARILY PROCURED, (3) INVENTORY CONTROLS OVER TITANIUM FASTENERS WERE INADEQUATE, (4) AIRCRAFT WERE MOVED ALONG THE PRODUCTION LINE IN ORDER TO COLLECT PAYMENTS RELATED TO THE ACCOMPLISHMENT OF MILESTONES, ALTHOUGH THE AIRCRAFT WERE INCOMPLETE, AND (5) THE SUBTERFUGE TO CONCEAL SUCH PROBLEMS BEGAN WITH THE ROLLOUT OF AIRCRAFT 0001. MR. DURHAM STATED THAT, AS A RESULT, PRODUCTION COSTS HAD BEEN INCREASED SIGNIFICANTLY.

OUR FINDINGS SUPPORT THE FOLLOWING CHARGES MADE BY MR. DURHAM.

--AIRCRAFT ASSEMBLY RECORDS DID NOT ACCURATELY REFLECT THE PHYSICAL CONDITION OF THE AIRCRAFT.

--PARTS HAD BEEN REMOVED FROM AIRCRAFT WITHOUT AUTHORIZATION.

--PARTS HAD BEEN ERRONEOUSLY SCRAPPED.

--THERE WERE INADEQUATE CONTROLS OVER DISBURSEMENT, HANDLING, AND USAGE OF TITANIUM FASTENERS.

WE COULD NOT, HOWEVER, DETERMINE THE FULL EXTENT OF THESE CONDITIONS OR THEIR IMPACT ON THE COST OR SCHEDULE OF THE C-5 AIRCRAFT PROGRAM.

OUR FINDINGS DO NOT SUPPORT THE FOLLOWING CHARGES MADE BY MR. DURHAM.

--WE DID NOT FIND EVIDENCE TO INDICATE THAT PARTS HAD BEEN UNNECESSARILY PROCURED. THIS IS BASED ON A DETAILED REVIEW OF A RANDOM SAMPLE OF PURCHASED PARTS.

--WE DID NOT FIND EVIDENCE TO INDICATE THAT LOCKHEED MAINTAINED THE PRODUCTION SCHEDULE IN ORDER TO COLLECT PAYMENTS RELATED TO THE ACCOMPLISHMENT OF MILESTONES. WE DID FIND HOWEVER, THAT THE AIR FORCE HAD WITHHELD ABOUT \$3.7 MILLION FROM MILESTONE PAYMENTS ON THE FIVE TEST AIRCRAFT BECAUSE OF SHORTAGES AND VARIANCES FROM SPECIFICATIONS WHEN THE AIRCRAFT WERE DELIVERED TO THE FLIGHT-TEST ORGANIZATION.

---WE DID NOT FIND EVIDENCE TO INDICATE THAT THERE WAS SUBTERFUGE INVOLVED IN THE ROLLOUT CEREMONY OF AIRCRAFT 0001. THE AIR FORCE ISSUED A PRESS RELEASE ON FEBRUARY 21, 1968, THAT THE C-5 AIRCRAFT ROLLOUT WOULD BE CONDUCTED ON MARCH 2, 1968. THE RELEASE ALSO INDICATED THAT THE C-5 AIRCRAFT WAS SCHEDULED TO FLY FOR THE FIRST TIME IN JUNE 1968. THIS SHOWS THAT THE AIRCRAFT WAS NOT INTENDED TO BE FULLY OPERATIONAL AT THE TIME OF ROLLOUT.

LOCKHEED-GEORGIA COMPANY  
CHATTANOOGA, TENNESSEE

Mr. DURHAM CHARGED, IN PART, THAT (1) THERE WERE INADEQUATE CONTROLS OVER TOOLS, RAW MATERIALS, AND MISCELLANEOUS SMALL PARTS, (2) THERE WAS UNNECESSARY PROCUREMENT OF MATERIAL AND HIGH-STRENGTH NUTS AND BOLTS, AND (3) THERE WAS MISHANDLING OF MATERIALS. HE STATED THAT THESE CONDITIONS AND PRACTICES HAD INCREASED THE COST OF OPERATING THE CHATTANOOGA PLANT.

OUR FINDINGS SUPPORT THE FOLLOWING CHARGES MADE BY Mr. DURHAM.

- HIGH-STRENGTH NUTS AND BOLTS HAD BEEN PURCHASED FOR PLANT MAINTENANCE WHEN, FOR SOME PURPOSES, LOWER GRADE MATERIALS WOULD HAVE SUFFICED.
- SUBSTANTIAL QUANTITIES OF MATERIAL AND MISCELLANEOUS SMALL PARTS HAD ACCUMULATED AS A RESULT OF CANCELED ORDERS AND TRANSFER OF ITEMS FROM ANOTHER PLANT.
- SOME ITEMS WHICH WERE AVAILABLE AT LESS COST FROM THE MARIETTA STOREROOM HAD BEEN PURCHASED LOCALLY.

OUR FINDINGS DO NOT SUPPORT THE CHARGES BY Mr. DURHAM THAT THERE WERE INADEQUATE INVENTORY CONTROLS OVER TOOLS, RAW MATERIALS, AND MISCELLANEOUS SMALL PARTS. WE FOUND THAT CONSUMABLE TOOLS, SUCH AS DRILL BITS, REAMERS, AND CUTTERS WERE PROVIDED TO EMPLOYEES AS THEY WERE NEEDED WITHOUT ESTABLISHING A RECORD OF ISSUE. WITH RESPECT TO RAW MATERIALS AND

MISCELLANEOUS SMALL PARTS, WE FOUND THAT THESE ITEMS WERE PURCHASED AND CONTROLLED ON AN INDIVIDUAL JOB ORDER BASIS IN LIEU OF DETAILED INVENTORY CONTROLS. WE BELIEVE THESE PRACTICES WERE REASONABLE BECAUSE IT IS GENERALLY IMPRACTICAL TO PROVIDE A DETAILED INVENTORY CONTROL SYSTEM FOR SMALL AND INEXPENSIVE TOOLS AND PARTS. IN ADDITION, WE FOUND THAT THESE PRACTICES WERE CONSISTENT WITH OTHERS IN THE INDUSTRY.

GENERAL

WE VISITED SEVERAL AEROSPACE FIRMS TO DETERMINE WHETHER PROBLEMS SIMILAR TO THOSE EXPERIENCED BY LOCKHEED COULD NORMALLY BE EXPECTED IN PRODUCING A NEW AIRCRAFT. WE WERE ADVISED THAT CONDITIONS SUCH AS OUT-OF-SEQUENCE WORK AND MISSING PARTS EXIST ON EVERY NEW AIRCRAFT PROGRAM. HOWEVER, IT WAS ALSO POINTED OUT THAT MANAGEMENT EMPHASIS IS DIRECTED TOWARD INSURING THAT SUCH CONDITIONS DO NOT DEVELOP INTO MAJOR PROBLEMS. WE WERE UNABLE TO OBTAIN SPECIFIC DETAILED INFORMATION THAT COULD BE USED FOR COMPARISON.

WE FOUND THAT PRIOR TO THE PUBLICATION OF MR. DURHAM'S CHARGES THE AIR FORCE WAS AWARE OF SOME OF THE CONDITIONS HE CITED. FOR EXAMPLE, THE AIR FORCE KNEW LOCKHEED WAS EXPERIENCING DIFFICULTIES WITH TITANIUM FASTENERS, FEEDER PLANT ASSEMBLIES, QUALITY CONTROL, AND OUT-OF-SEQUENCE WORK. HOWEVER, THE AIR FORCE COULD NOT PROVIDE ANY DOCUMENTATION THAT WOULD INDICATE THEY WERE AWARE OF OTHER CONDITIONS SUCH AS INACCURATE ASSEMBLY

RECORDS, UNAUTHORIZED REMOVALS, OR ANY OF THE CONDITIONS AT CHATTANOOGA.

FOR THE MOST PART, HOWEVER, THE AIR FORCE DID NOT DIRECT THE CONTRACTOR TO TAKE SPECIFIC CORRECTIVE ACTION BECAUSE THE AIR FORCE, IN ADMINISTERING THE CONTRACT, FOLLOWED A PHILOSOPHY OF "DISENGAGEMENT." THIS PHILOSOPHY REQUIRED MINIMAL PARTICIPATION BY THE AIR FORCE IN THE DAY-TO-DAY MANAGEMENT OF THE PROGRAM AS PRESCRIBED BY THE TOTAL PACKAGE PROCUREMENT CONCEPT UNDER WHICH THE C-5 AIRCRAFT WAS ORIGINALLY PURCHASED.

WE ALSO FOUND THAT PRIOR TO THE PUBLICATION OF MR. DURHAM'S CHARGES LOCKHEED'S MANAGEMENT WAS AWARE OF THESE PROBLEMS AND WAS DIRECTING CORRECTIVE ACTION, AS EVIDENCED BY (1) DISCUSSIONS AT SPECIAL MEETINGS HELD TO REVIEW THE PROGRESS OF THE C-5 AIRCRAFT PROGRAM AND (2) NUMEROUS LOCKHEED INTERNAL AUDIT REPORTS WHICH WERE WIDELY DISSEMINATED TO LOCKHEED OFFICIALS.

PROGRESS PAYMENT PRACTICES ON THE C-5  
AIRCRAFT PROGRAM

YOU REQUESTED OUR COMMENTS ON A FEBRUARY 20, 1970, REPORT OF THE DEFENSE CONTRACT AUDIT AGENCY ON PROGRESS PAYMENT PRACTICES ON THE C-5 AIRCRAFT PROGRAM. THE AGENCY'S REPORT CONCLUDED THAT:

- THE CONTRACTOR HAD UNDERSTATED THE COST OF DELIVERED ITEMS BY FAILING TO INCLUDE OVERRUNS.
- AS A RESULT, OVER \$400 MILLION WORTH OF PROGRESS PAYMENTS THEN OUTSTANDING WERE DUE TO THIS UNDERSTATEMENT OF THE COST OF DELIVERED ITEMS.
- THERE WAS A QUESTION AS TO WHETHER THE CONTRACTOR WOULD BE ABLE TO FINANCE HIS OVERRUNS AND COMPLETE THE CONTRACT, SINCE THE CEILING ON PROGRESS PAYMENTS WAS RAPIDLY APPROACHING.

FREQUENTLY A GOVERNMENT CONTRACT, AS WAS THE CASE IN THE C-5 AIRCRAFT PROGRAM, REQUIRES A LONG PERIOD OF PERFORMANCE OR SUBSTANTIAL EXPENDITURES BEFORE THE CONTRACTOR MAKES DELIVERY AND RECEIVES FULL PAYMENT. USING PRIVATE CAPITAL IN SUCH CASES MAY NOT BE ECONOMICAL OR FEASIBLE BECAUSE THE FINANCIAL REQUIREMENT MAY EXCEED THE CONTRACTOR'S CAPABILITY OR IMPAIR ITS ABILITY TO PERFORM. THUS, THE GOVERNMENT HAS FOLLOWED THE PRACTICE OF REIMBURSING THE CONTRACTOR FOR PART OF THE COSTS INCURRED ON WORK IN PROCESS BUT NOT YET DELIVERED. PAYMENTS



TO CONTRACTORS ON THIS BASIS ARE AUTHORIZED BY 10 U.S.C. 2307 AND THE DEPARTMENT OF DEFENSE PROCEDURES FOR SUCH PAYMENTS ARE INCLUDED IN THE ARMED SERVICES PROCUREMENT REGULATION.

THE STANDARD PROGRESS PAYMENT CLAUSE PROVIDES FOR PAYMENT OF A STIPULATED PERCENTAGE OF THE CONTRACTOR'S INCURRED COSTS. IN THE CASE OF THE C-5 AIRCRAFT PROGRAM, THE PROGRESS PAYMENT RATE WAS SET AT 90 PERCENT OF THE COSTS INCURRED. THE CUMULATIVE PROGRESS PAYMENTS COULD NOT EXCEED 90 PERCENT (SUBSEQUENTLY INCREASED TO 100 PERCENT) OF THE CEILING PRICE ESTABLISHED IN THE CONTRACT.

WHEN AN ITEM IS DELIVERED AND INVOICED, THE PROGRESS PAYMENTS RECEIVED BY THE CONTRACTOR DURING ITS PRODUCTION ARE DEDUCTED FROM THE TOTAL AMOUNT DUE. THIS IS KNOWN AS LIQUIDATING THE PROGRESS PAYMENTS. THE C-5 CONTRACT PROVIDED THAT THE AMOUNT OF UNLIQUIDATED (I.E., OUTSTANDING) PROGRESS PAYMENTS NOT EXCEED THE LOWER OF (1) 90 PERCENT OF THE COSTS INCURRED FOR UNDELIVERED ITEMS, OR (2) 90 PERCENT (SUBSEQUENTLY INCREASED TO 100 PERCENT) OF THE CONTRACT PRICE OF THE UNDELIVERED ITEMS. AS OF JANUARY 20, 1970, C-5 PROGRESS PAYMENTS WERE NOT IN VIOLATION OF ANY OF THE ABOVE CEILINGS.

THE REGULATIONS PROVIDED THAT THE COSTS FOR UNDELIVERED ITEMS BE DETERMINED BY DEDUCTING THE COSTS ATTRIBUTABLE TO ITEMS DELIVERED, INVOICED, AND ACCEPTED FROM THE TOTAL COSTS

INCURRED. THE REGULATIONS ALSO PROVIDED THAT THE COSTS OF DELIVERED ITEMS BE COMPUTED AS FOLLOWS:

"IN ORDER OF PREFERENCE, THESE COSTS ARE TO BE COMPUTED ON THE BASIS OF ONE OF THE FOLLOWING:

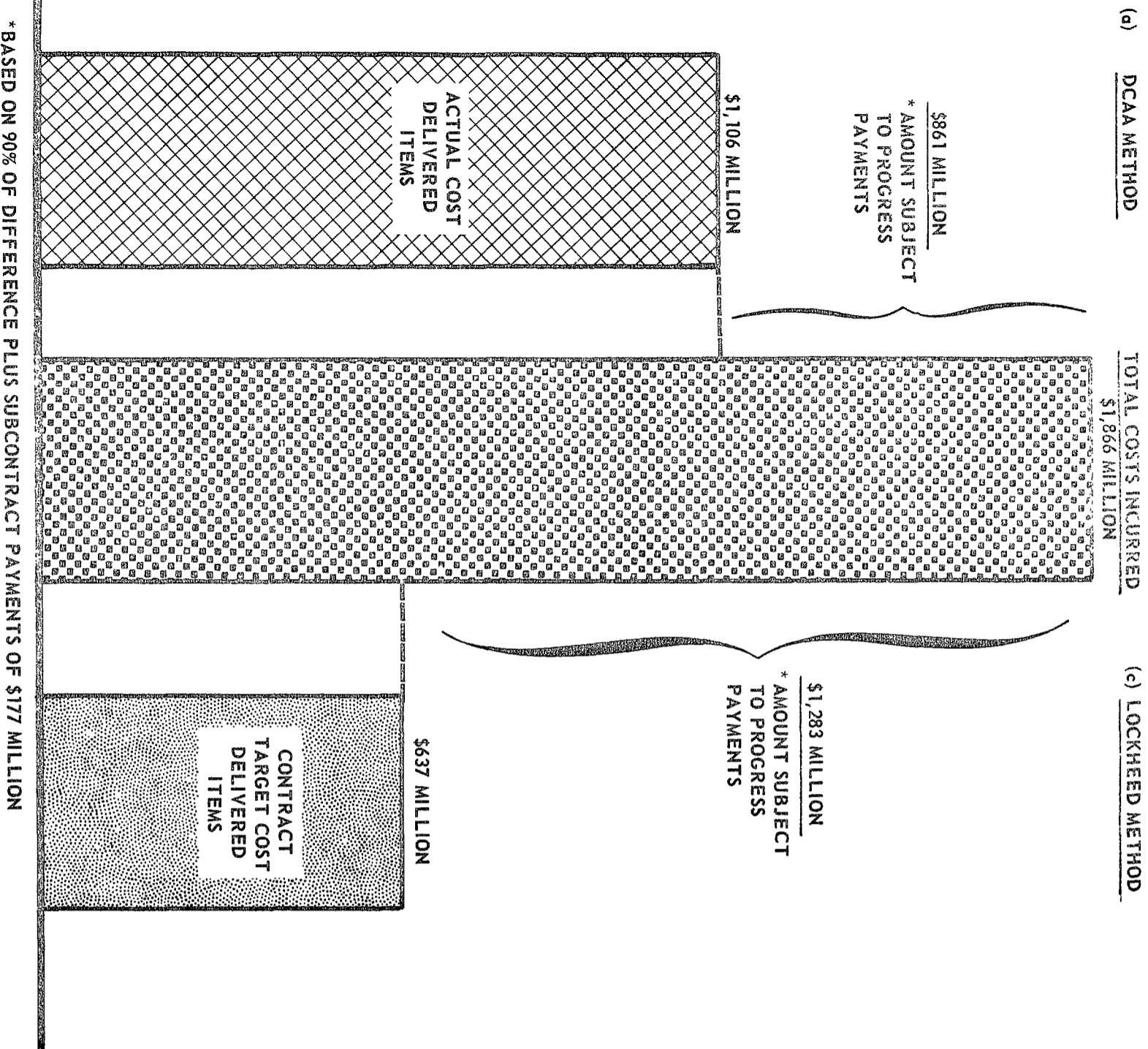
- (A) THE ACTUAL UNIT COST OF ITEMS DELIVERED, GIVING PROPER CONSIDERATION TO THE DEFERMENT OF THE STARTING LOAD COSTS;
- (B) PROJECTED UNIT COSTS (BASED ON EXPERIENCED COSTS, PLUS ESTIMATED COSTS TO COMPLETE THE CONTRACT), WHERE THE CONTRACTOR MAINTAINS COST DATA WHICH WILL CLEARLY ESTABLISH THE RELIABILITY OF SUCH ESTIMATES; AND
- (C) THE TOTAL CONTRACT PRICE OF ITEMS DELIVERED."

LOCKHEED FOLLOWED METHOD (C) IN COMPUTING THE COSTS OF DELIVERED ITEMS. THEREFORE, IN ARRIVING AT THE COSTS OF UNDELIVERED ITEMS, LOCKHEED DEDUCTED FROM THE TOTAL COSTS INCURRED AN ESTIMATED OR TARGET COST BASED ON THE CONTRACT BILLING PRICE OF DELIVERED ITEMS RATHER THAN ACTUAL OR PROJECTED COSTS (METHODS A AND B). BECAUSE THE COSTS DEDUCTED FOR DELIVERED ITEMS WERE LESS THAN THE ACTUAL COSTS OF SUCH ITEMS, THE AMOUNT SUBJECT TO PROGRESS PAYMENTS WAS INCREASED.

THIS WAS THE SITUATION PRESENTED IN THE DEFENSE CONTRACT AUDIT AGENCY'S FEBRUARY 1970 REPORT, WHICH STATED THAT LOCKHEED

HAD BEEN OVERPAID ABOUT \$400 MILLION. THE CHART ON THE FOLLOWING PAGE ILLUSTRATES HOW THE DEFENSE CONTRACT AUDIT AGENCY COMPUTED THE AMOUNT OF OVERPAYMENT.

**C-5A PROGRESS PAYMENTS AS OF JANUARY 20, 1970  
THERE WAS A \$400 MILLION DIFFERENCE BETWEEN THE TWO METHODS  
OF COMPUTING VALUE OF UNDELIVERED ITEMS**



The following is an explanation of how the \$400 million overpayment was computed by the Defense Contract Audit Agency:

- The center bar shows that total costs incurred by the contractor were \$1,866 million.
- The DCAA, based on data from the contractor's "Contract Status Analysis Report" concluded that the actual cost of delivered items was approximately \$1,100 million (left bar). On this basis, \$861 million was subject to progress payments as shown on the chart\*
- However, the regulations then in effect permitted the contractor to state the value of delivered items, as shown in the right-hand bar, at the contract target cost, which was reported by Lockheed as \$637 million in its Request for Progress Payments. Using this lower figure, the amount subject to progress payments was increased to \$1,283 million.
- By subtracting \$861 million, the amount available under method (a); from \$1,283 million, the amount available under method (c); we confirmed that Lockheed's method resulted in progress payments being \$400 million greater under method (c) than under method (a).

\* The amount subject to progress payments is determined by taking the difference between costs incurred and the value of delivered items times 90% (1866 minus 1106 equals 760 times 90% equals 684) plus payments to subcontractors of \$177 million (684 plus 177 equals 861).

THE REGULATIONS OF THE DEPARTMENT OF DEFENSE PERMITTED THIS PROCEDURE. THE AIR FORCE'S WRITTEN COMMENTS TO THE GENERAL ACCOUNTING OFFICE ON THIS MATTER POINTED OUT THAT:

- BOTH PARTIES RECOGNIZED THAT AN UPWARD ADJUSTMENT IN THE CONTRACT CEILING WAS ESSENTIAL BECAUSE OF SEVERAL FACTORS, INCLUDING INFLATION, REPRICING BECAUSE OF THE NUMBER OF AIRCRAFT BEING PROCURED UNDER "RUN B," AND REPRICING BECAUSE OF OVERCEILING COSTS ON "RUN A."
- THIS METHOD OF COMPUTING PROGRESS PAYMENTS HAD BEEN IN EFFECT FROM THE START OF THE CONTRACT. BECAUSE THE CONTRACTOR HAD FILED AN APPEAL WITH THE ARMED SERVICES BOARD OF CONTRACT APPEALS INDICATING AN INTENT TO LITIGATE CONTRACTUAL DIFFERENCES THE AIR FORCE CONSIDERED THAT PROGRESS PAYMENTS SHOULD BE CONTINUED USING THIS METHOD. THE AIR FORCE BELIEVED THAT TO DO OTHERWISE MIGHT INCUR A BREACH-OF-CONTRACT ACTION.
- THE AIR FORCE CONCLUDED THAT, WERE PROGRESS PAYMENTS SUSPENDED OR PAST PAYMENTS SIGNIFICANTLY RECOUPED, C-5 AIRCRAFT PRODUCTION WOULD COME TO A HALT AND THE ULTIMATE COST OF COMPLETING THE PROGRAM WOULD GREATLY INCREASE.

BETWEEN FEBRUARY 1970 AND MAY 1971, WHEN THE CONTRACT WAS RESTRUCTURED, THE AIR FORCE INCREASED THE CEILING PRICE OF THE CONTRACT BY ABOUT \$557 MILLION TO RECOGNIZE (1) FLUCTUATIONS IN THE ECONOMY IN EXCESS OF THE RATE INCLUDED IN THE ORIGINAL CONTRACT PRICE, \$143 MILLION, (2) PROVISIONAL ITEMS AND CHANGE ORDERS FOR WHICH FIRM PRICES HAD NOT BEEN ESTABLISHED, \$114 MILLION, AND (3) INTERIM REPRICING ADJUSTMENTS FOR "RUN B," \$300 MILLION. THESE ACTIONS PROVIDED ADDITIONAL FUNDS FOR PROGRESS PAYMENTS SINCE SUCH PAYMENTS ARE LIMITED BY THE CEILING PRICE FOR THE CONTRACT.

THE AIR FORCE ALSO CHANGED THE LIMIT ON THE PERCENTAGE OF THE CONTRACT PRICE THAT WOULD BE AVAILABLE FOR PROGRESS PAYMENTS. ORIGINALLY, PROGRESS PAYMENTS WERE LIMITED TO 90 PERCENT OF LOCKHEED'S ALLOWABLE INCURRED COSTS, UP TO A MAXIMUM OF 90 PERCENT OF THE CONTRACT CEILING PRICE. IN APRIL 1970 THE AIR FORCE CHANGED THIS MAXIMUM TO 95 PERCENT OF THE CEILING PRICE, WHICH PROVIDED AN ADDITIONAL \$73 MILLION FOR PROGRESS PAYMENT. THE CONTRACT WAS AGAIN CHANGED IN SEPTEMBER 1970 TO ALLOW PROGRESS PAYMENTS UP TO 100 PERCENT OF THE CEILING PRICE; THIS MADE AVAILABLE AN ADDITIONAL \$75 MILLION. THEREFORE, BY CHANGING THE LIMIT FROM 90 PERCENT TO 100 PERCENT, AN ADDITIONAL \$148 MILLION WAS MADE AVAILABLE FOR PROGRESS PAYMENTS TO LOCKHEED. THIS \$148 MILLION AND THE \$557 MILLION INCREASE IN THE CEILING PRICE COMPRISE THE \$705 MILLION DISCUSSED IN THE STAFF STUDY.

THE CONTRACT WAS CONVERTED TO A COST-REIMBURSEMENT CONTRACT IN MAY 1971, AND THE CONTRACTOR STOPPED RECEIVING PROGRESS PAYMENTS AND STARTED RECEIVING REIMBURSEMENT ON THE BASIS OF COSTS INCURRED. NEGOTIATIONS TO CONVERT THE CONTRACT CONSIDERED ALL PAYMENTS PREVIOUSLY MADE TO LOCKHEED.

THE METHOD LOCKHEED USED WAS ALLOWABLE UNDER THE CONTRACT AND WAS PERMITTED UNDER THE REGULATIONS THEN IN EFFECT; HOWEVER, AS PREVIOUSLY ILLUSTRATED, THIS METHOD PERMITTED THE CONTRACTOR TO RECEIVE PROGRESS PAYMENTS FOR COSTS INCURRED ON DELIVERED ITEMS IN EXCESS OF THE UNIT PRICES FOR SUCH ITEMS. BY JUNE 1968, SIX MONTHS AFTER LOCKHEED STARTED USING THIS METHOD, LOCKHEED AND THE AIR FORCE WERE PROJECTING AN OVERRUN ON THE CONTRACT.

IT IS OUR OPINION THAT THE METHOD USED FOR COMPUTING THE PROGRESS PAYMENTS WAS INAPPROPRIATE UNDER THE CIRCUMSTANCES. PROGRESS PAYMENTS ARE TO HELP CONTRACTORS FINANCE THE COST OF UNDELIVERED ITEMS AND WE BELIEVE THAT WHEN AN ITEM IS DELIVERED AND ACCEPTED THE ACTUAL COSTS TO PRODUCE THE ITEM SHOULD BE DEDUCTED FROM TOTAL COSTS INCURRED WHEN COMPUTING THE MAXIMUM PERMISSIBLE PROGRESS PAYMENTS.

AS A RESULT OF THE DEFENSE CONTRACT AUDIT AGENCY REPORT AND OF SUBSEQUENT STUDIES BY THE DEFENSE INTERNAL AUDIT STAFF, IT WAS DECIDED IN NOVEMBER 1971 THAT THE PRACTICE OF USING METHOD (C) TO COMPUTE THE COSTS OF DELIVERED ITEMS SHOULD BE DISCONTINUED. DEFENSE PROCUREMENT CIRCULAR 94, DATED NOVEMBER 22, 1971, ANNOUNCED PLANS TO REVISE THE PROGRESS PAYMENT REQUEST FORM, AND THE NEW FORM OMITTING METHOD (C) BECAME EFFECTIVE ON APRIL 1, 1972.

## ASSESSMENT OF ARMY SHOULD-COST STUDIES

IN TESTIMONY BEFORE THIS SUBCOMMITTEE IN APRIL 1971, WE REAFFIRMED OUR INTENTION TO FOLLOW UP ON THE EFFORTS OF THE MILITARY SERVICES IN PERFORMING SHOULD-COST STUDIES OF CONTRACTORS' OPERATIONS.

TO DATE WE HAVE COMPLETED OUR ASSESSMENT OF NINE ARMY STUDIES WHICH WERE MADE DURING 1970 AND 1971. SINCE OUR REVIEWS OF THE NAVY AND THE AIR FORCE SHOULD-COST STUDIES HAVE NOT YET BEEN COMPLETED, MY REMARKS TODAY WILL BE LIMITED TO THE ARMY STUDIES.

OUR PRIMARY OBJECTIVE WAS TO EXAMINE THE MANNER IN WHICH THE SHOULD-COST STUDIES WERE CONDUCTED AND TO IDENTIFY AREAS IN WHICH IMPROVEMENTS COULD BE MADE TO INCREASE THEIR USEFULNESS AND THE BENEFITS DERIVED FROM THE STUDIES. I WOULD LIKE TO EMPHASIZE THAT WE DID NOT ATTEMPT TO EVALUATE THE OVERALL CONDUCT OF CONTRACT NEGOTIATIONS.

THE ARMY'S OBJECTIVES IN MAKING SHOULD-COST STUDIES ARE TO DEVELOP REALISTIC GOVERNMENT ESTIMATES FOR USE IN NEGOTIATING CONTRACT PRICES, AND TO OBTAIN THE CONTRACTORS' AGREEMENT TO MAKE IMPROVEMENTS IN THOSE OPERATIONS DETERMINED TO BE BELOW ACCEPTABLE LEVELS. WE ESTIMATE THAT THE THREE STUDIES WHICH WE REVIEWED IN DEPTH COST A TOTAL OF ABOUT \$463,200, INCLUDING CONSULTANT FEES OF \$47,885. THE IN-PLANT PHASES OF THESE STUDIES CONSUMED PERIODS OF 5 TO 8 WEEKS AND THE STUDY TEAMS VARIED IN SIZE FROM 15 TO 27 MEMBERS.



ALTHOUGH NO TWO STUDIES WERE THE SAME IN AREAS COVERED, DEPTH OF REVIEW, FINDINGS, OR RECOMMENDATIONS, ON THE WHOLE WE BELIEVE THE STUDIES STRENGTHENED THE ARMY'S BARGAINING POSITION IN CONTRACT NEGOTIATIONS. SOME OF THE BENEFITS WHICH COULD HAVE RESULTED FROM THE STUDIES WERE NOT REALIZED, HOWEVER, BECAUSE INSUFFICIENT ATTENTION WAS GIVEN TO IDENTIFYING WAYS TO IMPROVE THE CONTRACTOR'S EFFICIENCY AND ECONOMY OF OPERATIONS.

THE TEAMS MADE IN-DEPTH ANALYSES OF THE CONTRACTORS' PROPOSALS AND ARRIVED AT COST ESTIMATES WHICH WERE MUCH LOWER THAN THOSE OF THE CONTRACTORS. THE NINE ARMY SHOULD-COST STUDIES EVALUATED CONTRACTORS' PROPOSALS TOTALING \$299.2 MILLION AND IDENTIFIED POTENTIAL REDUCTION OF \$97.8 MILLION. THE POTENTIAL PRICE REDUCTION REPRESENTS THE DIFFERENCE BETWEEN THE CONTRACTOR'S PROPOSED PRICE AND THE ESTIMATES DEVELOPED BY THE SHOULD-COST TEAMS.

THE PRICE REDUCTIONS REALIZED BY THE ARMY IN NEGOTIATIONS TOTALED \$46.7 MILLION, OR 15.6 PERCENT OF THE CONTRACTORS' PRICE PROPOSALS. FIGURES DEVELOPED BY THE ARMY SHOW THAT ON PRIOR PROCUREMENTS OF THE SAME OR SIMILAR EQUIPMENT FROM THE NINE CONTRACTORS PRICE REDUCTIONS AMOUNTED TO 8 PERCENT OF THE CONTRACTORS' PROPOSALS. WE CONFIRMED THIS FOR THREE OF THE NINE STUDIES.

WE COULD NOT DETERMINE THE PRECISE AMOUNT OF THE COST REDUCTION FOR EACH INDIVIDUAL SHOULD-COST FINDING

BECAUSE FINAL AGREEMENT WAS REACHED ON A LUMP-SUM BASIS RATHER THAN ON INDIVIDUAL ELEMENTS OF COST. IN ADDITION, THE FULL EXTENT OF THE SAVINGS TO THE GOVERNMENT CANNOT BE DETERMINED UNTIL THE FINAL COSTS OF PERFORMING THE CONTRACTS ARE KNOWN BECAUSE IN SEVEN INSTANCES FIXED-PRICE-INCENTIVE TYPE CONTRACTS WERE AWARDED. UNDER THIS TYPE OF CONTRACT THE CONTRACTOR IS PAID ON THE BASIS OF THE COSTS INCURRED IN PERFORMING THE CONTRACT UP TO A CEILING PRICE AND THE CONTRACTOR'S ACTUAL PROFIT IS DETERMINED BY THE EXTENT TO WHICH THE FINAL COSTS ARE EITHER HIGHER OR LOWER THAN THE CONTRACT TARGET COSTS.

IN ADDITION TO THE CONTRACT PRICE REDUCTIONS NEGOTIATED, SIX OF THE NINE CONTRACTORS AGREED TO APPLY THEIR BEST EFFORTS TOWARD ATTAINING A NUMBER OF IMPROVEMENT GOALS IN AREAS WHICH THE SHOULD-COST TEAMS FELT HAD POTENTIAL FOR IMPROVEMENT AND FROM WHICH THE GOVERNMENT STANDS TO BENEFIT FROM ANY SUBSEQUENT CONTRACTS. THE GOALS CONCERNED SUCH THINGS AS ACHIEVING HIGHER LABOR EFFICIENCY LEVELS AND PREPARING AND IMPLEMENTING ESTIMATING AND ACCOUNTING MANUALS.

THE STUDIES WE REVIEWED HAD FEW SUGGESTIONS FOR SPECIFIC CHANGES IN THE CONTRACTORS' OPERATIONS TO IMPROVE EFFICIENCY OR ECONOMY. THE TEAMS RELIED PRINCIPALLY ON IN-DEPTH ANALYSES OF THE CONTRACTORS' RECORDS AND ON THE TEAMS' JUDGMENTS. WE BELIEVE THE BEST MEANS TO CHALLENGE THE EFFICIENCY OF A CONTRACTOR'S OPERATIONS IS TO IDENTIFY THE SPECIFIC PRACTICES

WHICH NEED IMPROVEMENT. WE HAVE RECOMMENDED THAT THE ARMY GIVE INCREASED EMPHASIS TO THIS IN FUTURE STUDIES.

THE STUDY TEAMS DID NOT DISCUSS THEIR SPECIFIC FINDINGS WITH THE CONTRACTORS PRIOR TO NEGOTIATIONS FOR FEAR OF JEOPARDIZING THEIR NEGOTIATING POSITIONS. OUR VIEW, HOWEVER, IS THAT OPEN AND FRANK DISCUSSIONS THROUGHOUT THE STUDIES CAN HELP TO DEVELOP STRONGER BARGAINING POSITIONS BY ENABLING THE TEAMS TO ISOLATE AREAS OF AGREEMENT AND DISAGREEMENT EARLIER; TO UNDERTAKE ADDITIONAL WORK WHEN NECESSARY; AND TO REFINES THEIR POSITIONS WHEN JUSTIFIED. SUCH DISCUSSIONS WOULD ALSO ALLOW GREATER CONTRACTOR PARTICIPATION IN DETERMINING THE ACTIONS NEEDED TO IMPROVE THEIR EFFICIENCY AND WOULD LEAD TO QUICKER AGREEMENTS DURING NEGOTIATIONS.

WE FOUND LITTLE EVIDENCE THAT THE TEAMS HAD CONSIDERED THE NEED FOR OR THE DESIRABILITY OF CHANGES IN GOVERNMENT POLICIES, PROCEDURES OR PRACTICES TO REDUCE THE COSTS OF CONTRACTOR OPERATIONS. FOR EXAMPLE, WE HAVE FOUND IN OTHER REVIEWS THAT SUBSTANTIAL SAVINGS COULD BE ACHIEVED BY ELIMINATING OR MODIFYING CERTAIN GOVERNMENT TESTING AND PACKAGING REQUIREMENTS. WE HAVE RECOMMENDED THAT THESE MATTERS BE GIVEN ATTENTION IN FUTURE STUDIES. IN ADDITION, WE BELIEVE THAT THE DEPARTMENT OF DEFENSE SHOULD STUDY THE QUESTION OF WHETHER THE SHOULD-COST CONCEPT SHOULD BE EXPANDED TO INCLUDE CONSIDERATION OF THE IMPACT ON COSTS OF SCHEDULE AND PERFORMANCE REQUIREMENTS.

AT ONE LOCATION WE FOUND THAT THE RESIDENT AUDIT OFFICE HAD DIFFICULTY MEASURING THE CONTRACTOR'S PROGRESS TOWARD THE IMPROVEMENT GOALS FOR CERTAIN CATEGORIES OF INDIRECT EXPENSES. THE GOALS WERE EXPRESSED AS PERCENTAGE REDUCTIONS OR PERCENTAGE LEVELS TO BE ATTAINED. BECAUSE THESE RATES COULD BE AFFECTED BY COST ACCOUNTING CHANGES OR FLUCTUATIONS IN THE COSTS, CHANGES IN THE RATE DID NOT FURNISH MEANINGFUL INFORMATION AS TO THE CONTRACTOR'S PROGRESS IN REDUCING COSTS. WE HAVE RECOMMENDED THAT THE TEAMS DEFINE IMPROVEMENT GOALS IN TERMS WHICH WILL PERMIT MORE MEANINGFUL PROGRESS EVALUATIONS.

WE ARE CONVINCED THAT SHOULD-COST TECHNIQUES, PROPERLY APPLIED, CAN BE OF GREAT ASSISTANCE TO GOVERNMENT NEGOTIATORS IN ARRIVING AT FAIR AND REASONABLE PRICES. WE INTEND, THEREFORE, TO CONTINUE TO FOLLOW UP ON THE EFFORTS OF THE MILITARY SERVICES IN APPLYING THESE TECHNIQUES AND TO RECOMMEND IMPROVEMENTS WHEN WE FIND THE NEED FOR THEM. OUR ASSESSMENTS OF THE STUDIES PERFORMED BY THE NAVY AND THE AIR FORCE SHOULD BE COMPLETED SHORTLY, AND COPIES OF OUR REPORTS WILL BE PROVIDED TO THE SUBCOMMITTEE.

## IMPLEMENTATION OF THE EMERGENCY LOAN GUARANTEE ACT

THE EMERGENCY LOAN GUARANTEE ACT REQUIRES GAO TO MAKE AN AUDIT OF ANY BORROWER UNDER THE ACT. LOCKHEED AIRCRAFT CORPORATION HAS BEEN THE ONLY BORROWER.

WE HAVE CONCLUDED THAT LOCKHEED AND THE LENDING BANKS HAVE COMPLIED WITH THE REQUIREMENTS OF THE ACT. AS REQUIRED BY THE ACT, THE GOVERNMENT HAS BEEN PLACED IN A PREFERRED POSITION WITH RESPECT TO THE COLLATERAL AND, BASED ON CURRENT BOOK VALUATIONS AND CERTAIN KNOWN MARKET VALUES OF THE PLEDGED ASSETS, THE GOVERNMENT'S INTERESTS APPEAR TO BE ADEQUATELY PROTECTED.

BARRING UNFORESEEN CIRCUMSTANCES AVAILABLE INFORMATION INDICATES THAT LOCKHEED SHOULD BE ABLE TO GENERATE SUFFICIENT CASH DURING THE NEXT SEVERAL YEARS TO PERMIT REPAYMENT OF THE GOVERNMENT-GUARANTEED PORTION OF ITS LOAN. HOWEVER, UNLESS LOCKHEED IS SUCCESSFUL IN OBTAINING A SUBSTANTIAL NUMBER OF ADDITIONAL ORDERS FOR ITS L-1011 TRISTAR COMMERCIAL AIRLINER, LOSSES ON THAT PROGRAM COULD IMPAIR THE FINANCIAL CONDITION OF THE COMPANY. FIRM ORDERS AND OPTIONS AMOUNT TO 117 AND 67 AIRCRAFT, RESPECTIVELY, AS OF TODAY, COMPARED TO LOCKHEED'S ESTIMATED BREAK-EVEN POINT OF 275.

IN THIS CONNECTION OUR REVIEW OF AVAILABLE FORECASTS OF THE WORLD-WIDE DEMAND FOR WIDEBODIED TRIJET AIRCRAFT OF THE L-1011/DC-10 TYPE THROUGH 1980 INDICATES THAT LESS THAN

40 PERCENT OF THE DEMAND HAS BEEN THUS FAR SATISFIED IN THE FORM OF EITHER ORDERS OR OPTIONS RECEIVED BY THE TWO MANUFACTURERS OF THE TRIJET AIRCRAFT. IN PART THIS MAY BE ATTRIBUTABLE TO APPARENT AIRLINES POLICY OF NOT PLACING ORDERS OR OPTIONS MORE THAN 2 OR 3 YEARS IN ADVANCE.

SEVERAL IMPORTANT DEVELOPMENTS HAVE OCCURRED RECENTLY SUCH AS:

1. THE RECEIPT OF ORDERS FOR 32 ADDITIONAL AIRCRAFT (13 FIRM AND 19 OPTIONS) FROM CUSTOMERS THAT ARE EXPECTED TO HAVE SUBSTANTIALLY LARGER NEEDS FOR THESE PLANES IN THE LAST HALF OF THE DECADE OF THE 1970's.
2. THE ISSUANCE BY LOCKHEED OF A NEW 5-YEAR FORECAST THAT RECOGNIZES THE FOLLOWING FACTORS:
  - A. L-1011 PRODUCTION COSTS INCREASED DURING THE FIRST 6 MONTHS OF 1972 AND THE PRODUCTION SCHEDULE OF THE PLANES WAS EXTENDED BY 18 MONTHS. THESE TWO SITUATIONS HAVE CONTRIBUTED TO INCREASING THE BREAK-EVEN POINT, ESTIMATED BY LOCKHEED, FROM 265 TO 275 AIRCRAFT. LOCKHEED HAS ATTRIBUTED THE INCREASE IN PRODUCTION COSTS PRIMARILY TO OUT-OF-STATION WORK AND UNSCHEDULED OVERTIME REQUIRED TO MEET DELIVERY COMMITMENTS ON THE FIRST 12 AIRCRAFT. WE ARE SEEKING TO DETERMINE

WHETHER THERE ARE INDICATIONS THAT  
LOCKHEED IS RESOLVING THESE PROBLEMS  
AND BRINGING COSTS IN LINE WITH ITS  
INITIAL ESTIMATES.

- B. LOCKHEED WILL NEED TO DRAW DOWN A GREATER PROPORTION OF THE TOTAL FUNDS AVAILABLE UNDER THE \$250 MILLION GUARANTEED LOAN. INITIALLY LOCKHEED ESTIMATED IT WOULD DRAW A MAXIMUM OF \$150 MILLION. THIS HAS BEEN INCREASED TO AN AMOUNT BETWEEN \$195 MILLION AND \$220 MILLION. CURRENTLY, \$130 MILLION HAS BEEN BORROWED AND LOCKHEED'S FORECAST INDICATES THAT THIS IS EXPECTED TO REACH \$150 MILLION BY THE END OF THE YEAR.
- C. LOCKHEED ORIGINALLY PLANNED TO PAYBACK THE GUARANTEED LOAN BY THE END OF 1974. LOCKHEED CURRENTLY ESTIMATES PAYBACK WILL BE COMPLETED ABOUT 3 TO 6 MONTHS LATER. HOWEVER, THE CURRENT ESTIMATE IS STILL WITHIN LOCKHEED'S OBLIGATION TO FULLY REPAY THE GUARANTEED LOAN BY DECEMBER 31, 1975.

IN VIEW OF BROAD LANGUAGE IN THE LEGISLATION WITH RESPECT TO THE NATURE AND OBJECTIVES OF GAO'S EXAMINATION OF THE BORROWER, WE COORDINATED OUR PLANS WITH THE CHAIRMEN OF THE HOUSE AND SENATE BANKING COMMITTEES AND CONGRESSMAN DINGELL, THE SPONSOR OF THE GAO AUDIT PROVISION.

WE HAVE INTERPRETED THE STATUTE AS REQUIRING GAO TO:

- A. MONITOR THE FINANCIAL AND OTHER ACTIVITIES OF THE BORROWER TO PROVIDE ASSURANCE THAT THE BORROWER AND LENDERS COMPLY WITH THE TERMS OF THE STATUTE AND THE IMPLEMENTING AGREEMENTS, AND THAT THE INTERESTS OF THE GOVERNMENT ARE ADEQUATELY PROTECTED;
- B. ADVISE THE CONGRESS OF ANY MATTERS THAT MAY AFFECT THE ABILITY OF THE BORROWER TO REPAY THE GOVERNMENT-GUARANTEED PORTION OF ITS OUTSTANDING LOANS; AND
- C. INFORM THE CONGRESS OF ANY OTHER INFORMATION THAT MAY BE RELEVANT UNDER THE CIRCUMSTANCES EXISTING DURING THE LOAN GUARANTEE PERIOD.

IN ADDITION, SINCE ALL OF THE AUTHORITY TO ADMINISTER THE LOAN IS VESTED IN THE EMERGENCY LOAN GUARANTEE BOARD, WE CONSIDER THE REVIEW OF THE ACTIVITIES OF THE BOARD TO BE A VITAL PART OF OUR OVERALL EXAMINATION.

ALTHOUGH THE EMERGENCY LOAN GUARANTEE ACT DOES NOT REQUIRE GAO TO REVIEW THE BOARD'S ACTIVITIES, SUCH A REVIEW IS CLEARLY AUTHORIZED UNDER THE GENERAL AUTHORITY GRANTED TO GAO BY THE CONGRESS TO REVIEW THE RECORDS OF THE AGENCIES OF THE EXECUTIVE BRANCH OF THE GOVERNMENT. THE BOARD, AS YOU KNOW, HAS TAKEN THE POSITION THAT WE DO NOT HAVE



STATUTORY AUTHORITY TO REVIEW ITS INTERNAL RECORDS RELATING TO ITS DECISION-MAKING PROCESS AND CONTINUES TO HOLD TO THIS POSITION. WE BELIEVE THAT GAO HAS THE RESPONSIBILITY FOR REVIEWING THE ACTIVITIES OF THE BOARD AND HAS THE RIGHT TO EXAMINE ANY RECORDS RELATED TO THE DECISIONS PREVIOUSLY MADE BY THE BOARD. IN COMPLIANCE WITH THE VIEWS EXPRESSED BY THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS AND THE HOUSE COMMITTEE ON BANKING AND CURRENCY, THE BOARD PROVIDED US WITH CERTAIN CORRESPONDENCE AND FINANCIAL ANALYSES PREPARED BY ITS FISCAL AGENT WHICH ENABLED US TO EXAMINE THE ACTIVITIES OF THE BOARD IN CONNECTION WITH THE LOCKHEED GUARANTEE. CONSISTENT WITH ITS EARLIER POSITION, HOWEVER, THE BOARD STATED IN ITS ANNUAL REPORT DATED SEPTEMBER 5, 1972, THAT THE LEGAL DIFFICULTIES BETWEEN THE GAO AND BOARD WERE UNAFFECTED BY ITS RELEASE OF RECORDS TO US. THUS, THE BOARD HAS NOT CONCEDED THAT GAO HAS A LEGAL RIGHT TO RECORDS OF THE BOARD THAT GAO BELIEVES ARE NECESSARY TO CARRY OUT ITS STATUTORY RESPONSIBILITIES -- A POSITION WE THINK IS WITHOUT MERIT.

## STATUS OF SHIPBUILDING CLAIMS

IN HEARINGS BEFORE THIS SUBCOMMITTEE IN MARCH OF THIS YEAR WE DISCUSSED, IN SOME DETAIL, CONTRACTORS' CLAIMS FOR PRICE INCREASES AND WHY THESE CLAIMS HAVE BEEN A RECURRENT ELEMENT IN NAVY SHIPBUILDING PROGRAMS. A COMPARISON BETWEEN CLAIMS OVER \$5 MILLION THEN OUTSTANDING AND THE LATEST DATA REPORTED BY THE NAVY IS SHOWN BELOW.

	<u>MARCH 1, 1972</u>	<u>NOVEMBER 1, 1972</u>
AVONDALE SHIPYARDS, INC.	\$142.2	\$142.2
BETHLEHEM STEEL	53.6	49.1
DEFOE SHIPBUILDING	5.4	-
DILLINGHAM SHIPYARD	14.2	15.9
GENERAL DYNAMICS	204.6	204.6
INGALLS SHIPBUILDING, LITTON SYSTEMS, INC.	174.6	-
LOCKHEED SHIPBUILDING	139.6	139.6
NEWPORT NEWS SHIPBUILDING	<u>111.0</u>	<u>69.1</u>
	<u>\$845.2</u>	<u>\$620.5</u>

THESE FIGURES DO NOT INCLUDE CLAIMS THAT HAVE BEEN REFERRED TO THE ARMED SERVICES BOARD OF CONTRACT APPEALS OR CLAIMS THAT HAVE BEEN REJECTED BY THE NAVY.

THE DIFFERENCE BETWEEN THE VALUE OF CLAIMS OUTSTANDING AS OF LAST MARCH AND CURRENT CLAIMS IS ATTRIBUTABLE TO THE SETTLEMENT OF SOME CLAIMS BUT IS DUE PRIMARILY TO LITTON'S REFERRAL OF 3 CLAIMS TOTALING \$162 MILLION TO THE ARMED SERVICES BOARD OF CONTRACT APPEALS. A DISCUSSION OF THESE THREE CLAIMS FOLLOWS.

AMMUNITION SUPPLY SHIPS--AF 32-35

LITTON SYSTEMS, INC., INGALLS NUCLEAR SHIPBUILDING DIVISION, CLAIMS \$36,780,419 FOR ALLEGED EXTRA WORK PERFORMED DURING CONSTRUCTION OF FOUR AMMUNITION SUPPLY SHIPS AF 32-35. THE NAVY HAS ADVISED THE CONTRACTOR THAT IT HAD REVIEWED THE RECORD RELATING TO THIS CLAIM AND HAD DETERMINED THAT THE CLAIM FOR ADDITIONAL PAYMENT SHOULD BE GRANTED IN THE AMOUNT OF \$962,057.

ON AUGUST 14, 1972, THE CONTRACTOR SUBMITTED THIS CLAIM TO THE ASBCA.

NUCLEAR ATTACK SUBMARINE--SSN 680, 682, 683

LITTON IS CLAIMING \$30,575,000 DUE PRINCIPALLY TO LATE DELIVERY OF GOVERNMENT-FURNISHED MATERIAL. BY LETTER DATED JULY 31, 1972, THE NAVY ADVISED THE CONTRACTOR THAT IT WAS ENTITLED TO A COMPENSATION INCREASE OF \$3,774,803. ON AUGUST 14, 1972, THE CONTRACTOR SUBMITTED THIS CLAIM TO THE ASBCA.

VARIOUS CONTRACTS

LITTON ALLEGES THAT DUE TO THE IMPACT OF THE GOVERNMENT ACTIONS, IT INCURRED ADDITIONAL COST OF \$94,395,059. GOVERNMENT ACTIONS CITED INCLUDE MASSIVE CHANGES ON SUBMARINE CONTRACTS FOR SSN 621, 639, 648, AND 652, PRIORITIES, AND ACCELERATION OF SUBMARINE WORK. THE CLAIM WAS SUBMITTED IN MAY 1971.

THE CONTRACTOR APPEALED TO THE ASBCA ON JULY 11, 1972, WITHOUT WAITING FOR A CONTRACTING OFFICER'S DECISION.

### LHA PROGRAM CLAIM

ON MARCH 30, 1972, A \$270.7 MILLION CLAIM FOR AN EQUITABLE ADJUSTMENT WAS SUBMITTED BY LITTON SHIP SYSTEMS ON THE LHA CONTRACT. THE NAVY HAS REJECTED THIS CLAIM. LITTON ALSO PROPOSED PRICE INCREASES FOR COSTS RELATED TO THE CANCELLATION OF 4 SHIPS, ESCALATION CHARGES, AND MISCELLANEOUS OTHER CHANGES TO THE CONTRACT. NEGOTIATIONS ARE CONTINUING ON THESE PROPOSED PRICE INCREASES.

### CURRENT STATUS OF THE LHA PROGRAM

YOU ALSO ASKED THAT WE DISCUSS OUR WORK ON THE NAVY'S LHA AND DD963 SHIP ACQUISITION PROGRAMS. AS YOU KNOW, WE HAVE BEEN MAKING REVIEWS OF MAJOR ACQUISITION PROGRAMS FOR SEVERAL YEARS. THOSE REVIEWS ARE MADE AT THE REQUEST OF THE APPROPRIATIONS AND ARMED SERVICES COMMITTEES AND REPORTS ON OUR STUDIES ARE GIVEN TO THOSE COMMITTEES, AND TO OTHER INTERESTED CONGRESSIONAL COMMITTEES, EARLY IN EACH CONGRESSIONAL SESSION. OUR CURRENT WORK ON THE LHA AND DD963 PROGRAMS WAS UNDERTAKEN AS A PART OF THAT EFFORT. HOWEVER, A GREAT DEAL OF WORK REMAINS TO BE DONE BEFORE WE COMPLETE OUR REVIEW AND REPORT TO THE CONGRESS.

SERIOUS PROBLEMS HAVE BEEN ENCOUNTERED IN GETTING THE LHA PROGRAM UNDERWAY. LHA COST ESTIMATES ARE NOW MORE THAN CONTRACT PRICES AND DELIVERY OF THE SHIPS IS DELAYED TWO YEARS OR MORE. THE CONTRACTOR AND THE DEPARTMENT OF THE NAVY DISAGREE ON WHO IS PRIMARILY RESPONSIBLE FOR THE PROBLEMS AND THE RESULTING COST

GROWTH AND DELIVERY DELAYS. AMONG THE MANY FACTORS AFFECTING PRICE TO BE NEGOTIATED ARE; INCREASES DUE TO THE CANCELLATION OF 4 SHIPS, COSTS ASSOCIATED WITH DELAYS, DISRUPTIONS AND WORK STOPPAGES DUE TO MATTERS BEYOND THE CONTRACTOR'S CONTROL SUCH AS STRIKES, ACTS OF GOD, AND UNILATERAL NAVY PROGRAM CHANGES.

THE NAVY AND THE CONTRACTOR HAVE BEEN NEGOTIATING PRICE CHANGES SINCE MARCH 31, 1972, ON THE CONTRACTOR'S PROPOSAL TO RESET THE LHA PROGRAM PRICES, GIVING RECOGNITION TO ESCALATION ESTIMATE CHANGES, DELAYS AND CHANGES IN THE CONTRACT. NEGOTIATIONS ON THESE ITEMS ARE SCHEDULED FOR COMPLETION BY MARCH 1, 1973. BOTH THE NAVY AND THE CONTRACTOR PROJECT A COST INCREASE ON THE LHA CONTRACT BUT THE AMOUNT CANNOT BE DETERMINED AT THIS TIME. THE ORIGINAL CEILING PRICE OF THE NINE SHIP CONTRACT WAS \$1,199 MILLION.

THE CONTRACTOR NOW ESTIMATES THAT THE 1ST SHIP WILL BE DELAYED 23 1/2 MONTHS AND THE 5TH SHIP DELIVERY WILL BE DELAYED 32 1/2 MONTHS.

MAJOR SUBCONTRACTS HAVE ALL BEEN AWARDED. THESE 131 SUBCONTRACTS, TOTALING OVER \$100 MILLION, ARE FIXED-PRICE AWARDS. NO SIGNIFICANT DELIVERY PROBLEMS WERE NOTED.

LITTON'S DATA SYSTEMS DIVISION RECEIVED A \$150 MILLION WORK AUTHORIZATION FROM THE LITTON PRIME CONTRACTOR FOR COMMAND AND CONTROL EQUIPMENT, CERTAIN DESIGN FUNCTIONS AND DEVELOPMENT OF COMPUTER PROGRAMS FOR 9 SHIPS. THE DATA SYSTEMS DIVISION, AT THE REQUEST OF THE SHIPYARD, HAS SLIPPED ITS SCHEDULES FOR

LHA INSTALLATION WORK TO COINCIDE WITH THE SHIPYARD'S CURRENT SCHEDULE.

IN MOST FIXED-PRICE SHIP CONSTRUCTION CONTRACTS, PROGRESS PAYMENTS ARE MADE ON THE BASIS OF PERCENTAGE OF PHYSICAL PROGRESS MADE IN PERFORMANCE OF THE CONTRACT. THE FIXED-PRICE LHA CONTRACT, HOWEVER, PROVIDED FOR PAYMENTS ON THE BASIS OF PHYSICAL PROGRESS STARTING 40 MONTHS AFTER AWARD. PAYMENTS FOR THE FIRST 40 MONTHS WERE ON A "COST INCURRED" BASIS TO COVER ANTICIPATED HIGH START-UP AND PRELIMINARY DESIGN EFFORT. LITTON'S PRICE PROPOSAL ON THE LHA WAS CONDITIONED UPON INCLUDING THESE PROVISIONS IN THE CONTRACT.

THE COST REIMBURSEMENT METHOD OF PAYMENT WAS TO HAVE CEASED ON SEPTEMBER 1, 1972. BY THAT TIME A DETERMINATION WAS TO HAVE BEEN MADE OF THE STATUS OF PHYSICAL PROGRESS AS WELL AS AN ACCOUNTING OF THE STATUS OF PROGRESS PAYMENTS SO FAR MADE. BECAUSE OF A VARIETY OF DELAYS, THE NAVY EXTENDED THE DATE FOR PROGRESS PAYMENT CONVERSION TO FEBRUARY 28, 1973.

AS WE UNDERSTAND IT, THE NAVY PLANNED TO HAVE A BASIS FOR MEASURING PROGRESS EARLY IN THE PROGRAM BUT THIS HAS NOT BEEN ACCOMPLISHED. ON SEPTEMBER 29, 1972, HOWEVER, LITTON SUBMITTED A PLAN FOR MEASURING PHYSICAL PROGRESS MEASUREMENT WHICH IS BEING EVALUATED BY THE NAVY. THE PROGRESS MEASUREMENT ISSUE WILL EITHER BE NEGOTIATED BY FEBRUARY 28, 1973, OR DETERMINED UNILATERALLY BY THE NAVY IN CASE OF DISAGREEMENT.

A NEW CONTRACT PRICE FOR FIVE LHA SHIPS AND A SCHEDULE ARE TO BE DETERMINED BY THAT DATE.

AS OF NOVEMBER 29, 1972, PROGRESS PAYMENTS OF \$395 MILLION HAVE BEEN BILLED. THE CONTRACTOR REPORTS THAT AS OF THAT DATE HE CONSIDERS THE PROGRAM ABOUT 33 PERCENT COMPLETED. UNTIL THE CURRENT REPRICING NEGOTIATIONS ARE COMPLETED AND THE SYSTEM OF MEASURING PHYSICAL PROGRESS AGREED UPON, THE VALIDITY OF THE CLAIMED PROGRESS PAYMENTS CANNOT BE DETERMINED.

CURRENT STATUS OF THE  
DD963 PROGRAM

A DEVELOPMENT AND PRODUCTION CONTRACT FOR THE CONSTRUCTION OF 30 DD963 CLASS DESTROYERS WAS AWARDED TO LITTON SYSTEMS, INC., ON JUNE 23, 1970. THE DD963 DESTROYER CONTRACT IS A MULTI-YEAR, FIXED-PRICE INCENTIVE, SUCCESSIVE TARGET CONTRACT. THE INITIAL TARGET PRICE FOR THE 30 SHIP PROGRAM WAS \$1,798.2 MILLION WITH A CEILING PRICE OF \$2,139.9 MILLION. THE CONTRACT PROVIDES THAT THE SHIPS WILL BE FUNDED IN SPECIFIED INCREMENTS OVER FIVE FISCAL YEARS.

LITTON HAS PROJECTED SLIGHT CHANGES IN THE CONTRACTUALLY ESTABLISHED DELIVERY SCHEDULE. FABRICATION OF THE FIRST SHIP BEGAN IN JUNE 1972, AND CURRENTLY, THE DDs ARE SCHEDULED TO BE DELIVERED SLIGHTLY AHEAD OF THE CONTRACTUALLY ESTABLISHED DATES.

THE NAVY POSITION IS THAT IT IS TOO EARLY TO KNOW WHETHER COSTS WILL INCREASE OR DELIVERY SCHEDULES WILL SLIP BUT THE NAVY THINKS THEY PROBABLY WILL.

THROUGH FISCAL YEAR 1972, OVER \$1.4 BILLION HAD BEEN APPROPRIATED FOR 16 OF THE SHIPS. ACTION BY THE CONGRESS RESULTED IN A REDUCTION OF \$636 MILLION IN THE FISCAL YEAR 1973 BUDGET REQUEST OF \$610 MILLION FOR THE NEXT SEVEN DD963's. HOWEVER, THE CONTRACTOR HAS AGREED TO EXTEND THE OPTION DATE FOR FUNDING THESE SEVEN DESTROYERS FROM JANUARY 15, 1973, TO JANUARY 15, 1974, WITH NO CHANGE IN CONTRACT PRICE OR CONTRACT DELIVERY DATES PROVIDED FUNDING WAS PROVIDED TO CONTINUE LONG LEAD EQUIPMENT SUBCONTRACTS ON THEIR CURRENT SCHEDULES. THE FUNDS PROVIDED IN THE FY 73 BUDGET PROVIDE FOR THESE LONG LEAD SUBCONTRACTS.

THIS MATTER WILL HAVE TO BE DECIDED IN CONSIDERING THE FISCAL YEAR 1974 BUDGET. FURTHER, THE LAST SEVEN SHIPS WILL HAVE TO BE CONSIDERED AND FULL FUNDING OR LONG LEAD TIME MONEY PROVIDED.

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THIS CONCLUDES OUR STATEMENT, MR. CHAIRMAN, AND WE WILL BE PLEASED TO DISCUSS ANY OF THESE MATTERS IN FURTHER DETAIL OR ANSWER ANY QUESTIONS THE SUBCOMMITTEE MAY HAVE ON OUR STATEMENT.