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COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548



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Dear Mr. Aspin:

In accordance with your request of April 17, 1972, and subsequent discussions with a member of your staff, we have examined into certain matters concerning escalation in the Department of the Navy's 30-ship DD-963 program. We have inquired into the methodology used by the Navy and by Litton Systems, Inc., in computing escalation to determine whether their estimates appear reasonable and whether one estimate may be more realistic than the other.

METHODOLOGY OF COMPUTING ESCALATION

A contract for production of the DD-963 ships was awarded by the Navy to Litton on June 23, 1970. The initial contract price for 30 ships was \$1,789.2 million. The contract is a fixed-price incentive type and states that, regardless of actual changes in the cost of labor or materials during the performance of the contract, adjustments for escalation will be made in accordance with a specific contract provision for labor and material compensation adjustments.

This provision states that 14 percent of the initial target cost will constitute the labor cost that is subject to adjustment for escalation and that 79 percent will constitute the material cost subject to adjustment for escalation. The amount of escalation recoverable by the contractor will be determined periodically by applying actual labor and material indexes<sup>1</sup> provided by the Bureau of Labor Statistics to the contract provision.

The amount of escalation recoverable over the life of the contract was a factor in award of the contract, and the Navy and potential contractors, including Litton, projected labor and material indexes to the end of the contract. The

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<sup>1</sup>A labor index represents the monthly change in the straight-time average hourly earnings for selected shipyards, and a material index represents a weighted selection from the BLS Wholesale Price Index.

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Navy's escalation estimate of \$309.6 million, cited in your April 17, 1972, letter, was made by the Navy immediately after award of the contract to reflect the expected impact of the specific escalation provision. It resulted in increasing the \$173.1 million originally estimated for escalation by \$136.5 million. This new estimate, totaling \$309.6 million, was computed on the basis of Bureau labor and material indexes through June 30, 1970, and on the Navy's projection of the performance of these indexes through the end of the contract. The projection of how the indexes would perform through the end of the contract was based on Bureau historical data but was adjusted by the Navy to reflect its analysis of economic factors that could affect the labor and material markets. The Navy's projection was approved by the Secretary of Defense on December 5, 1970.

Litton's escalation estimate of \$441 million made at the time of contract award was based solely on Bureau indexes from January to September 1969 for labor and from January to November 1969 for material and Litton's projection of these indexes to the end of the contract.

In summary, both the Navy and Litton used BLS labor and material indexes as a basis for estimating escalation through the end of the contract. However, the Navy's estimate was \$131.4 million less than Litton's (\$309.6 million compared to \$441 million) because the Navy, in projecting future labor and material price trends, estimated that prices would not rise as sharply as Bureau historical trends indicated they would, whereas Litton estimated that future trends would be the same as those indicated by the historical trend.

In an attempt to determine the reasonableness of the estimates, we compared actual compensation earned under the escalation provision of the contract with the Navy's and Litton's quarterly estimates. A comparison of estimates covering the period July 1, 1970, through December 31, 1971, shows that both the Navy's and Litton's escalation estimates were less than the actual compensation of \$21,043,353 due December 31, 1971. Litton's estimate of \$19,978,400 was approximately \$1 million

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closer to the actual adjustment than the Navy's estimate of \$18,980,833.

REVISIONS OF ESTIMATES

Since the award of the DD-963 contract, both Litton and the Navy have revised their escalation estimates to reflect actual labor and material indexes developed by the Bureau. Litton's initial estimate of \$441 million was revised to \$455 million on the basis of (1) actual labor indexes through June 1971, (2) actual material indexes through September 1971, and (3) its index projections to the end of the contract. Litton's \$455 million estimate, along with the Navy's estimate of \$309.6 million, was shown in the December 1971 Selected Acquisition Report. At that point in time, the difference between the two estimates was about \$145 million.

The \$455 million estimate was subsequently reduced to \$438 million to reflect more recent labor and material indexes developed by the Bureau. On May 30, 1972, we were informed by a Litton official that Litton planned to revise the factors it used in forecasting escalation to give consideration to the current trend established by the Bureau's indexes. It appears that this would result in a further reduction in Litton's escalation estimate.

The Navy revised its estimate from \$309.6 million to \$346.2 million, an increase of \$36.6 million. The \$346.2 million estimate, which was shown in the March 1972 Selected Acquisition Report, was based on (1) actual labor indexes through December 1971, (2) actual material indexes through March 1972, and (3) the projection of estimated indexes to the end of the contract.

In its March 1972 Selected Acquisition Report, the Navy indicated that, should the indexes continue to rise at the current rates reported by the Bureau, its estimate of the escalation for the total program would increase.

Early in calendar year 1971 (before price controls and before revising its estimate to \$346.2 million), the Navy adjusted its estimated labor and material index projections

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and thus increased its escalation estimate to \$454 million. The Office of the Secretary of Defense, however, deferred this adjustment because of the national intent to hold inflation below 3 percent a year. That Office believed that minor changes on a yearly basis should be resisted because changes in subsequent years could offset an apparent trend established in a given year. The Office did say, however, that it would reconsider the Navy's revised index projection, pending the establishment of a long-term trend.

### CONCLUSION

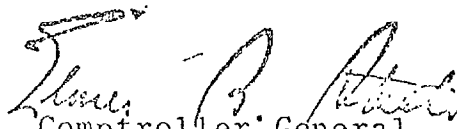
The difference between the Navy's and Litton's escalation estimates results from a difference in the projected annual rate that inflation will increase over the life of the DD-963 contract. The contract is in its early stages, and any analysis of the estimated rate of inflation over the life of the contract would be extremely difficult to make and in itself would be a subjective evaluation. Therefore, we did not attempt to make a determination as to whether the Navy's or Litton's escalation estimate will more closely approximate the actual amount to be paid over the term of the contract.

We did not obtain formal comments from the Department of the Navy on the matters included in this report but we discussed a draft with Navy officials.

We plan to make no further distribution of this report unless copies are specifically requested, and then we shall make distribution only after your agreement has been obtained or public announcement has been made by you concerning the contents of the report.

If we can further assist you in this matter, please let us know.

Sincerely yours,

  
Comptroller General  
of the United States

The Honorable Les Aspin  
House of Representatives