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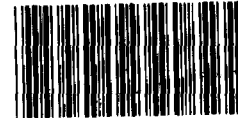
UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

PROCUREMENT AND SYSTEMS
ACQUISITION DIVISION

APR 19 1979

B-163058

The Honorable Harold Brown
The Secretary of Defense



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Attention: Assistant for Audit Reports
Room 3A336
ASD (Comptroller)

Dear Mr. Secretary:

We are presently conducting a review of change management and other aspects of the Navy's ship acquisition process for selected programs. The results of our review will be covered later in a report to the Congress. However, an issue relating to escalation provisions under shipbuilding contracts warrants your immediate action.

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Under some current shipbuilding contracts the Navy is paying shipbuilders for escalation on costs not subject to inflation. The Navy may soon negotiate a contract with similar provisions under the current request for proposals (N00024-78-R-2430) for 8 FFG-7 Class frigates plus an option for as many as 13 additional frigates with Bath Iron Works Corporation or Todd Pacific Shipyards Corporation. We believe that your action is needed to prevent such excessive and unwarranted payments under the proposed contracts.

BACKGROUND

Since Because construction of a naval ship takes several years, such construction would be a great risk to shipbuilders if they were not protected from cost increases over which they have little control. Shipbuilders are protected from these increases by special contract clauses which provide for escalation payments. Basically, this means that if shipbuilders' labor rates and material prices go up, they get paid for the increases during a designated period of time. Escalation payments are computed based on Bureau of Labor Statistics material and labor indexes of the shipbuilding industry.

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Because of the recent high inflation rate in the shipbuilding industry and the long construction period needed to complete the ships, the amount of escalation payments made are substantial. For example, the escalation paid and estimated to be paid on the six SSN-688 Class submarine contracts awarded through September 1977 totals almost \$900 million.

NAVY PAYS FOR ESCALATION ON COSTS NOT SUBJECT TO INFLATION

Action is needed to prevent such excessive and unwarranted payments under the proposed contracts.

Find/Con Escalation clauses in some current Navy shipbuilding contracts provide for escalation payments on portions of contract costs which do not vary with the economy. Making these excessive payments conflicts with the purpose of escalation payments (i.e., to protect shipbuilders from undue hardship), contradicts the requirements in the Defense Acquisition Regulation and provides the contractor with the means of realizing unearned profits.

Need to exclude escalation payments on certain costs

Not all of a contractor's costs increase with inflation and some increase slower than others. The Defense Acquisition Regulation recognized this, saying that escalation payments should not be made on costs not affected by fluctuations in the economy. Examples of such costs are: (1) the cost to the contractor of subcontracted items that may be fixed and, thereby, not subject to increases when they are delivered and (2) certain areas of overhead--such as depreciation charges, prepaid insurance costs, rental costs, leases, and taxes. The July 1978 Naval Ship Procurement Process Study also recognized the need to exclude certain costs from escalation by stating that:

"The portion of overhead which is subject to escalation should be decided on an ad hoc basis--after the shipbuilder's overhead accounts are reviewed and the parties have agreed to a negotiated overhead pool. Fixed costs, such as depreciation, should be excluded from the pool."

Further, it stated that the percentage of overhead costs on which overhead escalation is computed should not be standard but should vary among the shipyards. The reason for the variance is that the amount and percentage of nonescalating costs differ among shipyards.

Escalation coverage in prior and recent shipbuilding contracts

In prior shipbuilding contracts the Navy provided the same percentage of escalation to different shipbuilders under different shipbuilding programs but, in so doing, excluded some costs from coverage. In more recent contracts the Navy provided coverage on all costs.

In prior shipbuilding contracts awarded in the early 1970s the Navy provided different shipbuilders with escalation coverage based on 93 percent of the estimated contract costs and excluded 7 percent from coverage. It provided this coverage in the: June 1970, fixed-price incentive contract (N00024-70-C-0275) with Ingalls Shipbuilding Division of Litton Systems, Inc., for construction of 30 DD-963 SPRUANCE Class destroyers; January 1971 fixed-price incentive contract (N00024-71-C-0270) with Newport News Shipbuilding and Dry Dock Company for construction of 4 SSN-688 Class submarines; and the January 1971 and October 1973 fixed-price incentive contracts (N00024-71-C-0268 and N00024-74-C-0206) with the Electric Boat Division of General Dynamics Corporation for construction of additional SSN-688 Class submarines.

In more recent shipbuilding contracts awarded in the mid to late 1970s the Navy provided shipbuilders with escalation coverage based on all costs. This was done in the August 1975 and September 1977 fixed-price incentive contracts (N00024-76-C-2031 and N00024-77-C-2220) with Newport News for construction of eight SSN-688 Class submarines; the October 1977 fixed-price incentive contract (N00024-77-C-2051) with the Boeing Company, Boeing Marine Systems, for five PHM-1 Class hydrofoils; and the April 1979 fixed-price incentive contract (N00024-79-C-2720) with Electric Boat for two SSN-688 Class submarines.

We discussed these contracts with the Deputy Commander for Contracts, Naval Sea Systems Command, who said that the 93-percent coverage for the prior contracts and the 100-percent coverage for more recent contracts was not based on an analysis of shipbuilders' costs. He added that in the coverage of more recent contracts the Navy may have established the unfortunate precedent of allowing contractors escalation payments on costs not subject to inflation and that the Navy will probably continue the practice.

Because the Navy has not determined the percent of the above shipbuilders' costs not subject to inflation we could

not calculate the amount of excessive escalation payments those shipbuilders may receive during the contract period. However, even if only 1 percent of those costs were covered, the amount of excessive payments would be substantial. For example, if we were to assume that only 1 percent of the costs of the SSN-688 contracts awarded through September 1977 were not subject to inflation but received escalation payments, the excessive payments would total over \$9 million.

CONCLUSIONS

The prior Navy practice of providing a standard percent of escalation coverage to different shipbuilders, without determining the actual percentage of costs affected by inflation for each shipbuilder, contradicts the requirements in the Defense Acquisition Regulation and conflicts with the purpose of allowing escalation payments. The more recent practice of allowing shipbuilders escalation coverage on all costs adds to the impropriety begun by the former practice, because it increases the amount of unearned profits shipbuilders could receive in the form of escalation payments.

RECOMMENDATIONS

We recommend that you have the Secretary of the Navy:

- (1) --Delay the procurement of the FFG-7s under the current request for proposals (N00024-78-R-2430) and delay any other shipbuilding contract awards until you are confident ^{that the contractors will not be given excessive escalation payments.} ~~that the contractors will not be given excessive escalation payments.~~
- (2) --Direct Navy contracting officers to discontinue the practice of negotiating shipbuilding contracts which provide different shipbuilders with escalation payments for a standard percentage of costs and, especially, those which provide escalation on all costs.
- (3) --Ensure that the Navy adopt the policy of reviewing shipbuilders' price proposals before contract negotiations to determine the percent of costs subject to inflation. These percentages should be used as the basis for allowing escalation payments.

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We are sending copies of this report to the Secretary of the Navy and the Chairmen of the House Committee on Government Operations, Senate Committee on Governmental Affairs, and House and Senate Committees on Appropriations and Armed Services.

We would appreciate a response to this letter by May 11, 1979.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report. We would appreciate receiving a copy of these statements.

Sincerely yours,


J. H. Stolarow
Director