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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

The 1978 Navy Shipbuilding Claim Settlement At Electric Boat--Status As Of December 26, 1981

The Defense Appropriation Authorization Act of 1979 requires the Comptroller General to audit two contracts with Electric Boat for constructing SSN-688 class nuclear attack submarines that were involved in a shipbuilding claim settlement. The audit is to ensure that funds authorized to pay for contract modifications made in the interest of national defense are used only on the two contracts, and that the contractor does not use such funds to realize any total combined profit on these contracts.

GAO found that the funds are being spent as intended and a substantial loss is still being projected by the contractor. Moreover, the contractor, early in 1982, formally relinquished all rights to claim or seek insurance reimbursement for costs of defective workmanship under the contracts. Previously, Electric Boat sought to fully recover these costs.



119773



GAO/PLRD-83-5
OCTOBER 26, 1982

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

B-197665

To the President of the Senate and the
Speaker of the House of Representatives

This is our fourth report on the status of two contracts, modified in 1978 under the authority of Public Law 85-804, for constructing SSN-688 class attack submarines. This report covers the contractor's fiscal year ended December 26, 1981.

In 1978, after years of disagreement over shipbuilding claims filed by the General Dynamics Corporation's Electric Boat Division, the Navy and the contractor agreed to a settlement based on an estimated cost at completion of \$2,668 million plus \$3.9 million for change orders in process and adjudicated as part of the settlement. The agreement was reached under Public Law 85-804, which allows the President to modify contracts in the interest of national defense.

Among its terms, the settlement provided for (1) the contractor to absorb a \$359 million loss over the remaining submarine construction period, (2) the Navy to pay another \$359 million under the authority of Public Law 85-804, (3) cost overruns of up to a total of \$100 million to be divided equally with costs above that figure being the total responsibility of General Dynamics, and (4) cost underruns to be shared equally.

We made our review in compliance with section 821 of the 1979 Defense Appropriation Authorization Act. Section 821 requires the Comptroller General to report annually to the Congress on the results of reviews of contracts N00024-71-C-0268 and N00024-74-C-0206, which the Navy awarded to General Dynamics. These reviews are to ensure that funds authorized to provide relief under Public Law 85-804 in the 1978 claims settlement are used only on these two contracts and that the prime contractor does not use such funds to realize any total combined profit on the contracts. Our review was performed in accordance with our "Standards for Audits of Governmental Organizations, Programs, Activities, and Functions."

We made our review at the Electric Boat Division of General Dynamics Corporation and at the offices of the Supervisor of Shipbuilding, Conversion and Repair, U.S. Navy in Groton,

Connecticut. We reviewed Electric Boat and Navy cost and payment records, documents, and reports pertaining to the two contracts as of December 26, 1981, as well as events in early 1982 which affected that data. We did not, however, assess the reliability of computer-generated data provided by the contractor from its contractually required cost reporting system.

We also reviewed the Defense Contract Audit Agency's (DCAA's) audit of Electric Boat's progress payment requests for contract -0206 for the period ended December 31, 1981. DCAA is no longer reviewing any payments under contract -0268 since it is nearly complete. DCAA audited the progress payments to ensure that Electric Boat was following the billing procedures agreed to in the 1978 claims settlement and that Electric Boat's share of the loss was being absorbed through reductions in progress payments.

We found that as of December 26, 1981:

- Funds provided under the Public Law 85-804 settlement are still being used only on the specified contracts.
- Electric Boat continues to project an overall loss and is already in an actual loss position on the combined contracts.
- Electric Boat has delivered 12 of 18 submarines to the Navy.

Recently, Electric Boat and the Navy resolved the outstanding issues we discussed in our 1980 report. Under contract modifications, Electric Boat relinquished all rights to submit a claim or insurance request for any costs associated with the weld, steel, and paint problems in the SSN-688 program. The same contract modifications established Electric Boat's previously reported estimated delivery dates as the official contract dates with no adjustment in contract price.

USE OF AUTHORIZED FUNDS

As of December 26, 1981, Electric Boat has incurred \$196 million in excess of the absorbed loss and amounts billed the Government. The incurred costs include \$66.7 million questioned by DCAA as potentially unallowable under the Defense Acquisition Regulation. DCAA told us that \$25.5 million is subject to litigation before the Armed Services Board of Contract Appeals and the remaining \$41.2 million is subject to negotiation. Even if the entire \$66.7 million is disallowed, unreimbursed allowable costs would still total \$129.1 million. Since the amount expended on the contracts is greater than the reimbursement, the

funds provided under Public Law 85-804 are not being used on business other than the two contracts.

The table below shows by contract the unreimbursed cost after absorbing the loss.

	<u>Contract</u>		<u>Total</u>
	<u>-0268</u>	<u>-0206</u>	
	------(millions)-----		
Incurring costs	\$1,060.6	\$1,494.2	\$2,554.8
Less: Progress payments billed	-880.2	-1,112.6	-1,992.8
Extraordinary escalation			
billed or authorized			
(note a)	<u>-6.8</u>	<u>-61.0</u>	<u>-67.8</u>
Unreimbursed costs	173.6	320.6	494.2
Less: Absorbed loss (note b)	<u>-136.0</u>	<u>-162.4</u>	<u>-298.4</u>
Unreimbursed costs after absorbed loss	<u>\$ 37.6</u>	<u>\$ 158.2</u>	<u>\$ 195.8</u>

a/Extraordinary escalation is additional costs attributable solely to inflation above that included in the \$2,668 million estimated cost at completion of the 1978 settlement.

b/Settlement provides that estimated loss will be absorbed by contractor over the remaining construction period.

COMBINED PROFIT/LOSS POSITION

The contractor's estimated loss at completion as of December 26, 1981, is \$382 million, which is \$23 million over the \$359 million estimated loss after the 1978 financial settlement. The total cost overrun before applying the cost sharing provisions is \$46 million. Since the contractor and the Government share cost overruns equally up to a maximum of \$100 million, some \$54 million remained under the cost sharing provisions of the settlement. In March 1982, however, Electric Boat increased its estimated cost at completion, which increases its expected loss and further reduces the amount available under the cost sharing provisions.

The following table shows our calculation of the contractor's estimated loss. To determine the estimated cost at completion for sharing purposes, we reduced the total estimated cost by the costs for contract modifications and extraordinary escalation forecast from January 1978 to the estimated completion dates of

the two contracts. We made this reduction solely to convert total estimated cost to a basis consistent with the estimated cost at completion prepared at the time of the settlement.

	<u>Contract</u>		<u>Total</u>
	<u>-0268</u>	<u>-0206</u>	
	------(millions)-----		
Estimated cost at completion on December 26, 1981	\$1,062	\$1,791	\$2,853
Less: Contract modifications (note a)	-8	-22	-30
Extraordinary escalation forecast	<u>-7</u>	<u>-98</u>	<u>-105</u>
Estimated cost for sharing purposes	1,047	1,671	2,718
Estimated cost at completion at time of 1978 settlement (note b)	<u>-1,011</u>	<u>-1,661</u>	<u>-2,672</u>
Cost overrun	<u>\$ 36</u>	<u>\$ 10</u>	<u>\$ 46</u>
Amount of overrun to be absorbed by contractor per settlement terms (50 percent)	\$ 18	\$ 5	\$ 23
Estimated loss at completion of 1978 settlement to be absorbed by contractor	<u>136</u>	<u>223</u>	<u>359</u>
Estimated loss at completion as of December 26, 1981	<u>\$154</u>	<u>\$228</u>	<u>\$382</u>

a/Excludes \$3 million in profit.

b/We increased the \$2,668 million estimated cost at completion at the time of the settlement by the \$3.9 million ceiling price of contract modifications in process and adjudicated as part of the settlement.

We also projected an estimated \$382 million loss at completion in our 1980 report. The basic reason for the estimated loss not changing since last year is that increases in the estimated cost at completion were offset by changes to the extraordinary escalation forecast. (See app. I.)

The \$2,853 million estimated cost at completion includes \$67 million identified by DCAA as potentially unallowable costs and \$33 million in management reserve for contract -0206. Electric Boat, however, depleted the entire management reserve in early 1982. Consequently, as of December 26, 1981, the estimated combined loss could be less than \$382 million, depending on the amount of questioned costs disallowed.

As of March 27, 1982, Electric Boat increased its estimated cost at completion by \$41 million from \$2,853 million to \$2,894 million. The increase is solely applicable to contract -0206, since all submarines under contract -0268 have been delivered. The new estimated cost at completion increases the estimated loss by \$22 million, from \$382 million to \$404 million. As shown in appendix II, the contractor is nearing the \$50 million sharing ceiling beyond which it alone must absorb all costs.

PROSPECTS FOR AN OVERALL PROFIT
ON THE COMBINED CONTRACTS

Because cost underruns are shared equally by the contractor and the Government, the contractor would have to underrun the total estimated cost by \$764 million to break even on the maximum estimated loss of \$382 million or by \$690 million to break even on the minimum estimated loss of \$345 million. In our opinion, this is not possible. As of December 26, 1981, Electric Boat had incurred all but \$298 million of the estimated \$2,853 million.

The total amount received by Electric Boat will be affected by the amount of contract modifications executed under these contracts, because the ceiling price of these modifications is used to calculate the contract ceiling for the combined contracts. Moreover, Electric Boat is allowed to earn profits on change orders, as long as there is no overall profit on the combined contracts under the Public Law settlement. The impact from contract modifications, however, is minimal. Adjudicated or approved contract modifications have not been material, amounting to only \$35 million (ceiling price). At the same time, unadjudicated contract modifications and requests for proposal totaled only \$10.7 million.

POTENTIAL ISSUES WHICH COULD HAVE
AFFECTED THE ESTIMATED LOSS POSITION
HAVE BEEN RESOLVED

Last year we reported that Electric Boat was still incurring costs to correct construction problems related to defective workmanship and materials (unsatisfactory welds, use of nonconforming steel, and paint problems). We also pointed out that Electric Boat was seeking to recover from the Navy,

under the "builder's risk" insurance provision of the contracts, the costs incurred to correct faulty workmanship by its employees. ^{1/} Moreover, Electric Boat believed that it might have a sound legal basis to submit an insurance claim to recover a portion of the \$359 million settlement loss. All these issues have been resolved through contract modifications.

In 1982 the Navy and Electric Boat executed a contract modification which provided in part:

"* * * the contractor agrees with respect to the SSN 688 program it will not pursue, file, or submit any claim, request for equitable adjustment or insurance reimbursement request related to the matters commonly identified as the 'Weld and Weld Records,' 'Paint and Preservation,' and 'Carbon Steel' problems * * *."

Electric Boat incurred an additional \$22 million this past fiscal year to correct construction problems. DCAA, however, is no longer separately reporting these costs because they are no longer material. For example, for the first 4 months of 1982, only \$42,000 had been recorded for correcting these problems.

DELIVERY DATES UNCHANGED SINCE OUR LAST REPORT

The proposed delivery dates we reported last year were formalized in a February 1982 contract modification. As of July 1982, Electric Boat had delivered all ships under contract -0268 and five under -0206 to the Navy. A comparison of the Public Law 85-804 delivery dates to the recent contract modification is provided in appendix III.

ELECTRIC BOAT AND NAVY COMMENTS

Electric Boat commented on this report on August 13, 1982, and requested specific changes. (See app. IV.) These changes are reflected in the report.

Electric Boat suggested that congressional concurrence be requested for the discontinuance of future GAO reviews of these contracts "since there is no possibility that Electric Boat will realize any total combined profit on these contracts." While we agree that Electric Boat will probably not realize a profit on these contracts, unexpected large claims or change orders could alter this situation. As long as this possibility exists, we do not believe it is advisable to totally discontinue our efforts.

^{1/}Since 1942 the Navy has acted as a self-insurer of builder's risk associated with new ship construction.

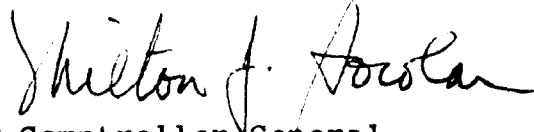
However, we believe that the following language in section 821 provides enough flexibility to allow us to adjust the scope of our audit as the possibility of a total combined profit becomes more remote:

"* * * shall be subject to such audits and reviews by the Comptroller General of the United States as the Comptroller General shall determine necessary to insure that such funds are used only in connection with such contracts and to insure that the prime contractors concerned do not realize any total combined profit on such contracts." (Underscoring added.)

The Navy, after reviewing the report, considered that a response was not necessary.

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We are sending copies of this report to the Chairmen, Senate and House Committees on Armed Services; Senator William Proxmire; and the Chairman, General Dynamics Corporation.



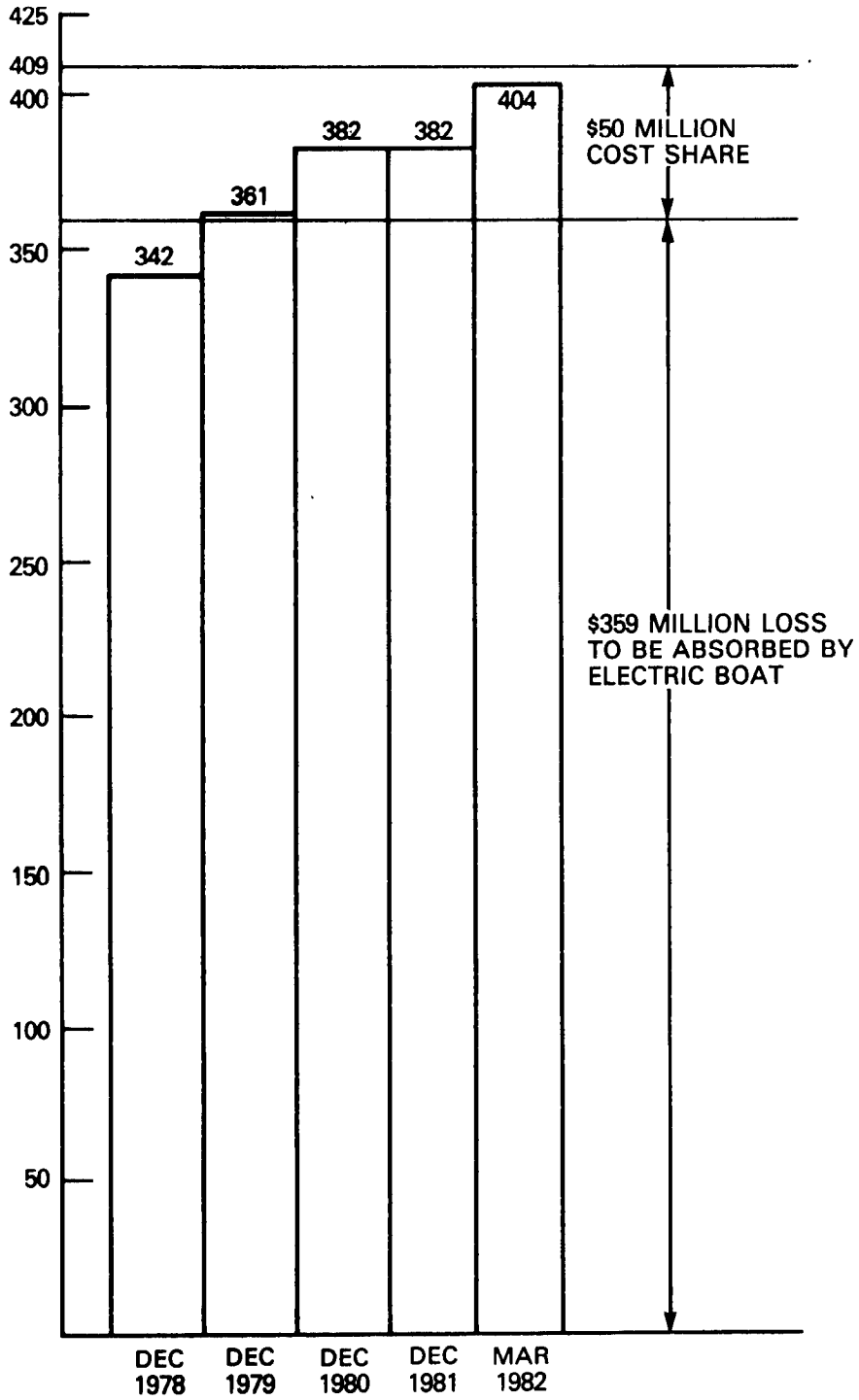
Acting Comptroller General
of the United States

COMPARISON OF ESTIMATED LOSS AT COMPLETION
AS OF DECEMBER 20, 1980, and DECEMBER 26, 1981

	<u>Combined contracts</u>		<u>Difference</u>
	<u>December 20,</u> <u>1980</u>	<u>December 26,</u> <u>1981</u>	
	------(millions)-----		
Estimated cost at completion	\$2,821	\$2,853	\$32
Less: Contract modifications	-29	-30	-1
Extraordinary escalation forecast	<u>-78</u>	<u>-105</u>	<u>-27</u>
Estimated cost for sharing purposes	2,714	2,718	4
Less: Estimated cost at completion at time of 1978 settlement (note a)	<u>-2,668</u>	<u>-2,672</u>	<u>-4</u>
Cost overrun	<u>\$ 46</u>	<u>\$ 46</u>	<u>\$ 0</u>
Amount of overrun to be absorbed by contractor per settlement (50 percent)	\$ 23	\$ 23	\$ 0
Estimated loss at completion at time of 1978 settlement	<u>359</u>	<u>359</u>	<u>0</u>
Total estimated loss at completion	<u>\$ 382</u>	<u>\$ 382</u>	<u>\$ 0</u>

a/See footnote b on page 4.

ELECTRIC BOATS ESTIMATED LOSS AT COMPLETION ON PL 85-804 CONTRACTS



COMPARISON OF DELIVERY DATES NEGOTIATED
UNDER PUBLIC LAW 85-804 WITH CURRENT DELIVERY DATES
FOR SSN-688s UNDER CONTRACTS -0268 and -0206

<u>Contract and hull number</u>	<u>Delivery dates</u>	
	<u>Public Law 85-804</u>	<u>Current</u>
-0268:		
SSN 690	6-10-77	<u>a</u> /6-10-77
692	3-10-78	<u>a</u> /3-10-78
694	6-09-78	<u>a</u> /6-09-78
696	3-31-79	<u>a</u> /1-23-79
697	<u>b</u> /9-08-79	<u>a</u> /11-30-79
698	10-27-79	<u>a</u> /2-13-81
699	2-23-80	<u>a</u> /3-31-81
-0206:		
SSN 700	6-21-80	<u>a</u> /6-26-81
701	10-18-80	<u>a</u> /9-30-81
702	2-14-81	<u>a</u> /12-18-81
703	6-13-81	<u>a</u> /12-22-81
704	2-06-82	<u>a</u> /7-19-82
705	6-05-82	<u>c</u> /12-14-82
706	10-02-82	<u>c</u> /5-28-83
707	1-29-83	<u>c</u> /10-22-83
708	9-24-83	<u>c</u> /3-17-84
709	1-21-84	<u>c</u> /9-08-84
710	5-19-84	<u>c</u> /2-16-85

a/Actual.

b/Revision to Public Law date per contract modification.

c/Contractual delivery dates as of February 19, 1982.

GENERAL DYNAMICS***Electric Boat Division***

Eastern Point Road, Groton, Connecticut 06340 • 203 446-5960

Date: August 13, 1982

Subject: General Accounting Office (GAO) Draft Report on "Status of the 1978 Navy Shipbuilding Claim Settlement at Electric Boat -- As of December 26, 1981."

Reference: (a) United States General Accounting Office Letter
(Mr. Donald J. Horan) to Electric Boat Division
(Mr. A. M. Barton), dated July 9, 1982, Same Subject

Mr. Donald J. Horan, Director
Procurement, Logistics and
Readiness Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Horan:

Electric Boat Division has received and reviewed the draft GAO audit report entitled "Status of the 1978 Navy Shipbuilding Claim Settlement at Electric Boat -- as of December 26, 1981". As requested in Reference (a), the following Electric Boat Division comments are provided:

General Comments

As stated in your report, this is the fourth report on the status of two contracts for constructing SSN688 class attack submarines at Electric Boat modified in 1978 under the authority of Public Law 85-804. The conclusion in each of the four reports has been the same, that is (1) funds authorized for payment under Public Law 85-804 contract modification are being used only on the two contracts and (2) Electric Boat will not use such funds to realize any total combined profit on these contracts. Since there is no possibility that Electric Boat will realize any total combined profit on these contracts, it is suggested that Congressional concurrence be requested for the discontinuance of future annual GAO reviews of these contracts.

The third item listed on page 3 of the draft report states "Electric Boat has delivered 11 of 18 submarines under these contracts to the Navy". Please note that the Division has now delivered 12 of 18 submarines under these contracts.

APPENDIX I ESTIMATED COSTS AT COMPLETION (DECEMBER 26, 1981)

Appendix I lists costs incurred, estimate to complete and estimate at completion for each SSN688 ship under contract 0268 and 0206. Electric Boat considers that estimated costs at completion, even on a total contract basis but especially on an individual ship basis, constitute sensitive business data of a proprietary nature, which should not be incorporated in your report since that report is

GENERAL DYNAMICS***Electric Boat Division***

Eastern Point Road, Groton, Connecticut 06340 • 203 446-5960

Mr. Donald J. Horan, Director
United States General Accounting Office
Page Two

subject to general public dissemination. Disclosure of such data would be harmful to Electric Boat's ability to compete successfully for SSN688 Class submarines. Moreover, since it is now absolutely clear, in light of actual costs incurred to date, that Electric Boat cannot realize any total combined profit on the 688-I and 688-II contracts, there is no longer any necessity for GAO to arrive at estimates at completion for these contracts nor are such estimates now relevant to the primary purposes of the GAO review as mandated by the Congress. We therefore request that Appendix I be deleted from your report. (See GAO note below.)

APPENDIX IV - COMPARISON OF DELIVERY DATES NEGOTIATED UNDER PUBLIC LAW 85-804 WITH CURRENT DELIVERY DATES FOR SSN 688's UNDER CONTRACTS - 0268 AND 0206

Regarding actual delivery dates the USS BOSTON (SSN703) was accepted by the United States Navy on December 22, 1981. The USS BALTIMORE (SSN704) was accepted by the United States Navy on July 19, 1982. Your final report should reflect these actual dates.

The Division requests that you make the above noted changes to your report and that a copy of this letter be included with your final report submitted to the Congress.

Very truly yours,

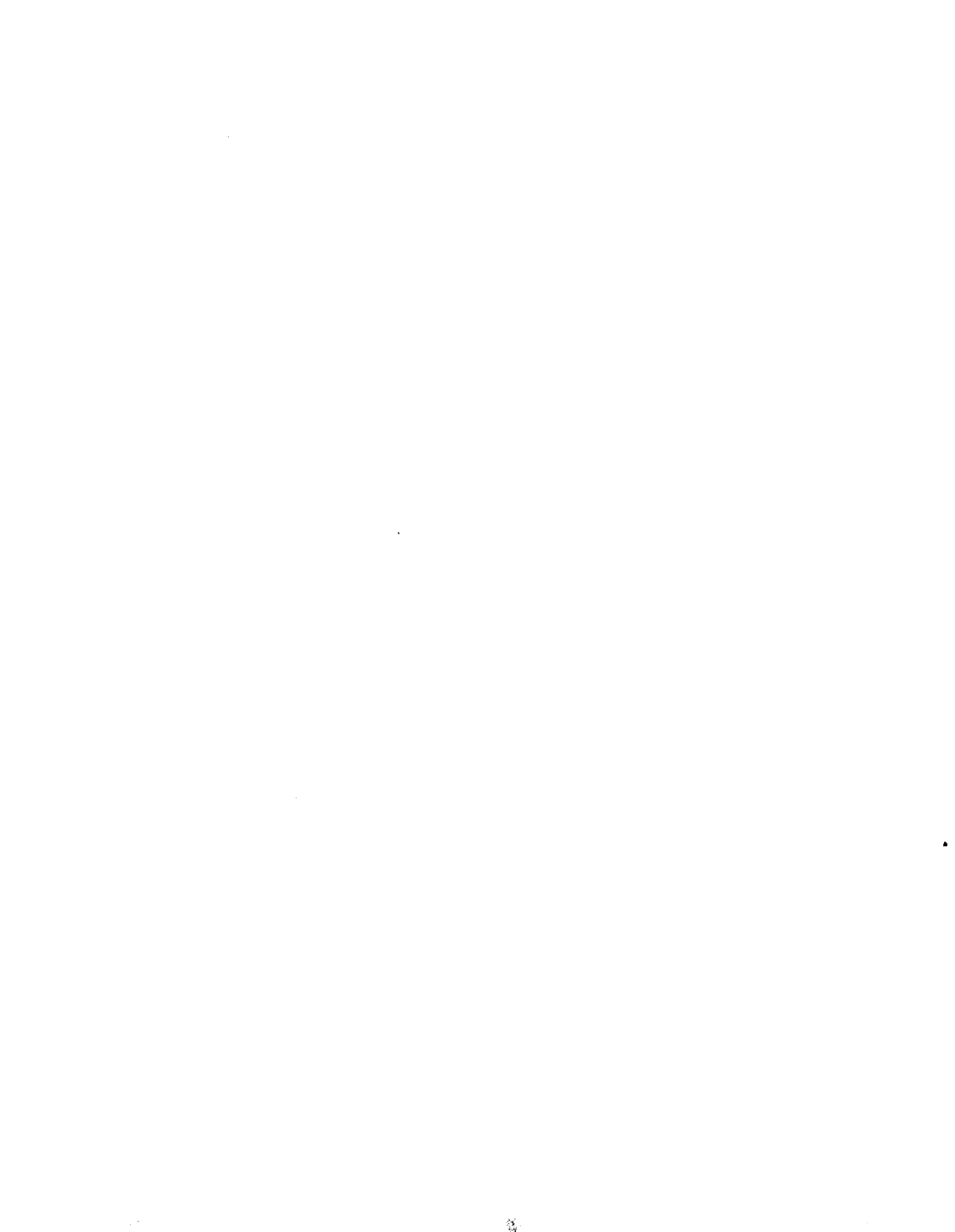
GENERAL DYNAMICS
Electric Boat Division



A. M. Barton
Assistant General Manager,
Planning and Control

GAO note: We have deleted the proprietary information contained in appendix I of the draft report.

(942117)



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