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Navy Ship Construction Contracts

Statement of
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Before the
Subcommittee on Defense
Committee on Appropriations
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the results to date of our ongoing review of selected ship construction contracts which we are conducting at the Subcommittee's request.

The objectives of our review are to determine: (1) whether contracts awarded over the past few years can be executed within the funding appropriated; (2) whether contract awards could result in future claims against the Government; (3) the actions that the Navy is taking to address current and anticipated claims; and (4) whether current staffing levels at Navy Supervisor of Shipbuilding, Conversion, and Repair (SUPSHIP) activities are providing effective oversight over the contracts.

We are reviewing 22 fixed-price incentive contracts, which were competitively-awarded over the past few years. Most of the contracts are still in progress, and the Navy is currently projecting their cost at completion to be about $11.2 billion. Ship delivery dates under these contracts extend out to 1991.

ADEQUACY OF FUNDING

Our work has shown that the Navy policy of increased competition for ship construction contracts has generally resulted in favorable prices and, in some cases, has produced lower and declining unit bid contract prices on ship programs.

However, Navy SUPSHIPs are projecting cost overruns totalling about $1.2 billion or about 15 percent over target costs on 17 of the 22 fixed-price incentive contracts. Some of these contracts are also experiencing schedule slippages and delivery delays.

On fixed-price incentive contracts, the Navy usually shares (generally 50/50) in the overrun exceeding the target cost up to a ceiling price. Amounts above ceiling prices are borne entirely by the contractor. If final costs come in at the current estimates, the Navy will have to fund about $597 million of the cost overruns over the next few years.

The ceiling price represents the break-even position. Many of the estimated costs at completion are very close to, or at contract ceiling price. Seven contracts still in progress have estimates of at least 90 percent of ceiling. At some shipyards, we found that the more recent the contract, the closer it is to ceiling price.

Five of the 22 contracts awarded to three shipbuilders, are underrunning target costs apparently because anticipated production efficiencies are being realized and construction costs are being reduced. In these cases, shipbuilders will realize the benefits of a Navy policy to reward producers through a greater share of the underrun savings. The Navy equally shares in such savings, and at current projections, its share would be about $30 million.

Because some of this cost information is business sensitive, we are providing for the Subcommittee's use, under separate cover, a schedule showing the details of the cost contract projections for the 22 contracts.

The causes for the projected overruns are many and varied. On some contracts, shipbuilders are experiencing labor productivity problems and shipyard inefficiencies; on others, the shipyards appear to have underestimated the complexities of construction. Some contracts have experienced a large amount of design changes and are being affected by problems external to the shipyard, such as late Government furnished equipment and data.

However, we found that the overruns can be primarily attributed to optimistic bidding fostered by a competitive environment, unrealized learning (expected production improvements during the construction period as a result of the learning curve), and unrealistically-low original labor hour estimates.

Our analysis of the contract award documentation confirmed that prices proposed on some contracts were identified by the Navy, at the time of the award, to be overly optimistic. The prices proposed were below cost estimates, and were cited by the Navy as presenting a cost risk to the Government.

We interviewed four shipbuilders to obtain their views on the current competitive process. There was a general agreement that the industry is currently competing in a "low ball" or close to the margin environment on Navy ship construction contracts. They stated that lack of commercial work has forced shipbuilders to rely on the Navy as their primary source for employment for both new construction and major repair work.

Comments received from representatives of one shipbuilder were illustrative of the general views expressed. We were told that they support the competitive process and fixed-price contracts for follow-on ships. However, they are very concerned about the long range effects of an emphasis on price competition in the weak shipbuilding industry. In their view, the competitive environment forces shipbuilders to bid aggressively for the limited awards available in order to obtain contracts, because the lowest price is the Navy's principal determining factor in awarding contracts.

According to the representatives, the Navy in its award process has not put adequate weight on price realism and the shipyard's ability to meet the price. They believe this leads to very low bids with a likelihood for overruns.

I should note that there is nothing to prevent an offeror from reducing its prices for competitive purposes. As long as the proposal is technically acceptable, fair and reasonable in terms of price, and the contractor is determined to be responsible, the contract may be awarded to that offeror. The contracting officer must, however, assure that change orders on follow-on procurements are not used to recover amounts of below-cost bids.

Our analysis showed that, although price was the major and highest-weighted factor in all of these procurements, the Navy in its evaluation of the offers did consider other technical and management factors. Where necessary, pre-award surveys were performed and, in all cases, a determination of contractor responsibility was made.

CONTRACT ADJUSTMENTS AND CLAIMS AGAINST THE GOVERNMENT

We identified situations where contractors are attempting to recover increased costs on three major ship programs by submitting Requests for Equitable Adjustment (REA). A REA is a request for monetary payment, extension of the delivery schedule, or both, which is not in dispute at the time the Government receives it. Whenever a dispute cannot be settled by an agreement, the contractor may file a claim relating to the dispute.

Bath Iron Works (BIW) submitted an REA proposal in November 1986 on three CG-47 Aegis cruiser contracts to cover cost overruns associated with those ships. The REA stated that BIW's and the Navy's projected cost to the Aegis cruiser program has changed for many reasons including: Government changes, delay, disruption, a shipyard strike, and shipyard performance problems.

As a result of these and many other variances, BIW stated that both parties need to re-establish cost, schedule and technical baselines. The REA assigned responsibilities (BIW, Navy and shared) for the cost increases and then computed a proposed contract adjustment of about $100 million. In December 1986, BIW responded to a Navy request and provided additional supporting data which assigned specific dollar amounts to each of the contractual issues. The Navy is currently reviewing this REA.

BIW also believes that it is entitled to additional compensation on the DDG-51 Aegis destroyer contract. BIW said it will seek the additional compensation through an REA or the conventional change process.

In January 1987, Electric Boat Division of General Dynamics Corporation submitted a formal plan detailing the schedule to be followed in preparing and submitting a REA relating to change orders associated with the AN/BSY-1(V) combat system to be installed on the SSN 751 submarine and follow-on ships. The Navy is currently waiting for the REA to be submitted.

To date, there has been only one relatively small claim filed under the 22 contracts reviewed. National Steel and Shipbuilding Company (NASSCO) filed a $1.5 million claim on a T-AKR contract, contending that it was not properly notified of the intent to disallow some items used in calculating overhead costs. NASSCO and SUPSHIP, San Diego are currently negotiating the claim. A NASSCO official told us the company will also file a claim on the T-AH contract for additional work they consider to be outside the scope of the contract.

For some of the other contracts reviewed, SUPSHIP officials anticipate REA's. They stated that some of these REA's could ultimately result in claims.

ACTIONS TAKEN TO ADDRESS CLAIMS

The Naval Sea System Command (NAVSEA) has policies and procedures for preventing, avoiding, reducing, and, if necessary, dealing with contractor claims for price increases on ship contracts.

These measures are required to be implemented, initially, at the SUPSHIP organizations that interface with the shipbuilder at the site of contract performance, where many of the incidents resulting in claims occur. Within the Navy, therefore, the SUPSHIPs are in a position to prevent claims, and contribute to a quick resolution of a claim once it is raised.

We found that SUPSHIP activities visited have implemented claims avoidance or prevention programs. An important aspect of these programs is maintaining a documented record of significant events occurring during the life of each contract, that may lead to a future claim. SUPSHIPs are currently monitoring items such as delivery schedule changes or problems, differences in interpretation of contract provisions, changes in the method of sequence of work, contractor errors, and non-compliance with contract terms.

While we found that there were active claims avoidance programs at the SUPSHIPs, I should note that there is concern among some of the SUPSHIPs that their staffing is not adequate to carry out oversight activities. SUPSHIP officials at two locations were particularly concerned.

At SUPSHIP, New Orleans, an official told us the workload over the last two and a half years increased 600 percent while the staffing increased 50 percent. Since 1983, contract dollars increased from $330 million to $2.2 billion in 1987; and the number of locations where contracts are being performed have increased from two to five. According to a SUPSHIP, San Diego official, that activity is understaffed in the new construction area and does not have sufficient staff to accurately monitor the recently-awarded AOE-6 contract.

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Mr. Chairman, that concludes my statement. I will be pleased to answer any questions you may have.