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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:

We are pleased to be here today to provide an update of the review we conducted last year at the Subcommittee's request of Navy ship construction contracts and potential claims against the government. As you know, Mr. Chairman, we testified on these matters before the Subcommittee in April 1987,¹ and issued a report to you in October 1987.²

To update our earlier report and testimony we obtained current information on the 22 fixed-price incentive contracts discussed in our October 1987 report that were competitively awarded over the past few years. Our purpose was to determine the extent those contracts (1) are still experiencing cost overruns, (2) have resulted in claims against the government or could result in future claims, and (3) can be executed within the funds appropriated for ship construction. We also obtained information on 4 fiscal year 1987 contracts. In total, the contracts covered 74 vessels involving 11 ship construction programs at 11 private shipyards.

¹Navy Ship Construction Contracts (GAO/T-NSIAD-87-30), April 23, 1987.

²Navy Contracting: Cost Overruns and Claims Potential on Navy Shipbuilding Contracts (GAO/NSIAD-88-15), October 16, 1987.

COST OVERRUNS
ARE INCREASING

We found that the contracts are now experiencing higher overruns, and more of the contracts are close to, at, or above the ceiling price than was the case when we testified before this Subcommittee about one year ago.

The Navy policy of competing ship construction contracts has generally resulted in lower and declining contract prices. However, as of February 1988 the Navy was projecting cost overruns totaling almost \$1.7 billion, involving 17 of the 22 contracts we reviewed last year. This represents a \$260 million growth, or an 18 percent increase in overruns since our October 1987 report, and a 40 percent increase since our testimony last April. The 4 fiscal year 1987 contracts are now projected by the Navy to overrun target costs by \$403 million. In summary, as of February 1988 the Navy was projecting cost overruns of almost \$2.1 billion, or 18 percent over target cost, for 21 contracts involving 60 vessels. Many of these contracts are still experiencing schedule slippages and delivery delays.

In analyzing the cost growth it is important to recognize that on fixed-price incentive contracts, the Navy shares a portion (generally 50 percent) of overruns exceeding the target price, up to a ceiling price. Costs above the ceiling are borne entirely by

the contractors. Thus, the Navy is potentially liable for one-half of the \$2.1 billion overrun, or about \$1 billion. As of February 1988, we found that 12 of the 22 contracts we reviewed last year were close to, at, or above the ceiling price. Of these 12 contracts, 7 had estimates of at least 90 percent of the ceiling price, and 5 had projected costs at or above the ceiling price. In comparison, when we reviewed the program last year, 10 of the 22 contracts were close to, at, or above the ceiling price. Of these 10 contracts, 6 contracts had estimates of at least 90 percent of the ceiling price, and 4 contracts had projected costs at or above the ceiling price. All 4 of the fiscal year 1987 contracts had estimates of at least 90 percent of the ceiling price, and 2 of these had projected costs at or above the ceiling price.

When we testified last April, we reported that 5 of the 22 contracts we reviewed were underrunning target costs by about \$60 million. When we issued our October 1987 report, the underruns had declined to 3 contracts projected to underrun target costs by about \$26 million. As of February 1988, there were still 3 contracts projected to underrun target costs, but only by about \$21 million. Savings from underruns are shared by the Navy and shipbuilders.

As we reported in October 1987, 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 external problems such as late Government furnished equipment and data.

It appears, however, that the overruns can be primarily attributed to optimistic bidding fostered by a competitive environment, anticipated production efficiencies which have not materialized and unrealistically low labor hour estimates. I should note, Mr. Chairman, that while a competitive environment may contribute to overruns it also creates incentives for the shipbuilders to produce as efficiently as possible.

Our analysis of the contracts showed that some price proposals were identified by the Navy, at the time of award, to be optimistic. The proposed prices were below the government estimates, and the Navy believed they presented a risk of cost overruns.

There is nothing, however, to prevent offerors from reducing their prices for competitive purposes. As long as a proposal is technically acceptable, fair and reasonable in terms of price, and the offeror is determined to be responsible to perform the work in terms of meeting certain financial, performance, managerial and business standards prescribed by the Federal Acquisition Regulation, the contract may be awarded to that offeror. However, the contracting officer must assure that change orders or follow-on

procurements are not used to recover losses from intentional below-cost bids. Although price was the highest-weighted factor in the 22 procurements we originally reviewed, the Navy did consider other technical and management factors during its evaluation of the offers. Pre-award surveys were performed where necessary and, in all cases, a determination of contractor responsibility was made.

ADEQUACY OF FUNDING

The Navy will have to fund about \$1 billion of the overrun, if the current estimate of a \$2.1 billion overrun proves to be accurate. Last year we found that the Navy, in most cases, had sufficient funds to cover its portion of the overruns being projected at that time. Navy officials told us they are uncertain whether current funding is still adequate. The Navy is currently conducting a Ship Cost Adjustment review to determine if the available ship construction funds are sufficient to cover the potential liability resulting from the overruns.

CLAIMS AGAINST THE GOVERNMENT

Where there are significant contract cost overruns there is an increased likelihood of contractor claims against the government or Requests for Equitable Adjustment (REAs). An 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. As of July 1987, contractors were attempting to recover, through REAs and claims, about \$180 million involving 7 of the 19 contracts then projecting cost overruns. As of December 1987, contractors were attempting to recover about \$110 million involving 5 of 21 contracts projecting overruns. (It is important to note that one REA and one claim account for almost all of these dollar values.) It appears the Navy is taking reasonably expeditious action to resolve REAs and claims. During 1987 the Navy settled 5 REAs and claims for \$28 million. The contractors originally sought \$91 million (one claim accounted for almost all of this amount.)

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In summary, Mr. Chairman, the amount of projected overruns and, therefore, the government's potential liability has increased since last year. The continued interest of this Subcommittee has focused attention on this developing trend. The Navy is now reviewing the funds available to meet the government's share of the overruns. If you desire, we will continue to monitor this issue and review the Navy's analysis of the available funds.

Mr. Chairman, this concludes my statement. I will be pleased to answer any questions.