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A-12 Default Termination Issues

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Before the
House Armed Services Committee
Subcommittee on Investigations



Mr. Chairman, we are pleased to appear before the House Armed Services Committee's Subcommittee on Investigations to present information on the termination of the Navy's A-12 aircraft program.

As you are aware, the A-12 was being developed to provide a stealthy replacement for the Navy's aging fleet of A-6 medium attack aircraft, which are no longer in production. Full-scale development of the A-12 by the contractor team of General Dynamics and McDonnell Douglas (the Team) had been underway since January 1988 when the Team was awarded a fixed-price incentive contract with a target price of \$4.4 billion and a ceiling price of \$4.8 billion.

The details of what transpired in the 3-year period since the contract was awarded are far beyond what we are prepared to discuss today. Many of those details have been presented in the Navy's report which is frequently called the "Beach Report" and various reports by the Department of Defense Office of the Inspector General and the Defense Contract Audit Agency.

At the request of the Chairman, House Armed Services Committee, we have reviewed and reported¹ on the Navy's total cost of the A-12 program and aircraft requirements. Our current work is focusing on alternatives to the A-12 aircraft, and the financial implications of the termination including government liability and the deferral agreement. In terms of the deferral agreement, we have attempted to obtain detailed information from DOD on its rationale and analysis performed in support of the decision to defer payment. We have not been provided this information.

As requested, we will discuss the information we have gathered on the A-12 program and the possible impact of the termination on the

¹ NAVY A-12: Cost and Requirements, (GAO/NSIAD-91-98) Dec. 31, 1990

government. Specifically, we will talk about the potential government liability arising from the termination and consequences of the termination on Navy efforts to address their medium attack aircraft needs subsequent to the termination.

In summary, total appropriations for the A-12 program, including research conducted before the full-scale development phase as well as production funding, totaled just over \$6.7 billion. At termination, just under \$3 billion had been spent on the program. Research and development and miscellaneous support costs accounted for about \$300 million of the amount spent. Of the remaining \$2.6 billion paid to the Team for the full-scale development effort and \$0.1 billion for the first two production options, the Navy demanded that \$1.35 billion be returned. This amount represented progress payments the Navy made for work it had not yet accepted as of the date of the termination.

On January 7, 1991, the government terminated the A-12 contract for default because the Team was unable to complete the design, development, fabrication, assembly and test of the A-12 aircraft within contract schedule, and deliver an aircraft that would meet the contract requirements.

The contractors have stated their intent to file legal action to contest the default termination and assert their rights to convert the termination to one for the convenience of the government. In addition, the Team submitted claims against the government stating that it is entitled to price adjustments that have yet to be resolved.

The government's liability would increase substantially if the termination is converted to one for the convenience of the government. In that case, the government's liability could include most costs incurred by the Team on the contract. Regardless of whether the termination of the A-12 contract is for default or

convenience, the Navy will have to take action to meet its need for attack aircraft.

Before I elaborate on these points let me present some background on the A-12 program.

BACKGROUND

The Navy's A-12 medium attack aircraft was being developed to replace its A-6E aircraft. The first version of the A-6, the A-6A, was introduced into the fleet in 1963 as the Navy's only day/night, all-weather, medium attack aircraft. The A-6 is also used to refuel other carrier-based aircraft. The latest version of the A-6, the A-6E, was introduced into the fleet in 1972. However, in the early 1980s wing cracks caused many of the A-6Es to be restricted to less demanding flight maneuvers or to be removed from flight status until appropriate repairs could be made. In fiscal year 1988, the Navy awarded a contract for the last A-6E production lot of eight aircraft to be delivered in 1991. The Navy has no plans to buy additional A-6Es. In 1988, the Navy awarded the Team a \$4.4 billion fixed-price incentive contract for full-scale development of the A-12. The Navy expected the A-12 to be significantly more capable and survivable against increasingly sophisticated integrated air defense systems being deployed by the Soviets and third world countries.

In December 1989, the Secretary of Defense directed a Major Aircraft Review of four aircraft programs, including the A-12. During his April 26, 1990, testimony on the Major Aircraft Review, the Secretary of Defense projected that the first flight of the A-12 would take place by early 1991 and that the full-scale development program would be completed within the current fixed-price incentive contract ceiling. On June 1, 1990, the Team advised the Navy that a significant slip occurred in the schedule for the first flight, the full-scale development effort would

overrun the contract ceiling by an amount that the Team could not absorb, and certain performance specifications of the contract could not be met. On July 9, 1990, the Secretary of the Navy ordered an inquiry to determine the facts and circumstances surrounding the variance between the current status of the A-12 program and representations made to the Secretary of Defense on behalf of the Navy regarding the program during the course of the Major Aircraft Review.

The investigation determined that the Navy and the Office of the Secretary of Defense had information that should have been considered during the Major Aircraft Review but was not. The investigation resulted in the censure and reassignment of two high-level Navy officers involved with the A-12 program. A third officer was forced to retire. Shortly thereafter, the Under Secretary of Defense for Acquisition resigned, and the Secretary of Defense gave the Navy until January 4, 1991, to show why the A-12 program should not be cancelled.

On January 7, 1991, the Navy terminated the A-12 contract for default because of difficulties the Team had in performing the contract and because the Secretary of Defense decided against restructuring the contract.

In our recent report² to Representative Andy Ireland on A-12 funding we reported that the A-12 program received total appropriations of \$6.74 billion through fiscal year 1991. These appropriations provided funds for research, development, test and evaluation, concept exploration, demonstration and validation, miscellaneous support, and other costs associated with the full-scale engineering development contract. The appropriations also

² NAVAL AVIATION: Navy A-12 Aircraft Funding Status
(GAO/NSIAD-91-171) Mar. 22, 1991

provided funds for procurement of aircraft under production options which were part of the A-12 development contract.

As of February 25, 1991, the Navy had spent about \$2.97 billion on the total program. The development contract progress payments to the Team totaled \$2.58 billion, as of the termination date, and another \$104 million more was spent on Lot I and Lot II production options, for a total of \$2.69 billion. The Navy received six design and management reviews³ which it priced at \$1.34 billion. On February 5, 1991, the Navy issued a demand letter to the Team requesting repayment of the \$1.35 billion for which no completed items had been accepted by the government. However, at the Team's request, the Navy has agreed to defer the repayment until litigation over termination is resolved in court or a negotiated settlement is reached.

Initially, the amount of repayment was reported as \$1.9 billion. Based on an explanation by the Navy's contracting officer the \$1.9 billion appears to have been a computational error. The DOD stated that the \$1.9 billion figure was a "rough order of magnitude estimate" made at the time of termination. Both the Navy and DOD now state that the correct amount is \$1.35 billion.

³ These items are initial, preliminary, and critical design reviews, a program management review, and phase IA test.

TERMINATION FOR DEFAULT VERSUS

TERMINATION FOR CONVENIENCE

DEFINITION

According to Federal Acquisition Regulation (FAR), termination for default is generally the exercise of the government's contractual right to completely or partially terminate a contract because of a contractor's actual or anticipated failure to perform its contractual obligations. On the other hand, termination for convenience is the exercise of the government's contractual right to terminate a contract without regard to a contractor's failure to perform.

The Navy's termination letter described two procedures available to the Team to appeal the default termination. First, the Team may appeal to the Armed Services Board of Contract Appeals within 90 days of the receipt of the termination letter. Second, the Team may instead bring an action directly in the U.S. Claims Court within 12 months from the date the termination letter was received.

GOVERNMENT LIABILITY

The financial liability of the U.S. Government, over and above goods and services delivered, is generally limited under a termination for default. According to the Navy contracting officer, this financial liability on the A-12 default termination is limited to the contract line items that have been delivered, that is, \$1.34 billion. There also may be additional costs for protection and preservation of property in which the government has an interest. According to Navy officials, while the exact cost is not known, they believe that these costs could be significant given the need to safeguard the program's special access items.

The FAR provides that if, after termination, it is determined that the Team was not in default or that the default was excusable, then

the rights and obligations of the parties will be the same as if the termination had been issued for the convenience of the government. Government liability would increase substantially if the termination is for convenience. In that case, the government's liability could include costs for the work done and preparations made for the terminated portions of the contract, adjusted by the application of an appropriate loss ratio.

DEFERRAL AGREEMENT

Under FAR 32.613, the collection of debts owed the government may be deferred. Deferments pending disposition of appeal may be granted to small business concerns and financially weak contractors, with a reasonable balance of the need for government security against loss and undue hardship on the contractor. If no appeal has been filed, deferment may be granted if the contractor is unable to pay in full at once or the contractor's operations under national defense contracts would be seriously impaired.

In its February 5, 1991, demand letter, the Navy advised the Team that it could submit a request for deferment of collection if immediate payment is not practical or if the amount is disputed. On the same day, February 5, 1991, the Team requested deferral of payment and the parties signed the deferment agreement.

The deferment agreement provides that the government will take no action, except as otherwise provided, to enforce collection pending (1) a decision by the Armed Services Board of Contract Appeals (ASBCA) or the Claims Court on the Team's appeal, or (2) a negotiated settlement between the government and the Team.

The deferment agreement also provides for the payment of interest to the government at the rate established by the Secretary of the Treasury as provided in section 12 of the Contract Disputes Act. That rate is currently 8 3/8 percent, and will be reviewed every 6

months. The agreement will remain in full force and effect until it is reviewed on December 1, 1992, and annually thereafter.

According to the Navy contracting officer, the Team advised the government that the issuance of a demand letter and the resulting reaction of the credit markets would cause financial hardship. Therefore, coordinated action was taken so that the demand letter, the request for deferment and the deferment agreement were all executed on the same day, February 5, 1991.

The apparent purpose of the deferment provisions of the FAR is to provide relief to contractors who are not in a position to effect immediate payment of contract debts. According to DOD, it granted a deferment to the Team to avoid placing the contractors in a financial condition that would endanger essential defense programs.

As indicated earlier, DOD has not provided us with the information it contends substantiated the assertion that immediate repayment was impracticable. DOD also has not provided us with its analysis of this information. We would expect that the DOD's review and analysis would have included comprehensive written financial analysis of operations and cash flows, so that a rational assessment of the Team's financial situation could be made.

GOVERNMENT PROPERTY

What does the government own under the A-12 contract? As stated earlier, the government has accepted and paid for six design and management reviews priced at \$1.34 billion. In addition, under the progress payment clause, the government obtains title to work-in-process, materials, tools, and similar items. In other words, the government currently has title to the aforementioned items included in the unliquidated progress payment amount of \$1.35 billion.

Once the Team repays the unliquidated progress payments, title to all material not accepted by the government shall vest in the Team. If the government wants to acquire other items related to the A-12 from the Team, a price must be negotiated between the government and the Team. According to Navy program office officials, the Navy is conducting a review of undelivered technical information and material developed under the A-12 contract that may be purchased by the U.S. Government.

CONTRACTOR CLAIMS

On December 31, 1990, the Team filed a claim of \$1.4 billion for equitable price adjustment. As the basis for the claim, the Team cited (1) the Navy's failure to disclose what they called its superior knowledge of facts vital to the Team's performance, (2) delays and disruptions, which the Team claims resulted from the Navy's conduct, (3) the Navy's flawed acquisition strategy, and (4) commercial impossibility of performance. On February 22, 1991, the Navy notified the Team that the claim would be considered when properly certified.

SUBCONTRACTOR CLAIMS

The FAR provides that subcontractors have no contractual rights against the government upon the termination of a prime contract. A subcontractor may have rights against the prime contractor or intermediate subcontractors with whom they have contracted. The termination clauses in the prime contract and each of the subcontracts will determine the rights and liabilities of the respective parties.

OTHER CONSEQUENCES OF TERMINATION

Regardless of whether the termination of the A-12 contract is for default or convenience, the Navy will have to take action to meet its need for attack aircraft. Since the early 1980s, the A-6 fleet has experienced wing cracks which have led to flight restrictions and groundings for a large portion of the A-6E inventory. To counter the resulting drop in the A-6E inventory, the Navy contracted with the Boeing Corporation to produce composite wings for retrofit on the A-6E fleet. The Navy originally planned to procure 174 sets of composite wings to maintain A-6E inventory levels until the A-12 entered the fleet in sufficient numbers. However, now the A-6E must continue to fulfill the Navy's medium attack requirements longer than planned. According to Navy officials, this situation requires the Navy to purchase at least 120 additional sets of composite wings at an estimated cost of \$2 billion. Approximately one half of this is because of the A-12 termination.

Further, in the wake of the termination, the Secretary of the Navy directed that alternative plans be developed to modernize Navy tactical aircraft. Specifically, he wanted the Navy to develop a short term alternative to supplement the declining A-6E fleet. Alternatives being considered are the F-14 or the F/A-18 and we have been told that the Office of the Secretary of Defense favors the F/A-18 alternative because it is less expensive than the F-14. Improvements to both these aircraft were already planned before the A-12 termination. In either case the aircraft's attack capabilities would be less than the A-6E.

As of December 31, 1990, the Navy had an inventory of 637 F/A-18 aircraft, of which 260 were F/18C and D models. In the near term the Navy plans to purchase more F/18 C and D models--it has proposed that the fiscal year 1992 supplemental request include 228 additional aircraft over 6 years, but the Office of the Secretary

of Defense has not yet approved it. In the longer term the Navy plans to procure an upgraded version of the F/A-18 that will be designated the F/A-18E and F. The F/A-18E and F will include a three-foot long plug in the fuselage and larger wings, which will provide for approximately 3,000 pounds of additional fuel capacity and a payload capacity of approximately 18,000 pounds. The larger wings will also accommodate 2 additional external weapons stations for a total of 11. The aircraft will also be given a more powerful engine. Night attack and under-the-weather capabilities have already been incorporated into the F/A-18 C and D. The F/A-18F is a two-seat version of the F/A-18E.

The Navy has an inventory of approximately 489 F-14 aircraft of all models. The model of the F-14 which would assume the attack role is the F-14D, of which the Navy has 43. There are several upgrades which make the F-14D unique from other versions of the aircraft. It contains digital avionics, a Hughes AN/APG-71 radar, and an infra-red search and tracking system. A F-14D upgrade called "Quickstrike" would provide night-time and under-the-weather capabilities and other attack enhancements. However, plans by the Navy to increase their F-14D inventory by remanufacturing F-14As were not approved by the Secretary of Defense.

Limitations to the F-14 and F/A-18 attack capabilities have forced the Navy to continue with their long term plan to replace the A-6E with a new start stealth aircraft now designated the AX. The Navy established a program office, prepared planning briefings for staff of the Office of the Secretary of Defense, and intends to submit a formal proposal to the Secretary of Defense in June 1991. Currently the Navy anticipates that it will take at least 15 years for the AX aircraft to reach the fleet with a research and development cost of \$11 billion. A total estimated program cost has not been made. It is not clear how much of the technology developed for the A-12 can be applied to the AX. Navy officials told us they are not sure to what extent they will be able to use

A-12 design studies to reduce the cost of developing another stealth aircraft because the studies were very A-12 design specific, and may not be applicable to another aircraft.

Mr. Chairman, that concludes our prepared remarks. We have attached our visual aides to the copies of our testimony. We will be happy to answer any questions.

(394392)

GAO Appropriations for the A-12 Program for Fiscal Year 1991 and Prior Years

Dollars in Millions

Account	Appropriated	Expended
Research, Development, Test, and Evaluation	\$4,734.1	\$2,853.1
Aircraft Procurement–Navy	2,003.0	113.2
Total	\$6,737.1	\$2,966.3

GAO Repayment Demanded on Full-Scale Development Contract

Dollars in Millions

Account	Expended	Value of Items Received	Repayment Amount
Research, Development, Test, and Evaluation	\$2,582.6	\$1,334.7	\$1,247.9
Aircraft Procurement–Navy	104.5	0	104.5
Total	\$2,687.1	\$1,334.7	\$1,352.4

GAO Component Level Manufacturing Sequence Tulsa

