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POINT PAPER

DD-963 PROGRAMBACKGROUND

Litton Industries is currently engaged in two major Navy shipbuilding programs. A contract for nine general purpose amphibious assault ships (LHA's) was awarded to the company on 1 May 1969; this contract was subsequently revised to provide for delivery of only five LHA's. A subsequent contract for 30 Spruance class destroyers (DD-963's) was awarded to Litton on 23 June 1970. Both ship programs were contracted for under the "Total Package Procurement" concept which assigned the contractor complete responsibility, subject to Navy approval, for the design, construction and equipping of the ships. When the contracts were awarded in 1969 and 1970, there was little to indicate to either the Navy or to Litton the problems which would be encountered in establishing a new shipyard with modern, automated facilities. We were also unable to forecast either the current severe inflationary financial conditions or the present critical manpower shortages we would find in the Pascagoula area. Both the Navy and the contractor, it is now clear, were overly optimistic in their cost and schedule estimates for both programs.

The basic DD-963 contract is a "fixed-price, incentive fee" instrument, which sets a negotiated, agreed-upon price for the 30 ships - the "target" price. At this target point, if the contractor delivers the ships in acceptable condition and on schedule, he would earn the target profit provided for in the contract. The contract also established a "ceiling" price, \$350 million higher than the target, at which the contractor's profits are zero, and beyond which all costs are borne by him. Between "target" and "ceiling," the government and the contractor share the costs on a predetermined percentage basis, with the profit margin diminishing steadily as the price to the government grows from target toward ceiling.

The contract also provided for a one-time "reset" proposal from the contractor. At a specified point in the construction project, because of the lack of definition of the ship when the original contract was signed, Litton was permitted to submit new cost and schedule estimates. This reset was based on the contractor's experience with the program and was, in effect, a revision of his initial estimates based on this experience.

CURRENT STATUS (DD-963)

This reset proposal is currently being negotiated, and it appears that the price of the 30 ships is approaching the negotiated "ceiling." The DD-963 program is now budgeted to approxi-

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mately \$200 million over the original "target;" with a \$350 million target-to-ceiling differential, the result is a requirement for an additional \$150 million to cover the growth to ceiling price. In addition, there is unbudgeted inflation in our earlier estimates for costs of government furnished equipment, contract incentives, outfitting material and refurbishment of land based test site equipment totalling another \$91 million.

The DD-963 contract provides for payments to the contractor for increases in his costs for labor and material over the life of the contract. These unpredictables are beyond his control and the government is obligated to compensate him for unforeseen increases in labor and material costs. An estimate, based on factors available when the contract was signed, projected that these increased costs would total \$186.6 million over the life of the contract. Current estimates, based on the latest reported factors, place this added cost at \$760.4 million, an increase of \$573.8 million. This increase, as an "unpredictable" is not related to "target-to-ceiling" growth.

The total shipyard skilled production manpower available in the Pascagoula area is inadequate to man the LHA and DD-963 programs simultaneously; there is a continuing shortage of approximately 1,000 workmen. Intensive recruiting, incentive and training efforts have not succeeded in overcoming this constant shortage. In this regard, the maning level and skill shortage problem is not unique to Litton nor Pascagoula; it is common throughout the country's shipbuilding industry.

Litton Industries is already in a loss position on the LHA contract; the DD-963 program still offers a potential for profit. The contractor has stated that it is his intention to meet the production (direct labor) manpower needs of the DD-963 at the expense of the LHA program to the degree this diversion of labor proves to be necessary. The Navy position is that Litton should be held to its contractual obligations in both programs, and we are currently conducting an intensive review of the contractor's announced delivery schedules for the DD-963 class.

USS SPRUANCE (DD-963), the first ship of the class, is scheduled by the contract for delivery on 31 October 1974; it is now evident that the ship will be delivered about three months late. This amount of slippage is not unusual in shipbuilding programs, especially for the first ship of a class.

PROGRAM PROGRESS

The first 12 destroyers of the 30-ship program are now under construction; four have already been launched. The ships are

being built in a "modular" fashion, with preassembled major sections being assembled into a complete hull and superstructure just prior to launch. This process takes full advantage of the modern facilities available in the Litton shipyard. Construction progress is generally satisfactory and the quality of workmanship is good.

Fourteen technical milestones were established for the DD-963 program and all have been met on or ahead of schedule. All except one have been accepted by the Navy. The milestone for delivery of the computer software program has been conditionally accepted pending further verification and tests.

SUMMARY

The DD-963 program is four years into contract. The contractor is building quality ships and there is every reason to believe that he can deliver all 30 ships to the Navy. Manpower problems, common to the shipbuilding industry, will probably cause a delay in delivery of some of the ships. Economic inflation, which is having a severe impact on U.S. industry in general and the shipbuilding industry in particular, will continue to cause significant program cost increases.

4/28

NATIONAL SECURITY COUNCIL

To: Bud McFarlane

From: Dick Boverie

PER OUR TELECON:

THIS IS PRINCIPALLY A
DOD-OMB MATTER INVOLVING
CLAIMS + FUNDING CONCEPTS.

-- IT ABANDONS THE FULL-FUNDING
CONCEPT

-- IT GOES FROM FIXED PRICE
TO COST PLUS CONTRACTS, etc.

-- IN SHORT, SOME CAN VIEW
THIS AS A BIG GIVE-AWAY TO
NEWPORT NEWS + LITTON.

RICKOVER WILL CERTAINLY
BLAST IT.

Mr. Ogilvie

STATEMENT
OF
HONORABLE WILLIAM P. CLEMENTS
DEPUTY SECRETARY OF DEFENSE
BEFORE THE
COMMITTEE ON ARMED SERVICES
UNITED STATES SENATE

APRIL 29, 1976

I. Introduction

Mr. Chairman, members of the Armed Services Committee, I am pleased to have this opportunity to discuss with you the serious matters that beset the Navy's shipbuilding program. Seven years ago (March 1969) the Secretary of Defense, Melvin Laird, in his first appearance before your Committee spoke of the urgent need for a comprehensive review of the Navy shipbuilding program. He cited an estimated deficit of \$600 - 700 million of funds required to complete ships then in the on-going building program. He spoke of large cost over-runs, of multi-million dollar claims, of programmed ship cancellations. He said we must begin to get this program under better control.

In the intervening seven years, Mr. Chairman, this program has not lacked over-sight, review, studies in detail by the Congress, the G.A.O., Commission on American Shipbuilders, the Navy, the industry and others. Annually since 1968, the Senate and House Appropriations and Armed Services Committees have made significant comment on the Navy's shipbuilding claims problems. The Joint Economic Committee conducted extensive hearings on "The Acquisition of Weapons Systems) in the period 1969 - 73. The Navy's shipbuilding program is thoroughly covered in that committee reports with very detailed comments and explanation by Admiral Kidd, Admiral Rickover, Gordon Rule, F. Trowbridge vom Bauer, Gilbert Cuneo and others.

In 1970 and 1974, the Seapower Subcommittee of the HASC held extensive hearings on the state of the Navy's shipbuilding program, Naval shipyards and private shipyards. I quote several of the conclusions in the subcommittee's report of 31 December 1974, which I believe are most pertinent to our discussions today.

"1. A viable, healthy system of shipyards -- both naval and private -- is necessary to our national security. But our shipbuilding program is experiencing serious difficulties, with major new construction concentrated in only three yards and with severe manpower problems that have adversely affected costs and scheduled in two of those yards. One of the key causes of trouble has been the inability of shipyards to plan for the future because of the lack of a clearcut, long-range national program and a pattern of peaks and valleys in shipyard activity.

2. The building of naval combatant vessels is extraordinarily complex. In the past, however, the problems of the shipyards have been relegated to the lower levels of management by the Executive Branch. One of the purposes of the subcommittee in conducting the hearings has been achieved by the hearings themselves: to focus adequate attention on the problems of the shipbuilding industry by the highest officers of the Department of Defense and other departments of the Executive Branch. But the problems of shipyards do not admit of easy, one-time solutions; they require sustained, outstanding management from the highest levels.

6. There have been long delays in the settlement of shipbuilders' claims. In part, delays have been due to the necessity of carefully considering each element of complex claims; in part, to the changing nature of contractor submissions; and in part, to delays by shipbuilders in producing evidence in support of claims. Nevertheless, the present procedures allow for unacceptable delay in settlement of claims. The Navy has had to refer some recent claims to the Department of Justice for possible legal action. Hugh claims have been submitted to the Navy in recent months and others are threatened. These can only result in overwhelming Navy personnel responsible for the programs unless they can be given adequate professional assistance. The Navy has not been able to pay interest on claims found to be just, although in such cases the contractor's money has been tied up for substantial periods.

7. Unanticipated inflation has caused losses on some shipbuilding contracts and led to charges of substantial cost overruns. In the past the Navy has been constrained from using realistic escalation factors in cost estimates for future fiscal years, but more acceptable procedures are now being permitted.

8. While the subcommittee appreciates that the margin of profit for shipbuilders has not always been adequate on naval combatant vessel programs, assured profits cannot be legislated and experience has proved that cost plus contracts lead to abuses that cannot be completely prevented under any procedure yet devised.

10. All of the evidence examined by the subcommittee in this and earlier studies indicate the Navy should enter the 1980's with an absolute minimum of 600 ships. The present Navy has under 500 ships. To build the new ships needed, the Navy has had to give up older assets; but there is a limit to this process. To reach the desired total of over 600 ships by the 1980's, the Navy will have to construct ships at the rate of at least 35 per year."

As you know, I assumed my present office as Deputy Secretary of Defense in January 1973. From the beginning of my work in the Pentagon, I have been concerned with overseeing the management of the weapons acquisition process. Of all our major systems acquisition programs I believe the problems in the Navy combatant ship acquisition program have been and are the most long enduring, most vexatious, and most difficult to bring under orderly control and management by the Secretary of the Navy and the Secretary of Defense. And while I do not dispute conclusion #2 of the Sea Power Subcommittee Report (quoted above), I want to say, Mr. Chairman, that I personally have focused a considerable amount of my working time since taking office on the Navy's shipbuilding program and, more recently, I have become almost preoccupied with it.

II. Background Data on the Shipbuilding Claims Problem

Mr. Chairman, I would like to summarize the scope of the Navy's Shipbuilding Claims problem for the period 1 January 1969 through 1 April 1976. I will do this using four categories; viz

Category A -- Settlements made 1 January 1969 - 1 April 1976

Category B -- Request for Equitable Adjustments
Outstanding as of 1 April 1976

Category C -- Armed Services Board of Contract Appeals (ASBCA)
Decisions on Shipbuilding Claims
1 January 1969 to 1 April 1976

Category D -- Claims pending before the Armed Services
Board of Contract Appeals (ASBCA) as of
1 April 1976

Statistical Summary
 Navy Shipbuilding Program
 Claims - Requests for Equitable Adjustment
 Category A - Settlements
 January 1, 1969 - April 1, 1976

	No. of Claims	Claimed Amount (In Thousands)	Settlement Amount	Settlement as Percentage of Claim	Types of Vessels
General Dynamics:					
Electric Boat Div.	8	294,600	122,600	41.6%	SSN, SSBN
Quincy Div	8	216,755	90,124 (a)	41.6	AE, AS, AOR, LSD
TOTAL	16	511,355	212,724	41.6	
Litton Systems (Ingalls)	3	34,119	19,922	58.4	SSN, AE, LPH
Newport News S&DD Co.	10	145,562	78,220	53.7	CVA, SSBN, SSN, LCC, LKA
Alabama DD&SB Co.	1	14,219	4,977	35.0	ASR
Avondale Shipyards	2	169,144	80,000	47.3	DE
Bethlehem Steel	2	52,178	18,501	35.5	AE, AO
Defoe Shipbuilding	5	16,063	4,478	27.9	DDG, DE, AGOR, T-AGS
Lockheed Shipbuilding	9	208,923	79,452 (b)	38.0	DEG, AO, DE, AGEH, AE, DE, LPD
National Steel & SB	1	49,200	35,300	71.7	LST
Northwest Marine	1	2,092	372	17.8	AGOR
Todd Shipbuilding	4	114,634	96,890	84.5	DE
TOTAL	54	\$1,317,488	\$630,836	47.9%	
<u>Recapitulation</u>					
Nuclear	14	339,152	144,705	42.7	
Non-nuclear	40	978,336	486,131	49.7	
TOTAL	54	\$1,317,488	\$630,836	47.9	
% of total nuclear		25.7	22.9		
% of total non-nuclear		74.3	77.1		
		<u>100.0</u>	<u>100.0</u>		

(a) Includes \$-0- settlement amount for \$25,600,000 claim decision of ASBCA on which ASBCA denied contractor's appeal; ASBCA found that contractor had incurred \$12,282,523 additional costs; contractor's suit for such amount is pending in U. S. Court of Claims.

(b) Includes finding of entitlement of \$61,612,158 by ASBCA on claims of \$170,192,538.

Statistical Summary
 Navy Shipbuilding Program
 Category B - Requests for Equitable Adjustment
 Pending as of April 1, 1976

	<u>Amount of Claim</u>	
Pending as of April 1, 1976:		
Boland Marine		
DLG-10	\$3,297,314	
Litton Systems (Ingalls)		
LHA	\$504,847,301	
Newport News SB&DD Co.		
DLGN 36-37	\$151,040,521	
DLGN 38-40	159,774,936	
SSN-688	78,543,149	
SSN 689-91-93-95	191,567,199	
CVN 68-69	221,280,223	
SSN 686-87	92,099,492	
	<u>\$894,305,520</u>	
	<u>\$1,402,450,135</u>	
<u>Recapitulation</u>		
Non-nuclear	\$508,144,605	36.2%
Nuclear	894,305,520	63.8
	<u>\$1,402,450,125</u>	<u>100.0%</u>

NOTES:

Anticipated to be received in CY 1976:

General Dynamics Corp (Elec. Boat Div.) \$200 to \$250 million
 National Steel and Shipbuilding Company \$21.6 million

Statistical Summary
 Navy Shipbuilding Program
 Category C - ASBCA Decisions
 January 1, 1969 - April 1, 1976

	<u>Date of ASBCA Decision</u>	<u>Claim Amount</u>	<u>Amount Approved by ASBCA</u>
General Dynamics Corp (Quincy)	5/14/73	\$23,416,246	-0- (a)
Lockheed Shipbuilding Co.	5/13/75 Reaffirmed 10/24/75	<u>\$62,000,000</u>	<u>\$62,000,000</u> (b)
		<u>\$85,416,246</u> (c)	<u>\$62,000,000</u> (c)

NOTES:

- (a) ASBCA denied contractor's claim. In an appendix to the ASBCA decision, the Board found the contractor's increased performance costs to be \$12,282,523. Suit has been filed in the U. S. Court of Claims.
- (b) Award made by ASBCA based on tentative agreement between Navy and contractor but lacking "higher authority" approval. Amount of claim settlement reported as \$61,612,158 by NavSeaSysCom, not yet paid due to allegation of possible fraud.
- (c) Does not include decision of ASBCA of April 16, 1976 in which the Board determined the adjusted claim to be \$30,335,136 and in which the Board determined \$16,535,771 to be due the contractor (Litton Systems - Ingalls, SSN 680 claim).

Statistical Summary
 Navy Shipbuilding Program
 Category D - Claims Pending Before the Armed Services
 Board of Contract Appeals
 As of April 1, 1976

	<u>Amount of Claim</u> (In Thousands)
Litton Systems (Ingalls)	
Project X	\$107,821
SSN-680 (a)	31,156 (a)
LHA (\$505 million) (b)	
	<u>\$138,977</u>
Merrit-Chapman & Scott	
(formerly New York Shipbuilding)	6,844
Todd Shipbuilding Co.	
Agor	<u>2,965</u>
	<u>\$148,786</u>

(a) ASBCA decision of 4/16/76 awards contractor \$16,535,771; claim as adjusted stated to be \$30,335,136.

(b) The LHA claim pending before the ASBCA was withdrawn from the docket to permit further negotiations. The LHA claim is included in the schedule of Category B - Requests for Equitable Adjustment.

Statistical Summary
 Navy Shipbuilding Program
 Category D - Claims Pending Before the Armed Services
 Board of Contract Appeals
 As of April 1, 1976

	<u>Amount of Claim</u> (In Thousands)
Litton Systems (Ingalls)	
Project X	\$107,821
SSN-680 (a)	31,156 (a)
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(b) The LHA claim pending before the ASBCA was withdrawn from the docket to permit further negotiations. The LHA claim is included in the schedule of Category B - Requests for Equitable Adjustment.

In Category "A" (settlements made) there were 54 claims for a claimed amount of \$1,317 million which was settled for \$631 million (or 47.9%). About 80% of the settlements were for conventional ships, i.e. aircraft carrier, Destroyers, Destroyer Escorts, Amphibious ships, Fleet tenders, and Fleet auxiliaries. The remainder were for nuclear ships, mainly submarines.

In Category "B" (outstanding REA's or Claims) there are 8 REA's in hand for a total of \$1,402 million. In addition, there are anticipated REA's for \$200 - 250 million expected to be filed before the end of 1976. About two-thirds of these claims are for nuclear ships. The large LHA claim in the amount of \$505 million forms the bulk of the conventional ship claims.

The Category "C" (ASBCA decisions) record is very brief. Only two shipbuilders Lockheed Shipbuilding Company claim for \$62 million settlement has been upheld by the Board. appeal for relief have been decided. / The claimed amount of \$24 million by General Dynamics (Quincy) was denied. However, General Dynamics has filed suit in U.S. Court of Claims for increased performance costs of \$12 million found to be valid by the ASBCA in its denial decision.

In Category "D" there are four shipbuilders' appeals before the ASBCA in the total amount of \$149 million.

From the foregoing, it can be said that the overall universe of the shipbuilding claims problem since January 1969 to 1-April 1976 amounts to \$2,952 million.

Of this amount \$1,317 billion have been settled and \$1,635 million are pending.

I have attached to this statement in tabular form a more detailed breakdown of the four categories discussed.

III. Critical Impact of Present Conditions in Navy Shipbuilding Program on National Defense

Mr. Chairman, in my letter to your earlier this month (2 April), I said that I had informed the Secretary of the Navy and the Chief of Naval Operations

of my determination to take remedial action under P.L. 85-804 because of the threat to our national defense which the unsatisfactory business relations between the Navy and the shipbuilders has brought about. I would like now to briefly comment on several specific situations which in the aggregate have hardened my resolve to seek and direct early remedial action to counter this threat to our national defense.

- The Newport News Shipbuilding and Dry Dock Co Situation

In July 1975 in a prepared statement to a DoD review group Mr. John Diesel, President of Newport News said:

"What you see here is a scenario for another shipbuilder to say 'enough' of Navy business, and probably one that Bethlehem Steel and New York Shipbuilding faced prior to going out of Navy shipbuilding. This would add Newport News to the list of five shipyards no longer in the Naval nuclear ship construction programs, leaving only one active."

The statement then went on to say that Newport News would have been bankrupt and "without a prayer for obtaining private capital," had not Tenneco financed the losses, the working capital and the capital improvements requirements. The present profitability and future potential in commercial sales was cited as the rationale for Tenneco's support of the shipyard. The statement concluded, with respect to Newport News financial situation, as follows:

"Summarizing the historical reference for Newport News, the past five years have been bad for the shipyard with its 1969 equity base seriously eroded because of the negative returns on naval shipbuilding. They will be nothing compared to the next five years if the Navy does not provide a sufficient profit base to justify continuing Naval shipbuilding by Newport News."

Examples of the hardening attitude of the management at Newport News has been:

(a) The failure to this date of both Navy and Newport News to definitize the contract for the construction of the CVN 70 (Vinson), even though, in April 1974, the Navy formally exercised the unpriced option in the CVN 68 - 69 contract for the construction of the CVN 70. In fact Newport News has informed

me that they will not continue their present work on the CVN 70 project or attempt to negotiate pricing and other terms until and unless the Navy takes positive steps to act on Newport News' requests for equitable adjustment (REAs).

(b) The stop work action Newport News took in July of 1975 in regard to the DLGN-41 construction project. The Navy sought an injunction in the U.S. District Court of Virginia at that time. As a result of that legal action, the District Court judge directed Newport News and Navy to continue the DLGN project on an interim twelve-month modus operandi wherein Newport News works under a Cost Plus Fixed Fee contract while the parties try to negotiate their differences. It is my understanding that up to the present very little real progress has been made towards a mutual agreement regarding the DLGN-41 contract.

(c) The strong reluctance of Newport News last year to bid on the Navy's FY 1975 SSN (688 class) follow-on production R.F.P. After considerable entreaty by the Navy, the company did submit a bid proposal and sought and received a significantly improved escalation clause in the new contract that was negotiated.

• The Electronic Boat Situation

The E. B. Division of General Dynamics Corp. has currently in hand contracts for 18 SSN-688 class submarines and 4 Trident submarines. Three additional Trident submarines are programmed to be awarded in FYs 78 and 79. Recently a settlement of \$97 million on a claim for \$232 million was made by the Navy on the first production flight of 7 SSN 688 boats. Further, another large multimillion dollar claim is anticipated from E. B. against the 2nd production flight of 11 SSN 688 boats at E.B.

General Dynamics has recently made a significant capital investment at Electric Boat (about \$140 million) for facilities for Trident production, and the creation and outfitting of the Quonset Point division of E. B. The

government has given General Dynamics assurances of pricing arrangements to assist in amortizing this investment as Navy work progresses over the next several years.

The Navy is the only customer E. B. has. To be a viable enterprise it must be financially sound. I am uneasy in this regard -- especially when I realize that the Navy's current plans for submarine construction are limited to E.B. and Newport News.

- The Ingalls Shipbuilding/Litton Situation

Litton currently has under contract 5 LHA's and 30 DD963 class destroyers. Deliveries on both these contracts have just begun. Despite the many problems of management, design, facilities installations, production processing, quality control, work force recruitment and retention, etc., there is now in place at Pascagoula a modern shipbuilding complex which is an unquestioned national asset for defense purposes. However, in a financial sense we are faced with a giant dilemma. It is my understanding that Litton faces up to a probably \$300 - 350 million loss in the LHA contract and a probable profit *up to \$100 million) in the 963 contract -- although there are some who are not sanguine about any significant profit accruing in the 963 contract. It would appear that absent any remedial action, the viability of this shipbuilding complex, if not the parent corporation, may be short lived.

- The General Situation as Relates to Other Major Shipbuilders

As has been brought out in the hearings of the HASC Seapower Subcommittee, Bethlehem Steel Shipbuilding Co. and Sun Shipbuilding Co. for several years now have adopted a policy of not participating in the Navy's shipbuilding program because of their abhorrence of the business relations that ensue.

Recently, in connection with the first follow on production of the Navy's F.F.G. program (formerly the Patrol Frigate (P.F.)), I was very concerned

at the lack of response by the industry to the Navy's R.F.P. Although 8 companies (BIW, Todd, Newport News, Arondale, Defoe, National Steel, Lockheed, Litton) were tendered RFPs and had received a detailed pre-RFP briefing by the Navy on the planned production program, only 2 contractors responded -- BIW and Todd. On inquiry, I learned that Avondale's top management was vehemently opposed to certain Navy policies and practices used in naval ship procurements and, perhaps more importantly, Avondale was psychologically very upset with the Navy's handling of their major claim for \$140 million for the 27 ship DE production program which had been completed in September 1974. As a result, the Avondale top management elected not to participate in the FFG program. Defoe, a smaller ship builder, indicated it could not afford the large expense involved in preparation of the bid as outlined in the RFP. Lockheed, National Steel, Litton, and Newport News had an assortment of reasons for not participating including current workload, no real interest in FFG program because they thought it had been locked in to BIW and Todd from the start, current claims settlement problems, etc.

The FY 72 and 73 submarine tender (AS) RFP received no response from the industry on the basis of the solicitation for a Fixed Price incentive type contract. The Navy finally negotiated for this shipbuilding project on a sole-source, cost type contract, with Lockheed Shipbuilding at Seattle in November 1974.

IV. Present Status of the Navy's Shipbuilding Production Base -

An Assessment

In 1960, 14 private shipyards were engaged in the construction of 83 major combatant, amphibious warfare, and large auxiliary naval vessels. Also, naval vessels were being built in five naval shipyards. Fifteen years later in 1975, over 90% of the Navy's shipbuilding program (62 of 66 ships) was concentrated in three yards (Newport News, E. B., and Litton) and no new construction ship project has been assigned to a naval shipyard since 1967. This situation resulted because the Navy had consciously made a policy decision in the late sixties to concentrate their work in a few large yards on the basis that mobilization planning and policies to insure the availability of a broad shipbuilding base to support the Navy in emergencies, was no longer necessary or economically affordable. I believe this was a mistaken policy -- both then, and certainly today.

Mr. Chairman, following the Seapower Subcommittee hearings in 1974, I formed in concert with the Secretary of Commerce, a joint DoD/ Dept of Commerce Informal Planning Group to implement some of the planning recommendations concerning a re-assessment of the mobilization requirements of the U. S. for shipbuilding, overhaul, repair and conversion of Naval and commercial ships, and the readiness of the U.S. shipbuilding industry to support these requirements. In addition, the DoD and Commerce/ MARAD joined with the Office of Management and Budget (OMB) in 1975 in a study to develop five year projections of subsidized, private unsubsidized, and Navy ship construction in U.S. shipyards, to identify potentially conflicting

demands for resources among the programs, to recommend possible solutions to identified problems, and to assess predictive techniques. The resource availability analysis was to encompass shipbuilding, way space, critical ship components plus steel, and skilled manpower.

The OMB/DoD/Commerce study is classified but I can state its scope and conclusions as follows:

Scope

o Shipbuilding Programs - Two projected programs were analyzed. In the first, or base-case program, the Navy ship list is similar to that now included in the DoD Five Year Defense Plan (FYDP), and the MarAd list reflects annual construction differential subsidy (CDS) funding at a rate of \$250 million, which is the currently approved rate. The second program, designated high-level, includes Navy ships needed for a buildup to a 600-ship force, and the CDS projection is based on an annual CDS funding level of \$300 million. A third program, designated low-level, was developed but it was not subjected to analysis. It encompassed a Navy program smaller than the FYDP program and a MarAd projection keyed to yearly CDS appropriations of \$200 million.

Conclusions

1. Base-Case and High-Level Programs

- o There is sufficient shipyard capacity and materials are potentially available to meet construction requirements.
- o There is a requirement to improve and expand shipyard labor training programs.
- o Shipyards will continue to experience high labor turnover,

particularly in the mid-Atlantic and Gulf Coast regions, but, shipyard labor problems anticipated under the base-case and high-level programs will not be as difficult in general during the period 1975-1980 as problems encountered by the industry in 1973 and 1974.

- o The availability of trained and trainable workers will present a significantly greater problem at Newport News than in the balance of the industry.
- o While it cannot be predicted with high confidence that there will be no slippage of ship delivery schedules, there is no available evidence that slippage will necessarily occur.
- o Commitment by ship builders of yard capacity needed to do Navy or CDS program shipbuilding work as opposed to other ship or non-ship work, such as drilling rig construction, should be reassessed on a continuing basis.
- o There is need for greater pre-award assurance that contract work can be accomplished, particularly in yards with known problems.

V. Some General Principles

Mr. Chairman, in my statement thus far one might conclude that I have reached a harsh judgment of the Navy's management of its shipbuilding program over the past ten years. Such a conclusion is incorrect and simplistic. Most of what I have outlined thus far has been previously well-reported here in the Congress, publicly by the industry, or in the press. I have reiterated it in order to set the stage for a mutual appreciation by

your committee and we in DoD of the overall size of the problem, the many facets involved, and the grave impact it has on our national defense.

The Navy Department -- Secretaries Warner, Middendorf; the CNO's, Adm Zumwalt and Adm Holloway; the Chiefs of Naval Material, Adm Kidd and Adm Michaelis; all of these responsible officials have worked earnestly and with dedication to bring about an amelioration of the manifold problems alluded to and to address in an equitable and legal manner the many complaints, claims, and controversies that the shipbuilders have lodged with the Navy. Unfortunately, for a variety of reasons largely identified with the unusual economic conditions of the past five years and rigid nature of the contracts signed in the period 1968-1973, their efforts have not been successful.

And I must admit, also, that I have been a little slow in forming my present judgment that it is essential that the Secretary of Defense invoke P. L. 85-804 to deal with this threat to our national defense.

In October 1974, I tabled with the Seapower Subcommittee of the HASC a set of general principles which I believe respond to most of the problems of the past 10 to 15 years in the Navy's shipbuilding program. In view of the foregoing I would like to restate these at this time.

General Principles

- o U.S. Seapower is a vital part of our national security. It is made up of the Navy, the Marine Corps, and the Merchant Marine. It is essential that the Secretary of Defense and the Secretary of Commerce maintain a close and continuing liaison to insure the complementary nature of plans and policies which guide the maintenance and development of these elements.

- o The Private U.S. Shipbuilding industry and the Naval shipyards are both vitally essential to our National security. The government has been and will continue to be a principal customer of the industry. It is incumbent upon the DoD and the Department of Commerce (MARAD) to deal in a fair and equitable manner with the members of the industry and to foster a cooperative mutual professional association in support of our nation's seapower.

- o Naval construction shall be conducted in private shipyards to the maximum extent consistent with the mobilization requirement for maintenance of Naval Shipyards and the capability of private yards to perform in a timely manner. Some new construction should be assigned to the Naval shipyards on a continuing basis.

- o The "lead ship-follow ships" technique should be employed. Unless military exigencies require otherwise, the first ship of a class should be substantially completed before the construction of other ships of the same class is begun

so that the class design is finalized and construction problems resolved before subsequent ships are partially completed. Every effort shall be made to insure that contract designs and specifications are complete and adequate prior to award of contract in order to minimize change orders.

• Ship construction contracts should be of a type appropriate to the level of risk involved in their performance: generally, cost type for lead ships and fixed price incentive type for follow ships. These contracts, especially the fixed price incentive type, should include escalation provisions which protect contractors against abnormal inflationary cost growth while maintaining discipline against real cost growth; they should provide for an adequate profit commensurate with the risk, investment and performance to yield a fair rate of return to the contractors and to maintain a viable shipbuilding industry.

• Oversight of government contractors, including requirements for cost reporting, financial audits, management reviews, and on-site inspections, shall be the minimum consistent with the Defense Department's obligation to the American public to safeguard its tax dollars. Surveillance for its own sake will not be tolerated.

• Ship acquisition program managers shall be given the necessary authority and responsibility to manage ships acquisitions effectively and efficiently. The program manager should be the man in charge of all aspects of an

acquisition program and should not be restricted by overlapping layers of authority. The on-site government representative (Supervisor of Shipbuilding) should be the direct representative of the program manager.

• The Defense Department should insure that contract disputes are settled or decided as speedily and inexpensively as possible consistent with equity and due process. The methods and procedures currently used by the Armed Services Board of Contract Appeals (ASBCA) should be examined to determine their effectiveness in accomplishing this goal. In addition, the Secretary of Defense and the Secretaries of the Military Services should examine other alternatives for the expeditious and inexpensive resolution of contract disputes.

• To improve and stabilize our ship acquisition planning program the DOD should request multi-year authorization of the Naval Shipbuilding Program from the Congress. With such planning, the Navy, together with MARAD, should inform the shipbuilding industry of their multi-year forecasts so that industry can plan its facilities and manpower projections in a more orderly fashion.

• The United States must adequately fund the Navy shipbuilding program that is deemed required to meet the demands of national security. With the U.S. Navy currently at its lowest level in number of ships since before World War II, it is essential that new ship programs go forward.

past
and failure of the Congress to provide for full-funding

Problems in acquisition management and unprecedented and unanticipated inflation have created a current situation where the Navy has on hand considerably less funds than are required to complete ships in FY 75 and prior year programs. The Defense Department, working with the Congress, must develop a straightforward solution to this serious problem.

The President's budget request for 1977 ~~has~~ provides full funding for these programs

VI. Current Plan and Activity to Exercise Authority of Public Law 85-804

Mr. Chairman, as I informed you in my letter of 2 April, I appointed on 30 March a Shipbuilding Executive Committee to guide and monitor all actions necessary by the Navy Department and to advise and assist me in the application of PL 85-804. This Committee is chaired by Mr. F. Shrontz, the ASD (I&L) and has as members

Mr. R. Wiley - General Counsel, Department of Defense
Mr. G. Penisten - Assistant Secretary of Navy (Financial Management)
Mr. Brehm - Assistant Secretary of Defense (Legislative Affairs)
Admiral Michaelis, USN, Chief Naval Material
VAdmiral R. C. Gooding, USN, Chief Sea Systems Command

This Committee has been very active since 30 March familiarizing themselves with the Navy's total shipbuilding program, with the contracts which are the subject of claims or requests for equitable adjustment, with the nature and content of the Request for Equitable Adjustments, and have been engaging in dialog with the three major contractors (Newport News, Electric Boat and Litton). Supporting the Committee is a working group chaired by RAdmiral LeRoy Hopkins, USN, the director of the Contracts Division of the Sea Systems Command.

My charge to the Committee directs that they examine those shipbuilding contracts entered into in the 1968-73 time period referred to previously to determine precisely how to reform them, and particularly to provide for escalation recovery which reflects current Navy Department shipbuilding contract practice notwithstanding the existing provisions of these contracts.

It appears now that it will require at least another 30 to 45 days for the Committee to accomplish its detailed study and negotiation with

the shipbuilders, make firm recommendations to the Secretary of Defense
and for me to make the formal PL 85-804 determination necessary to
implement the appropriate contractual actions. On this basis I would hope
to complete the formal PL 85-804 action on or about 15 June.

Mr. Chairman, I am mindful of the legal requirement to inform the
Committees of Armed Services of the Senate and the House of Representatives
in writing of PL 85-804 proposals to obligate the United States in any amount
in excess of \$25,000,000; and of the requirement for a period of 60 days of
continuous session of Congress to expire following the date on which such
notice was transmitted to such committees and neither House of Congress
has adopted within such 60 day period a resolution disapproving such
obligation. I have prepared such a written notice in the case of Newport
News, Electric Boat, and Litton which I will present to you and to the
chairmen of the House Armed Services Committee today. The letter notice
will not, at this time, be in definitive amount other than in excess of \$25
million. I ask the committee's indulgence to permit this procedure in order
that we may address the emergent nature of this serious threat to our
national defense as expeditiously as possible. I expect that by 15 May I
shall be able to inform you in more precise terms the amount of the proposed
obligations to be incurred under the proposed application of PL 85-804.

At this time I can advise you tentatively concerning the funding that will
be required to support this proposed action. In terms of the 1977 DoD budget
request you are currently considering, I believe DoD's original request for
\$320 million in FY 77 plus current SCN program assets of approximately

\$100 million may be sufficient to meet our needs through FY 77. I would suggest, however, that the bill's language concerning the purpose of the \$320 million should be made flexible enough so that it can be used for both claim settlement and increased escalation costs. The full funding impact of this extraordinary action both in its totality and in the identification of the out year pay-out increments is still to be determined. In any event, should my present evaluation of the immediate fund needs through FY 77 be less than the requirements that might develop, we will consider a supplemental budget request. Again, I would expect to advise you in more detail and with more certainty about 15 May 1976.

VII. Escalation Forms - The Old and the New

In applying the extraordinary broad authority of PL 85-804 I am mindful of the statement in the report of the Committee on Judiciary which accompanied the bill authorizing the making, amendment, and modification of contracts to facilitate the national defense, which became PL 85-804. The committee report stated:

"This broad power is designed to provide the flexibility required by the Government to deal with the variety of situations which will inevitably arise in a multi-billion dollar defense program and for which other statute authority is inadequate. By providing means for dealing expeditiously and fairly with contractors the enactment of this bill will help assure that vital military projects will proceed without the interruptions generated by misunderstandings, ambiguities, and temporary financial difficulties."

And while I think it may be necessary to restructure certain of our on-going shipbuilding contracts from fixed price incentive to a cost type, it is my present judgment that the largest part of the inequities which we recognize in on-going contracts signed in the period 1968-1973, can be overcome by a reformation of the provision for escalation. In doing this, the govern-

ment would be applying to these older contracts essentially the same type of escalation provision that has been written into new shipbuilding contracts since 1974.

Let me contrast the old escalation forms and the new types.

o The Old Type (the 1962 Standard Escalation Clause)

The traditional contractual provisions for escalation for the shipbuilding contracts were designed to sustain for the contractor the same incentives he would have under a firm fixed-price contract without escalation. Escalation or economic fluctuation is measured by a single labor index and a single material index. The labor index is computed and published by BLS based upon direct labor data input from approximately 21 different ship-builders spread around the entire nation. The material index is a weighted composite from the BLS publication "Wholesale Prices and Wholesale Price Indices." The weighting is as follows: 45% Iron & Steel; 40% General Purpose Mach. & Equip.; and 15% Elec. Mach. & Equip.

The bases for escalation payment are set forth in the contract schedule in a predetermined and fixed way. The mix of labor and material and the expenditure profile is determined prior to contract award and remains fixed throughout the entire contract period, except in the event of partial termination. Therefore, the only unknown relevant to the amount of escalation payments to be made is the movement of the relevant index.

To assure that the intent of the parties at the outset is not disrupted during the life of the contract, changes are priced as though there was no

provision for escalation in the contract, except, that in the event of a cost decrease change, consideration is given to the amount of escalation which might be paid on those decreased costs as a result of the change.

Provisions are made in the contract to assure that there is a control on the combination of escalation payments and progress payments to be made to avoid excessive payments - payments are limited to 105% of cost incurred, greater progress notwithstanding.

The clause does not cover any extension in performance beyond the original contract delivery date; and further, it does not cover work added by contract modification. Such price adjustments are made on the same basis as if the contract did not provide for escalation. In other words, labor and material adjustments will be priced on the basis of current estimates of the work covered by the modification involved. This procedure loses utility with unpredictable inflation and is further impacted by the long periods of time that must be anticipated in multi-ship contracts.

When the realities of a shipbuilding program are considered, the potential inequities of the clause become obvious. The clause can operate unfairly with respect to contractors in that

(1) it exposes the contractor to the risk of inflation whenever performance is extended;

(2) changed work is excluded from coverage under the clause thereby forcing the contractor to predict the effects of future inflation when pricing the changes;

(3) the consequential effect of the inflationary period of the early '70s which the contractors could not have been expected to predict and for which the present contracts offer no relief is the extended delivery periods for ship board equipment and materials. To the extent that these extended deliveries caused prices to be higher and to be paid to a later period and to the extent they caused ship construction to fall in a later time frame neither the escalation clause nor the original incentive pricing arrangement adequately protected the contractor.

To summarize, the "traditional" clause affords an adequate vehicle to compensate a contractor for changes in the cost of labor and material in an environment where either performance proceeds relatively in accordance with the expectations of the parties at the time they entered into the contract, or where the parties are able to agree promptly on the responsibility for variations from the scheduled performance, or where the level of the applicable BLS Index is relatively constant or changes at a rate predictable at the time the contract was executed.

During the Korean War period there was a steady percentage increase in the Material and Labor Index values of approximately 5% - 6%. For the next ten years the percentage increase in the Material Index was a very low 0.4% and while the Labor Index increased at a slightly greater rate the trend was a steady increase over a period of approximately 5 to 6 years. Starting in 1966 there was an increase in both Indices to approximately 5% to 6% but in line with a trend that the contractors had previously experienced and therefore would apparently have developed some degree of confidence in the

predictability of the trend. This period lasted for approximately six years.

Unfortunately, during the period 1973-74 none of these stable conditions have proved to be the case in Navy Shipbuilding Contracts. Performance of contracts was delayed for a variety of reasons but also for such uncontrollable events as the oil embargo, international economic dislocation following in the embargo, and raw material shortages. Simultaneously, and for many of the same reasons, the rate of increase in the BLS indices accelerated. The effect of these two factors on contractors was both to increase the likelihood of late performance as well as the contractual penalty it enacted in the form of increased costs of work in a later period which was uncompensated by escalation.

In mid-1972 an inflationary trend began that certainly was not predicted and for which there was no recent experience. During the years of 1973 and 1974 the Labor Index increased 8.8% and 12.6% while the Material Index increased 22.7% and 15.1%. The impact of these unpredictable changes in past trends had a significant impact on work performed in a time frame after the original contract delivery date for which the contractor could not be compensated by the escalation provisions of the contract. The forward pricing of work added by change orders could not be accomplished because of the lack of confidence in predicted labor and material prices.

In the past, although contractors had performed work after contract delivery dates, there was not a significant financial problem as long as there was only moderate predictable inflation. The "traditional" or formula method of paying escalation provided cash flow to the contractor

in some cases prior to the purchase of material. This positive cash flow and the positive aspects considering the time values of money ameliorated the economic and financial disadvantage of performing after expiration of contract escalation coverage. However, when the runaway inflation of 1973 and 1974 occurred, the contractors quickly found that the cash flow advantages of the old escalation clause was quickly overshadowed by the inflation rates experienced in the BLS indices.

o The New Standard Escalation Clause

In response to the inequities in the traditional clause, the Navy has developed in 1975 a new escalation clause for use in all new contracts, such as the FFG. This clause has the following general characteristics:

(a) Escalation is paid on the basis of actual expenditure phasing, as incurred, rather than on the basis of a pre-established and fixed phasing.

(b) Escalation is paid on the basis of allowable costs incurred not to exceed ceiling price rather than on the fixed basis of initial target cost.

(c) Escalation coverage does not cease on a date related to contract delivery date but continues to actual delivery date.

(d) For periods beyond the contract delivery date escalation is paid on the basis of the BLS index for the contract delivery date or the then current index value, whichever is less.

The approach in this clause has many advantages:

(a) It represents an equitable sharing of contract risk, consistent with the sharing inherent in an FPI contract.

(b) It reduces the need for contingency pricing which is consistent with the central purpose of basis DoD escalation policy.

(c) It supplements the delivery incentive provided through contract delivery provisions and basic contract incentive pricing through the "index ceiling" at contract delivery date.

(d) It more accurately reflects cost growth due to economic factors as opposed to lack of production efficiencies, etc.

(e) It provides an incentive for cost discipline through the use of an independent index.

(f) It limits the maximum amount of escalation to that based on costs not to exceed ceiling price.

Nevertheless, the Navy today has 11 major shipbuilding contracts which still contain the old escalation clause. These contracts include virtually every major combatant ship destined for the fleet of the 1980s and beyond. Additionally, the Navy has claims of \$1.7 billion outstanding from a total of more than \$3 billion in claims asserted against its shipbuilding contracts. I am satisfied that a major portion of these claims were generated directly or indirectly by this inequitable situation, and that shipbuilders will continue to pursue this laborious avenue of financial relief so long as the fundamental problem is not corrected. While it is not the policy of the Government to relieve contractors from the burdens of unprofitable contracts fairly entered into, neither is it in the Government's interest to persist in attempting to enforce contracts of such importance to the national defense when their terms have proven to be

unworkable. Economic events of recent years have far overtaken the pricing structures incorporated in these long-term contracts, and while new contracts will better protect the shipbuilders against such unanticipated business fluctuations, many years of performance still remain under these existing agreements. The litigious atmosphere and mutual distrust spawned by this situation has diverted the efforts of all parties from their primary job of constructing new naval vessels and seriously threatens the success of further shipbuilding construction programs being planned.

VIII Planned Steps to Improve Navy Shipbuilding Contracting and Contract Administration Procedures

While I believe forthright action utilizing the broad authority of PL 85-804 is the most effective immediate and essential step towards resolving the many current problems typified by the many claims and unsatisfactory business relations that exist between the Navy and the shipbuilders -- I believe also that we --(both the Navy and the shipbuilders) need to reform and improve our business and interpersonal relations and procedures if we are to make positive steps forward in the future and avoid the mistakes and sins of the past.

Senior Navy and OSD personnel have developed a plan in this regard that can be discussed in three parts:

1. Improving flexibility in contracting
2. Strengthening personnel staffing in project and procurement offices
3. Refinement and acceleration of Navy contract administration

IMPROVING FLEXIBILITY IN CONTRACTING:

The plans for improving flexibility in contracting have, for the most part, been drawn from contracting practices which have been tried experimentally and proven successful or from practices which have been generated to cope with inflation, shortages and other similar problems frequently confronting the Navy and its contractors under long term shipbuilding contracts.

The idea of greater flexibility in contracting rests upon the premise that risk sharing must at all times be fair. This means that in times of economic uncertainty such flexibility must afford protection for both contracting parties, that is, neither devastating losses on the one hand for the contractors, nor prices on the other hand that are unreasonable for the Government to pay.

Based on this approach, the following contracting policies and procedures will be more widely employed in the negotiation of prices, contract terms, and conditions at the time of award of new shipbuilding contracts.

(a) Economic Adjustment (Escalation) Clauses

The new escalation, already discussed in some detail, affords the contractor substantial protection for material and labor escalation over the performance period of the contract.

(b) Increased Ceiling Protection - Incentive Contracts

It is a well-known fact that there are very substantial technical, engineering and production risks in producing, today's complex combatant ships. The employment of higher ceilings, that is, higher target to ceiling spreads in incentive contracts, is therefore a means of recognizing these risks without shifting 100% of such risks to the Government. In other words, the contractor must continue to perform to a price even though that price expressed as a ceiling may be somewhat higher than was the practice in the 1960's during which the shipbuilding claims arose.

(c) Latent/Patent Defects Policy Covering Government-Furnished Data

This policy, which had been recently employed on an experimental or optional basis in Navy contracts, will be applied generally to all new contracts. The policy provides that a patent defect, that is, a defect which is discovered by the contractor in the bid or quotation turn-around period, will be corrected by the contractor and will be paid for in the negotiated price of the contract at time of award. A latent defect which would not be discovered until later during the performance period would be covered by a clause in the contract requiring the Navy to pay for the correction of the latent defect when it is discovered. This new policy supersedes a former policy of using disclaimer clauses which put the risk of such defects upon the contractor.

(d) Single Contingency Clause

This clause may be used in firm fixed-price contracts or in incentive contracts. The clause recognizes that a single contingency such as an upcoming union agreement or a possible energy interruption might have a major impact upon price. If such a clause is not employed, the contractor's only recourse is to put some contingency or protection in its quoted price. Then if the anticipated contingency does not occur, the contractor may receive a windfall. This clause would be used only where such anticipated events after time of award are very substantial in amount.

(e) Use of Fall-Back Options - Late or Defective Government-Furnished Property

This approach entails the idea of planning ahead of time for a fall-back option to another proven item of equipment should the preferred item of Government-furnished property prove to be defective, or so late as to have a devastating effect upon the overall shipbuilding program.

(f) More Realistic Delivery Schedules

In certain former cases, delivery schedules were either optimistic or were not attainable due to delays in the planning and award process or for other reasons. Because of the close tie-in between the delivery time frame and the adequacy of the pricing and economic adjustment or escalation clause terms of shipbuilding contracts it is imperative that realistic delivery schedules be adopted and that the contract pricing and escalation protection be premised upon such schedules.

(g) Use of Cost-Type Contracts for Lead Ships

In some cases, it will be desirable to contract for the lead ship of a class under a cost-type contract, in recognition of the very high risk associated with such contracts.

(h) Increased Delivery Time Interval Between Lead and Follow Ships

By increasing the delivery time interval between lead and follow ships, a more orderly transmission and communication interval will be provided for covering lead ship plans and all related interfaces and communications.

(i) Design Review by Follow Yards

In some cases it will be desirable and necessary to provide for design review by the follow yard, or by a potential follow yard under a separate design review contract. The result of this step is a verification of design feasibility and an excellent communication vehicle for early training, learning, and other related advance preparation where the design review yard in turn becomes the follow yard producer.

(j) Policy Covering Tailor-Making Other Clauses

In contracts of such long duration, complexity, and large dollar size, it is unrealistic to assume that standard clauses and terms will in all best serve to describe the mutual obligations and rights of the parties. It is the intent of this policy to encourage both contractors and contracting officers to innovate where necessary and to tailor-make special clauses where necessary to more clearly define the undertaking or the mutual obligations and rights of the parties.

In summary, the above items are descriptive of some of the more important procurement policy and procedure changes aimed at introducing greater flexibility and a more balanced risk-sharing into the Navy's future shipbuilding contracts. I am convinced that changes in this direction are essential to the timely achievement of the Navy's true shipbuilding needs as authorized by the Congress, and also essential to maintaining a viable shipbuilding industry in this country.

I think that the Navy has the procurement authority under present laws and Department of Defense regulations to undertake most if not all of these new or revised procurement policies and practices. To the extent that there are any implementing actions which may be required by the Department of Defense, I will initiate such actions promptly.

STRENGTHENING PERSONNEL STAFFING IN PROJECT AND PROCUREMENT OFFICES:

I am convinced that certain actions are necessary to strengthen personnel staffing at the senior level in the Navy's project and procurement offices. I am speaking both of military and civilian senior positions which are now unfilled because of previously directed reductions in military and civilian staffings and of some critical new positions which must be created to strengthen the Navy's project management, shipyard management, contracting officer, and negotiating capabilities.

While reductions in all of the Department of Defense components have been necessary, it is apparent that a thorough assessment of senior military and civilian capability must be made. This assessment must assure that each project and procurement office assigned to or covering a critical Navy program is adequately and properly staffed with senior personnel.

To carry this out I have been assured by the Navy that such an assessment will be made and that actions to carry out necessary

replacements or new assignments will be promptly accomplished. To the extent that any implementing actions are required by the Department of Defense to bring about this strengthening of senior military and civilian personnel staffing, I will initiate the necessary steps.

REFINEMENT AND ACCELERATION OF NAVY CONTRACT ADMINISTRATION CHANGES:

We are cognizant of several causes of claims which the General Accounting Office recently cited in its 1974 Report on Shipbuilding Claims:

- . Inadequate or defective specifications
- . Defective and late GFI and GFM
- . Unanticipated increases in quality assurance requirements
- . Failure to identify early potential claim problems

We hear that defective or inadequate specifications are major contributing factors to claims. I am directing the Navy to review actions taken to date to ameliorate this problem. I am asking for a detailed review of all past and pending claims; a clear identification of the reasons behind the specification defects and inadequacies that have occurred; an articulation of the lessons learned from these experiences; and a teaching of these lessons learned to the people who have a need to know, i.e., the Navy technical specification interns. I consider this an important action and will follow-up on its implementation.

We are going to plan ahead more effectively to reduce the impact of late and defective GFM that may occur. This is often a significant element in shipbuilding claims because of the complex sequential nature of shipbuilding which requires the availability of suitable equipment for timely installation.

By careful planning, we can avoid ordering systems which are beyond the state of the art, or where not avoidable, provide for alternative or fall-back options in the event that the GFM is late or defective. To minimize the employment of such options, I am recommending a comprehensive review of the Navy's GFM reporting system.

I want to minimize what contractors refer to as excessive Navy inspection. More specifically, contractors complain about how inspectors insist that contract work be performed in a certain way, or that additional work be performed, contrary to the contractor's protests. We certainly want a product that fully complies with the terms of the contract, but we don't want to see the unnecessary creation of constructive change orders under the guise of quality assurance. I will recommend that training programs be implemented providing guidance to Navy inspectors on the handling of situations involving contractor protesting the directions of Navy inspectors. Moreover, I will ask that quality assurance procedures be clearly defined with a view towards minimizing disputes involving the inspection system.

Finally, I believe there is more that we can do to identify potential claims-related trouble early enough in the contract performance



to facilitate its resolution. The Navy is already contractually obligating the contractor to notify the Navy when it feels an event has occurred giving rise to increased Navy-responsible costs. In this regard, the notification which must occur within a specified number of days permits early forward pricing and adjustment of this claim. I am requesting the Navy to refine this surveillance effort by establishing daily inspection teams to record and photograph claims-related events and to participate in timely and equitable adjudication of potential claims.

For the shipbuilding industry I would like to urge the following actions toward improving relations with the Navy.

(a) In a cooperative effort with the government seek to establish in a business-like manner, greater visibility between costs and work performed.

(b) Accept the fact that as one party to a contract, private shipbuilders share the responsibility for the excessively adversarial relationship that has existed. In the past ten or more years, many mistakes have been made on both sides of the table. In the public interest, industry and the government should strive to avoid such mistakes in the future.

(c) Prior to entering into a Navy shipbuilding contract, the shipbuilder should carefully review in detail the proposed contract delivery schedules and independently assess the realism of the schedule against his own capacity (i.e., facilities and manpower),



the state of his order book, and the projected availability of government furnished information and material. Shipbuilders should not contract to do work to a schedule that is impractical if not impossible.

(d) Of equal importance, shipbuilders should carefully examine the adequacy and completeness of the contract plans and specifications. They should raise questions and insist on amplification of the government's procurement proposals, where necessary, to enable the contractor to make a realistic bid as to price and time.

(e) Recognize that when a deliberate "buy-in" with an unrealistic bid is made, any attempt to "get well" via the "change-order" or claims route will be noted by the government and firm action taken to prevent unwarranted price adjustments.

(f) As an industry, work to improve the overall attractiveness of shipbuilding employment, and in concert with the government, increase the formal training programs (e.g., apprentice schools) offered nationwide so that prospects for available work force increases may be realized.

(g) Increase overall labor productivity. Display of multi-year building programs and encouragement of reasonable profits for capable firms should enable the shipbuilding community to increase overall productivity and reduce the extreme labor intensiveness of naval shipbuilding in the United States. Increasing labor productivity



would decrease shipbuilding cost susceptibility to wage rate inflation and would be beneficial for all parties.

IX. Conclusions:

Mr. Chairman, I hope I have covered the background, the current status, our present and future plans to resolve the numerous difficulties that beset the Navy's shipbuilding program. May I summarize briefly reasons why we in DOD must take the actions I have discussed in this statement and why I earnestly solicit the strong support of the committee to permit us to go forward.

. The national defense requires a strong Navy and we must have the shipbuilding industry working with us to efficiently complete our presently authorized programs and to be ready, able, and willing to undertake new authorizations for naval construction that are so sorely needed.

. The Navy is currently providing broad, equitable economic coverages in its major shipbuilding contracts. By recognizing the principle that equity will be served by backfitting this superior coverage to all major shipbuilding contracts, the government is effectively discharging its responsibilities in the partnership with the shipbuilding industry.

. Significant economic advantages will accrue to the Navy. Much manpower and other resources can be used in acquiring new ships that is currently involved in the complex and time consuming



claims processing procedures. Key Navy people, such as the ship acquisition program managers, the supervisors of shipbuilding, the functional and technical support personnel will be able to more readily to get in harness with the shipbuilders towards achieving the common goal of efficiently rebuilding the Navy.

. The current large backlog of shipbuilding claims should be resolved or cancelled.

. Future shipbuilding claims on these contracts will be minimized. Basic features of new escalation coverage provide strong deterrent to delay claims in the future. Anticipate release for all causes of claims on all affected contracts up through date of settlement.

Mr. Chairman, this completes my statement. I stand ready with my colleagues now to deal with your questions.

Thank you.

THE WHITE HOUSE
WASHINGTON

NOTE FOR MAX'S OFFICE

Mr. Marsh thinks there should be pre notices to the Hill concerning this, particularly to Price.

The above message was given to Nancy Kennedy by Donna Larsen

AUG 21 1976

THE WHITE HOUSE

WASHINGTON

August 20, 1976

MEMORANDUM FOR:

~~JACK MARSH~~
BRENT SCOWCROFT

FROM:

BOB WOLTHUIS *RKW*

SUBJECT:

President's DOD Supplemental Message

At the Senior Staff Meeting this morning Don Ogilvie gave me the attached letter from Chairman Mel Price of the House Armed Services Committee.

I suggest you review his letter before the President signs the Defense message. Chairman Price is very firm in his opposition to any further authorization and appropriation requests. Furthermore he states that to enact any new authorization after the May 15 Budget Act deadline requires the House Rules Committee to determine "that emergency conditions require a waiver of the Rule." Price says he believes that emergency conditions cannot be demonstrated.

If the purpose of the President's message is to secure enactment of the supplemental request then I'm sure you and the President will want to review Chairman Price's letter.



U.S. House of Representatives

COMMITTEE ON ARMED SERVICES

Washington, D.C. 20515

NINETY-FOURTH CONGRESS

MELVIN PRICE, CHAIRMAN

August 10, 1976

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FRANK M. SLATINSHER, CHIEF COUNSEL

The Honorable Donald Rumsfeld
Secretary of Defense
Washington, D.C. 20310

Dear Mr. Secretary:

I have carefully reviewed your letter of August 2, 1976 which requests a supplemental appropriation authorization for FY 1976 and FY 1977 and forwards certain general conclusions of the NSC with regard to our maritime strategy. In response, I offer the following views which, in my opinion, represent the views of the majority of the Members of the Committee on Armed Services.

The FY 1977 SCN Budget

In the most generous terms, the FY 1977 SCN budget requests can only be described as vacillating and confusing. As presented to the Committee in connection with the FY 1976 request, the FY 1977 SCN program included funds for 20 ships plus nine PHM vessels. We are aware that the Navy's request and indeed the approved DoD request at one time contained funds for additional FFG ships, an additional AO, and long lead funds for a carrier. We are also aware that the President, on November 22, 1975, ordered a \$6.8 billion reduction in the DoD request. Included in this action was the decision to fund the DDG-47 as the first AEGIS ship, the deferral of funds for the carrier, and the deferral of funds for an additional AO and AO.

As a result of the above actions, in January you presented a shipbuilding program to the Committee containing only 16 ships. During your appearance before the Committee, you indicated something less than satisfaction with the FY 1977 SCN program and stated that you might make further recommendations to the Congress later in the year. By letter of March 15, 1976, you advised that the appropriate structure of our naval forces was under study and that the study "should be complete within a few weeks", at which time you expected to be able to make recommendations on a five-year shipbuilding program.

The Congressional Budget Act of 1974 was applied for the first time with respect to the FY 1977 budget. The procedures and deadlines



established by the Act placed tremendous pressures upon the Committee. As you know, the Act established a March 15 deadline upon the submission of our Committee's recommendations to the Budget Committee as to the level of spending in the entire defense area. In order to present recommendations representing agreed upon positions of the Committee it was necessary to hold extensive hearings and mark-up sessions well in advance of March 15, which the Committee did. I am advised that, prior to the Committee's completion of mark-up of the FY 1977 authorization bill on March 9, Chairman Bennett of the Seapower Subcommittee telephoned the President imploring that the shipbuilding budget amendment be expedited because of the established deadlines. Our Committee reported the authorization bill on March 20, and it was passed by the House on April 9, 1976. The President, however, did not transmit his amended request to the Congress until May 10, 1976.

Action by the House

Having in hand a FY 1977 shipbuilding request which the Committee considered inadequate for the Navy's needs, our Committee reported a revised program which, in our best judgement, would address the air, surface and subsurface threat which your August 2 letter outlines. Our bill would have restored the Trident building schedule, and provided three additional support ships resulting in considerable future cost reductions. In addition, the bill contained the then unrequested funds for the carrier and AO, as well as funds for the BELKNAP conversion for which we had received no request whatever at that time. The House bill deleted the DDG-47 and four FFG frigates. We substituted a fourth SSN, four DD-963 class AAW ships and long lead funding for the LONG BEACH conversion.

As our Committee report (No. 94-967) points out, there was considerable opposition within the Committee to the authorization of any FFG frigates. An amendment to strike all of these ships during debate in the House was defeated by a vote of 37 to 56. An amendment to add four FFGs was rejected by voice vote.

At this point, I believe it is appropriate to comment on the great difficulty which the Committee experienced in receiving timely information during our hearings. While an abundance of information was made rapidly available with respect to the items contained in the original SCN request, we encountered a stone wall when we requested such things as the Navy carrier study, specific information on claims, vulnerability and engineering studies on the DDG-47 and the FFG, and shipbuilding capacity for ships not requested. Witness after witness refused to comment upon items not included in the President's budget request. The dogged opposition to all unrequested items contained in the House bill almost caused the loss of the carrier by an amendment which was defeated by a vote of 182 to 195. On balance, the obstacles which were placed before



the Committee only made our work more difficult and the result can only be considered as counterproductive to the Navy's shipbuilding program.

The FY 1977 Authorization Act

The FY 1977 Authorization Act, signed by the President on July 14, 1976, authorizes \$6.655 billion for 17 new ships, long lead funds for a fourth NIMITZ class carrier, and the conversion of LONG BEACH and BELKNAP. Included is \$1.6 billion for cost growth and escalation. This is the largest peacetime authorization for SCN in history.

This legislation resulted from a long and arduous conference which, at times, appeared to be completely deadlocked with respect to the shipbuilding program. The Senate Conferees were adamant against the CSGN, while the House Conferees were equally adamant against the DDG-47 and in favor of the LONG BEACH conversion. Also, the Senate Conferees insisted upon fully funding the \$1.6 billion cost growth and escalation items, as requested by the President, while the House Conferees opposed the creation of such huge unobligated balances. Thus, the resulting authorization act was a product of considerable compromises; compromises without which there would have been no FY 1977 Authorization Act.

The FY 1976, FY 1977 Supplemental Request

Your letter of August 2 requests the Committee to consider the following changes to the FY 1976 and FY 1977 Authorization Acts:

(in millions)

SCN authorized by P.L. 94-106	\$6,655.0
Add 4 FFG class	521.0
Add 1 DDG-47	858.5
Add CSGN LLT	170.0
Sub-total	<u>\$8,204.5</u>
Delete LONG BEACH conversion	371.0
Authorize BELKNAP in FY 1976 vice FY 1977	213.0
Total	<u>\$7,620.5</u>
Requested increase over P.L. 94-105 authorization	969.5

I will take this opportunity to discuss each of the requested actions.

Add \$520M for four FFG-7 Class

Having experienced the debate within the Committee, in the House chamber and in the Conference concerning the FFG-7 class frigate,

authorization of the eight ships originally requested was, in my view, a tremendous compromise of the House position. As our report on H.R. 12438 (No. 94-967) indicates, the Committee has great reservations about this program from both a military and cost effectiveness point of view.

The FFG-7, sold to the Congress as a "cheap ship", is tremendously expensive considering its size, weaponry, speed, vulnerability and lack of a future potential for modernization. I have expressed the Committee's concerns to Deputy Secretary Clements on several occasions. Notwithstanding the inclusion of 60 of these ships in your five-year shipbuilding plan, our Committee is not committed to this program beyond the 18 ships authorized to date.

Add \$858.5 for one DDG-47

After thorough hearings, which included the President's determination required by Title VIII of P.L. 93-365 and as much other material as we could obtain from DoD, our Committee unanimously rejected the DDG-47. The Committee's rationale for this action is set forth on pages 30-32 of our report. You may recall my letter to the President, dated January 14, 1976, in which I indicated the items of information and the comprehensiveness of that information which the Committee would require to satisfy both the spirit and letter of Title VIII of P.L. 93-365. If the DDG-47 is again proposed, we would expect compliance with the requests contained in that letter in formulating any new Presidential determination. As our report points out, the determination submitted previously contained a considerable number of errors and omissions which should be corrected before the program is again considered by the Committee.

Add \$170M for long lead items for one CSGN

The House Committee on Armed Services fully supported both the FY 1976 and FY 1977 requests for long lead funding of a nuclear powered strike cruiser (CSGN). While the House has authorized this program on two occasions, it was vigorously opposed by the Senate each time.

Delete \$371M for long lead
funding of USS LONG BEACH conversion

DoD opposition to the conversion of the LONG BEACH has never been satisfactorily explained to the Committee. It is most difficult to understand why the Department would not enthusiastically support the conversion of this ship, now 15 years old and almost useless in its present configuration, into a first line AEGIS ship configured as a strike cruiser. Nor has the Committee received satisfactory reasons, other than "fiscal reasons", for delaying the conversion of LONG BEACH until 1984, when the ship will be 23 years old and the costs will be much higher. The authorization and appropriation for the conversion of this ship to begin in FY 1977 removes the "fiscal reasons".

The Department should cease its opposition and proceed with this work without delay.

Fund USS BELKNAP Conversion in
FY 1976 instead of FY 1977 (\$213M)

Notwithstanding the fact that USS BELKNAP was damaged on November 22, 1975, the official request to fund its conversion was not forwarded to the Congress until May 10, 1976. Anticipating the need for an authorization for this purpose, our Committee recommended that \$213 million be included in the FY 1977 bill. The Senate Armed Services Committee recommended that the same amount be provided as a supplement to the FY 1976 authorization. The recommendations of their respective Committees were adopted by the House and Senate. Prior to these actions on the authorization bill, a similar situation existed with respect to the FY 1976 supplemental appropriations bill. The Conferees in that case adopted the position of the House and deleted the \$213 million from the supplemental appropriation. Faced with this accomplished fact, the Conferees on the authorization bill had little choice but to authorize funds for BELKNAP's conversion in FY 1977.

The funds authorized and appropriated for BELKNAP will become available for obligation on October 1, 1976. When one considers the time involved in passing supplemental authorization and appropriations bills containing controversial items such as the FFG, CSGN, and DDG-47, and having them approved by the President, it is doubtful that the funds would become available at an earlier date.

Summary

At this point, Mr. Secretary, I will summarize the primary reasons which, in my opinion, would make the passage of supplemental authorization and appropriations bills along the lines of your request most difficult.

First, each item included in the request has been considered during the FY 1977 authorization and appropriation process. The CSGN was rejected by the Senate. The DDG-47 was rejected by the House. The Conferees rejected both ships. While sentiment in the House was about equally divided between authorizing no FFGs and adding four of these ships, the Senate refused to add any of these ships when the President's May 10 request was before it. In addition, the House would not in my view rescind the authorization for the LONG BEACH conversion, and recission of the BELKNAP funds would serve no useful purpose. Since the reasons for the additional four FFGs and the BELKNAP existed prior to the original budget submission in January, and I understand the FFGs were in the budget at one point, there is no good reason for considering them now as a supplemental.

Second, the situation has not materially changed since the authorization bill was adopted and signed into law. No new compelling

information or reasons have been supplied to the Congress which requires an add-on of nearly a billion dollars to the FY 1977 authorization.

While we appreciate receiving the preliminary information developed by the NSC, there is nothing new in this information whatever. It is merely a repetition of the testimony already in the Committee's files and serves to confirm the findings of our staff following its inspection of the fleet last October.

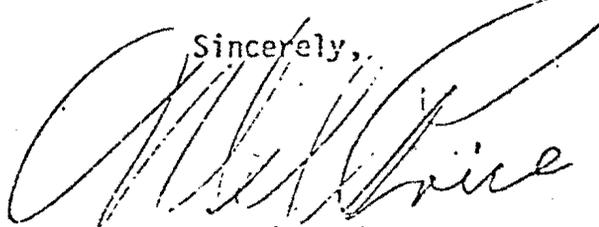
Based upon the lack of full compliance with Title VIII and other factors previously outlined, the House would in all probability reject the DDG-47 as an AEGIS ship. I have seen no evidence that the Senate is, at this time, more receptive to the CSGN.

Also, the NSC study has not been made available to the Congress, and from all indications that study is not yet complete. For this reason, the mix of ships, the five-year shipbuilding plan, and the future role of attack carriers are matters which must receive the Committee's attention in connection with the FY 1978 budget. It is my hope that, in the spirit of cooperation, any studies will be made available to the Committee as soon as they are completed and that those who prepared them will be made available as witnesses.

Third, the Committee is bound by section 402 of the Congressional Budget Act of 1974. This provision states that the House may not consider new authorizing legislation reported subsequent to May 15 unless the Committee on Rules "determines that emergency conditions" require a waiver of this rule. The Senate has a similar rule requiring the adoption of a waiver resolution to be originated in the Senate Budget Committee. I do not believe that "emergency conditions" can be demonstrated in order to obtain a waiver.

I hope that this very long letter will serve to explain some of the difficulties which attend your request, and some of the primary reasons why I cannot foresee a favorable outcome for such legislation.

Sincerely,

A large, stylized handwritten signature in black ink, appearing to read 'Melvin Price'.

Melvin Price
Chairman

MP:akw