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The Secretary of the Navy's Proposal To Modify the SSN-688 Ship Construction Contracts with Electric Boat Division of General Dynamics. August 3, 1978. 76 pp. + enclosure (46 pp.).

Testimony before the House Committee on Armed Services; by Jerome H. Stolarow, Director, Procurement and Systems Acquisition Div.

Contact: Procurement and Systems Acquisition Div.

Organization Concerned: Department of the Navy; General Dynamics Corp.; Electric Boat Div.

Congressional Relevance: House Committee on Armed Services.

Authority: P.L. 85-804.

The Secretary of the Navy has proposed to reformat two contracts with General Dynamics Corporation (Electric Boat Division) for the construction of 18 SSN 688 class submarines in order to facilitate the national defense. The contractor planned to stop work on the 15 submarines not yet delivered to the Navy because of anticipated nonreimbursable costs of \$843 million. The Secretary's action would increase the contract price and pay for costs incurred by unanticipated inflation and other factors. In exchange, the contractor agreed to accept an anticipated loss of approximately \$359 million and to waive current and pending claims under the contracts. The proposed actions of the Secretary are within the authority conferred by P.L. 85-804; the settlement is apparently necessary to maintain the construction of the submarines, and it would appear that it could not be negotiated within the terms of the contract. Electric Boat's first major claim was for \$220 million in 1975, and the second major claim was for \$544 million in 1976. In addition, the contractor was reportedly preparing additional claims in the range of \$750 million. It appears that every ship claim has been due to a combination of causes--partly the contractor's responsibility, partly the Government's responsibility, and partly due to factors outside the control of the contracting parties. The following alternatives have been considered by the Navy: complete construction at other shipyards, exercise the default clause in the contract, seek a court order to compel the contractor to complete the work, and buy the shipyard and hire a contractor to operate. None of the alternatives is feasible.

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Statement of
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ACQUISITION DIVISION
before the
House Armed Services Committee
on
The Secretary of the Navy's Proposal to
Modify the SSN-688 Ship Construction
Contracts with Electric Boat Division
of General Dynamics

Mr. Chairman and Members of the Committee:

We are pleased to appear here today to discuss the action which the Department of the Navy proposes to take to provide financial relief to General Dynamics Corporation under two ship construction contracts.

Secretary of the Navy Claytor pointed out in his formal letter of notification to this Committee on June 22, 1976, that he intended to use the authority of Public Law 85-804 to reform two contracts with the General Dynamics Corporation (Electric Boat Division) for the construction of 18 SSN 688 class submarines in order to facilitate the national defense. The Secretary said that the contractor planned to stop work on the fifteen submarines not yet delivered to the Navy because it anticipated it would incur non-reimbursed costs of \$843 million. The Secretary's proposed action will increase the contract price and pay the contractor for costs caused by unanticipated inflation and other factors. In exchange for this action the contractor agreed to accept an anticipated loss of approximately \$359 million and to waive current and pending claims under the contracts.

In connection with this matter you asked us to provide answers to a number of specific questions. These are provided as an attachment to this testimony and we will submit them for the record.

I would now like to highlight several significant matters dealing with the following:

- the legal authority of the Secretary to implement Public Law 85-804,
- the contracts in question,
- the claims and efforts to settle them,
- causes of increased costs resulting in claims,
- estimated costs to complete the contracts,
- ability of General Dynamics to absorb losses,
- potential cost to the Navy if the settlement proposal is adopted, and
- alternatives to the proposed settlement under Public Law 85-804.

We have two significant points that we particularly wish to call to your attention:

1. We believe the Committee should be aware that the settlement amounts are by no means fixed. The obligation of both the contractor and the Government could vary substantially from the estimates presented.
2. The amounts presented both for costs incurred to date and total costs to complete, are subject to question.

LEGAL AUTHORITY

Public Law 85-804 provides that the President may authorize any department or agency of the Government which exercises functions in connection with the national defense to enter into contracts or amendments or modifications of contracts, without regard to other provisions of law, whenever it is determined that such action will facilitate the national defense. Although the use of extraordinary contractual relief to keep contractors

who are in a loss position from going out of business is one means of facilitating the national defense, neither Public Law 85-804 nor its implementing regulations require such a showing as a prerequisite for its use.

The Act is an extraordinary relief measure, broad in scope, and is generally used in instances where no other authority is available. A grant or relief to a contractor under the Act is to be allowed or denied at the discretion of designated officials. No agreement obligating the United States in an amount in excess of \$25 million can be entered into unless the Committees on Armed Services of the Senate and House of Representatives have been notified in writing of such proposed obligation, and neither House of Congress adopts a resolution disapproving such obligation within 60 days of continuous session of Congress following the date of transmission of the notice.

In our opinion, the current proposed actions of the Secretary of the Navy are within the authority conferred by Public Law 85-804. The settlement negotiated with Electric Boat is apparently necessary to maintain the construction of the 688 Class submarines - and it would appear that it could not be negotiated within the terms of the contract.

CONTRACTS FOR SSN 688's

Electric Boat was the principal designer of Navy submarines for many years. In 1970 the Navy decided to develop

an alternate design capability for submarines and did so by designating Newport News Shipbuilding as the design agent and lead-yard for the SSN 688 class of submarines. Electric Boat was selected as the follow-yard and was awarded two contracts for 18 submarines. The first contract, awarded in January 1971, was for seven submarines; and the second contract, awarded in November 1973, was for 11 submarines.

Both contracts are fixed-price-incentive type and provide for escalation payments over and above the contract price. The original contract ceiling prices were \$428 million for the first group of 7 boats and \$847 million for the second group of 11 boats for a total of \$1.275 billion - or an average of about \$71 million per submarine. The ceiling prices have increased to \$1.476 billion since that time. The increases resulted from 3,449 modifications to the contract including a settlement of \$97 million on a claim under the first contract and a provisional payment of \$66.5 million on claims under both contracts.

THE CLAIMS AND EFFORTS TO SETTLE THEM

First Major Claim

Electric Boat submitted its first major claim on the first contract on February 14, 1975, for \$220 million. The principal basis of the claim was that defective and late Government furnished design data caused ship delivery extensions and additional work not covered by the original pricing. That claim was settled on April 7, 1976, for \$97 million and the contract was modified to extend delivery dates for a total of 84 months.

Proposed Use of Public Law 85-804 In 1976

After that settlement and before another claim was submitted by Electric Boat, the Deputy Secretary of Defense proposed on April 30, 1976, the use of Public Law 85-804 to settle anticipated claims from Electric Boat and claims from three other shipbuilders. He blamed unanticipated inflation as the cause of many of the claims and proposed revising the escalation clauses in the SSN 688 contracts estimating that this would result in payments of an additional \$178 million to Electric Boat. At that time the shipbuilder was estimating a loss of \$142 million under the two SSN 688 contracts. Although Electric Boat showed a willingness to accept the proposal, it was withdrawn by the Government because other shipbuilders were not willing to accept similar settlements.

Second Major Claims

On December 1, 1976, Electric Boat filed \$544 million in claims under the first and second contracts. The claim under the first contract was for \$121 million and covered purported Navy caused actions occurring from May 21, 1975, through October 31, 1976. The principal basis of this claim was delay and disruption caused by design changes. In addition, the contractor alleged that costly rework and ship completion delays occurred at Electric Boat because a reasonable interval between the lead-ship at Newport News and the first follow-ship at Electric Boat was not maintained.

The claim under the second contract was for \$423 million and was based on delay and disruption resulting from delays on the first contract. In addition, the contractor alleged that costs had increased due to unsuitable design data.

The Navy Claims Settlement Board completed its evaluation of the \$544 million in claims in January 1978 and valued them at \$125 million. Before a settlement was reached, General Dynamics notified the Navy on March 13, 1978, of its intention to discontinue work on the SSN 688 submarines on April 12, 1978. The contractor later agreed to extend the stop-work dead-line until June 11, 1978, in exchange for provisional price increases of \$66.5 million under the two contracts and an immediate cash payment of \$25 million. This deadline was waived by the contractor because of the Secretary's proposed agreement.

Anticipated Claims

In addition to the claims mentioned above the Navy reported that the contractor was preparing additional claims in the range of \$750 million.

CAUSES OF INCREASED COSTS RESULTING IN CLAIMS

As you know, the construction of naval vessels is a complex process. There are a multiplicity of reasons why cost growth occurs, including, but not limited to:

- overly optimistic original estimates
- unanticipated inflation
- poor design drawings and specifications
- change orders
- late delivery of Government-furnished equipment
- poor shipyard management

--low rates of labor productivity and inability to attract experienced labor.

While the causes are known, it is extremely difficult to assess the cost impact of each and to ascertain to what extent the Government and the contractor should each be held responsible. It is almost certain, in our opinion, that every ship claim that has arisen during the past several years was due to a combination of causes--partly the contractor's responsibility; partly the Government's responsibility; and partly due to factors outside the control of the contracting parties.

Given the inability to accurately determine financial responsibility for the cost growth, it forces the parties to negotiate a somewhat arbitrary settlement.

In this case, the Navy agrees with Electric Boat that some increased costs were caused by Navy actions but states that other increased costs were caused by poor contractor management as well as causes beyond the control of either party. For example, Navy officials believe the contractor (1) grossly underestimated the man-hours required to build the submarines at the time the contracts were negotiated, and (2) overestimated its ability to hire additional skilled labor. The Navy also says that the contractor underestimated the complexity of the SSN 588 and was unable to control manpower and productivity effectively.

In a press release the contractor stated that the Navy imposed more than 35,000 revisions to drawings used in

constructing the SSN 688 submarines (about 6 revisions per drawing) which caused tremendous cost growth because of delay and disruption to the production line. Although the Navy generally agrees with the contractor as to the number of revisions per drawing, it contends that the number of revisions should have been expected by Electric Boat since it had experienced about the same number on prior submarine construction programs. For example, Electric Boat was the design agent for the SSN 637 class submarine which required about 42,000 revisions for the approximate 8,000 drawings involved, or about 5 revisions per drawing.

ESTIMATED COSTS TO COMPLETE THE CONTRACTS

General Dynamics has estimated that the 18 SSN 688's will ultimately cost a total of \$2.668 billion to complete, or \$843 million more than the \$1.825 billion allowed under the contracts. The settlement proposed by the Secretary is based upon the current estimated cost to complete but the actual cost at completion can vary substantially. It is therefore essential to determine the reasonableness of the estimated cost to complete.

The estimate submitted by the contractor consisted of actual costs incurred, plus projected costs to completion. Although the actual costs incurred can be verified through an audit, the estimated future costs are based on several key assumptions as to future happenings. To determine the reasonableness of these assumptions as well as confirming the costs incurred, the Secretary hired the independent public

accounting firm of Coopers and Lybrand. Coopers and Lybrand issued a report to the Navy, on June 19, 1978, dealing with its review of the estimated cost to complete the contracts and the impact which a significant loss would have on the contractor.

Review of Costs Incurred

In its estimate, the contractor reported \$1.341 billion of costs incurred under the two contracts as of December 24, 1977. In its report, Coopers and Lybrand said it confirmed the costs incurred as of December 24, 1977, with Arthur Andersen and Company the contractor's independent auditors. Coopers and Lybrand also stated that it compared the costs incurred figures to the contractor's internal work-in-process reports and data which the contractor provided to the Navy Supervisor of Shipbuilding located at the shipyard. However, Coopers and Lybrand did not state whether all of the \$1.341 billion of reported costs were allowable under the terms of the contracts because of the Armed Services Procurement Regulation or other agreements between the Navy and contractor.

During our visit to the shipyard our staff learned that the Defense Contract Audit Agency resident auditors located at the shipyard had not reviewed the accuracy and allowability of the \$1.341 billion of reported costs incurred because the Navy had not asked them to do so. We felt that such a review was needed to assure that costs reported by the contractor were not overstated since that would in turn inflate the newly proposed contract price and thus increase the Government's obligation.

We, therefore, contacted Navy officials and suggested they request DCAA to conduct such a review. The Navy adopted our suggestion and on July 27, 1978, asked DCAA to determine the amount of allowable costs incurred under the contract as of December 24, 1977.

The DCAA completed its review and issued a report dated August 1, 1978, in which it questioned the allowability of about \$36.8 million of the \$1.341 billion of costs. The final determination as to the allowability of these costs rests with the contracting officer, the Armed Services Board of Contract Appeals, or the courts. If these costs, or any portion thereof are found to be unallowable, the Navy's proposed contract price will be overstated by the amount of the unallowable costs. Because of the nature of the current settlement, this can result in the Navy's paying a portion of the costs that would otherwise be born by the contractor.

We suggested to the Navy that the proposed settlement be modified to reflect the unallowable costs, but Navy officials felt it was too late to make an adjustment. While we do not agree with the Navy's position, we do recognize that this is an extra-legal settlement, and that the amounts paid to the contractor are a compromise. In this context, it can be argued that the issue of unallowable costs is irrelevant.

Review of Costs to Complete

The most critical areas concerning the estimate of costs to complete the SSN 688 contracts involve assumptions about

labor costs since this is a large unknown cost; the estimates for overhead are also sensitive to these assumptions since overhead rates are applied to labor costs. Assumptions concerning materials are not considered critical as most materials needed for the completion of the work have already been acquired or are under firm commitments.

General Dynamics' independent auditors - Arthur Andersen - and the firm hired by the Navy - Coopers and Lybrand - found that several of the assumptions upon which the labor hours and labor rates are based are optimistic in light of the contractor's recent experience. The estimate of cost at completion was compiled assuming 7 percent labor rate increases each year. Recent Electric Boat wage settlements have averaged 10.7 percent annually. The difference between the recent labor rate increase experience and the 7 percent rate used for the estimate to complete amounts to more than \$110 million for labor and overhead. Coopers and Lybrand found that the 7 percent rate was used in order to conform with the Administration's inflation predictions.

Two critical assumptions involved in the estimate of labor hours - the attrition rate and the skill mix level - are also considered optimistic in light of recent Electric Boat experience. It was not possible to directly relate the cost estimate to these assumptions because Electric Boat has not directly correlated the detailed assumptions to the cost estimate.

General Dynamics has stated that all of its assumptions must prove correct if its \$2.668 billion cost to completion estimate is to be achieved.

GENERAL DYNAMICS' ABILITY TO ABSORB LOSS

Under the proposed settlement, the estimated loss to the contractor on the SSN 688 contracts is \$359 million.

In its report to the Navy, Coopers and Lybrand concluded that based on an estimated \$2.67 billion to complete the two SSN 688 contracts, General Dynamics could even sustain the entire \$943 million estimated loss and remain solvent if its lenders would agree to either waive or revise certain existing minimum loan covenants. Coopers and Lybrand did not speculate on the maximum loss General Dynamics could absorb if the lenders did not agree to waive or revise the loan covenants.

POTENTIAL COST TO NAVY IF THE SETTLEMENT PROPOSAL IS ADOPTED

The proposed settlement amount includes escalation at a rate of 7 percent for labor and overhead, and 6 percent for material. The proposed settlement agreement also provides that the Navy will pay the contractor separately for escalation beyond those rates and will reduce payments to the contractor for escalation below those rates. The rate of escalation is based on the index published by the Bureau of Labor Statistics (BLS).

If the contractor completes the contract at or below the current estimated cost of completion and the labor and overhead escalation rate throughout the construction period does

not exceed 7 percent and the material escalation rate does not exceed 6 percent, the Navy would be required to pay the contractor no more than \$484 million (\$125 million for the value of the current claim plus \$359 million of payments under Public Law 85-804).

If the actual cost to complete the contracts exceeds the estimated cost by \$100 million or more and if the labor and overhead escalation rate through the construction period exceeds 7 percent, the Navy may be required to pay the contractor \$534 million (\$125 million for the value of the current claim, \$359 million of additional payments under the revised contract price and \$50 million for the Navy's share of the contractor's costs in excess of estimated costs) plus, \$31 million for every 1 percent that the labor and overhead escalation rates exceed the 7 percent rate provided for in the contract estimate.

In addition to the above payments, the Navy will also pay separately for about \$3.9 million of changes which have not been adjudicated as of June 9, 1978, and any changes to the contract after that date. Furthermore, the Navy would be required to negotiate the settlement of any additional claims filed by the contractor after June 9, 1978.

ALTERNATIVES TO THE PROPOSED
SETTLEMENT UNDER PUBLIC LAW 85-804

Navy officials have considered several alternatives, other than reforming the contracts under Public Law 85-804, to assure construction of the remaining SSN 688 submarines. Among these alternatives are the following:

- complete the construction at other shipyards,
- exercise the default clause in the contract,
- seek a court order to compel the contractor to complete the work, and
- buy the Electric Boat shipyard and hire a contractor to operate it.

Use Other Shipyards

The Navy does not believe the submarines could be completed on any reasonable schedule unless Electric Boat continues construction. It claims only one other private shipyard has the capability to construct nuclear submarines and the backlog at this yard precludes it from accepting additional work for delivery in the next several years. In addition there are very high risks in transporting incomplete hulls in the open sea and subassemblies that cannot be disassembled for transport without irreparable damage. Also a tremendous administrative burden would be involved in inventorying and documenting hundreds of millions of dollars of material.

The Navy believes it would be feasible to construct only 3 of the remaining submarines at the few Navy shipyards capable of doing this work because of the capacities, workloads, and capabilities of the yards. Over three thousand additional personnel would have to be hired at Navy shipyards for this work and large capital investments would have to be made.

Default Clause

The Navy does not believe it is feasible to take over and manage the construction of the submarines under the default clauses in the contract. Assembling a large new management force would be a difficult task. Sufficient supervisory personnel could not be obtained from Navy shipyards on short notice. The labor force available to the Navy would be composed primarily of employees furloughed by Electric Boat following its stoppage of work. These would be the least experienced and least productive personnel as they would have the lowest seniority.

Because Electric Boat is still under contract for the TRIDENT program there would be inevitable conflicts in assigning priorities for commonly used facilities and services in the shipyard.

Obtain a Court Order to Force Completion

If General Dynamics stopped work and the Navy sought a court order to compel the contractor to complete the submarines it might result in the court ordering the Navy to pay the contractor's costs pending settlement of the claims as previously happened in the Litton claims on the LHA contract. This would require the Navy to spend large additional funds and would result in a long legal struggle causing a disruptive relationship with a major defense contractor. The Navy does not consider this course of action desirable.

Government-Owned Contractor-Operated Yard

The Navy does not consider purchasing the shipyard and hiring a contractor to operate it as a course of action which would facilitate the construction of the SSN 688 submarines in a reasonable timeframe. The Navy believes there would be difficulties in arriving at an overall price for the yard resulting in disputes and serious delays which could be as expensive and time consuming to settle as the claims on the SSN 688 contracts. In addition, the Navy believes there would be no incentive for the contractor to negotiate the lowest possible labor rates to perform work under the cost type contracts which would be used in a Government-Owned Contractor-Operated shipyard environment.

Mr. Chairman, this concludes my prepared statement. We will be happy to answer any questions you have at this time.

THE CONTRACTQUESTION

1. Please provide the Committee with a history of the two SSN 688 contracts with Electric Boat including but not limited to target and ceiling prices and any modifications.
2. How does the contractor justify its growth in claims pertaining to the SSN 688 contracts.

ANSWERAward of Contracts

The SSN 688 class submarine construction program at Electric Boat Division consists of 18 ships awarded under two contracts, hereafter referred to as the first and second flight contracts. On January 8, 1971, the first flight contract N00024-71-C-0268 was awarded to Electric Boat for the construction of seven SSN 688 class submarines. On November 1, 1973, the Navy awarded the second flight contract N00024-74-C-0206 to Electric Boat for the construction of seven additional SSN 688 class submarines with an option for the award of up to four additional submarines. On December 10, 1973, the Navy exercised the option and increased the number of submarines under the second flight contract to eleven.

The ships were to be built from drawings to be supplied by the lead-yard, Newport News. The original target and ceiling prices for both contracts are shown in the following table, and provided for an average ceiling unit price of about \$71 million per submarine.

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	<u>First Flight (7 ships)</u>	<u>Second Flight (11 ships)</u>	<u>Total</u>
Target Price	\$412,943,238	\$769,923,000	\$1,182,866,238
Ceiling Price	428,074,000	846,780,000	1,274,854,000

Both contracts are fixed-price incentive with escalation. Under the pricing arrangements of the two contracts the Government pays for all costs included in the target price and the contractor and Government share costs incurred between the target price and an amount known as the point of total assumption. Beyond the point of total assumption the Government does not share in costs incurred and the contractor absorbs any additional cost from his profit. When costs reach the ceiling price the contractor's profits are completely exhausted and any additional cost becomes a loss.

As of May 31, 1978, there have been 3,449 changes or modifications to the contracts as shown in the following table.

	<u>First Flight</u>	<u>Second Flight</u>	<u>Total</u>
Priced	2,200	635	2,835
Unpriced	<u>506</u> <u>2,706</u>	<u>108</u> <u>743</u>	<u>614</u> <u>3,449</u>

Priced modifications have resulted in net increases to the contracts target and ceiling prices of \$189,507,791 and \$200,857,369 respectively. These increases include the settlement of a claim on the first flight contract for a \$93,571,552 target price increase and a \$97 million ceiling price increase. Also included is a \$66.5 million provisional ceiling price increase for the current unsettled claims. As

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of May 31, 1978, the target and ceiling prices were as shown in the following table and provided for an average ceiling unit price of \$82 million per submarine (or an increase of \$11 million per submarine since the original contract price).

	<u>First Flight</u>	<u>Second Flight</u>	<u>Total</u>
Target Price	535,299,252	837,074,777	1,372,374,029
Ceiling Price	554,956,629	920,754,740	1,475,711,369

Submission of Claims

Electric Boat has submitted two claims under the first flight contract. On February 14, 1975, the company submitted a claim in the amount of \$220,330,000 that was subsequently reduced to \$199,582,000. The principal basis of the claim was that defective and late Government furnished design data resulted in ship delivery date extensions and additional work not covered by the original contract bid.

Late and inaccurate Navy furnished design agent data was alleged to have produced both program and local type disruption and to have required extensive subcontracting to mitigate schedule slippages. Electric Boat alleged that the detailed design data developed by the design agent was unsuitable in that it was more complex and required more work than, as an experienced shipbuilder, Electric Boat could have been expected to include in its bid which was based on the preliminary design information in the contract bid package. As a result of the late and inaccurate design data, Electric Boat claimed schedule delays totaling 84 ship months and

associated delay costs for the seven ships under the first flight contract.

The claim was settled for an increase in the contract ceiling price of \$97 million on April 7, 1976. As part of the settlement Electric Boat released the Government from liability for all events, with limited exceptions, occurring on or before May 20, 1975, insofar as they affected the performance of the first flight contract. Electric Boat reserved its rights under the first flight contract for Government responsible events occurring after May 20, 1975, and all of its rights under the second flight contract without limitation. In addition, Electric Boat agreed to submit by December 1, 1976, any further claims on the first flight contract for events after May 20, 1975, and any claims it might have on the second flight contract.

On December 1, 1976, Electric Boat submitted its second claim on the first flight contract for approximately \$121.3 million for events that occurred during the period of May 21, 1975, through October 31, 1976. On the same date, Electric Boat submitted a claim on the second flight contract for approximately \$422.6 million for Government responsible acts and omissions both before and after May 20, 1975. The total value of these two claims is approximately \$544 million.

The basis of the claim on the first flight contract is delay in ship deliveries and disruption costs because of

design changes received by Electric Boat subsequent to May 20, 1975. Electric Boat also alleged that failure to maintain a reasonable interval between the lead ship at Newport News and the first follow ship at Electric Boat resulted in costly rework and ship completion delays.

The basis for the claim on the second flight contract is delay and disruption costs resulting from delivery delays of first flight ships.

On March 13, 1978, General Dynamics notified the Navy of its decision to discontinue work on April 12, 1978, on the remaining 16 SSN 688 submarines under construction at its Electric Boat Division. General Dynamics alleged that the contracts for these ships had been materially breached by Navy actions. Subsequently, General Dynamics agreed to extend the stop-work deadline for a period of 60 days through June 11, 1978, provided that the Corporations' negative cash flow on the two contracts for that two month period would be essentially eliminated.

As a result of discussions between officials of General Dynamics and the Navy, the prices of the two contracts were provisionally increased by \$66,500,000. This included \$12,600,000 under the first flight contract and \$53,900,000 under the second flight contract. The contractor received an immediate cash payment of \$25 million which essentially eliminated the Corporation's negative cash flow on the two contracts for the two month period. These provisional increases were based upon the Navy Claims Settlement Board's analysis of the previously submitted claims.

THE CONTRACTQUESTION

3. Methods of compensation and modifications thereto.
4. How much compensation has Electric Boat received under the SSN 688 Contract in progress payments against the ceiling price and for undisputed or adjudicated changes? For escalation? How much was paid pursuant to court orders?
5. Has compensation received by Electric Boat exceeded the ceiling price? The amounts specifically authorized for the SSN 688 program? If so, what is the source of funds?

ANSWER

Payments against the contract price on both contracts are based on the percentage of physical progress, but limited to costs incurred less a fixed percentage withheld by the Government. Payments on both contracts include amounts for escalation which is calculated separately from progress payments against the contract prices. Adjudicated changes are included as increases in the contract prices and are paid according to the percentage of physical progress on the contracts. There have been no modifications to either contract that would have altered the methods of compensation to the contractor for either progress payments or escalation payments.

Payments to General Dynamics as of May 31, 1978, have not exceeded the ceiling price or the amounts appropriated for the SSN 688 program.

The following chart shows the amounts paid by the Navy through May 31, 1978, on the contracts. Included in these

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amounts are provisional payments against the current claim of \$10,706,400 for the first flight contract and \$15,102,486 for the second flight contract.

	<u>First Flight</u>	<u>Second Flight</u>	<u>TOTAL</u>
Progress Payments	\$473,304,998	\$257,760,617	\$ 731,065,615
Escalation	<u>93,901,703</u>	<u>158,223,288</u>	<u>252,124,991</u>
Total Payments	<u>\$567,206,701</u>	<u>\$415,983,905</u>	<u>\$ 983,190,606</u>

The ceiling price on the first flight contract as of May 31, 1978, was \$554,956,629 plus escalation of \$93,901,703 for a total of \$648,858,332. The ceiling price includes \$97 million for the settlement of the initial \$199.6 million claim, \$12.6 million for a provisional price adjustment on the unsettled \$121.3 million claim and \$17,296,620 on other contract changes and modifications.

The ceiling price on the second flight contract as of May 31, 1978, was \$920,754,740 plus escalation of \$158,223,288 for a total of \$1,078,978,028. The ceiling price includes \$53.9 million for a provisional price adjustment on the \$422.6 million unsettled claim and \$19,961,061 in other contract changes and modifications.

THE CONTRACT

QUESTION

6. Any assumptions of responsibility by General Dynamics Corporation of the obligations, duties, and liabilities of the Electric Boat Division.

ANSWER

The Electric Boat Division is not a separate corporate entity but is a part of the General Dynamics Corporation. Therefore, Electric Boat's obligations, duties, and liabilities are General Dynamic's obligations, duties, and liabilities.

THE CONTRACTQUESTION

7. Claims, litigation, and other actions pending or anticipated in the courts, ASBCA, Navy Claims Settlement Board, or others.

ANSWER

Electric Boat Division submitted a Request for Equitable Adjustment of \$220,300,000 on the first flight contract on February 14, 1975. The request was subsequently amended, in the amount of a target cost increase of \$199,582,000. The principal basis of the claim was that defective and late government furnished design data resulted in ship delivery extensions and additional work not covered by the original contract pricing.

On April 7, 1976, a negotiated settlement was reached with Electric Boat for an increase in the contract ceiling price of \$97,000,000 and an extension of contract delivery dates by 84 ship months. In addition, Electric Boat agreed to a release for all causes of claims as of May 20, 1975, on the first flight contract, with limited exception to the release for outstanding formal contract changes, special contract articles such as nuclear identification and unknown government furnished equipment defects. Also, Electric Boat agreed to submit by December 1, 1976, any further claims it may have on the first flight contract, for events after May 20, 1975, and any claims it may have on its second SSN 688 contract.

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On December 1, 1976, the Electric Boat Division of General Dynamics filed approximately \$544 million in claims under these two contracts. This included a claim of \$121,310,990 under the first flight contract that covered events that occurred during May 21, 1975, through October 31, 1976. The basis of the claim is delay in ship deliveries and disruption costs based on the effects of design changes received by the contractor. The claim also alleges failure to maintain a reasonable interval between the lead ship and the first follow ship at Electric Boat resulting in costly rework and ship completion delays.

A claim of \$442,568,739 was filed covering the second flight contract. The basis of this claim is delay and disruption costs resulting from delays of SSN 688 Class first flight ships. Electric Boat also alleged increased costs due to unsuitable design data and an inadequate escalation recovery provision in the contract.

On March 13, 1978, General Dynamics notified the Navy of its decision to discontinue work on April 12, 1978, on the remaining 16 SSN 688 submarines under construction at its Electric Boat Division. General Dynamics alleged that the contracts for these ships had been materially breached by Navy actions. Subsequently, General Dynamics agreed to extend the stop-work deadline for a period of 60 days through June 11, 1978, provided that the Corporation's negative cash flow on the two contracts for that two month period would be essentially eliminated.

As a result of discussions between officials of General Dynamics and the Navy, the prices of the two contracts were provisionally increased by \$66,500,000. This included \$12,600,000 under the first flight contract and \$53,900,000 under the second flight contract. The contractor received an immediate cash payment of \$25 million which essentially eliminated the Corporation's negative cash flow on the two contracts for the two month period. These provisional increases were based upon the Navy Claims Settlement Board's analysis of the claims.

In addition to the above filed claims, the Navy reported that General Dynamics was preparing additional claims under the contracts in the \$750 million range.

Furthermore, the contractor has sought the following Administrative Remedies from the Armed Services Board of Contract Appeals to appeal contracting officers decisions:

1. Appeal of Electric Boat Division, General Dyanmics Corporation, ASBCA Number 21823

Filed: February 28, 1977

Subject: Appeal from decision of the Contracting Officer dated February 10, 1977, that certain overhead amounts for 1973 and 1974 are unallowable costs which may not be billed on the contracts. The dollar amount applicable to the SSN 688 contracts is \$8,905,028.

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History: This case has been consolidated under ASBCA case number 21737, (filed January 21, 1977) which deals with unallowable overhead.

Status: Discovery proceedings are underway. The Board will try the issue of entitlement, not the amount.

2. Appeal of Electric Boat Division, General Dynamics Corporation, ASBCA Number 22417

Filed: October 11, 1977

Subject: Appeal from Decision of the Contracting officer dated September 19, 1977, that certain overhead amounts for 1975, are unallowable costs which may not be billed on the contracts. The dollar amount applicable to the SSN 688 contracts is \$16,576,669.

History: This case has been consolidated under ASBCA case number 21737, (filed January 21, 1977), which also deals with unallowable overhead.

Status: Discovery proceedings are underway. The Board will try the issue of entitlement, not the amount.

THE CONTRACTQUESTION

8. Why is it necessary to invoke the extraordinary provisions of Public Law 85-804?

ANSWER

This authority is referred to as "extraordinary" because it explicitly gives the President statutory power to authorize any department or agency of the Government to amend national defense contracts without consideration, that is to say, without receiving anything specific of value in return, "whenever he deems that such action would facilitate the national defense."

Thus, a contract amendment increasing the price of a contract may be made, without regard to any "other provision of law relating to the making, performance, amendment, or modification of contracts." It is a basic rule of Government, as well as private, contract law that contracts (and amendments or supplemental agreements) must be based upon an exchange of consideration, the so-called "quid pro quo." Public Law 85-804 completely overrides this basic rule, so long as the action taken would "facilitate the national defense."

Executive Order No. 10789, implementing Public Law 85-804, states, however, that amendments "may be with or without consideration."

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The short answer of why is it necessary to use this extraordinary power in the General Dynamics case is that no other clear, legal authority exists to permit the action proposed by the Secretary of the Navy. The payments to be made to the contractor exceed the currently established ceiling price.

Section 2307 of title 10, U.S. Code, authorizes the Secretary of the Navy to make "advance, partial, progress, or other payments under contracts made by the [Navy]." (Emphasis added.) However, such payments "may not exceed the unpaid contract price." Since anticipated costs of completing the contract exceed the original ceiling price, the Secretary of the Navy has no authority under this statute, 10 U.S.C. §2307, to make the payments in question. This is the only statute of which we are aware that permits provisional payments.

The only other legal theory that occurs to us that could conceivably avoid use of Public Law 85-804 would be an amendment to the contract provisionally increasing the contract price by an amount sufficient to cover the cost of completing the submarines, with that amendment subject to subsequent downward adjustment. This, arguably, could then provide the Secretary of the Navy with authority to make payments pursuant to 10 U.S.C. §2307. A basic principle of Government contract law is that an officer authorized to make a contract for the United States has the implied authority to negotiate modifications in the provisions of that contract where it is clearly in the

best interests of the United States to do so. Also, of course, the Navy's contracts provide for unilateral or bilateral modifications.

However, it is also well recognized that no officer or employee of the Government may modify a Government contract in favor of another party, or surrender or waive a vested contract right of the Government, absent a compensating benefit to the Government. Our Office and the courts have generally required more than mere nominal consideration in exchange for the modification of a Government contract. Instead, it has generally been maintained that the Government should receive "compensating" or "adequate" benefit for a contract modification.

Therefore, if the Navy were to attempt to modify contracts, under authority other than Public Law 85-804, a question would arise as to the adequacy (or existence) of the consideration.

In short, such action might be under a legal impediment. Moreover, it would not afford the Congress the degree of oversight and immediate right of disapproval afforded by Public Law 85-804. Therefore, such action would seem fraught with possible legal difficulties and would not appear to be a prudent action for the Secretary to take. In our opinion, the current proposed actions of the Secretary of the Navy are within the authority conferred by Public Law 85-804.

THE CONTRACTQUESTION

9. Is the obligation which the Department of Defense will incur "within the limits of the amounts appropriated and the contract authorization provided therefore?"

ANSWER

The proposed settlement with General Dynamics will cost the taxpayer about \$484 million more than the contracts currently provide. Of this additional cost, the Navy has made provisional contract modifications as of April 5, 1978, to pay \$66.5 million, leaving \$417.5 million to go. Also, the Navy will require an additional \$194.2 million to pay a similar settlement on the LHA and DD 963 contracts with the Ingalls Shipbuilding Division of Litton Industries.

The Navy has only \$404 million in funds specifically available for these contract reformations leaving a shortfall of \$207.6 million. The Navy proposes to provide the additional funds by reprogramming \$325.6 million in the Fiscal Year 1979 DOD Budget Request. (The Budget Request had originally marked these funds for a nuclear submarine procurement). According to the Navy, if the reprogramming action is approved, the funds would be applied to the General Dynamics and Litton Industries settlements and any excess not needed for these particular settlements would be held in reserve for settlements of claims on other shipbuilding contracts.

CLAIMSQUESTION

10. How many drawing revisions were made to the SSN 688 class of submarine? Can they be readily categorized as to significance e.g., clerical errors, omissions, major ripout, etc.?

ANSWER

As of April 14, 1978, the Navy had issued through its design agent 37,353 revisions to the SSN 688 drawings. Electric Boat personnel stated that with this large number of changes there are many different types, and to categorize them would confuse their real importance and impact. Electric Boat personnel further stated that it is the cumulative effect of the changes, i.e., the impact of this many change documents on the contractor's engineering and production control and the construction process which has caused the problem.

The Navy advised us that drawing revisions are issued for a number of reasons which include incorporation of design improvements, correction of errors, clarifications, authorization of shipbuilder proposed alternate construction methods, and acceptance of fabrication mistakes. The Navy further stated that although there were over 36,000 drawing revisions to the SSN 688 submarine - or about 6 revisions per drawing - the number of revisions is in line with experience in other submarines programs. For example, the Navy claims that the SSN 637 Class submarine which was designed for the Navy by Electric Boat had experienced about 5 revisions per drawing. It added that there have been comparable numbers of revisions

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per drawing for other recent ship designs. Consequently, the number of SSN 688 drawing revisions is consistent with past Navy shipbuilding experience.

FINANCIAL CONDITION OF GENERAL DYNAMICSQUESTION

11. Please provide the Committee with copies of General Dynamics' most recent 10-K and 8-K filings with the SEC.

ANSWER

Copies of the most recent, Securities and Exchange Commission forms 10-K and 8-K filed by General Dynamics Corporation are being provided for the record. The Committee asked for the 10-K and 8-K for Electric Boat. However, Electric Boat is a division of General Dynamics Corporation and is included in the consolidated financial statements filed with the Commission.

FINANCIAL CONDITION OF GENERAL DYNAMICSQUESTION

12. Has Electric Boat/General Dynamics received an audit by independent accountants within the preceding calendar year? If so, what was the accounting firm's opinion of EB's overall financial position?

ANSWER

Arthur Andersen and Co., Certified Public Accountants, examined the balance sheets and the related statements of earnings, shareholder's equity and changes in financial position of General Dynamics Corporation and subsidiaries as of December 31, 1977, and as of December 31, 1976.

In its report, Arthur Andersen and Company stated that its opinion was subject to the final resolution of the SSN 688 problems as follows:

". . . the financial results of the Corporation's SSN 688 program are dependent upon the recovery through present and future claims or other settlements from the U.S. Navy of the costs at completion in excess of anticipated revenues from the current contracts (the excess is presently estimated at \$840 million assuming an annual inflation rate of about 7 percent over the projected six years to complete the contracts). It is not possible to determine at this time the final resolution of this matter or the effect, if any, on the accompanying financial statements.

In our opinion, based upon our examination and the reports of other auditors referred to above, and subject to the final

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resolution of the matter referred to in the preceding paragraph, the accompanying financial statements present fairly the financial position of General Dynamics Corporation and subsidiaries as of 31 December 1977, and 31 December 1976, and the results of their operations and the changes in their financial position for the years then ended, and the supporting schedules present fairly the information required to be set forth therein, all in conformity with generally accepted accounting principles consistently applied during the periods."

The complete accountants report is included in the form 10-K annual report which we will provide to the Committee.

FINANCIAL CONDITION OF GENERAL DYNAMICSQUESTIONS

13. What is the cash flow position of EB/General Dynamics?
14. Do factors, other than shipbuilding, contribute to a cash flow problem?
15. Is EB, in the opinion of the Comptroller General, now bankrupt or in danger of bankruptcy?
16. Without relief under Public Law 85-804, or otherwise, could EB complete its SSN 688 contracts and remain a viable contractor for future defense work?
17. What is the profit and loss condition of EB, and what effects would the Navy's proposed settlement actions, whether or not under Public Law 85-804, have on the shipbuilder's overall profitability and on its profits and losses on SSN 688's?

ANSWERS

The Navy contracted with the public accounting firm of Coopers and Lybrand to conduct an analysis of General Dynamics Corporation's financial forecasts for the years 1977 through 1981. They concluded, based on the forecasted financial statements provided by General Dynamics and the analyses they performed on those data, that General Dynamics appears to possess the financial ability to continue performance on the SSN 688 contracts on the basis of an estimated \$2.67 billion cost of completion. In other words, General Dynamics could absorb the entire estimated loss if Public Law 85-804 action were not

adopted as long as the Corporation's lenders agreed to either waive or revise certain existing minimum loan covenants.

Coopers and Lybrand stated that if the claim remains unsettled as of December 1979, their analysis indicates that short-term borrowings of \$138 million are expected, an amount which is within the limits of the Corporation's existing \$150 million line of credit. In addition, if the claim remains unsettled as of December 1979 and General Dynamics "worst case" conditions are realized, \$220 million in short-term borrowings could be required in 1979.

Coopers and Lybrand concluded that considering General Dynamics' relatively strong debt-to-equity position, extensive near-term funded backlog, potentially profitable F-16 and Trident contracts, and the Corporation's estimated potential short-term bank borrowing capacity, it appears that General Dynamics could negotiate the required funding. Additionally, if required, General Dynamics appears to be capable of borrowing on a long-term basis for the reasons cited above, even though the Corporation has stated that it is reluctant to do so.

Coopers and Lybrand also concluded that based on an estimated \$2.67 billion cost of completion on the two contracts, and assuming that General Dynamics was required to recognize a loss on the SSN 688 contracts of \$774 million in 1978, General Dynamics would remain solvent if its lenders would agree to either waive or revise certain existing minimum loan covenants.

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Coopers and Lybrand assumed that \$774 million is the maximum loss which General Dynamics would sustain on the SSN 688 contracts under a \$2.67 billion cost at completion. This loss level was derived by subtracting the current contract ceiling price from the new estimate of cost at completion, as adjusted by the \$66.5 million provisional contract price increase provided by the Navy.

If General Dynamics were required to recognize a loss of \$774 million on the SSN 688 contracts, according to Coopers and Lybrand's analysts, it could be expected that the largest volume of short-term bank borrowings required would be \$138 million in 1978, which is well below the Corporation's estimated potential short-term borrowing capacity of \$375 million. However, the \$200 million minimum working capital requirement included in an existing \$75 million credit agreement is expected to be broken if General Dynamics recognized a loss of approximately \$400 million. The minimum owner's equity covenant is expected to be broken if a loss of approximately \$700 million were recognized. Thus, if General Dynamics's lenders would agree to waive or revise certain minimum loan covenants, Coopers and Lybrand believes the Corporation should be able to sustain even a \$774 million loss and remain solvent.

If the amount of the recognized loss were less than \$774 million, short-term borrowing requirements would be expected to be reduced due to the infusion of cash from the Navy both at the date of the settlement and over the remaining life of the SSN 688 contracts.

Coopers and Lybrand also analyzed the profitability of the Electric Boat Division alone. They analyzed the return on net assets employed, that is, the return on the investment of General Dynamics in Electric Boat. They concluded that the return on net assets for the Electric Boat Division is forecasted to increase from 1977 through 1981.

FINANCIAL CONDITION OF GENERAL DYNAMICSQUESTION

18. What is the validity of the statement that as of February 28, 1978, Electric Boat had spent \$400 million of its own funds on construction of SSN 688's and that it was losing about \$15 million a month on these contracts?

ANSWER

As of February 28, 1978, Electric Boat's records show that incurred costs under the SSN 688 program exceeded payments received by \$389.3 million as summarized below.

	<u>Contract</u>		<u>Total</u>
	<u>-0268</u>	<u>-0206</u>	
	(in millions)		
Incurring costs	\$835.3	\$459.4	\$1,294.7
Payments received	<u>537.7</u>	<u>367.7</u>	<u>905.4</u>
Unreimbursed expenditures	<u>\$297.6</u>	<u>\$ 91.7</u>	<u>\$ 389.3</u>

An analysis of Electric Boat's records for the 6 months ended February 28, 1978, also disclosed that Electric Boat's unreimbursed expenditures averaged \$16.7 million a month on the SSN 688' contracts.

The total SSN 688 program cumulative unreimbursed costs decreased by \$12 million to approximately \$377 million at the end of April 1978. Navy projections indicate that the total cumulative unreimbursed costs will stabilize in the range of \$380-385 million through September 1978 which indicates only minimal additional investment by Electric Boat during this period of time. The reduction in the previous unreimbursed cost increase of about \$16.7 million per month is primarily

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due to the effects of the April 1978 \$66.5 million provisional price increase, lower overhead rates, reduced manning and release of performance reserves for ship deliveries.

FINANCIAL CONDITION OF GENERAL DYNAMICSQUESTION

19. What was General Dynamics position in 1976 on the Public Law 85-804 proposal?

ANSWER

A letter of understanding dated May 21, 1976, was signed by General Dynamics and the Department of Defense. A proposed contract modification was to be executed subject to (1) Congressional review required pursuant to the provisions of Public Law 85-804, and (2) availability of appropriations. Following is a summary of the major provisions of the proposed modification.

1. New contract delivery dates were to be established for all 18 submarines covered by contracts N00024-71-C-0268 and N00024-74-C-0206.

2. A new escalation article and associated payments provisions, which represent current NAVSEA shipbuilding contract escalation policy, were to be substituted in both contracts.

3. The modification was to provide for lump sum pricing of a portion of the outstanding changes on the two contracts. For future adjudications, changes were to be priced in base month dollars with escalation to be paid on the changed work.

4. Electric Boat was to provide the Government with a claims release for all events up to the date of this agreement on the two contracts.

5. Other Issues: In order to form a basis for a continued effective business relationship, resolution of the following

open issues were to be provided for in the modification.

These issues included:

(a) An Electric Boat agreement to commence demonstration of a cost/schedule control system that would meet the requirement of DOD INST 7000.2 by 14 June 1976.

(b) An Electric Boat agreement to accept Government disallowance of all costs associated with two outstanding DCAA actions.

Although Electric Boat showed a willingness to accept the above proposal, it was withdrawn by the Government because it was intended to be a "package deal" for four shipbuilders but not all of the other three shipbuilders were willing to accept the proposal.

GENERALQUESTION

20. What other alternatives are available to the Navy or the Department of Defense to assure the construction of the remaining SSN 688's? Is the alternative which the Secretary of the Navy has chosen to pursue the least costly alternative?
21. Are any Navy shipyards capable of finishing construction of any three SSN 688's now under contract at EB? What would it cost the Government in terms of facilities improvements, increased hiring, etc., to enable any Navy shipyard to accomplish this work?
22. Would the addition of this work to any Navy yard hamper any overhaul and repair work currently underway or projected at that yard or at any other Navy shipyard?

ANSWER

Navy officials have considered several alternatives other than reforming the contracts under Public Law 85-804 to assure completion of the remaining SSN 688's. Among these alternatives are the following:

- complete the construction at other shipyards,
- exercise the default clause in the contract,
- seek a court order to compel the contractor to complete the work, or
- buy the Electric Boat shipyard and operate it as a Government-owned contractor-operated facility.

Have the Vessels Completed at Other Shipyards

The Navy believes that the technical, legal, contractual, and financial obstacles to completing the submarines at other

shipyards would delay their completion for years, thereby jeopardizing the national defense.

In addition, difficult problems would be encountered in moving the submarines. The Navy believes the size (360 feet long) and weight of these submarines are such that they cannot be moved by any means other than ocean towing. But because these ships are uncompleted submarines, designed for submerged operations, they are just barely seaworthy when being towed on the surface. In 1967, the Navy attempted to tow a smaller nuclear attack submarine of the SSN 637 class, USS FOGY (SSN 680), from New York Shipbuilding where the contract was terminated, to the Ingalls Shipyard in Pascagoula, Mississippi. Three tow-lines broke, and the ship several times narrowly escaped breaking up and sinking. Each submarine of the SSN 698 class is larger and even less tow-worthy than the FOGY; towing even one to another yard would be an extremely difficult and hazardous task.

Disassembly and removal of submarines that cannot even float would be equally difficult. In the Navy's opinion, the act of disassembly and transportation would inevitably damage many items so irreparably that they could not be reassembled at all. Documenting the disassembly and reassembly would itself be a difficult and complex task.

According to the Navy, it would be necessary to inventory and document hundreds of millions of dollars worth of material and to search and categorize every record in the yard for those

applicable to the 688 class. The documentation problem would be exacerbated by the requirement, as part of the Navy's "subsafe" program, to trace many of the components of these ships through every stage of fabrication from extraction of the raw material to the finished product, lest defective materials cause disaster at sea. According to the Navy, a new contractor would have to spend large amounts of time simply getting ready to begin construction unless it were already qualified to construct similar submarines (only one other yard is so qualified--Newport News Shipbuilding and Drydock), and even then all the problems of transition would remain.

The Navy believes the inevitable delays introduced into the process would have a very deleterious effect on much of the material already procured. Sensitive parts can become defective simply from long shelf storage without use; the alternative of frequently operating such parts to keep them operational also puts wear on them, and can be very time-consuming and expensive. Metal parts can rust or deform during long storage, and other materials can similarly age simply sitting on the shelf.

Even if the Navy were to devise a plan for the construction of these submarines at another shipyard, there are only two alternatives: a yard that is now qualified to build such ships or one that can become qualified. In order for any shipyard to be qualified to engage in nuclear ship construction, it must have both the necessary nuclear facilities and personnel trained and qualified in the complex requirements

of nuclear construction and testing. Yards that engage in nuclear work have found it necessary to segregate their different trades personnel into separate shipyard organizations in order to carry out the shipyard's numerous responsibilities in a satisfactory manner. Such organizations of experienced personnel cannot be quickly mobilized and qualified, and they are expensive both to establish and to maintain. Given the current relatively low nuclear ship construction rate and the Navy's desire to minimize costs by keeping sufficient work in each nuclear shipyard, nuclear construction capacity now exists in only two shipyards, Electric Boat and Newport News Shipbuilding and Drydock Company. Newport News, which is building the thirteen SSN 688 class submarines not under construction at Electric Boat, is therefore the only yard other than Electric Boat now qualified to build such ships.

Newport News's contractual commitments preclude its accepting additional nuclear submarine construction work for delivery in the next several years. Based on Newport News's capacity and contractual commitments, the Navy believes Newport News could not deliver any additional SSN 688 submarines to the Navy (i.e., beyond those already under contract at Newport News) until 1984 at the earliest. Since the next SSN 688 now under construction at Electric Boat is due for delivery this June, a transfer of the Electric Boat ships to Newport News would cause a delay in delivery of more than five years. Weaving the almost-completed Electric Boat submarines into the Newport News schedule might appear to offer an accelerated

rate of delivery, but in fact any time apparently saved in delivering some ships earlier would be lost in later years because of delays to ships which are in earlier stages of construction. Further, the Navy's commitment to a 90-ship nuclear attack submarine force requires construction of SSN 688 class ships beyond those already under contract. If ships currently under construction at Electric Boat were to be moved to Newport News, that contractor would be unable to build those additional ships for which the Navy is now planning.

If Electric Boat were to stop work, an alternative to Newport News constructing the submarines would be to develop another qualified source for these ships. Again, the problems and time loss involved would be extremely large. At a conservative estimate, it would take a minimum of three years for any shipyard to qualify to do this work and begin to do it. Given this long time-lag, it is likely that much of the material and documentation at Electric Boat would become lost, deteriorated or, at the least, very disorganized. Further, in the early stages of construction any newly qualified yard would be far slower and less efficient than the yards that are qualified at present, and this would introduce additional delay into the construction process. The increased cost of constructing one of these ships in a new shipyard would be large. Among the many contributors to increased cost would be: (a) the capital investment in facilities necessary to construct these vessels; (b) the cost of training workers to develop skills necessary

for nuclear submarine construction; (c) extra labor costs attributable to the inefficiencies that always occur in building a new type of ship; and (d) the inflation-related increases in all costs that will result from performing the construction work that was to be performed by Electric Boat in a later time-frame. These elements of additional cost are difficult at best to estimate; however, the Navy believes, based on the experiences of Electric Boat and Newport News, that the costs of learning-related inefficiencies alone (item (c) above) will substantially exceed one hundred million dollars and may approximate two hundred million.

Another alternative is to use a Navy shipyard to construct the submarines. The Navy believes that only the last three submarines on which the least work has been done could be economically completed in Navy shipyards because of the costs involved, the capacities, workloads, and capabilities of the Navy yards. The Navy's Mare Island Yard is considered the most suitable for completing these submarines. Nuclear submarine overhaul work being done at Mare Island would have to be transferred to other Navy yards and a \$30 million capital investment would be necessary to make it suitable to the SSN 688 construction.

Assignment of three SSN 688 submarines to Mare Island would also require Navy shipyards to increase personnel ceilings by

more than 3,000 by the end of fiscal year 1982. This level of employment would have to be sustained through fiscal year 1984.

In addition, all of the problems of documentation and transfer of equipment mentioned for the private shipyard alternatives would occur.

Exercise the Default Clause

If the Navy attempted to exercise its contractual rights under the default clause to construct the submarines at Electric Boat yard with Electric Boat tools and equipment, very serious administrative difficulties would be encountered. The Navy believes it is not equipped to take over and manage a new-construction yard of the size and complexity of Electric Boat's and, has never done so before. Furthermore, even if the Navy were to move in and attempt to construct the SSN 688 submarines at that yard, this effort would inevitably interfere with the Electric Boat's contract for construction of the larger and vitally important TRIDENT submarines.

According to the Navy the situation would not be such that the Navy could merely replace certain Electric Boat managerial personnel with Navy personnel and order work to continue. Rather, the Navy would first have to assemble and organize "from the ground up" a large force of management and labor personnel to replace the Electric Boat personnel affected by the work stoppage. Before any physical work on the ships could begin, it would be necessary for the Navy to establish a management and supervisory organization with an estimating,

planning, production control, quality control, and material management capability sufficient to enable the Navy to determine the precise status of the work when it was stopped by Electric Boat and the effort which would be required to complete the work. These personnel would then have to determine the initial work scopes, material requirements, sequencing of work and the type and number of tradesmen required so that work could be resumed in an orderly manner. In addition, the Navy would have to establish its own procedures for inspection, quality control, material management and a myriad of other functions inherent in the construction of large naval vessels. It would then be necessary to obtain the services of skilled tradesmen to perform the work. This would require an organization to establish positions, prepare position descriptions, classify position descriptions, advertise vacancies, rate applicants, determine the security clearance of each individual and actually hire the thousands of trademen who would be needed, assuming they were willing to work for the Navy.

In addition to the above mentioned organizational efforts, which pertain to preparing for physical construction of the ships, the Navy would also have to create an organization for handling financial matters and a contracts organization capable of placing orders for materials, equipment and services with vendors and subcontractors. Further, it would have to determine the status of in-process purchase orders, bids,

subcontracts and the like. In many cases, the Navy would have to negotiate with existing subcontractors for delivery of materials and components which the subcontractors might otherwise be unwilling to deliver to the Navy since their contracts would be only with Electric Boat.

In summary, before work on the ships could begin again, the Navy would be required to establish a large and entirely new organization to plan and manage the construction effort. The Navy has never undertaken to establish such a comparable organization in a contractor's shipyard, particularly a shipyard with operations as extensive as Electric Boat's.

Besides lacking any experience in creating the organization necessary to build ships in the yard of a contractor who has stopped work, the Navy believes it lacks the capability to create and operate such an organization within any reasonable period of time. Although the Navy has a number of shipyards of its own, a transfer of their management and supervisory personnel to the Electric Boat yard in the numbers necessary to staff and operate the yard would substantially impair the ability of the Navy's shipyards to carry out their assigned missions. In addition, the present SUPSHIP Groton organization, which is the Navy entity most familiar with Electric Boat's facilities and operations, is organized and staffed only for the purpose of administering and monitoring the Navy's contracts with Electric Boat. It lacks the expertise and manpower to assume management responsibility for the SSN 688 class construction program.

Based on the above discussion, the Navy does not believe it has the capability of establishing within any reasonable period of time an organization capable of constructing the SSN 688 class ships in Electric Boat's shipyard. The large scale of effort which would be involved in establishing such an organization and lack of prior Navy experience in this regard makes it impossible to estimate the amount of time which would be lost before the Navy was ready to resume construction.

Even if the Navy were somehow able to establish the required management organization, it would still face extremely large obstacles to the efficient construction of the ships. Besides the fact that new management and supervisory personnel would inevitably make mistakes, it is quite possible that labor difficulties would be experienced. First of all, the labor market on which the Government would have to draw would most likely be composed primarily of employees furloughed by Electric Boat following a work stoppage on the SSN 688 class ships. It is not unreasonable to expect that these individuals would be the least experienced and least productive of the tradesmen presently employed by Electric Boat, since in accordance with the existing labor contracts between Electric Boat and the trades unions, the individuals lowest on the seniority lists would be terminated first. Therefore, the overall level of productivity and rate of progress would be expected to be lower than it is with the present Electric Boat workforce. The foregoing, of course, assumes that the Navy will

be able to hire the required number and types of tradesmen. There is, however, no assurance that this would be the case. In addition, the Navy is not a party to the existing labor contracts between Electric Boat and the various trade unions. It is unlikely that a suitable agreement could be negotiated between the unions and the Navy within any reasonable time. Further, it is not possible to predict the ability of separate Navy and Electric Boat organizations to maintain uniform work rules concerning their separate work forces or the effect of different work rules on productivity, morale and labor relations between the unions, Electric Boat and the Navy.

Even if the Navy were able to assemble the necessary labor force, additional serious problems would remain. For example, there is an intermingling at Electric Boat's yard of certain plant facilities, tools and machinery between the TRIDENT and SSN 688 construction programs. These items would still have to be shared by these two programs. Assigning priorities for the use of these items between the two programs would be an extremely difficult process and would almost inevitably lead to disputes and delays in both programs. Wherever adversely affected by such sharing, Electric Boat would undoubtedly submit delay and disruption claims under the TRIDENT program contract. For example, dual crews would be assigned to use the same machine shop machinery in the same timeframes to accomplish different tasks. The result would be utter confusion in the performance of both tasks, if they could be accomplished at all. Since utility services would, of necessity, continue to be

provided by Electric Boat, some method of cost allocation between the two construction programs would have to be devised. It is impossible to predict how this could be accomplished in a manner suitable to both parties. A similar allocation would have to be made for other common services, such as security and custodial services. Also, since SSN 688 class construction material and equipment would be stored in Electric Boat warehouses, Navy personnel would have to become completely familiar with Electric Boat's storage system and records. Merely inventorying the items in stock and on order would be a large task in itself.

Finally, the degree of cooperation which the Navy could expect from Electric Boat is uncertain. If Electric Boat chose to be uncooperative, it is likely that any Navy ability to construct the SSN 688 class ships could be severely diminished. It is impossible to predict how long it would take the Navy to construct and deliver the ships. In the Navy's opinion, deliveries would occur substantially later than if construction were continued by Electric Boat without any significant interruption.

Obtain a Court Order to Force the Contractor to Complete the Work

If General Dynamics were to stop work on the contracts and the Navy sought a court order to force General Dynamics to complete the submarines it might result in the Court ordering the Navy to pay the contractor's costs pending settlement of the claims as in the Litton case. In the Navy's opinion a long

legal struggle would ensue causing a disruptive relationship with a major defense contractor.

Government-Owned Contractor-Operated Yard

The Navy does not consider purchasing the shipyard and hiring a contractor to operate it as a course of action which would facilitate the construction of the SSN 688 submarines in a reasonable timeframe. The Navy believes there would be difficulties in arriving at an overall price for the yard resulting in disputes and serious delays which could be as expensive and time-consuming to settle as the claims on the SSN 688 contracts. In addition the Navy believes there would be no incentive for the contractor to negotiate the lowest possible labor rates to perform work under the cost type contracts which would be used in a Government-owned contractor-operated shipyard environment.

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GENERAL

QUESTION

23. Are there legal impediments to the acquisition/purchase of the shipyard by the Government?

ANSWER

Electric Boat officials see no major legal problem with the Government acquiring the shipyard.

GENERALQUESTION

24. In what way will the contract modification contribute to an orderly resolution of the claims and litigation between General Dynamics and the Government?

ANSWER

The proposed modification will settle the current \$544 million claim and will also prevent the contractor from submitting another anticipated claim on actions covering the period before June 9, 1978. It will not, however, prevent the contractor from filing future claims on actions occurring after June 9, 1978, and throughout the contract period which is currently estimated to end in 1984.

GENERAL

QUESTION

25. Do the contract modifications fully comply with the requirements of Public Law 85-804, its implementing Executive Order No. 10789, as amended, with DOD and Navy directives, and previous decisions of the Comptroller General?

ANSWER

The proposed modifications appear to comply with all of the requirements of Public Law 85-804, Executive Order No. 10789, as amended, and applicable regulations and Comptroller General decisions.

The Secretary of the Navy states that the contract modifications are an exercise of his "residual powers" under Public Law 85-804. The term "residual powers" includes all authority under Public Law 85-804 except for (1) contractual adjustments, such as amendments without consideration, correction of mistakes and formalization of informal commitments; and (2) advance payments.

Public Law 85-804, then, appears to be the only adequate legal authority for the proposed modification.

Navy plans to make the payments in excess of the ceiling price from Shipbuilding and Conversion Navy [SCN] appropriations.

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GENERAL

QUESTION

26. Do the contract modifications under the Secretary's proposed agreement fully comply with other Federal statutes?

ANSWER

To the best of our knowledge, the proposed contract modifications comply with other applicable Federal statutes.

Inasmuch as these are modifications to existing contracts, all applicable legal requirements imposed in the basic contracts should apply to these modifications.