

REPORT TO
THE CONGRESS OF THE UNITED STATES

REVIEW OF PRICE INCREASES
UNDER
SHIPBUILDING CONTRACTS

DEPARTMENT OF THE NAVY



BY
THE COMPTROLLER GENERAL
OF THE UNITED STATES

DECEMBER 1966

TO THE READER:

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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DEC 5 1966

To the President of the Senate and the
Speaker of the House of Representatives

The General Accounting Office has examined into the propriety of certain price increases under shipbuilding contracts. Our findings are summarized in this letter and described in more detail in the accompanying report.

The Department of the Navy agreed to reimburse prime shipbuilding contractors for price adjustments paid to their supplier of marine propulsion equipment and turbine generator sets on the basis of increases in the supplier's catalog prices for designated commercial items. Within 3 months after the award of the related subcontracts, the supplier increased the catalog prices for the designated commercial items and claimed and was paid price increases of more than \$1.7 million for items purchased by the Government.

The record shows, however, that, with respect to certain of these items, there were no commercial sales of the items designated by the supplier as the nearest commercial equivalent upon which to base price adjustments. Also, for the remaining items, increases in the commercial selling prices were not proportionate to the increases in the supplier's catalog prices. In fact, in some instances, even though the catalog prices were increased, the commercial selling price remained the same.

The Department of the Air Force resident auditor responsible for all Department of Defense activities at the supplier's plants requested the supplier to furnish information on its commercial selling prices and other pertinent data concerning the price increases prior to the time the Navy reimbursed the prime contractors for the \$1.7 million discussed in this report. The requested information was not furnished by the supplier.

The prime contractors and the supplier advised us, in substance, that the price increases were in accordance with contractual arrangements. Complete details of their positions are included in the report.

The Armed Services Procurement Regulation in effect at the time of negotiations did not specifically require the agency or the prime contractors to establish that catalog prices were bona fide commercial prices before agreements were reached to pay price increases based upon increases in catalog prices. In accordance with the provisions of Public Law 87-653, the procurement regulation has been revised to require that catalog prices for designated commercial equivalents be verified to ensure that they represent actual prices of commercial items sold in substantial quantities to the general public. Further revisions are being considered by the Armed Services Procurement Regulation Committee.

In addition, we were advised that our findings on certain of these items suggested a possible breach of contract and that the Navy would make a detailed evaluation.

Department of the Navy officials advised us also that, if the study indicates a basis for recovery, the Navy will evaluate the remaining items discussed in this report as well as other items purchased under other Government prime contracts and subcontracts awarded under conditions and terms similar to those discussed in this report. We are requesting that we be advised of the Navy's final determination in this matter.

We are submitting this report to the Congress as an illustration of the need for the Government to establish that catalog prices represent those at which substantial sales have been made to the general public before relying on such prices as a basis for procurement actions.

Copies of this report are being sent to the Director, Bureau of the Budget, the Secretary of Defense, and the Secretary of the Navy.



Comptroller General
of the United States

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REPORT ON
REVIEW OF PRICE INCREASES
UNDER
SHIPBUILDING CONTRACTS
DEPARTMENT OF THE NAVY

INTRODUCTION

The General Accounting Office has examined into the propriety of price increases paid to General Electric Company (GE) under 10 subcontracts for marine propulsion equipment and turbine generator sets on the basis of changes in its catalog prices of designated commercial equivalents. Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), the Accounting and Auditing Act of 1950 (31 U.S.C. 67), and the contract clauses prescribed in 10 U.S.C. 2313(b).

The 10 subcontracts were awarded to GE's Medium Steam Turbine Generator and Gear Department, Lynn, Massachusetts, and Small Steam Turbine Department, Fitchburg, Massachusetts, by the Bath Iron Works Corporation, Bath, Maine, and the Defoe Shipbuilding Company, Bay City, Michigan, prime contractors to the Department of the Navy for the construction of eight guided missile destroyers under negotiated fixed-price contracts with a price adjustment clause.

We directed our examination primarily to those matters which appeared to warrant our attention and included an evaluation of the justification for the price increases paid to GE under the 10 subcontracts. We did not make an overall evaluation of GE's contract performance or of the reasonableness of the basic prices negotiated with GE. In the examination made as a part of our continuing review of the negotiation and administration of Government contracts, we included a review of information made available to us by GE on

the increase in prices of the units purchased under the 10 subcontracts. We also reviewed and considered available documents at the Department of the Navy, the prime contractors', and other sources.

This review was conducted prior to the reorganization of the Department of the Navy, effective May 1, 1966. Under this reorganization, the Office of Naval Material became the Naval Material Command; the Bureau of Supplies and Accounts became the Naval Supply Systems Command; and the material support functions of the Bureau of Naval Weapons and the Bureau of Ships were assigned to four systems commands--the Naval Air Systems Command, the Naval Ship Systems Command, the Naval Ordnance Command, and the Naval Electronics System Command. Responsibility for those actions of the former Bureau of Ships discussed in this report have now been transferred to the Naval Ship Systems Command. In this report we have referred to the Navy organizations as they existed at the time of our review.

BACKGROUND

The Bureau of Ships, Department of the Navy, awarded prime contracts NObs-3919 and NObs-3989 to Bath Iron Works Corporation and NObs-3921 and NObs-3990 to Defoe Shipbuilding Company for the construction of eight guided missile destroyers. Construction of these ships was included in the Navy's shipbuilding program for fiscal years 1957 and 1958, and the related funds were included in the appropriation for shipbuilding and conversion.

In April 1957 and February 1958, the General Electric Company, under these prime contracts, was awarded 10 fixed-price subcontracts, with price escalation clause for 16 main propulsion units, 32 turbine generators, spare parts, and tools at a total price of about \$20.5 million. Each propulsion unit consists of a high-pressure turbine, a low-pressure turbine, and reduction gears. This equipment, with a rating of 35,000 shaft horsepower when connected to the main boilers, provides the power necessary to propel a ship. The turbine generator sets, with a rating of 500 kilowatts when actuated by steam pressure, provide the electrical power for a ship.

The subcontracts awarded to GE involved extended delivery periods and provided for adjusting the subcontract price to protect the supplier against unforeseen increases in price levels and to protect the Government in the event price levels declined. The prime contracts provided for adjustments in the contract price in the event that the prescribed Department of Labor indices for material and labor increased or decreased. They also provided that the prime contractors would be reimbursed by the Navy for the total amount of price adjustments paid to their subcontractors.

Each subcontract awarded to GE by Bath and Defoe for propulsion equipment and turbine generator sets contained a price

adjustment clause which permitted GE to increase or decrease its prices for these items if the GE catalog price of its designated commercial equivalent unit changed. Any price increase was to be limited to 10 percent of the negotiated price and was to be applied only to units undelivered at the time of the increase.

The cognizant supervisors of shipbuilding were responsible for administration of the contracts, and the Air Force resident auditors at the two General Electric Departments and the local Navy Area Audit Office were responsible for auditing GE's and the prime contractors' activities, respectively.

The principal management officials of the Department of Defense and the Department of the Navy responsible for the administration of activities discussed in the report are listed in appendix I.

FINDINGS AND CONCLUSIONS

CATALOG PRICES USED TO JUSTIFY PRICE INCREASES NOT REPRESENTATIVE OF ACTUAL SELLING PRICES

The Department of the Navy agreed to reimburse prime shipbuilding contractors for price adjustments paid to their supplier of marine propulsion equipment and turbine generator sets on the basis of increases in the supplier's catalog prices for designated commercial items. Within 3 months after the award of the related subcontracts, the supplier increased the catalog prices for the designated commercial items and claimed and was paid price increases of more than \$1.7 million for items purchased by the Government.

The record shows, however, that, with respect to certain of these items, there were no commercial sales of the items designated by the supplier as the nearest commercial equivalent upon which to base price adjustments and that, for the remaining items, increases in the commercial selling prices were not proportionate to the increases in the supplier's catalog prices. In fact, in some instances, even though the catalog prices were increased, the commercial selling price remained the same.

The Navy consented to the inclusion of the price adjustment clause in the subcontracts and to the related price increases without providing for review and evaluation by either the prime contractors or the Navy of the reasonableness of the catalog prices of the designated commercial equivalents or of the subsequent increases in the prices.

The Armed Services Procurement Regulation 7-106.4 and the price adjustment clause included in the subcontracts contributed to the deficiencies disclosed by our review in that they did not specifically require Government prime contractors and/or contracting

officers to determine that catalog prices were bona fide commercial prices before agreeing to pay price increases based on the catalog prices. Neither did the regulation or clause provide for examining the supplier's sales records for evidence supporting increases made in the catalog prices of designated items, nor did they require suppliers to furnish evidence that commercial sales had actually been made at the increased catalog prices prior to approving the price increases claimed for items to be furnished to the Government.

Details of our finding follow.

Bath and Defoe, under their prime contracts, awarded 10 fixed-price subcontracts to two departments of GE for marine propulsion units, turbine generator sets, and related items at a total price of about \$20.5 million. Each subcontract contained a clause which permitted GE to increase or decrease the prices for the equipment to be furnished if the established price of the commercial equivalent unit changed. Any price increase, however, was to be limited to 10 percent of the negotiated unit price. The pertinent section of the clause contained in the subcontracts follows:

"The Seller warrants that the supplies covered by this Purchase Order are supplies which the Seller customarily offers for sale commercially, except for modifications in accordance with the specifications of this Purchase Order, and that as of the contract date any differences between the unit prices stated herein and the Seller's established prices for like quantities of the supplies which are the nearest commercial equivalents of the supplies covered by this Purchase Order (herein referred to as the established price) are due to compliance with such specifications, and to compliance with any requirements which this Purchase Order may contain for preservation, packaging, and packing beyond standard commercial practice. The term established

price as used in this clause is the net price after applying any applicable standard trade discount offered by the Seller from its list or catalog price." (Underscoring supplied)

The clause further defined "established price" as the price stated in GE's catalog. The catalog did not stipulate any standard trade discounts.

The record shows that within 3 months after the award of each of the 10 subcontracts by Bath and Defoe, GE increased its catalog prices for the designated commercial equivalent of the 500-kilowatt turbine generator set and the 32,000- or 35,000-shaft-horsepower propulsion unit. GE subsequently claimed and was paid price increases under these subcontracts totaling more than \$1.7 million solely on the basis of increases made in its catalog prices for the designated propulsion units and generator sets. A schedule of the subcontracts and the related price increases paid to GE follows:

Prime contract NObs	Subcontracts	Price increases	
		Propulsion units	Turbine generators
3919	DDG2/G&C-204;205 DDG2/G&C-1	\$ 366,024	\$113,680
3989	DDG10/G&C-204;205 DDG10/G&C-1	301,548	93,729
3921	DDG-100 DDG-101	374,890	114,140
3990	DDG-12-100 DDG-12-101	322,443	47,642
Total		<u>\$1,364,905</u>	<u>\$369,191</u>

Evaluation of the price adjustment clause
by the prime contractors and the Navy

Bath and Defoe accepted statements made by GE that equivalent rated propulsion units and turbine generator sets were being offered for sale commercially, on the basis of established catalog prices, without inquiring into the propriety of these statements. They merely submitted the subcontracts containing the price adjustment clause to the cognizant supervisors of shipbuilding for approval as required by their contracts with the Navy. The supervisors approved the subcontracts without (1) evaluating the possible misapplication of the price adjustment clause and without (2) determining whether the commercially equivalent units cited in the clause by GE did in fact exist and were being sold at the established catalog prices.

The Armed Services Procurement Regulation (ASPR) 7-106.4, in effect at the time the subcontracts were awarded, authorized the use of the price adjustment clause only where prices could be related to nearly equivalent standard supplies for which established prices existed. The ASPR at that time did not specify the criteria for determining the existence of established prices. It appeared that Bath, Defoe, and the Navy accepted GE's commercial catalog prices as being sufficient support of the fact that established prices did exist.

When we attempted to ascertain the basis for the Navy's approval of the price adjustment clause, we were informed that the contract files maintained by the supervisors who were responsible for such approval could not be located. Available records indicated that, in February 1964, the resident supervisor informed the Navy auditor at Defoe that the intent of the supervisor's approval

of the subcontracts awarded to GE was to ratify source inspection, verify progress reports, acknowledge that technical reviews had been accomplished, and approve the administrative terms and conditions of the subcontracts. It appeared from this statement that the supervisor at Defoe was not concerned about the price adjustment clause and its possible applications and that no evaluation was made of the propriety of GE's statements included therein.

Had the prime contractors or the Navy properly evaluated the price adjustment clause, they would have found it inappropriate because (1) the propulsion units specified in the clause as the nearest commercial equivalents were not being sold commercially, (2) other propulsion units and the turbine generator sets designated as commercial equivalents were being sold at prices significantly below GE's catalog prices, and (3) there was no assurance that GE's catalog prices for such items or subsequent changes in those prices were reasonable since the catalog prices were not established by, nor subject to, the restraints of open market competition.

Evaluation of the supplier's price increases by the prime contractors and the Navy

Within 3 months after the award of the 10 subcontracts, GE increased its catalog prices for the designated commercially equivalent units and requested price increases from Bath and Defoe totaling more than \$1.7 million. The terms of the price adjustment clause did not require GE to submit any data but a reprinted catalog page showing that the prices of the items had been increased. Bath and Defoe paid the price increases without inquiring into the propriety or the reasonableness of the increased amounts except for assuring themselves that the price increases requested by GE were in accord with the revised catalog prices.

In accordance with the terms of the prime contracts which provided for reimbursement of price adjustments paid to subcontractors, Bath and Defoe requested reimbursement from the Navy for the price increases they had paid to GE. The Navy auditors responsible for reviewing Defoe's prime contracts requested the Air Force resident auditor at GE to review the justification for the price increases.

In March 1961, the Air Force resident auditor submitted an initial advisory audit report on the price increases paid GE by Defoe. This report stated that GE declined to submit evidence to show that its catalog prices were the prices charged commercial customers. The report also stated that GE refused to provide any cost data, and, therefore, the price increases paid to GE could not be related to increased costs. It was the opinion of the Air Force resident auditor that GE had not submitted sufficient justification to warrant the price increases. Apparently because of this audit report, the Navy's contracting officer withheld his approval of reimbursement to Defoe for the increased prices Defoe had paid GE.

We found no evidence that the Navy auditor responsible for reviewing Bath's prime contracts requested the Air Force auditor to perform a similar review of the price increases paid to GE by Bath under its contracts. When the Navy auditor at Bath was informed of the Air Force resident auditor's report on the Defoe subcontracts, he recommended to the contracting officer that reimbursement to Bath for the price increases paid to GE be withheld until a final decision was reached with respect to reimbursement to Defoe.

In another report which the Air Force auditor submitted to the Navy in May 1963, he, in effect, reiterated his opinion that GE had not submitted sufficient evidence to justify its price increases. Despite these audit reports which indicated that there was insufficient justification for the GE price increases, the Navy reimbursed Bath and Defoe in December 1963 and February 1964, for the price increases they had paid GE.

We met with the cognizant contracting officer; representatives of the Office of Counsel, Bureau of Ships; and the Auditor General of the Navy to determine what actions had been taken with respect to the audit report. We were informed by these representatives that the Air Force auditor had exceeded the contract terms in inquiring into the reasonableness of the price increases paid to GE. We were further informed that (1) the cognizant supervisors of shipbuilding were solely responsible for determining the reasonableness of GE's warranties, (2) the Navy had no legal right to require GE to submit justification for the catalog price increases, and (3) the reimbursements were considered to be proper under the terms of the prime contracts. It appeared, therefore, that the price adjustments were paid to GE solely on the basis of the examination of GE's catalog prices.

Commercial catalog prices
not representative of
actual selling prices

Under the terms of the price adjustment clause, GE warranted that its designated commercial equivalent to the propulsion equipment and power generating units ordered by Bath and Defoe were customarily offered for sale commercially at catalog prices. GE designated its 32,000- and 35,000-shaft-horsepower propulsion units and 500-kilowatt turbine generator set as being the nearest commercial equivalents to the propulsion units and turbine generators ordered by Bath and Defoe.

GE officials refused to make available to us any information pertaining to its commercial sales or pricing policies or to permit a determination of whether commercial sales were actually made at the catalog prices. Nevertheless, sales information obtained during our prior reviews at GE and information obtained from other reliable sources showed that GE had apparently not sold commercially either a 32,000- or 35,000-shaft-horsepower propulsion unit. Available records show that the Government had been GE's sole customer for marine propulsion equipment in this shaft horsepower range and that GE's sales of marine propulsion equipment were customarily in the 10,000-to 25,000-shaft-horsepower category. The records showed also that GE customarily sold marine propulsion units at prices which ranged from 8 to 17 percent below catalog prices and that changes in catalog prices had little or no effect on the actual prices charged commercial customers.

With respect to the 500-kilowatt power generating units, available commercial sales and purchase order information for 500-, 600-, and 750-kilowatt power-generating units showed that GE's prices for these units ranged from 5 to 22 percent less than its

catalog prices. Thus, not only the 500-kilowatt unit designated in the clause as the nearest commercial equivalent to the unit being procured for the Navy but other units were being sold commercially by GE at prices significantly below its catalog prices, and catalog price changes had little or no relationship to the changes in commercial purchase order prices.

A comparison of the commercial selling prices and the established catalog prices including catalog price changes and their relation to commercial sales prices are set forth in the following table.

Comparison of Commercial Sales Prices
and Related Catalog Prices

<u>Unit rating</u>	<u>Commercial price</u>	<u>Catalog price</u>	<u>Commercial sales price below catalog price</u>	
			<u>Amount</u>	<u>Percent</u>
<u>Power generator units</u>				
600	\$143,594 ^b	\$150,664	\$ 7,070	4.7
500 ^a	120,000	153,446	33,446	21.8
500 ^a	120,000	153,446	33,446	21.8
600	150,000	162,785	12,785	7.8
750	112,817	144,000	31,183	21.6
750	118,115	134,900	16,785	12.4
<u>Propulsion equipment</u>				
9,900	641,125	732,530	91,405	12.5
12,100	720,400	784,445	64,045	8.2
12,100	720,400	789,030	68,630	8.7
12,100	720,400	839,030	118,630	14.1
13,750	737,296	896,570	159,274	17.8

^aThese units had the same kilowatt rating as the generators sold to Bath and Defoe for which GE received its price increases.

^bIdentical units sold to two different customers.

Comments of contractors and
the Department of Defense

We brought our findings to the attention of GE, Bath, Defoe, and the Department of Defense in two draft reports dated June and August 1965. In our draft reports we recommended that (1) the agency obtain a refund from GE for the price increases for the marine propulsion units and (2) the Armed Services Procurement Regulation, (ASPR 7-106.4) be revised to specifically require prime contractors or agency contracting officers to obtain evidence that catalog price increases represent bona fide price increases and that adjustments in sales prices are made to a significant number of buyers representing the general public.

GE, Bath, and Defoe did not agree with our findings. The Department of Defense advised us that, in accordance with our recommendation, the procurement regulation had been revised to require verification that catalog prices for designated commercial equivalents represented actual prices of commercial items sold in substantial quantities to the general public and that further revisions were being considered by the Armed Services Procurement Committee. We were advised in addition that our findings on certain items suggest a possible breach of contract and that the Navy would make a detailed evaluation of the matter. In a subsequent meeting with Navy officials, we were advised that, if the study indicated that a basis for recovery existed, the Navy would evaluate the remaining items discussed in this report as well as other items purchased under Government prime contracts and subcontracts, awarded under conditions and terms similar to those discussed in this report.

The principal comments of the contractors and the Department of Defense together with our views thereon are set forth in the

following sections of this report. Except for the voluminous exhibits attached to the letter received from Bath Iron Works, the full text of the comments are included as appendixes II through V of this report.

General Electric Company comments

GE stated that the price increases were obtained in accordance with the contractual arrangements made with Bath and Defoe.

Since the terms and conditions of the subcontracts we reviewed stated that GE would be paid price adjustments in accordance with changes in the catalog prices of its designated commercial equivalents of the propulsion units and power-generating sets and since GE raised the catalog prices of the equivalents within 3 months after the award of the subcontracts, we agree that the price increases were in accordance with the contractual arrangements.

GE stated that "reference [in our draft report] to matters such as cost justification, relationship of catalog prices and alleged prevailing commercial prices and examination of sales records were irrelevant to an examination of the parties' obligations and responsibilities under the clause [price adjustment clause] in question."

The cost data referred to by GE has been deleted from this report. We disagree, however, with the position taken by GE on the remaining matters cited. We believe that the examination of sales records and the relationship of catalog prices to prevailing commercial prices were extremely relevant to evaluating the reasonableness of the price increases and the responsibilities of the prime contractors and the Navy to protect the Government's interests. GE warranted in each of the 10 subcontracts referred to in this report that the designated commercial equivalents were being offered for sale commercially at the established catalog prices

less applicable standard trade discounts. We know of no practical way for the prime contractors or the Navy to have substantiated GE's warranties other than by examining GE's commercial sales records and comparing prevailing commercial prices with its catalog prices.

In this regard, we were advised by GE officials that GE did not offer standard trade discounts from its established catalog prices for power generator sets and propulsion units. However, our review disclosed that GE did, in fact, sell these items of equipment commercially at prices substantially lower than its catalog prices. (See schedule on p. 13 .) Moreover, we found that GE had not sold the propulsion units designated as commercial equivalents on the commercial market. Consequently, in our opinion, the catalog prices of the designated commercial equivalents did not represent valid commercial prices and the increases made in these prices did not result from open market operations and its accompanying competitive restraints. Therefore, we cannot agree that the matters cited by GE are irrelevant.

GE stated that, in its opinion, the release of a report along the lines indicated by the draft reports would be both unfair and misleading.

It is certainly not our intent to be unfair or misleading in any report. We have the responsibility, however, of reporting on those contractual arrangements which appear to have been conducted inappropriately or which are prejudicial to the Government's interests. It is noteworthy that the Department of Defense, in commenting on this matter, agreed that changes in ASPR were required to provide greater assurances that claims for price increases occurring under this clause would be fair and reasonable.

Bath and Defoe comments

Bath and Defoe stated that ASPR provided for the price adjustment clause that was used and that GE had complied with the clause by submitting revised catalog prices of the designated nearest commercial equivalent units. Bath and Defoe stated also that they were contractually obligated to pay the price increases claimed by GE.

These comments are essentially the same as those submitted by GE and dealt with previously in this report. In our draft reports, we stated that ASPR did not specifically require the Navy or the prime contractors to determine that GE's catalog prices represented its actual commercial selling prices or that increases therein represented price changes resulting from open market operations and the accompanying competitive restraints. The ASPR did not prohibit the Navy or the prime contractors from making this type of evaluation.

In this respect, the ASPR has recently been revised to require that items of equipment be sold at catalog prices in substantial quantities to the general public before agreements are reached to pay price increases on the basis of changes to catalog prices.

Bath stated that "GE's designated commercial equivalent list as published in its handbook is and was recognized in the trade as a list of equipment offered for sale by GE. Upon the publication and distribution of such list both BIW¹ and the Navy were justified and in fact required to accept the prices therein set forth." (Underscoring supplied)

As stated previously, GE warranted that the designated commercial equivalents were offered for sale commercially at the catalog prices. We found no evidence, however, that GE had ever sold, commercially, the propulsion unit designated as the commercial

¹Bath Iron Works Corporation, Bath, Maine

equivalent. Moreover, for other items of propulsion equipment and for power generating sets which were sold commercially, we did not find one instance where GE quoted or sold these items of equipment at the catalog prices. It seems to us that the catalog prices alone provide little assurance as to their reasonableness.

Department of Defense comments

The Navy stated that "The escalation or price adjustment clause used was that provided for in ASPR 7-106.4 and the only available clause which was acceptable to both the subcontractors and the Navy."

The acceptance of a contract clause does not ensure that it is fair and reasonable to the parties concerned or justify agreements which are not in the best interests of the Government. As shown in this report, the Government incurred increased costs of more than \$1.7 million because the Navy and the prime contractors agreed to pay price increases based solely on changes in the catalog prices of GE's designated commercial equivalents although the prices did not represent bona fide commercial prices and the designated propulsion units had not been sold on the commercial market.

The Navy stated that "The use of such a clause is beneficial to both contract parties because it obviates the need for contractors to place a contingency factor in their price as a hedge against a rise in labor and materials which may or may not occur."

We agree that the use of a price adjustment clause normally obviates the need for including a contingency factor in negotiated prices. In this case, however, neither Bath, Defoe, nor the Navy reviewed GE's cost estimates for producing the propulsion units or power generating sets. Therefore, they had no assurance that GE

had not included contingency factors in the negotiated prices that would be subject to the application of the price adjustment clause. Moreover, the Department did not furnish any data which would indicate that contingency factors were not included in the basic prices that were negotiated.

Further, we do not agree that the use of the clause in this case was beneficial to both parties. It seems clear that the use of the clause was beneficial to GE since (1) price adjustments were tied to the catalog prices of the designated equivalents which had not met the price restraints of open market operations and (2) GE could effect an increase in the subcontract prices by unilaterally increasing its catalog prices.

The Navy stated in regard to the propulsion units that, after careful and full consideration of all relevant facts, the Navy was of the opinion that no legal basis existed for obtaining a refund from GE. The Department of Defense, however, stated that certain findings in the report on power generating sets "suggest a possible breach of the escalation clause of the purchase order" and that the Navy would study the matter and take such action as may be warranted.

In view of the above comments, we met with cognizant officials of the Departments of Defense and Navy to clarify our understanding of the Department's position. We have been advised that the Navy is currently performing an evaluation of the 10 subcontracts cited in this report to determine if a refund should be sought from GE for the total amount of the price increases--about \$1.7 million. We, therefore, have no further comment to make at this time.

The Navy stated that the ASPR was revised to restrict the use of the clause included in the subcontracts with GE. It stated also that the revised ASPR restricted the use of the clause to cases where established prices existed and had been verified in accordance with the criteria set forth in ASPR 3-807.1-- that prices be based on established catalog or market prices

of commercial items sold in substantial quantities to the general public. The Navy stated that the revised ASPR would ensure that the clause was used only in cases where catalog prices were realistic indicators of actual market prices. The Department of Defense stated that our report and recommendations had been brought to the attention of the ASPR committee to determine whether additional provisions are required.

The revised ASPR 7-106.4 referred to by the Navy requires that the following criteria included in ASPR 3-807.1 be used by agency officials to determine that prices are catalog prices of commercial items sold in substantial quantities to the general public.

- "(i) An 'established catalog price' is a price included in a catalog, price list, schedule, or other form that (A) is regularly maintained by the manufacturer or vendor, (B) is either published or otherwise available for inspection by customers, and (C) stated prices at which sales are currently, or were last, made to a significant number of buyers constituting the general public. An 'established market price' is a current price, established in the usual and ordinary course of trade between buyers and sellers free to bargain, which can be substantiated from sources independent of the manufacturer or vendor.

- "(ii) A 'commercial item' is a item, which term includes both supplies and services, of a class or kind which (A) regularly used for other than Government purposes, and (B) is sold or traded in the course of conducting normal business operations.

- "(iii) Supplies are 'sold in substantial quantities' when the facts or circumstances are sufficient to support a reasonable conclusion that the quantities regularly sold are sufficient to constitute a real commercial market for the item. Nominal quantities, such as models, specimens, samples, and prototype or experimental units, cannot be considered as meeting

this requirement. Services are sold in substantial quantities if they are customarily provided by the contractor, with personnel regularly employed, and with equipment, if any is necessary, regularly maintained, solely or principally for the purpose of providing such services.

"(iv) An item is sold 'to the general public' if it is sold to other than affiliates of the seller for end use by other than the Government. Items sold to affiliates of the seller and sales for end use by the Government are not sales to the general public.

"A price may be considered to be 'based on' established catalog or market prices of commercial items sold in substantial quantities to the general public if the item being purchased is sufficiently similar to such a commercial item to permit the difference between the prices of the items to be identified and justified without resort to cost analysis."

The revised ASPR incorporates changes required by Public Law 87-653, effective December 1, 1962, and we believe that these revisions will contribute to an effective solution of the deficiencies cited in this report.

Conclusions

The Government, in our opinion, incurred increased costs of more than \$1.7 million for marine propulsion equipment and power generating sets because, within 3 months after the award of 10 subcontracts, GE raised the catalog prices of its designated commercial equivalents and received from the Government corresponding price increases in accordance with the price adjustment clause included in the subcontracts. The pertinent records show, however, that, with respect to certain of these items, there were no commercial sales of the items designated by the supplier as the nearest commercial equivalent upon which to base a price increase. For the remaining items, increases in the commercial selling prices were not proportionate to the increases in GE's catalog price. Further, in some instances, even though the catalog price was increased the commercial selling price remained the same.

The Armed Services Procurement Regulation in effect at the time the subcontracts were awarded did not specifically require the agency or prime contractors to establish that catalog prices were bona fide commercial prices before agreements were reached to pay price increases based upon increases in catalog prices, and, in this respect, the ASPR contributed to the increased costs. We believe, however, that effective contract negotiations and administration and proper discharge of responsibilities by the prime contractors and the Navy should have included steps to make a positive determination that GE's catalog prices actually represented its commercial prices before the subcontract terms and conditions were negotiated.

Agency action

In accordance with the provisions of Public Law 87-653 the ASPR has been revised to require that catalog prices for designated

commercial equivalents be verified to ensure that they represent actual prices of commercial items sold in substantial quantities to the general public. Also further revisions to the regulation are being considered by the ASPR Committee. Accordingly, we are making no recommendation in this area at this time.

As a result of our findings, a study is being performed by the Navy to determine whether a refund should be sought from GE. We are requesting that we be advised of the Navy's final decision in this matter.

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APPENDIXES

TO THE READER:

**SEVERAL PAGES OF THE FOLLOWING MATERIAL
MAY BE ILLEGIBLE BECAUSE OF THE POOR
QUALITY OF THE COPY SUBMITTED FOR
MICROFILMING**

PRINCIPAL MANAGEMENT OFFICIALS OF THE DEPARTMENT OF DEFENSE
AND THE DEPARTMENT OF THE NAVY
RESPONSIBLE FOR THE ADMINISTRATION OF ACTIVITIES
DISCUSSED IN THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
<u>DEPARTMENT OF DEFENSE</u>		
SECRETARY OF DEFENSE:		
Charles E. Wilson	Jan. 1953	Oct. 1957
Neil H. McElroy	Oct. 1957	Dec. 1959
Thomas S. Gates, Jr.	Dec. 1959	Jan. 1961
Robert S. McNamara	Jan. 1961	Present
DEPUTY SECRETARY OF DEFENSE:		
Rueben B. Robertson	Aug. 1955	Apr. 1957
Donald A. Quarles	May 1957	May 1959
Thomas S. Gates, Jr.	June 1959	Dec. 1959
James H. Douglas	Dec. 1959	Jan. 1961
Roswell L. Gilpatric	Jan. 1961	Jan. 1964
Cyrus H. Vance	Jan. 1964	Present
<u>DEPARTMENT OF THE NAVY</u>		
SECRETARY OF THE NAVY:		
Charles S. Thomas	May 1954	Apr. 1957
Thomas S. Gates, Jr.	Apr. 1957	June 1959
William B. Franke	June 1959	Jan. 1961
John B. Connally	Jan. 1961	Dec. 1961
Fred Korth	Jan. 1962	Nov. 1963
Paul H. Nitze	Nov. 1963	Present
UNDER SECRETARY OF THE NAVY:		
Thomas S. Gates, Jr.	Oct. 1953	Apr. 1957
William B. Franke	Apr. 1957	June 1959
Fred A. Bantz	June 1959	Jan. 1961

PRINCIPAL MANAGEMENT OFFICIALS OF THE DEPARTMENT OF DEFENSE
AND THE DEPARTMENT OF THE NAVY
RESPONSIBLE FOR THE ADMINISTRATION OF ACTIVITIES
DISCUSSED IN THIS REPORT (continued)

Tenure of office
From To

DEPARTMENT OF THE NAVY (continued)

UNDER SECRETARY OF THE NAVY (continued):

Paul B. Fay, Jr.	Feb. 1961	Jan. 1965
Kenneth E. Belieu	Feb. 1965	July 1965
Robert H. B. Baldwin	July 1965	Present

ASSISTANT SECRETARY OF THE NAVY (MATERIAL)

(redesignated Assistant Secretary (Installations and Logistics,) January 1961:

Raymond H. Fogler	Oct. 1954	Jan. 1957
Fred A. Bantz	Apr. 1957	Apr. 1959
Cecil P. Milne	Apr. 1959	Jan. 1961
Kenneth E. Belieu	Feb. 1961	Feb. 1965
Graeme C. Bannerman	Feb. 1965	Present

CHIEF, BUREAU OF SHIPS (redesignated Naval Ship Systems Command, May 1966):

Rear Admiral Albert G. Mumma	Apr. 1955	Apr. 1959
Rear Admiral Ralph K. James	Apr. 1959	Apr. 1963
Rear Admiral William A. Brockett	Apr. 1963	Jan. 1966
Rear Admiral Edward J. Fahy	Feb. 1966	Present

**GENERAL  ELECTRIC
COMPANY**

1100 WESTERN AVENUE, WEST LYNN, MASS. . . . TELEPHONE LYNN 8-6000

MEDIUM STEAM
TURBINE GENERATOR
AND GEAR DEPARTMENT

August 3, 1965

Mr. J. K. Fasick
Associate Director
United States General Accounting Office
Washington 25, D. C.

Dear Mr. Fasick:

This letter is in response to your letter of June 8, 1965 requesting our comments on the draft of report N-112 regarding marine propulsion equipment.

Before attempting to comment on individual items in the draft, let us emphasize that the marine propulsion equipment referred to was purchased on a competitive basis and that the price escalation terms now being commented on by your office was a Government requirement in preference to other terms offered by the Company. Payment was in accordance with the terms of the contract agreed upon by all parties as a result of free and uncoerced negotiations.

We also wish to emphasize that in view of the market conditions at the time, the business outlook, and the long history of steady inflation then existing, these provisions appeared sensible to all contracting parties. Some form of escalation was commonly used at that time in virtually all business contracts for heavy equipment. The equipment was delivered on time, in accordance with the quality specified, and has performed with distinction. As a matter of fact, the ships involved have logged about two million miles of operation without incurring a single known breakdown of the propulsion equipment, and the maintenance costs to the Government have been negligible. This record is not a happenstance, rather it is a consequence of design and manufacturing excellence, and of continued surveillance and service of the equipment by General Electric.

Now to comment on some of the pertinent items of the report:

1. As to the escalation provisions, the Company was willing to accept any of several types of escalation including (a) "Baker" clause prescribed by the Armed Services Procurement Regulation, or (b) a Bureau of Labor Statistics Material and Labor Indices Type Escalation, and, in one instance, (c) a Price in Effect at Time of Shipment provision, rather than the "Baker" clause. The Baker clause, the only clause acceptable to the Government, was agreed upon by all parties and it is the application of this

GENERAL  ELECTRIC

clause, which was authored by the Government and not the Company, which is now being questioned.

2. The questions raised as to costs incurred by the Company in connection with the contract are not relevant since nowhere in the contract is there any provision which would indicate that the Company was required to substantiate its price changes by supplying cost data. The purpose of the clause was to determine the percent by which the competitive contract price would be increased (up to a 10% limit) or decreased (no limit) to give effect to changed prices at the time of shipment.
3. The comment in the draft that "there were no known commercial sales of the items designated as the nearest commercial equivalent ---" is also not relevant because there is no requirement in the contract that the designated commercial equivalent be sold, only that it be offered for sale. This requirement was fully satisfied by the Company. The inclusion of this equipment in the Merchant Marine Turbine-Gear Handbook, which set forth the equipment the Company was offering for sale and the prices of the equipment enabled shipbuilders, architects and shipowners to plan future ship construction. Anyone desiring equipment of this type could purchase the same from the Company. Thus, the equipment designated by the parties to the contract as the nearest commercial equivalent was in fact being offered for sale commercially, as required by the ASPR escalation clause included in these contracts.
4. Throughout the report, reference is made to discounts and it is stated that the price adjustment clause defined the established prices as the net price "after applying discounts". This is an inaccurate representation of the clause, and many of the references in the draft to the lack of adjustment of the catalog prices for "discounts" apparently stem from this misunderstanding of the clause. The clause actually defines "established prices" as the "net price after applying any applicable standard trade discounts offered by the contractor from his list or catalog prices" (underlining supplied). The omission of the underlined words gives an entirely different meaning to the clause than that which obtains by their inclusion. A proper interpretation would recognize that the clause speaks of standard trade discounts which are not price variations based on competitive market conditions as the draft discusses, but rather, a discount offered to a particular type of customer in the distribution chain, such as, a discount to a warehousing distributor. As there was no such "standard trade discounts" on this equipment, the escalation on the basis of the Handbook price changes was correct under the terms of the contract binding on all parties.

GENERAL  ELECTRIC

We believe that the release of a report along the lines indicated by the draft would be both unfair and misleading. We earnestly hope that your review will lead to the same conclusion.

We appreciate the opportunity to submit our comments on the draft of the report. In the event that any report is ultimately released, we request that our comments be included in their entirety as a part of the formal record. We will obviously be pleased to meet with you to discuss in detail any of the points reviewed above.

Very truly yours,

H. R. Hill

GENERAL MANAGER

GENERAL  ELECTRIC
COMPANY

166 BROAD ST., FITCHBURG, MASS. 01421 . . . TWX 617-345-5414, TELEPHONE 343-6441

SMALL STEAM
TURBINE
DEPARTMENT

September 30, 1965

Mr. J. K. Fasick
Associate Director
United States General Accounting Office
Washington 25, D. C.

Dear Mr. Fasick:

This letter is in response to your letter requesting our comments on the draft of report N-113 regarding turbine-generator sets used in ship construction.

At the outset, it should be emphasized that the equipment referred to in the report was purchased on a competitive basis, and the price escalation provisions contained in the contract which your office is commenting upon was a Government requirement which was used in preference to other terms offered by the Company. Payment of the escalation was in accordance with the terms of the contract, particularly the Government-authored escalation clause which had been agreed upon by all parties as a result of free and uncoerced negotiations.

It must be recognized that at the time these contracts were let some form of escalation was commonly used in all contracts for heavy equipment. In its proposals, the Company indicated it was willing to accept different types of escalation. The Baker clause, the only clause acceptable to the Government was agreed upon by all parties. It is the operation of this clause, which was authored by the Government, and not the Company, that the draft report questions.

The questions raised as to sales records and pricing data of the Company to support the price increases in its catalog price are not relevant since nowhere in the contract is there any provision which would indicate that the Company was required to substantiate its price changes by supplying this data. The limited operation and application of the clause is clearly recognized at pages 12 and 14 of the draft report. The purpose of the clause was to determine the

GENERAL  ELECTRIC

Small Steam Turbine Dept.
Fitchburg, Mass. 01421
September 30, 1965

Mr. J. K. Fasick

percent by which the competitive contract price would be increased (up to 10% limit) or decreased (no limit) to give effect to changed prices at the time of shipment.

In view of these recognized limitations of the escalation clause in question, it is submitted that the reference to matters such as cost justification, relationship of catalog prices and alleged prevailing commercial prices and examination of sales records is irrelevant to an examination of the parties' obligations and responsibilities under the clause in question.

There can be no question that the parties completely complied with their contractual obligations as set forth in the clause, and that the payments in question were made in compliance with these contractual obligations.

While your office may have questions regarding the appropriateness and the future of the particular escalation clause as presently worded, it is submitted that recognition should be given to the fact that all parties lived up to their obligations under the escalation provisions, and that there were no other obligations nor requirements imposed by the escalation provisions. The release of a report along the lines indicated by the draft, therefore, would be misleading and unfair to all parties concerned. We trust that your review will lead to the same conclusion.

We appreciate the opportunity to submit our comments of the draft of the report. In the event that any report is ultimately released, we request that our comments be included in their entirety as part of the formal record.

We obviously would be pleased to meet with you to discuss in detail any of the points reviewed above.

Very truly yours,



A. E. PELTOSALO
General Manager

AEP:bjl



BATH IRON WORKS CORPORATION
SHIPBUILDERS AND ENGINEERS
BATH - MAINE 04830

JAMES F. GOODRICH
PRESIDENT

10 August 1965

Mr. J. K. Fasick, Associate Director
United States General Accounting Office
Defense Accounting and Auditing Division
Washington 25, D. C.

Dear Mr. Fasick:

By letter dated 8 June 1965, you sent to Bath Iron Works Corporation a preliminary draft report of the General Accounting Office entitled "Unjustified Price Increases for Marine Propulsion Equipment Paid to General Electric Company Medium Steam Turbine Generator and Gear Department, Lynn, Massachusetts", and requested our comments thereon.

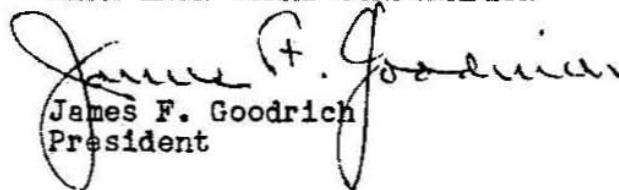
Enclosed you will find our comments as requested. We believe that the report in the draft form submitted to us unfairly reflects on Bath Iron Works Corporation and, if issued, would be grossly misleading. We trust that further consideration of all of the facts will result in a determination by your office not to go forward with this report.

In the event that any report on this matter is released by your office, we request that a copy of our enclosed comments be included as an exhibit to your report and that the same circulation be given to our comments as is given to your report.

Thank you very much for your courtesies in this matter.

Very truly yours,

BATH IRON WORKS CORPORATION


James F. Goodrich
President

Enclosures

COMMENTS BY BATH IRON WORKS CORPORATION ON DRAFT REPORT OF
THE UNITED STATES GENERAL ACCOUNTING OFFICE ENTITLED "REPORT
TO THE CONGRESS OF THE UNITED STATES, UNJUSTIFIED INCREASES
FOR MARINE PROPULSION EQUIPMENT PAID TO GENERAL ELECTRIC
COMPANY MEDIUM STEAM TURBINE GENERATOR AND GEAR EQUIPMENT,
LYNN, MASS."

Bath Iron Works Corporation (hereinafter called "BIW") makes the following comments on the draft report (hereinafter called "Report") sent to it by the General Accounting Office (hereinafter called "GAO") concerning the propriety of price increases paid to the General Electric Company (hereinafter called "GE") by BIW and Defoe Shipbuilding Company under subcontracts for main propulsion turbines and main reduction gear (hereinafter called "Main Propulsion Units").

BIW PAYMENTS REQUIRED BY APPROVED CONTRACT TERMS.

The BIW purchases discussed by GAO were made by BIW as the prime contractor under contracts NObs 3919 and NObs 3989.

All payments made by BIW to GE as the subcontractor for main propulsion units installed under contracts NObs 3919 and NObs 3989 were made under subcontracts approved by the Navy. Further, the amounts of the price increases actually paid by BIW to GE under these contracts were also approved by the Navy.

STATEMENT CONCERNING SUBCONTRACT
FOR MAIN PROPULSION UNITS AWARDED
UNDER CONTRACT NOBS 3919

Copies of BIW's price inquiries for the main propulsion units as issued to GE are attached hereto marked Exhibit A.

These inquiries provided that consideration would be given to proposals on a fixed price basis with adjustments for increases and decreases based on such changes in the corresponding established prices of the nearest commercial equivalents offered for sale by the bidder.

In response thereto, GE submitted its proposal for the main propulsion units. BIW accepted the GE proposal. A price adjustment clause of the "Baker" type was included in the subcontract, a copy of such clause being attached hereto marked Exhibit B.

On July 1, 1957, GE increased its catalog prices for its designated commercial equivalent unit and notified BIW of the increase.

Before making payment to GE for the amount billed for its equipment, BIW secured approval of the payment from the Navy.

In making such payment, BIW did not depart from its contract obligations with GE and did not pay more than it was required to pay pursuant to the terms of the approved contract with GE.

STATEMENT CONCERNING SUBCONTRACT
WITH GE FOR EQUIPMENT UNDER
CONTRACT NOBS 3989

BIW was awarded Contract NObs 3989 for two ships in January of 1958. Steps similar to those taken by BIW to secure propulsion equipment under NObs 3919 were taken in connection with Contract NObs 3989. Clauses similar to those discussed above were in the subcontract awarded to GE and approvals similar to those outlined above were obtained from the Navy.

COMMENTS ON THE GAO'S CRITICISM OF
FAILURE ON BIW TO CHECK COST JUSTI-
FICATION FOR PRICE INCREASES MADE BY GE

The GAO criticism of the price increases made effective by GE in relation to the propulsion equipment which it furnished to BIW are based largely on GAO's conclusion that "list prices on the designated commercial equivalent were not a proper basis for determining propriety of the subsequent price increases under the six subcontract."

The answer to GAO's hindsight conclusion concerning the Baker Clause used in GE's subcontract is that, BIW did not originate the Clause, it was in general use at the time BIW accepted GE's bids, there was and is nothing illegal about it, its meaning is clear and requires no construction, and having agreed to the Clause its provisions were binding upon BIW, GE and the Navy. Upon BIW being notified that the price of commercial equivalents had been increased, such increases, up to 10% became binding upon BIW and the Bureau of Ships.

BIW BOUND BY GE'S PUBLISHED PRICES

GAO criticizes BIW for not inquiring into the propriety of GE's statement that "equivalent shaft horsepower propulsion units were being offered for sale commercially." This was not a statement by GE. GE's designated commercial equivalent list as published in its handbook is and was recognized in the trade as a list of equipment offered for sale by GE. Upon the publication and distribution of such list both BIW and the Navy were justified and in fact required to accept the prices therein set forth.

COMMENTS RE FAILURE OF PRIME CONTRACTORS TO GIVE CONSIDERATION TO DISCOUNTS ON PRICE INCREASES

GAO's comments re failure of prime contractor to give consideration to discounts on price increases fails to recognize that the clause speaks of standard trade discounts which type of discount did not obtain for this equipment. Therefore, there was no basis for the prime contractor to give the consideration suggested by GAO.

ANSWER TO GAO'S COMPLAINT THAT BIW FAILED TO EVALUATE AMOUNT OF THE INCREASES

The answer to this Complaint is given by GAO itself at page 9 of the Report;

"Within three months after the award of each of the six subcontracts, GE increased its catalog prices for the commercially designated equivalent units and requested price increases from BIW and Defoe totaling about \$1.4 million. In accordance with the terms of the price adjustment clause, GE was not required to submit any data but a reprinted catalog page indicating that the prices had been increased."

This is a correct statement of the operation of the Baker Clause. Upon the submission of the reprinted catalogue page, BIW had no alternative but to accept the price increase there indicated so long as the same was within the ceiling of not more than 10%. The reasons why GE put the price increase into effect were immaterial. It had the right so to do under the terms of its contract. It acted within its contract and the action taken was binding on BIW.

SUMMARY

In purchasing the propulsion equipment under both contracts discussed by GAO, BIW asked for bids from responsible subcontractors. In the case of both contracts, in the opinion of BIW, the most advantageous proposals for propulsion equipment were made by GE. Price adjustment clauses, with the approval of the Bureau of Ships, were accepted by BIW. The equipment furnished met contract specification and was placed in the ships. It has performed satisfactorily since the ships have been in service.

As to the price paid therefore, BIW acted entirely within the terms of its contract. It did not fail to take any action which was required of it. All payments made under the subcontracts were required by the subcontract terms, and were approved by the Navy.

August 10 , 1965

BATH IRON WORKS CORPORATION

By James H. Goodrich
President



BATH IRON WORKS CORPORATION
SHIPBUILDERS AND ENGINEERS
BATH - MAINE 04530

JAMES F. GOODRICH
PRESIDENT

September 16, 1965

Mr. J. K. Fasick, Associate Director
United States General Accounting Office
Defense Accounting and Auditing Division
Washington 25, D. C.

Dear Mr. Fasick:

By letter dated August 5, 1965, you sent to Bath Iron Works Corporation a preliminary draft report of the General Accounting Office entitled "Increased Costs For Turbine Generator Sets Used In Ship Construction" and requested our comments.

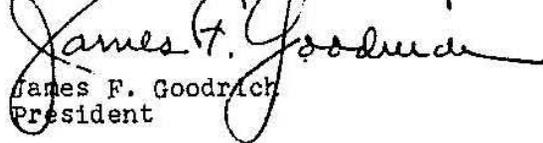
Enclosed you will find our comments as requested. We believe that the report in the draft form submitted to us unfairly reflects on Bath Iron Works Corporation. Although it concludes that we acted in full compliance with our contractual obligations, it still intimates in several places that we should have gone far beyond these contractual obligations in evaluating the price adjustments.

In the event that any report on this matter is released by your office, we request that a copy of our enclosed comments be included as an exhibit to your report and that the same circulation be given to our comments as is given to your report.

Thank you very much for your courtesies in this matter.

Very truly yours,

BATH IRON WORKS CORPORATION,


James F. Goodrich
President

Enclosure

COMMENTS BY BATH IRON WORKS CORPORATION
ON DRAFT REPORT
OF THE UNITED STATES GENERAL ACCOUNTING OFFICE
ENTITLED
"REPORT TO THE CONGRESS OF THE UNITED STATES,
INCREASED COSTS FOR TURBINE GENERATOR SETS
USED IN SHIP CONSTRUCTION"

Bath Iron Works Corporation (hereinafter called "BIW") makes the following comments on the draft report (hereinafter called "Report") sent to it by the General Accounting Office (hereinafter called "GAO") under date of August 5, 1965 concerning an evaluation of the justification for price increases paid to the General Electric Company (hereinafter called "GE") under the terms of four subcontracts for marine turbine generator sets (hereinafter called "Turbine Generators").

BIW PAYMENTS REQUIRED BY APPROVED CONTRACT TERMS

The BIW purchases discussed by GAO were made by BIW as the prime contractor under contracts NObs 3919 and NObs 3989.

All payments made by BIW to GE as the subcontractor for generator sets installed under contracts NObs 3919 and NObs 3989 were made under subcontracts approved by the Navy. Further, the amounts of the price increases actually paid by BIW to GE under these contracts were also approved by the Navy.

STATEMENT CONCERNING SUBCONTRACTS WITH GE
FOR TURBINE GENERATORS

The GAO report at page 4 states:

"Each subcontract awarded to GE by Bath and Defoe for turbine generators contained a price adjustment clause which permitted GE to increase or decrease its prices for the equipment to be furnished if the GE catalog price of its designated commercial equivalent unit changed. However, any price increase was to be limited to 10 percent of the negotiated price and was to apply only to the undelivered units."

Within three months after the award of each of the two subcontracts by BIW, GE increased its catalog prices for the commercial equivalent of the 500-kilowatt turbine generator sets and notified BIW of the increase.

Before making payment to GE for the amount billed for its equipment, BIW secured approval of the payment from the Navy.

In making such payment, BIW did not depart from its contract obligations with GE and did not pay more than it was required to pay pursuant to the terms of the approved contract with GE.

GAO'S CRITICISM OF INCREASED COST OF TURBINE
GENERATORS IS DIRECTED TO ARMED SERVICES
PROCUREMENT REGULATION 7-106.4

While the GAO report comments that if BIW had checked GE sales it would have been obvious that increases in published catalog prices were not an appropriate basis for price increases, the GAO report concludes that BIW acted in full compliance with its contract obligations.

The Report states that Armed Services Procurement Regulation (ASPR) 7-106.4 was the contributing cause of the increased cost of the turbine generator sets.

The Report at page 13 makes the following statement:

"Since Bath, Defoe and the Navy were not specifically required to determine that the established prices were GE's actual commercial prices, they paid the requested price increases under the four subcontracts on the basis of changes in the catalog prices of GE's designated commercial equivalent. Moreover, GE did not volunteer and was not required to furnish any evidence that sales were actually made to its commercial customers at the increased catalog price prior to the time it claimed and was paid the \$369,000 price increases."

Later in the Report at page 14, the following statement is made concerning ASPR 7-106.4:

"In this instance, the Armed Services Procurement Regulation (ASPR) 7-106.4 contributed to the increased costs since the regulation did not and does not specifically require Government prime contractors and/or agency contracting officers to determine that established prices are bona fide commercial prices before agreeing to pay price increases based on those established prices. Moreover, it does not provide for an examination of contractors' sales records at the time price increases are claimed nor does it require contractors to furnish any evidence that commercial sales are actually made to customers at established prices before price increases may be paid. Furthermore, unless ASPR is revised to correct the foregoing deficiencies, there is no assurance that the Government will not incur additional increased costs by the use of this price-adjustment clause in future prime contracts and subcontracts."

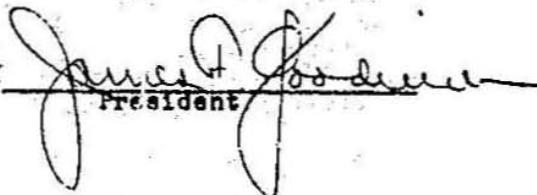
SUMMARY

In purchasing the turbine generators under the two subcontracts, BIW asked for bids from responsible subcontractors. In the case of both subcontracts, in the opinion of BIW, the most advantageous proposals for turbine generator sets were made by GE. The price adjustment clauses submitted by GE were in accord with ASPR 7-106.4. The equipment furnished met contract specifications and has performed satisfactorily since the installation. As to the prices paid therefor, BIW acted entirely within the terms of its contract; the contract complied with ASPR requirements; BIW did not fail to take any action which was required of it and BIW did not make any payment to which it was not committed under the terms of its subcontracts.

September 16, 1965

BATH IRON WORKS CORPORATION

BY



James H. Goodwin
President

**DEFOE SHIPBUILDING COMPANY**

BAY CITY, MICHIGAN

★

July 23, 1965

Mr. J. K. Fasick
Associate Director
U. S. General Accounting Office
Washington 25, D. C.

Dear Mr. Fasick:

In your letter of June 8, 1965 you invited comments from our company on the preliminary draft report entitled, "Report to The Congress of the United States - Unjustified Price Increases for Marine Propulsion Equipment Paid to General Electric Company, Medium Steam Turbine Generator and Gear Department, Lynn, Massachusetts".

This preliminary draft report covers subcontracts awarded by our company and the Bath Iron Works to the General Electric Company. Before our company issued these subcontracts to the General Electric Company, we naturally discussed with their representatives proposed escalation provisions. Escalation at that time was a normal part of such long term subcontracts. The type of escalation clause agreed upon was the same as that used in contracts between the General Electric Company and other shipbuilders and in contracts between the General Electric Company and the U. S. Government. This type of escalation clause was approved by and in use by government agencies.

The top of page 9 of the draft is headed, "Inadequate Evaluation of Price Increases by Bath, Defoe and the Navy", and further at the top of page 11, the draft states, "in light of the above it is evident that neither the prime contractor nor the Navy evaluated the reasonableness of the price increases claimed by GE". Nothing contained in the escalation clause or in the purchase order to General Electric gave us any right to question in any manner General Electric's costs or profits in the performance of these subcontracts. The payment of escalation to General Electric was in no way dependent upon their profits. It is, therefore evident that the contractor had no right to request cost figures or profit figures from General Electric. The catalog prices as submitted to us were submitted in accordance with the accepted escalation provisions.

Mr. J. K. Fasick
U. S. General Accounting Office - Page 2

July 23, 1965

In view of the fact that the contractor fulfilled the requirements of the acceptable escalation provisions and that these provisions did not require or permit the inspection of General Electric costs or profits, the contractor cannot agree that he inadequately evaluated the price increases.

We are in agreement with the information given to the General Accounting Office by the Counsel of the Bureau of Ships as stated in the last paragraph on page 10 of the draft.

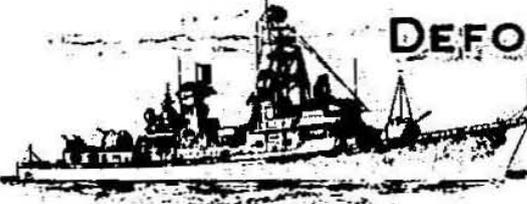
Yours very truly,

DEFOE SHIPBUILDING COMPANY



W. M. Defoe

WMD:ew

A detailed black and white illustration of a large industrial ship, possibly a tugboat or a specialized cargo vessel, with multiple masts, funnels, and complex rigging. It is shown from a side profile, moving towards the right.**DEFOE SHIPBUILDING COMPANY****BAY CITY, MICHIGAN**

*

September 7, 1965

Mr. J. K. Fasick
Associate Director
U. S. General Accounting Office
Washington 25, D. C.

Dear Mr. Fasick:

Your letter of August 5, 1965 invited comments from our company on the preliminary draft report entitled, "Report to the Congress of the United States - Increased Costs for Turbine Generator Sets Used in Ship Construction".

This report covers subcontracts awarded by our company and the Bath Iron Works to the General Electric Company to supply turbine generator sets for use aboard guided missile destroyer type ships. At the time these subcontracts were awarded, it was common practice to include escalation provisions in this type of subcontract where long delivery times were involved. In our more recent construction programs, we have been able to purchase this type of equipment under subcontracts not having escalation clauses.

As you note in your report, the escalation clause used in the subcontracts in question was a clause that met the requirements of the Armed Services Procurement Regulations. This same type of escalation clause was, in fact, used by government agencies in certain prime contracts. At the time the General Electric Company notified us of the price increases, they submitted to us the increased catalog price. This then met the requirements of the escalation clause. We did not have any right to question General Electric's cost of production or profit figures and it is extremely doubtful that General Electric would have been willing to disclose any such figures to us. It was not intended that the escalation clause would be used in any way as a profit limitation device.

Mr. J. K. Fasick
U. S. General Accounting Office - Page 2

Sept. 7, 1965

In view of the fact that the escalation clause that was used was an acceptable clause under the Armed Services Procurement Regulations and in view of the fact that our company did abide by the terms of this clause, we do not feel that our company was lax in the handling of this matter. We agree with the statements made by the Navy representatives as shown in the third paragraph on page 11 of the draft.

If you should desire any further comments, please let me know.

Yours very truly,

DEFOE SHIPBUILDING COMPANY



W. M. Defoe

WMD:ew



DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20350

APPENDIX V
Page 1

17 15 1965

Dear Mr. Fasick:

The Secretary of Defense has asked me to reply to your letter of 8 June 1965 which forwarded the GAO draft report on price increases for marine propulsion equipment paid General Electric Company Medium Steam Turbine Generator and Gear Department, Lynn, Massachusetts.

I am enclosing the Navy reply to the report.

Sincerely yours,

VICTOR M. LONGSTREET
ASSISTANT UNDER SECRETARY OF THE NAVY
(FINANCIAL MANAGEMENT)

Mr. J. K. Fasick
Associate Director
Defense Accounting and Auditing Division
U. S. General Accounting Office
Washington, D. C. 20548

Enclosure

- (1) Navy Reply to GAO Draft Report of 8 June 1965 on Unjustified Price Increases for Marine Propulsion Equipment Paid to General Electric Company, Medium Steam Turbine Generator and Gear Department, Lynn, Massachusetts (OSD Case No. 2319).

NAVY REPLY
TO
GAO DRAFT REPORT OF 8 JUNE 1965
ON
UNJUSTIFIED PRICE INCREASES FOR MARINE PROPULSION EQUIPMENT
PAID TO GENERAL ELECTRIC COMPANY, MEDIUM STEAM TURBINE
GENERATOR AND GEAR DEPARTMENT,
LYNN, MASSACHUSETTS
(OSD Case No. 2319)

A. GAO FINDINGS AND CONCLUSIONS

GAO states that the General Electric Company received about \$1.4 million in unjustified price increases under six subcontracts for marine propulsion equipment awarded by Bath Iron Works Corporation and Defoe Shipbuilding Company as prime contractors to the Department of the Navy. GE claimed and was paid price increases under the price adjustment clause included in the subcontracts. Bath and Defoe claimed and were paid corresponding price increases under the price adjustment clause included in the prime contracts. GAO further states that had the Navy required or performed a review and evaluation of the reasonableness of either the GE list prices of the commercial equivalents designated in the price adjustment clauses, or the subsequent increase in list prices, it seems reasonable that the \$1.4 million increase in the subcontract prices would not have been approved.

B. GAO RECOMMENDATIONS

1. That refunds be obtained from GE for unjustified price increases on six subcontracts.
2. That \$4.4 million in price increases paid to GE on other orders for marine propulsion equipment having similar price adjustment clauses be reviewed to determine if the increases were justified.
3. That the Department of Defense review and revise management practices relating to the use and approval of price adjustment clauses to ensure that appropriate determinations and evaluations are performed prior to the acceptance of price adjustment clauses and subsequent price increases.
4. That the findings in this report be brought to the attention of contracting officials throughout the Department of Defense.

C. NAVY POSITION

The Navy does not consider that it paid unjustified price increases to Bath or Defoe through increases paid under six subcontracts on a price adjustment basis with General Electric but rather that the prices were agreed to under the terms and conditions of the prime and subcontracts and that no basis in law exists for seeking a refund. However, these transactions will be taken into consideration by the Navy incident to its review of the General Electric Actions reported by GAO in OSD Case #2347.

Bath and Defoe obtained price competition for subcontracts for main propulsion turbines and gears. The vendors, in this case General Electric, required an escalation provision in the subcontracts as was customary in the industry at that time. The escalation or price adjustment clause used was that provided for in ASPR 7-106.4 and the only available clause which was acceptable to both the subcontractors and the Navy. The use of such a clause is beneficial to both contract parties because it obviates the need for contractors to place a contingency factor in their price as a hedge against a rise in labor and materials which may or may not occur. This clause, including the identification of the established price of the nearest commercial equivalent, was included in the subcontracts which were approved by the Navy. It is the position of the Navy that cost data is irrelevant to the operation of the clause once it is included in the contract. Hence, there is no clear legal basis for seeking to obtain a refund.

The request for approval of a price adjustment was made by the prime contractors early in 1961. Careful and full consideration of all relevant facts concerning these six subcontracts was made by contracting and legal personnel of the Navy during a period between 1961 and December 1963 when the Navy decided that the subcontract price adjustments were made in accordance with the subcontract terms and the Bath and Defoe were entitled to the resulting adjustments in accordance with the terms of the prime contracts. Considerations was given to the price adjustment clause in the prime contracts which provided for reimbursement of the prime contractor for the net amount of any adjustments made by the prime contractors pursuant to subcontracts or purchase orders on a price-adjustment basis approved in writing by the Navy. The subcontracts were approved by the Navy, the selection of the nearest commercial equivalent was approved by the Navy, the catalog price thereof was increased, the amount billed by the subcontractors was determined to be in accordance with the approved subcontracts and the prime contractors were entitled to seek reimbursement in accordance with the terms of the price adjustment clause in the prime contracts.

There was no requirement at the time in question for the subcontractor to show that it had actually sold the designed commercial equivalent at the catalog price or to justify the price increase. This, coupled with the fact that the prime contractors had been obligated to reimburse the subcontractor pursuant to a clause which the Navy had agreed to, led the Navy to decide, in accordance with the price adjustment provisions of the prime contract, that the escalation claims should be paid.

Considering that the price increases on the six subcontracts were justified as in accordance with both the prime and subcontract terms, there is no legal basis for reviewing price adjustments for marine propulsion equipment which were made at the same time pursuant to price adjustment clauses similar to those above discussed.

Since 1959 steps have been taken by the Department of Defense to correct whatever deficiencies may have existed in connection with the use of price adjustment clauses. A new price adjustment clause for shipbuilding contracts approved in 1959 and the later clause approved in 1962, presently in use, do not contain the provision for reimbursement to prime contractors for escalation paid to subcontractors.

In addition, on 19 May 1965 the Armed Services Procurement Regulation Committee approved for printing a revision of the instructions in ASPR 7-106.4 concerning the use of the escalation clause for semi-standard supplies. These instructions restrict the use of the clause to cases where the prices of semi-standard supplies can be reasonably related to the prices of nearly equivalent standard supplies for which established prices exist and have been verified in accordance with criteria in ASPR 3-807.1 (b) (2); i.e., that the prices be based on (a) and established catalog or market price, (b) of commercial items, (c) sold in substantial quantities, (d) to the general public. This ASPR change will ensure that the clause is used only in cases where catalog prices are realistic indicators of actual market price.

Further the DOD reply to the GAO draft report dated 5 August 1965 concerning the use of the same ASPR clause (OSD Case #2347) states that this matter has been brought to the attention of the ASPR Committee to consider whether any changes should be made to the clause itself.

The changes described above make unnecessary the matters of concern indicated in recommendations 3 and 4.



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D. C. 20301

INSTALLATIONS AND LOGISTICS

17 NOV 1965

Mr. J. Kenneth Fasick, Associate Director
Defense Accounting and Auditing Division
General Accounting Office
Washington, D. C. 20548

Dear Mr. Fasick:

This refers to your letter of August 5, 1965, to the Secretary of Defense transmitting copies of a draft report entitled, "Increased Costs for Turbine Generator Sets Used in Ship Construction," (OSD Case #2347).

Your report states that General Electric Company, within 3 months after being awarded four subcontracts for 500-kilowatt marine turbine generator sets from Bath Iron Works Corporation and Defoe Shipbuilding Company, raised the catalog price of the 500-kilowatt generator sets it designated as commercial equivalents and accordingly claimed and was paid price increases totaling \$369,000 in accordance with the price adjustment clause in the four subcontracts. Since the prime contracts between the Government and Bath and Defoe provided for reimbursement of price adjustments paid by them on subcontracts, the price increases were ultimately borne by the Government.

The report states further that Bath and Defoe agreed to pay the price adjustment to General Electric on the basis of General Electric's submitting a reprinted catalog page indicating that the prices had been increased without determining if General Electric normally sold its designated commercial equivalents at the catalog price. Had Bath and Defoe made this evaluation, or had the Navy made its own review prior to approving the price increases, the report finds they would have discovered

that General Electric's commercial customers were not paying the catalog price for 500-kilowatt and other comparable turbine generator sets. The report, therefore, concludes that if such a review had been made, the price increases would not have been approved.

You note that under the Armed Services Procurement Regulation, 7-106.4, which was then in effect, prime contractors and contracting officers were not required to determine that established prices were bona fide commercial prices before agreeing to pay for increases based on those established prices. Moreover, the ASPR did not provide for an examination of contractor's sales records at the time price increases were claimed nor did ASPR require contractors to furnish any evidence that commercial sales were actually made to customers at those established prices. In the absence of a requirement to determine whether the prices as increased were bona fide commercial prices, the prime contractors and the Navy accepted General Electric's claimed increases on the basis of a revised catalog price. Payment was made in accordance with the procedures set forth in the contract clause.

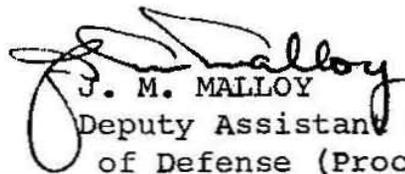
However, we agree that your findings on the actual selling prices to GE's commercial customers of 500-kilowatt to 750-kilowatt turbine generator sets suggest a possible breach of the escalation clause of the purchase order. The Navy will look into this matter and take such action as may be warranted.

The report recommends that ASPR 7-106.4 be revised to specifically require prime contractors or agency contracting officers to obtain evidence that catalog price increases reflect bona fide price increases and that adjustments in sales prices are made to a significant number of buyers constituting the general public. We concur in the thrust of this recommendation. In this connection it should be noted that

ASPR 7-106.4 was revised on August 1, 1965, to provide that catalog prices for commercial equivalents be verified in accordance with the criteria set forth in ASPR 3-807.1(b)(2) for "established catalog or market prices of commercial items sold in substantial quantities to the general public." Also, an ASPR subcommittee is considering various aspects of price warranties under ASPR Case No. 65-108.

While these changes should contribute to the solution of the problem with which this report deals, it may be that additional changes in the ASPR are required. Therefore, the report and your recommendation have been brought to the attention of the ASPR Committee for appropriate action.

Sincerely yours,



J. M. MALLOY
Deputy Assistant Secretary
of Defense (Procurement)