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REPORT BY THE COMPTROLLER GENERAL OF THE UNITED STATES RELATIVE TO
THE CONVERSION OF TWO COST-PLUS-A-FIXED-FEE CONTRACTS BETWEEN THE
UNITED STATES MARITIME COMMISSION AND CALIFORNIA SHIPBUILDING COR-
PORATION TO A FIXED-PRICE BASIS AND TO THE DISPOSAL OF THE SHIPYARD
AND INVENTORY TO SAID CORPORATION

INTRODUCTION

The purpose of this report is to bring to the attention of the Congress several transactions between the United States Maritime Commission and California Shipbuilding Corporation. Speaking generally, these transactions may be divided into two classes, one involving the conversion of certain contracts from a cost-plus type to a lump-sum type, and the other involving the disposal of the shipyard and surplus materials located there to the said corporation.

The practice of converting contracts from a cost-plus-a-fixed-fee to a fixed-price basis has been discussed by representatives of the General Accounting Office before committees of the Congress on several occasions. In my testimony before the Senate Committee Investigating the National Defense Program on July 29, 1946, I called attention to the fact that such conversions had taken place and that, in some instances, the contracts were converted after all, or a substantial portion, of the work had been done. Similarly, in testifying before the House Committee on the Merchant Marine and Fisheries on September 23, 1946, a representative of the General Accounting

Office cited several specific cases of conversions, including the one which is the subject of this report. And more recently, on April 9, 1947, representatives of this office discussed conversions in testimony before a Subcommittee of the House Committee on Appropriations; and, at the request of the Subcommittee, there was furnished a list of Maritime Commission contracts which had been converted from one type to another.

Moreover, the subject of shipyard disposals has engaged the consideration of various Congressional committees from time to time and, upon each occasion, there has arisen the question of the terms upon which the shipyard at Terminal Island, California, was sold to California Shipbuilding Corporation. And at the Hearings on the Navy Department Appropriation Bill, 1947 (Part 2, pages 70-75), there was entered for the record the entire agreement covering the sale of the yard as well as a statement by the Maritime Commission containing figures purporting to show that the terms of the transaction were beneficial to the Government. Subsequently, the matter was investigated by the House Committee on the Merchant Marine and Fisheries. In House Report No. 4, 80th Congress, said Committee reported the status of such investigation as follows (page 5):

"6. Shipyard disposal

"Information developed by the committee staff indicated that shipyards and surplus shipbuilding materials within these shipyards valued at many millions of dollars, were being disposed of to private operators who were being paid additional substantial sums of money to take the yards. In the case of the California Shipbuilding Co., for example, a yard costing \$25,000,000 and surplus materials costing \$14,000,000 were sold by the Commission under an agreement which provided that the company would be paid an additional \$2,500,000 for taking them. The Maritime Commission attempted to justify this transaction on the grounds that it was required by the terms of its lease of the property on which the yard was built to remove the

installations and restore the property to its original condition, and that the yard, the property, and the additional payment had been made to the shipbuilding company in return for its assuming this obligation of the Commission.

"Final action on this matter has not yet been taken because of time limitations resulting from the recess and the expiration of the Congress. The problem of shipyard disposal should continue to be studied during the coming Congress."

It is in light of this background that the present report has been prepared. It is doubtful whether the action of the Maritime Commission in executing these contracts was illegal, principally because of the broad authority conferred by the various statutes under which the action was taken. Also, it is doubtful whether the said contract may be set aside or any recoveries made thereunder, since there has been found no fraud or collusion in connection therewith. Possibly, the Congress may wish to consider these questions and render its own judgment thereon. However, it is believed that the facts concerning both the conversion of the contracts and the disposal of the shipyard and surplus inventory clearly evidence a lack of that zealous care for the interests of the United States which is expected of all Government officials exercising functions in connection with the expenditure of public funds or the sale of public property. Under such circumstances, I deem it proper that the Congress be apprized of the facts of the matter.

BRIEF HISTORY OF THE CALIFORNIA SHIPBUILDING CORPORATION

The California Shipbuilding Corporation, hereinafter called "Calship," was incorporated under date of January 6, 1941, for the express purpose of building, converting, and repairing ships for the Maritime Commission. The incorporators of the company were Messrs. R. F. Lewis, L. H. Herman, and Walter Lens, all of Wilmington, Delaware,

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who also were incorporators of the Houston Shipbuilding Corporation, the Richmond Shipbuilding Corporation, and the Permanente Metals Corporation. At a meeting at the Carlton Hotel here in Washington on January 11, 1941, the first permanent organization was set up, consisting of the following personnel:

S. D. Bechtel	President and Director
Henry J. Kaiser	Vice-President and Director
Joseph Haag, Jr.	Vice-President and Director
J. A. McEachern	Vice-President and Director
John D. Reilly	Director
John A. McCone	Vice-President and General Manager
Ralph M. Parsons	Vice-President
R. J. Lamont	Vice-President
K. K. Bechtel	Secretary and Treasurer
W. E. Waste	Assistant Secretary and Assistant Treasurer
E. P. Enfer	Assistant Secretary and Assistant Treasurer
Charles F. Strenz	Assistant Secretary and Assistant Treasurer

The original stockholders in the company, and the investment of each, were as follows:

<u>Subscriber</u>	<u>No. of Shares</u>	<u>Investment</u>
Todd Shipyards Corporation	500.0	\$50,000
Henry J. Kaiser Co.	62.5	6,250
J. F. Shea Co., Inc.	45.5	4,550
W. A. Bechtel Co.	62.5	6,250
General Construction Co.	45.5	4,550
The Kaiser Co.	62.5	6,250
Bechtel-McCone-Parsons Corp.	62.5	6,250
The Utah Construction Co.	45.5	4,550
Morrison-Knudsen Co., Inc.	45.5	4,550
MacDonald & Kahn, Inc.	45.5	4,550
Pacific Bridge Co.	22.5	2,250
Totals	1,000	\$100,000

It is understood that one year after the incorporation of the company the Todd interests withdrew from the company and that, in 1945, the Kaiser interests likewise withdrew. (Further details on this aspect of the matter are contained in the Hearings on Shipyard Profits,

held pursuant to H. Res. 38, 79th Congress, pages 189, et seq.)

The newly formed company entered into several so-called facilities contracts with the Maritime Commission early in 1941, under which the company agreed to construct the necessary buildings, shipways, and other facilities required for the construction of ships. Such contracts provided for complete reimbursement to the contractor of the costs incurred in the work, but stipulated that no profit was to be realized thereunder. The yard was constructed upon approximately 86 acres of land on Terminal Island, which land was leased by the contractor from the Harbor Board of the City of Los Angeles under an agreement obligating the lessee to restore the property to its original condition at the termination of the lease. Such restoration cost was actually an obligation of the Maritime Commission by force of provisions in its contracts with Calship.

It is understood that during the war period the business of Calship was devoted solely to the construction or repair of ships for the Maritime Commission. In that connection, various contracts were let, some on a cost-plus-a-fixed-fee basis and others on a selective-price basis. The first section of this report will be devoted to the matter of the conversion of two cost-plus-a-fixed-fee contracts to other forms.

CONTRACT CONVERSIONS

Under date of April 20, 1943, the Maritime Commission executed contract No. MC-15740 (hereinafter called "contract No. 1") with Calship calling for the construction of 84 vessels (design VC2-S-AP3) for which the Commission was to pay the entire cost of construction, plus a fee

for each vessel—the maximum amounts payable not to exceed \$134,400,000 in the absence of written consent by the Commission. The contract stipulated a base fee of \$74,000, which could be increased to \$100,000, or decreased to \$37,000, depending upon the date the vessel was delivered and the number of man-hours of labor expended in connection therewith. Article 31 of said contract No. 1 stipulated that the contract was subject to the Renegotiation Act.

An addendum to said contract No. 1 was entered into as of March 1, 1945. In said addendum the following recitations were made: (1) the fact of the existence of the original contract for the construction of 84 vessels of VC2-S-AP3 design; (2) a previous agreement not to build 4 of the 84 vessels; (3) a previous direction by the Commission to complete 21 as combat loaded troop ships (design VC2-S-AP5); (4) that 9 vessels already had been partially completed and delivered as combat loaded troop ships; (5) that 32 vessels had been completed as VC2-S-AP3, the original design; and (6) a previous direction by the Commission to complete 18 vessels as VC2-S-AP2's.

Article 1 of said addendum dated as of March 1, 1945, amended said contract No. 1 to constitute it a contract covering only the 62 vessels described in items 3, 4 and 5 of the recitations, and referred to them as the "completed vessels." Article 2 provided for a fixed price of \$130,000,000 for said completed vessels in lieu of the amount of costs and fees payable under contract No. 1. The contractor agreed to repay to the Commission profits in excess of \$3,260,000, if any, after they had been determined. And, in connection with such determination of profits, it was agreed that:

"(1) No item of cost which would have been allowed as a reimbursable item of cost under the terms of the Vessel Contract shall be disallowed for the purposes of determining profit hereunder.

"(2) No item of cost which under the terms of the Vessel Contract would not be allowed as a reimbursable item of cost because of the purpose for which the expenditure was made shall be allowed as an item of cost for the purpose of determining profit.

"(3) No reallocation of cost shown on the books and records as costs of the Completed Vessels as of February 15, 1945 shall be made to any other contract between the Contractor and the Commission, nor shall any item of cost shown on the Contractor's books and records on such date as allocable to the performance of any work under any other contract between the Contractor and the Commission, or to the performance of work upon the remainder of the vessels called for by the Vessel Contract be allocated to the cost of constructing the Completed Vessels, it being understood and agreed that the provisions of this subparagraph (3) shall be applicable not only to the determination of profit provided for in this Article but also to the determination of costs incurred under other contracts between the Contractor and the Commission.

"(4) No disallowance from cost shall be made on account of any expenditure duly approved by the Commission's authorized representatives on the grounds that such expenditure constituted an expenditure for shipyard facilities instead of construction of vessels."

Provision also was made that, in case the contractor's profits should be less than \$3,260,000, it should be paid the difference, or \$1,200,000, whichever should be the lesser amount. And, finally, it was provided that the compensation payable under said addendum should cover also all claims for the vessels cancelled under item (2) above, and partially completed under item (4) above. The remaining 18 vessels, referred to in item (6), were transferred to another contract to be discussed hereinafter.

Contract No. MCo-30603, dated as of July 18, 1944, hereinafter called contract No. 2, called for the construction of 45 vessels (design VC2-S-AP2) for which the Commission agreed to pay Calship the entire cost of construction plus a base fee of \$74,000 per vessel.

It was provided that said fee could be increased to \$100,000 by bonuses or decreased to \$37,000 through penalties but that in no event should the total payments under the contract exceed \$72,000,000, in the absence of the written consent of the Commission. Article 31 provided that said contract should be deemed to contain all the provisions required by the Renegotiation Law.

As of March 1, 1945, there was executed contract No. WCC-34764 (hereinafter called contract No. 3) calling for the construction of 79 vessels on a selective-price basis. Of these 79 vessels, 18 originally had been covered by contract No. 1, 45 by contract No. 2, and 16 had not been included in any previous contract. All vessels apparently were to be of the design VC2-S-AP2.

Article 4 of said contract No. 3 provided that the Commission would furnish to the contractor the principal items of material, machinery, equipment and certain subcontract work for which \$1,175,000 would be deducted from amounts otherwise payable for each vessel. Article 7 stipulated a base figure of \$207,375,000 as the contract price for all work to be performed, which price was subject to various kinds of adjustments. The figure of \$207,375,000 was computed on the basis of \$2,625,000 per vessel.

Under article 8 of said contract No. 3 the contract price was subject to adjustment for increases or decreases in labor or material costs. Article 9 provided for adjustments due to changes in the plans and specifications. Article 10 provided for a maximum retainable profit of \$7,531,070, unless increased by the selective-price method, with provision for recapture of any excess. Prior to the laying of the keel for any vessel the contractor was permitted to select the

price for which it would construct the vessel, such prices ranging from \$2,175,000, with a retainable profit of \$152,210, to \$3,075,000, with a retainable profit of \$38,450. It was provided that even with adjustment the maximum profit should not exceed \$12,024,590. And, finally, article 32 exempted the contract from renegotiation.

Addendum No. 1, dated as of May 17, 1945, amended contract No. 3 with respect to certain of the materials, etc., to be furnished by the Commission and is not material to this report. Work on 10 of the vessels covered by said contract No. 3 was terminated by the Commission on August 14, 1945. By addendum No. 2 contract No. 3 was converted from a selective-price contract to one providing for a lump-sum payment of \$171,700,000 for all work to be performed under the contract as modified by the termination notice of August 14, 1945, subject to adjustment only for changes in labor or material costs and changes in plans and specifications. A maximum profit of \$8,358,890 was provided for; and the contractor was to be reimbursed for all costs of paying claims of subcontractors whose contracts had been terminated.

By addendum No. 3, dated as of December 1, 1945, contract No. 3 was again amended to change the contract price to \$170,100,000, which price was not subject to any adjustment. Said addendum contained the same provisions as addendum No. 2 with respect to the amount of retainable profit and the payment of termination claims. The remaining provisions of said addendum No. 3 primarily concerned the terms upon which the shipyard and surplus material were turned over to Calship, which matter will be considered separately later on in this report.

EFFECT OF CONVERSIONS

By letter dated November 15, 1946 (B-37463), this office requested the Chairman of the Maritime Commission to furnish a statement showing the basis upon which it had been determined that the execution of contract No. 3 and addenda Nos. 2 and 3 thereto were in the interest of the Government. In reply, there was received a letter dated December 18, 1946, from the Chairman of the Commission, reading, in part, as follows:

"The conversion of the two cost-plus-a-fee type contracts (MCC-15740 and MCC-30603) to the so-called selective-price type of fixed-price contract was made at a time when very little work had been performed under one of such contracts, and a substantial portion of the work remained to be performed under the other of such contracts. In this connection, it may be pointed out that the contractor agreed to enter into this type of contract prior to the date of the Commission's action authorizing the execution of the contract dated March 1, 1945.

"The contract with California Shipbuilding Corporation, dated April 20, 1943 (Contract MCC-15740) covered the construction of 84 Design VC2-S-AP3 cargo vessels. Thirty-two of these vessels had been constructed in accordance with the terms and conditions of the contract. Pursuant to instructions received from the Commission, the contractor completed 21 of these vessels as combat-loaded troop ships (Design VC2-S-AP5) and partially completed 9 others in this manner. The Commission directed the Contractor to perform no work on four other vessels, in order that they might be built by another contractor. At that time the contractor was building the 18 vessels which remained in the contract in accordance with Design VC2-S-AP2, pursuant to instructions from the Commission.

"The Contractor desired to combine the 18 Design VC2-S-AP2 vessels which it was building, in a selective price contract with the 16 additional vessels theretofore awarded to it by the Commission, in order to obviate a situation where cost-plus-a-fee and fixed-price contract work would be performed concurrently in the same shipyard.

"The contract dated April 20, 1943, was a so-called 'manhour' type of contract and specified a base fee of \$74,000, a minimum fee of \$36,000, and a maximum fee of \$100,000. The Commission had previously authorized increasing these fees to \$120,000, \$60,000 and \$160,000, respectively, for those vessels which were completed in accordance with the VC2-S-AP5 design.

"The performance records of the contractor indicated that, in the construction of the AP5 vessels, only the minimum fee of \$60,000 had been earned. With respect to the AP3 vessels, however, it appeared that the contractor had earned less than the normal fee, but more than the minimum. In a letter dated February 21, 1945, the California Shipbuilding Corporation set forth certain considerations in view of which the Contractor estimated that the adjusted fee per AP3 vessel would amount to \$71,070. The contractor's estimate, however, presumed the allowance by the Commission of claims for increases in estimated average vessel manhours totalling many times the aggregate increase claimed by Oregon for similar vessels constructed in the latter's yard. It also presumed the approval by the Commission of certain claims for extension of contract delivery dates. The Committee on Awards was not in a position to consider these claims which were matters for decision by the Commission upon the recommendations of its Change Review Board and Board for the Adjudication of Claims for Delay, respectively. On the other hand, the construction cost and building time for California's AP3's were substantially greater than those for Oregon's first 32 AP3's. On the basis of the information then available to the Committee, therefore, the fee which California would earn on the AP3's built under Contract WCo-15740 had to be taken as indeterminate, but was assumed to be substantially less than that earned by Oregon.

"The Commission's Resident Auditor found the cost incurred in the performance of work on the 62 AP3 and AP5 vessels to be the sum of approximately \$125,298,412. Certain charges and liabilities which had not been recorded on the Contractor's books were not included in such costs.

"The contractor proposed that an agreement be entered into providing for the amendment of Contract WCo-15740 so as to exclude therefrom the 18 AP2 vessels which it desired to have included under its selective price contract, and to provide for the payment of a lump-sum amount equal to its costs, fees and a contingency item on account of the construction of the 62 vessels which remained in the contract, such agreement to provide that all profits in excess of the estimated amount of fees earned would be subject to recapture.

"The Committee, after considering the foregoing facts, advised the contractor that it would recommend to the Commission the making of a lump-sum agreement covering the aforementioned 62 vessels and specifying the contract price of \$130,000,000, payment of such price less the sum of \$1,200,000 to be made forthwith. This price included the recorded costs of the contractor, a contingency item to take care of unrecorded costs, and a profit factor equal to the fee determined in the manner hereinafter described.

"As stated above, the contractor apparently had earned on the completed AP5 vessels the minimum fee of \$60,000 per vessel. The contractor requested the sum of \$25,000 to be included in the contract price and recapture figure on account of the nine AP5 vessels which

were delivered in an incomplete state. This figure is arrived at by multiplying the percentage of the contractor work completed on such vessels by the base fee of \$120,000, stipulated in the contract. Under the terms of the cancellation provision of the contract, the contractor would be entitled to such normal fee multiplied by the percentage of work completed, inclusive of materials delivered to the shipyard. On such basis, the contractor's fee would be approximately \$790,000, since more than 75 percent of the work had been completed on these vessels. The Committee felt that the circumstances in respect to the removal of these nine vessels from the contractor's shipyard for completion elsewhere would not justify the payment of the full cancellation fee specified in the contract. There was, therefore, included in the contract price and recapture provision the sum of \$400,000, being approximately equal to the minimum fee of \$60,000 per vessel multiplied by the percentage of work completed, including materials delivered.

"With respect to the AF3 vessels, the Committee, after taking into account all considerations properly within its cognizance, including comparison with the profit allowance of \$71,000 per vessel made in connection with a similar agreement recommended for Oregon, was of the opinion that California's fee should be approximately \$50,000 per vessel, which is roughly 3% of the resultant price per vessel.

"The agreement provided that no part of the \$1,200,000 withheld was to be paid until the Contractor's costs had been determined, and that all profits in excess of the sum of \$3,260,000 would be recapturable.

"The agreement also provided that no reallocation of costs would be made subsequent to January 31, 1945, the date on which the costs referred to herein were determined, as between the performance of the work on the aforementioned 62 vessels and work under any other contract. It should also provide that any amounts previously allowed for maintenance will not be disallowed in determining profit on the grounds that they constituted expenditures for shipyard facilities.

"Contract WCo-34764 was drawn under the provisions of Public Law 247 (77th Congress). The provisions in Commission selective-fixed price contracts in respect to recapture of profits, pursuant to Public Law 247, differ from those contained in the contracts entered into under the Merchant Marine Act of 1936, as amended, in the following respects:

"(1) No provision is made for allowing the contractor to charge losses on other contracts against profit realized.

"(2) The profit is stated as a definite figure rather than a percentage and is subject to adjustment only for changes in plans and specifications and not, as is the case with the Merchant Marine Act contracts, for increases under the so-called escalator clause.

"(3) Special provision is made for the manner of determining the costs of performing the contract work.

"Another difference between the recapture of profits as provided for in Section 505(b) of the Merchant Marine Act of 1936 and that which results where a recapture provision is included in the contract as a matter of agreement rather than statutory requirement is that under the latter type of recapture provision the contractor is not entitled to recompute its taxes in accordance with the provisions of Section 726 of the Internal Revenue Code. Under this provision of law, the contractor may include in its tax base all profits derived from the performance of the contracts under the Merchant Marine Act and deduct from its taxes an amount equal to that paid in recapture.

"Finally, it may be noted that the percentage of the contract price which the contractor is entitled to retain after recapture under selective-fixed price contracts varies from 1½ percent to 8 percent, whereas under the Merchant Marine Act this profit is fixed at 10 percent.

"From the foregoing, it will be seen that the question of changing the type of contract was given thorough consideration by Commission representatives; that it was not desirable to have contract work performed under cost-plus-a-fee and selective-fixed price contracts concurrently in the same yard; and that such conversion was in the interest of the Government.

"With respect to the 'estimated' figures referred to in connection with Addendum No. 3 to Contract MCo-34764, no change has been made and nothing has developed, as of this date, necessitating a change."

In the first place, there will be noted the contention of the Commission that the conversion of contracts Nos. 1 and 2 took place at a time when "very little work had been performed under one of such contracts, and a substantial portion of the work remained to be performed under the other of such contracts." But the records of this office indicate that as of March 1, 1945, the date of the execution of addendum No. 1 to contract No. 1, providing for a lump-sum payment of \$130,000,000 for 62 of the original 84 vessels, all 62 such vessels had been delivered, 53 entirely complete, and 9 partially complete. Of course, 4 vessels had been eliminated. The remaining 18 vessels were transferred to contract No. 3, and evidence of record here in-

icates that as of March 1, 1945, 15 of these had been completed and that 98.58 percent of the work on all 18 vessels had been performed. It is understood, however, that as of March 1, 1945, only 16.40 percent of the work called for under contract No. 2 had been performed.

As indicated above, contract No. 1 called for a base fee of \$74,000 which could be increased by bonuses to \$100,000 or decreased by penalties to \$37,000. Evidence of record here indicates that for the 32 AP3 vessels completed under said contract No. 1, the average earned fee per vessel amounted to but \$18,465.67. So that, if payment had been made under the terms of said contract No. 1, the minimum fee of \$37,000 would have been payable for each of those 32 vessels, or a total of \$1,184,000. However, under addendum No. 1, the contractor received fees totalling \$1,600,000--\$50,000 per vessel--or \$416,000 in excess of the amount payable under the original contract.

Then, there is for consideration the effect of the transfer of the 18 AP2 vessels from contract No. 1 to contract No. 3, 15 of which had been completed and delivered. By addendum No. 2 to said contract No. 3, the contractor was allowed a profit of \$3,717,870 on the first 39 AP2 vessels called for thereunder, or an average of \$95,330 per vessel. The 15 AP2 vessels completed under contract No. 1 were, of course, included in the said 39. AP2 vessels are understood to be substantially the same as AP3 vessels, the only variance being the installation of a propulsion unit of lesser power; hence, it would appear proper to apply the formula of contract No. 1 to determine the fees payable for those of the 15 vessels for which individual hull costs are reported. This computation indicates that but \$915,734.43 would have been paid for the 15 vessels under contract No. 1, instead of \$953,300 under addendum No. 2 to contract No. 3.

a difference of \$37,565.57. And, of course, it is reasonable to assume that an indeterminate amount more was paid for the 5 other vessels whose costs are unknown.

During the course of the investigation of this matter, officials of the contractor stated to representatives of the General Accounting Office that the conversions had made possible the reduction of administrative costs and business machine rentals. It has been reported, however, that the ratio of such costs to direct labor increased rather than decreased after the conversions of March 1, 1945. The results of this study, as reported, are as follows:

	Oct. '44 through Feb. '45	Mar. '45 through July '45
Ratio of administrative costs to direct labor	35.49%	38.35%
Ratio of business machines rentals to direct labor	.20%	.38%

While not directly or proximately a result of the conversions referred to above, it should be noted that, under contract No. 1, the recorded costs of the contractor for the fiscal year ended November 30, 1946, and the amount recapturable under said contract as of that date, appear to be as follows:

Total paid to contractor	\$128,800,000.00
Recorded costs	<u>125,251,082.43</u>
Gross profit	\$3,548,917.57
Maximum allowable profit	<u>3,260,000.00</u>
Recapturable profit	\$ 288,917.57
Repaid by check on October 7, 1946	<u>250,587.22</u>
Amount remaining for recapture	\$ 38,330.35

Thus, from March 1, 1945, to October 7, 1946, the contractor was permitted to retain, interest free, the sum of \$288,917.57, and, so far as the General Accounting Office is aware, the contractor still

retains over \$38,000.

Insofar as the amount of recapturable profits under contract No. 3 is concerned, the following is reported:

Final Contract Price, per Addendum 3		\$170,100,000.00
Less: Value of Commission material -		
63 vessels @ \$1,175,000.00	\$74,025,000.00	
6 vessels @ 1,082,546.00	6,495,276.00	
Unbilled contract price	6,437.04	
		<u>80,526,713.04</u>
Total billings per Application No. 35		\$ 89,573,286.96
Recorded costs, 11/30/46	\$76,351,501.33	
Commission exceptions outstanding	893,568.98	
Admissible costs		\$ <u>75,457,932.35</u>
Gross Profit		\$ 14,115,354.61
Maximum allowed	\$ 8,358,890.00	
Retention per Addendum 3	<u>2,500,000.00</u>	
Total for retention by Contractor		<u>10,858,890.00</u>
Net recapturable		\$ 3,256,464.61
Paid by Contractor to Commission:		
Ck. 220221, 7/26/46	\$ 1,000,000.00	
Ck. 220575, 10/7/46	<u>1,006,258.43</u>	
		<u>2,006,258.43</u>
Balance due		\$1,250,206.18

While on the subject of contract conversions some general observations are deemed appropriate. Where the Government is legally bound under a contract to reimburse a contractor all his costs and, in addition, pay him a stipulated fee, are we to believe that such contractor will agree to the cancellation of that contract and to the execution of a new contract in some other form covering the same work unless he is to receive at least as much, if not more, money under the new agreement? Certainly, those representing the Government in these transactions are not so superior to the contractors in bargaining skill as to be able to take from them a dollar and give them back fifty cents or any other

amount less than a dollar. And yet, invariably, that is what the administrative offices contend is the final result of a conversion. It is in this light that the General Accounting Office views with suspicion all conversions of contracts under which all or a substantial portion of the work has been completed.

Moreover, conversions serve the purpose of foreclosing the General Accounting Office from auditing individual items of cost under cost-type contracts, and from disallowing credit for items for which reimbursement should not properly have been made under the terms of the contract. Consequently, where work under a cost-type contract has been substantially performed and the contractor is apprehensive that all items of cost for which he has made claim will not eventually be allowed as reimbursable, his readiness to wipe the slate clean by entering into a lump-sum contract is understandable. It will be noted that, in the present case, the addendum to contract No. 1 contains provisions precluding any future reallocation of costs between the vessels covered thereby and any other vessels or the facilities themselves.

As vicious as this practice of converting contracts was generally, it is believed to have been exceptionally inexcusable in the case of Maritime Commission contracts. It is fundamental, of course, that no administrative office could conscientiously determine the execution of a new fixed-price contract to be to the advantage of the United States in the absence of fairly accurate and reliable knowledge of the ultimate costs under the existing cost-type contract. The General Accounting Office has submitted to the Congress audit reports of the Maritime Com-

mission for the war years showing the deplorable state of the accounting records of that agency. The Commission itself admitted (page 5 of House Report No. 1, 80th Congress);

* * * * There was, from 1942, no possibility that the cost of contracts or of ships would ever be known unless the whole system were revised and brought into relation with the flow of money and events. The disorder was widely known.

"The whole bookkeeping system of the Commission, in which all of its activities, including shipyards, were supposed to be combined, was confused, cumbersome, and badly suited to its needs."

Subsequently, the House Committee on the Merchant Marine and Fisheries made its own independent investigation of the accounting practices of the Commission and concurred in the findings and conclusions of the said audit report. See House Report No. 1, 80th Congress.

It is conceded by all concerned that the failure of the Maritime Commission to keep proper accounts undoubtedly resulted in serious monetary losses to the Government. The Commission maintains, however, that by converting the cost-plus-a-fixed-fee contracts here in question to fixed-price contracts the Government saved money. The basis for such determination is not understood. Possibly, in view of the wholly incomplete and unsatisfactory state of the Commission's own records as to the cost of ships, reliance was placed on figures reflected by the books of the contractor. At any rate, the conclusion is inescapable that officials of the Maritime Commission converted these contracts after a substantial portion of the work had been performed, with full knowledge of the inadequacy of the cost data applicable to the vessels.

DISPOSAL OF FACILITIES AND INVENTORY

Addendum No. 3 to contract No. 3, which, it will be recalled, was executed as of December 1, 1945, contains various provisions dealing

with the disposition of the shipyard facilities and surplus inventory.

Briefly, such provisions were:

1. The contractor assumed, or released the Maritime Commission from, the following obligations:
 - a. To reimburse the contractor for the costs of the contractor in satisfying its lease obligations, including its obligations to pay rents and to restore the leased real property;
 - b. Those of the Commission under its leases of the shipyard site and property used in connection therewith, including its obligations to pay rents and to restore such property; and
 - c. Those of the Commission under an agreement with the Pacific Electric Company and under an agreement with the Board of Harbor Commissioners, City of Los Angeles, to pay rents and to restore and replace property.
2. In consideration of the assumption of such obligations by the contractor, the Commission agreed:
 - a. To pay the contractor \$2,500,000, which sum was to be paid by a reduction in recapturable profits under contract No. 3, as amended;
 - b. To transfer to the contractor title to all material, inventory, machinery, equipment, structures, and all other property of the Maritime Commission located on the shipyard premises or in the custody of the contractor as of 12.01 a.m., December 1, 1945, except for spare parts later to be placed on the vessels and property shipped to the shipyard for storage, only; and
 - c. To transfer to the contractor title to all material, inventory, machinery, equipment, including railway cars, and

all other property of the Commission used in connection with a certain contract with the Pacific Electric Company, and in the custody of said company as of 12.01 a.m., December 1, 1945.

Thus, in consideration for the assumption by the contractor of the Commission's obligation to restore the leased property upon which the shipyard was located, the contractor received a credit of \$2,500,000 and title to all facilities and material located there. Since, apparently, it had been determined by the Maritime Commission that the shipyard in question would not be needed for postwar use and since it had been constructed on leased land, it was quite naturally to be expected that the Government would lose a substantial amount of money in connection with its disposition. At the same time, however, it devolved upon those in the Commission to take every precaution to minimize as much as possible the financial loss to be incurred. Hence, the question here is solely whether reasonable care and judgment were exercised in connection with the agreement executed with Calship relating to the sale of the shipyard and surplus material. And, in considering that question, it is essential that the entire situation be viewed with a clear understanding of the fact that the present approach is a matter of hindsight rather than foresight. The unfairness of viewing the matter any other way is obvious.

It appears that by letter dated November 23, 1945, Calship, through its Vice President and General Manager, submitted a proposal under which it would assume the obligations of the Commission to restore the leased shipyard site to its original condition. This proposal contained substantially the same terms as the agreement eventually consummated, but the estimates of cost and values set out therein are material.

The original cost of materials on hand at the shipyard was stated at \$14,024,467.02; of this amount, \$5,007,289.39 was stated to represent materials constituting scrap or having no sale value, leaving a book value of saleable material of \$9,017,177.63. The original cost of the machinery, equipment and structures comprising the shipyard facilities was fixed at \$25,216,116.52; the net book value of such facilities, after deductions for freight, installation charges, and obsolete equipment, was stated to be \$6,584,936.00; and the estimated cost of restoration, \$5,254,055.00. The proposal at that time was for Calship to take title to the shipyard and materials and to be credited with \$3,000,000 in recapturable profits in return for the assumption of the Commission's obligation to restore the land.

On page 74, part 2, Hearings on the Navy Department Appropriation Bill, 1947 (H.R. 6496, 79th Congress), the Maritime Commission inserted for the record the following figures on the matter:

*Total investment in shipyard (all on leased lands, 151 acres)	\$25,282,989
<hr/>	
*Investment in Government-owned improvements and structures on leased lands which would have had to be removed and on which the salvage would have been less than the cost of demolition, removing and restoration (also includes overhead)	13,891,607
*Remaining investment in Government-owned facilities, machinery, and equipment after deduction for buildings, improvements, and structures on leased lands as above	11,391,382

Transportation system cost \$2,308,211, including roads, railroad tracks, and rolling stock. Probably about 10 percent recoverable; deduct \$2,077,390, leaving an estimated approximate recovery value of \$230,821.

"Estimated approximate investment in machinery and equipment after above deductions 9,083,171

Estimated recoverable value of machinery and equipment above after allowing for structural, mechanical, and economic depreciation, cost of inventorying, dismantling, care, and handling, and cost of selling, \$937,635.74.

"Add estimated recoverable value of transportation system above (\$230,821) to estimated recoverable value of machinery and equipment above (\$937,635.74) \$1,168,457

"Total estimated cost of surplus ships' material and operating supplies, all on leased properties, \$14,024,467; Estimated receipts 15 percent 2,103,670

Total estimated recoverable value of all materials and supplies, equipment, machinery, etc., located on leased lands 3,272,127

COST OF RESTORING PREMISES, ETC.

"Estimated cost of restoring leased properties as required by the leases \$5,250,000

"Estimated cost of handling, loading, and transporting materials and supplies 1,000,000

Total of above \$6,250,000

"Deduct estimated recoverable value of all materials, supplies, equipment, and machinery 3,272,127

Net amount due contractor by Commission on estimates above 2,977,873

"Amount asked by contractor 3,000,000

"Negotiated settlement: Actual amount paid contractor by Commission 2,500,000"

And, finally, by letter of October 29, 1946, addressed to the General Counsel, House Merchant Marine and Fisheries Investigating Committee, the transactions carried on by Calship up to September 30, 1946, were summarized as follows:

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"Revenues:

"Reduction of provision for recapturable profits due United States Maritime Commission	\$2,500,000.00
"Proceeds of sales	5,093,647.47
"Other Sundry Revenues	<u>221,419.24</u>
	<u>\$7,815,066.71</u>

"Operating Expenses:

"Balance Reserve for Demolition and Restoration	<u>\$4,962,409.76</u>
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Appended to this tabulation was the following note:

"This fund of \$4,962,409.76 may be increased through further sales of materials, as hereinabove commented on but, before profit or loss can be computed there must be deducted all expenses of continued operation, cost of demolition, cost of restoration, unknown claims, losses and contingencies."

Representatives of the General Accounting Office have reported certain facts and statistics concerning this phase of the matter which would seem to indicate that the true picture may be somewhat different from that heretofore depicted. In the first place, it is understood that the sale of the yard assets was handled by the Industrial Equipment Company, whose president is J. M. Warfield, the Vice President and General Manager of Calship. Also, it is understood that said Industrial Equipment Company was formed in collaboration with the Bechtel and Consolidated Steel interests for the purpose of salvaging Japanese and Allied vessels sunk during the war; that extensive salvage and repair facilities have been established at Engineers Island, in Manila Bay, and at Samar, near Leyte; that said firm employs about 5,000 persons; and that such of the equipment located at Calship as was needed to carry on such venture was purchased at lower than

market value levels.

Moreover, a representative of the Maritime Commission at the shipyard stated that as soon as the agreement relative to the sale of the assets to Calship became effective representatives of Bechtel, one of the so-called Kaiser group and a stockholder in Calship, appeared at the site and tagged all equipment needed for their use. Further information concerning the sales, particularly as to the identity of the purchasers, could not be obtained, the contractor's representatives having refused to furnish same. However, the indications are that possibly other affiliates and associates of the contractor also benefited by purchases at far less than market values. And, of course, little significance can be attached to the figures furnished by the contractor as representing "proceeds of sales" if, in fact, the bulk of the equipment and materials was sold to friends or business associates.

In the statement of values set upon the shipyard facilities and materials by the contractor in submitting the proposal of November 23, 1945, the buildings at the site, costing originally \$3,912,815.30, were written off as having no book value whatever. But there is of record in the General Accounting Office a clipping from the Los Angeles Evening Herald and Express (March 1, 1947) advertising for sale Shop Buildings, Administration Buildings, and a Warehouse Building. The advertisement represents that the buildings are adaptable to modification for industrial use at their present location or for removal from the premises. It is stated further that the owner "will assist purchasers in securing ground leases for present location." The advertisement was inserted by the Industrial Equipment Company and is understood

as referring to buildings at Calship.

Further, in this connection, it has been ascertained that buildings at the Consolidated Steel Corporation Shipyard, Wilmington, California, which are similar to those at Calship, were sold for between \$1 and \$3 per square foot, depending upon the size of the building. Taking as an average a rate of \$2 per square foot, the major buildings at Calship, making allowance for those included in a release to the Board of Harbor Commissioners, should be worth approximately \$2,181,630. Hence, while no breakdown of actual sales of such buildings is available, the indications are that substantial revenue may have been or may be derived therefrom.

The contractor was unwilling to furnish representatives of the General Accounting Office with any details concerning its operating expenses in connection with the sale of the equipment, materials, etc. However, included in a schedule supporting its "Statement of Reserve for Demolition and Restoration for the Ten Months Ended September 30, 1946," is an item of "Commissions" totalling \$425,000, an item denoted "U. S. M. C. Exceptions" amounting to \$22,626.44, and an item of "Advertising" in the amount of \$54,932.93. The commissions were stated by the contractor as having been paid to the Industrial Equipment Company for selling the plant equipment. The Maritime Commission exceptions were admitted by the contractor to represent nonreimbursable costs under ship construction contracts. And the advertising was an expense incurred by the Industrial Equipment Company in connection with the sale of the property. That such items properly are includable as legitimate operating expenses of Calship in selling the equipment and materials is open to question.

Also, in the same schedule of operating expenses is an item denoted "Subcontracts - Demolition and Restoration" in the amount of \$486,126.80. It is understood that this item represents the final cost to Calship of restoring the area called "Shipways, Gantry Piers and Storage Platforms." In its original proposal of November 23, 1945, the estimate given for this work was \$1,611,183. Representatives of the General Accounting Office conferred with the General Manager, Los Angeles Harbor Department, who confirmed the view that the area involved was the same one covered by the earlier estimate.

Also, it was learned from the said General Manager of the Los Angeles Harbor Department that certain of the shipyard property had been turned over to the Board of Harbor Commissioners, who leased it to the National Steel and Metal Company under a lease obligating said company to restore the premises to their original condition. This portion of the site constituted 19.5 percent of all the land covered by the shipyard. The General Manager further stated that while Calship was still obligated to restore the remaining portion of the leased property, in the event Calship could secure responsible tenants to take a substantial part of the remaining property under leases placing upon them the restoration obligation, Calship would be relieved of any further costs in that connection.

It might be mentioned, also, that the United States Maritime Commission itself has repurchased from Calship material originally turned over to said company to the extent of \$42,888.13.

Under a contract with the Maritime Commission, the Pacific Electric Railway Company (hereinafter called Pacific Electric) constructed and maintained a railway line for the purpose of carrying

shipyard workers to the Calship yard. And under another contract with the Maritime Commission, the Los Angeles Board of Harbor Commissioners, in conjunction with the laying of this line, constructed tracks across a bascule drawbridge over the Cerritos Channel, which bridge is owned by the City of Los Angeles. The contract provided, also, that the Board would remove the tracks from the bridge and resurface and re-balance it at the end of hostilities at the expense of the Maritime Commission. The obligations of the Maritime Commission under both of these contracts were taken over by Calship under the terms of addendum No. 3 to contract No. 3. However, by an agreement between the contractor and Pacific Electric, dated January 8, 1946, the latter assumed the obligation of restoration under both of these contracts except for one-half of the cost of restoring the bascule drawbridge. In return, Pacific Electric received title to all facilities, railway motor cars, tracks, equipment and material in its custody by reason of its contract with the Maritime Commission, except one 1940 Dodge sedan, which was retained by the contractor and subsequently sold for \$300.

The total cost to the Government in connection with the Terminal Island Extension amounted to \$1,478,568.51, made up of the following items:

Construction of track	\$1,017,182.97
Laying of tracks on bascule drawbridge	35,446.79
Purchase of two mercury arc rectifiers	91,306.75
Purchase of 59 cars and two trailers	<u>334,632.00</u>
Total	\$1,478,568.51

Prior to the transfer of all assets to Calship, the Maritime Commission disposed of 37 of the motor cars and two trailers as follows:

2 trailers transferred to the Marine Corps and the Navy	\$ 8,792.07
30 cars and 7 extra sets of motors sold to Pacific Electric	268,660.20
7 cars less motors transferred to War Assets and sold by them to Pacific Electric	<u>3,500.00</u>
Total	\$280,952.27

The recoupment of \$280,952.27 thereby reduced the total cost to the Commission to \$1,197,616.24.

Under the agreement with Calship, dated January 8, 1946, Pacific Electric was obligated to demolish 2.88 miles of double track which was part of the Terminal Island Extension and to pay for the restoration of the bascule drawbridge over the Cerritos Channel, receiving from Calship 50 percent of the bridge restoration cost. In return, Pacific Electric received and is now using in its commercial operations, 22 motor cars, the Watts substation equipped with mercury arc rectifier, a portable substation, approximately three-fourths of a mile of double track on Flint Avenue joining the Los Angeles-San Pedro line to the Long Beach-Wilmington Line and 1.7 miles of single track on the Long Beach-Wilmington Line. In addition, Pacific Electric received the Terminal Island mercury arc rectifier, which it carries in stock as stand-by equipment for the Watts substation, as well as the salvage from the demolition of the 2.88 miles of double track mentioned above.

The total cost to the Pacific Electric of the demolition of Terminal Island Extension, including its portion of the cost of restoration of the bascule drawbridge, was \$92,203.76, against which were credited sales of material salvaged therefrom as scrap in the total amount of \$13,332.16, or a net cost of \$78,871.60. In all, Pacific Electric received assets having a depreciated value of \$620,436.19, in return for the performance of restoration work costing \$92,203.76.

The results of the transaction involving the sale of the shipyard and inventory can be summarized as follows:

(a) Calship		
Reduction of recapturable profits	\$2,500,000.00	
Estimated sales value of buildings	2,181,630.00	
Book value of equipment	4,705,557.69	
Estimated net value of materials	9,017,177.63	
Value of scrap materials costing \$5,007,289.39		Indeterminate
Proceeds from sale of automobile		300.00
	\$18,404,665.32	
Less: Restoration expense per Calship estimate	5,200,000.00	
Potential profit to Calship		\$13,204,665.32
(b) Pacific Electric		
Book value of assets received	\$ 550,300.53	
Book value of materials	56,803.50	
Proceeds of sale of scrap	13,332.16	
	\$ 620,436.19	
Less: Pacific Electric expenses before credit of scrap sale	92,203.76	
Potential profit to Pacific Electric		528,232.43
Total potential profit		\$13,732,897.75

SUMMARY AND CONCLUSIONS

It is difficult to extract from the maze of contracts, amendments, cancellations, settlements, and the like, executed in this case, any concise set of facts. However, it has been shown that originally the Maritime Commission started out with two cost-plus-a-fixed-fee contracts

with Calship; that, after one of these contracts calling for the construction of 84 vessels had been in existence for almost two years and virtually all the work thereunder had been performed, the contract was amended to provide for a lump-sum payment for 62 completed vessels and for the transfer of certain other vessels virtually completed to another contract executed as of the same date as the amendment. Also, it has been shown that by reason of such amendment there resulted an excess payment in fees, alone, of \$416,000 for 32 of the vessels which had been completed under the contract as originally executed. It has been further shown that with respect to the vessels which were transferred from the contract as originally executed to the newly executed contract the Commission paid in excess of \$37,565.57 more in fees than it would have been required to pay under the original contract.

As previously stated, it is almost impossible in the case of some contract conversions to find conclusive evidence that the action taken resulted in a financial loss to the Government. However, the facts in the present case seem adequately to support the charge that the amendments and cancellations of existing contract rights and obligations resulted in an excessive and wasteful expenditure of public funds.

Moreover, as previously indicated, the precise extent of the loss suffered by the United States in this case will perhaps never be known. The lack of sufficient data and accounting information relative to the cost of the vessels covered by the subject contracts

unquestionably will preclude any accurate determination of what the cost to the Government would have been under the contracts in their original form. And, as I have previously stated, this confused state of the accounting records of the Commission serves but to accentuate the viciousness of the practice of effecting lump-sum settlements with the contractor for vessels completed under these cost type contracts at a time when there could not have been known, even in a general way, what the actual allowable cost of construction of the vessels was.

With reference to the disposal of the shipyard facilities and surplus materials, there again would seem to be evidence that the Maritime Commission was guilty of negligence in failing to safeguard the best interests of the United States. Calship would leave the impression in various correspondence that their participation in the transaction relative to the disposition of the shipyard facilities and material was undertaken with great reluctance. And, the Maritime Commission has represented that the Government secured the best possible return for the property sold and has, in effect, implied that those in the Commission representing the Government in this transaction are deserving of praise for the results accomplished. However, it now develops that a new company has been organized, composed of long-time business associates of the so-called Kaiser group, for the express purpose of continuing in the business of ship repair and reconstruction. It further appears that the figures which have been furnished to various committees of Congress relative to the expected return from the

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material and the cost of restoring the shipyard site are open to serious question.

On the whole, the facts as reported in this case were deemed such as to warrant submission of the matter to the Congress for its information and such action as may be considered appropriate.

Respectfully submitted,

(Signed) Lindsay C. Warren

Comptroller General
of the United States.