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FISCAL YEAR 1977 AUTHORIZATION FOR
MILITARY PROCUREMENT, RESEARCH
AND DEVELOPMENT, AND ACTIVE
DUTY, SELECTED RESERVE AND CIVIL-
IAN PERSONNEL STRENGTHS

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HEARINGS
BEFORE THE
COMMITTEE ON ARMED SERVICES
UNITED STATES SENATE
NINETY-FOURTH CONGRESS

SECOND SESSION

ON

S. 2965

TO AUTHORIZE APPROPRIATIONS DURING THE FISCAL
YEAR 1977 FOR PROCUREMENT OF AIRCRAFT, MISSILES,
NAVAL VESSELS, TRACKED COMBAT VEHICLES, TOR-
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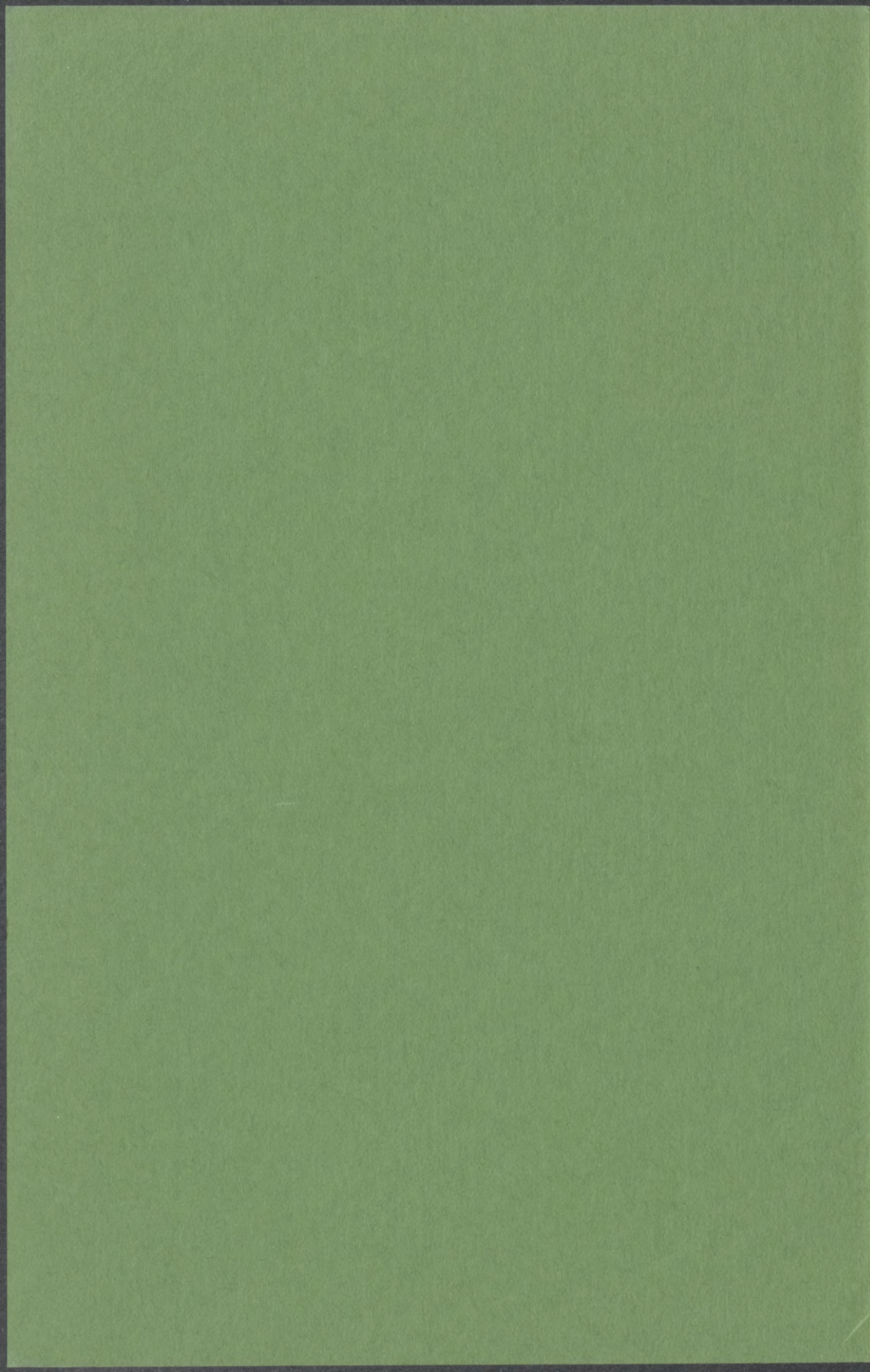
PART 8

SHIPBUILDING
COST GROWTH AND ESCALATION

APRIL 29, 1976



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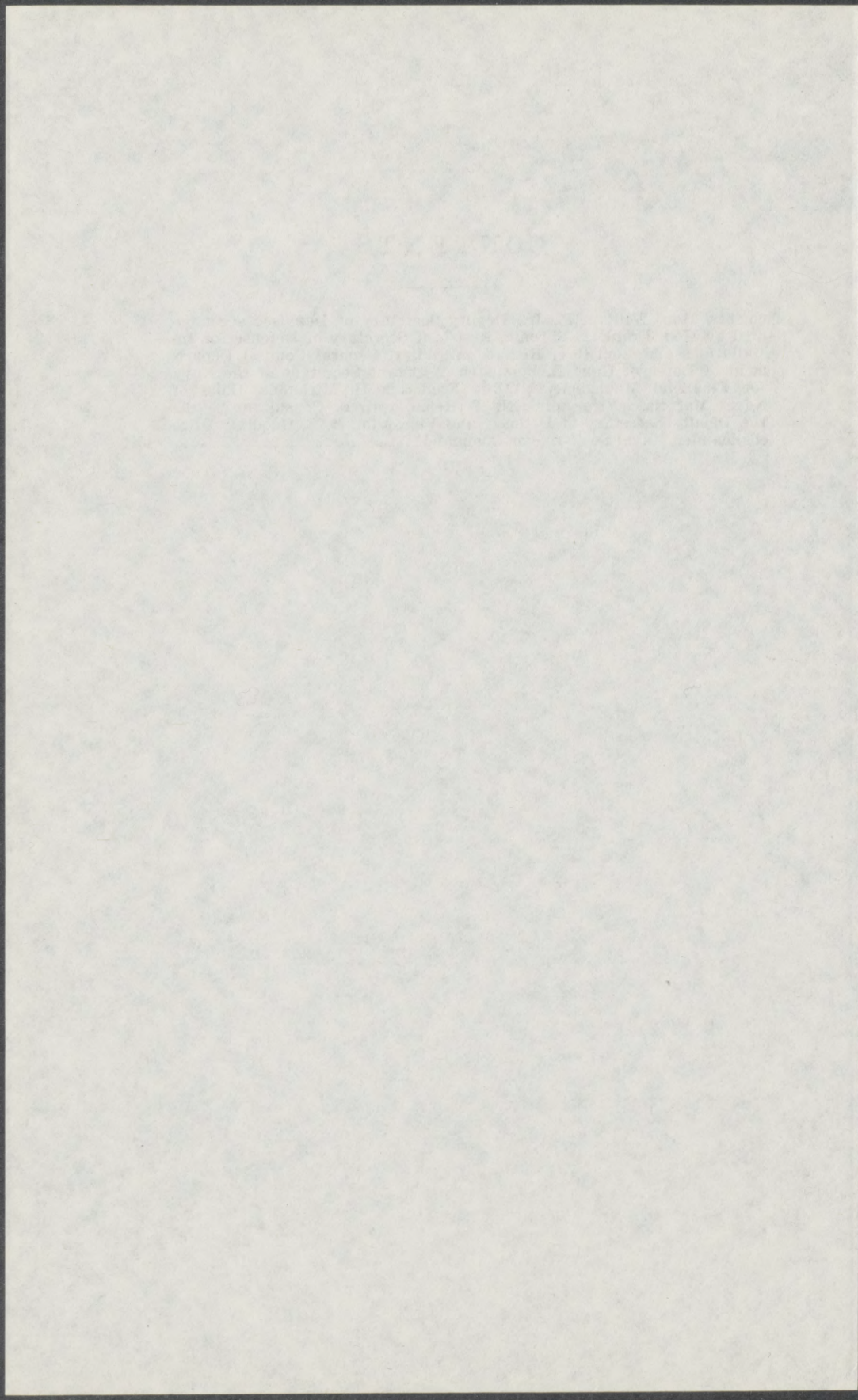
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MILITARY PROCUREMENT, FISCAL YEAR 1977

THURSDAY, APRIL 29, 1976

U.S. SENATE,
COMMITTEE ON ARMED SERVICES,
Washington, D.C.

SHIPBUILDING COST GROWTH AND ESCALATION

The committee met, pursuant to notice, at 10:15 a.m., in room 212, Russell Senate Office Building, Senator John C. Stennis (chairman) presiding.

Present: Senators Stennis, Symington, Nunn, Leahy, Thurmond, Taft, and Bartlett.

Also present: T. Edward Braswell, Jr., chief counsel and staff director; W. Clark McFadden, counsel; John T. Ticer, chief clerk; Phyllis A. Bacon, assistant chief clerk; Charles J. Conneely, George H. Foster, John A. Goldsmith, Edward B. Kenney, Don L. Lynch, Robert Q. Old, Francis J. Sullivan, George F. Travers, professional staff members; Louise R. Hoppe, Roberta Ujakovich, research assistants; Christine E. Cowart, clerical assistant; Jeffery Record, assistant to Senator Nunn; Charles Stevenson, assistant to Senator Culver; Doug Racine, assistant to Senator Leahy; Will Ball, assistant to Senator Tower; and Fred Ruth, assistant to Senator Bartlett.

OPENING STATEMENT BY SENATOR STENNIS, CHAIRMAN

The CHAIRMAN. Gentlemen of the committee, we have Mr. Clements, and other witnesses, here, whom we asked to come regarding resolution of ship claims.

Now, Mr. Clements, we know of your activities in the Pentagon with reference to industrial and business matters, contracts, et cetera. This hearing involves a review of that situation. We have several contracts involved and, of course, you will go into it. We focus today on this matter of contract claims in the construction of naval ships.

Like other sectors of the economy, shipbuilding has suffered in recent years from substantial inflation and cost growth. Unlike most other areas of defense procurement, however, Navy shipbuilding, particularly on our nuclear programs, has generated a large backlog of contract claims and requests for equitable adjustments. The present level of all ship claims—and they will define the claims later—is about \$1.7 billion. This level has increased so precipitously in recent years and has become so large that a special examination of shipbuilding management is clearly in order.

These claims have far-reaching implications for the Navy shipbuilding program, both for ships now under construction and those to be built. I, therefore, felt it was essential that the committee receive testimony from the Defense Department on shipbuilding claims attempting to decide on a new ship construction program for fiscal year 1977. We will also have the Secretary of Defense here early next week to testify on the shipbuilding program that is in the fiscal year 1977 budget and the changes made by the House in this area.

Mr. Clements, we know that you have considerable experience in these fields in the time you have been with the Department of Defense. We expect to receive a full explanation of the contract problems, including claims in Navy shipbuilding, the consequences of those special action claim matters, and the alternative available to the Department of Defense and the Congress. We know in a general way that you have naval vessels authorized and the money appropriated. And you haven't been able to get contracts for them. We want you to go into these problems.

[The Chairman's prepared statement follows:]

PREPARED STATEMENT OF SENATOR JOHN C. STENNIS, CHAIRMAN

The Committee meets today to focus on one of the most significant and difficult problems in the management of our national defense resources—contract claims in the construction of naval ships.

Like other sectors of the economy, shipbuilding has suffered in recent years from substantial inflation and cost growth. Unlike most other areas of defense procurement, however, Navy shipbuilding, particularly on our nuclear programs, has generated a large backlog of contract claims and requests for equitable adjustments. The present level of all ship claims is about \$1.7 billion. This level has increased so precipitously in recent years and has become so large that a special examination of shipbuilding management is clearly in order.

These claims have far-reaching implications for the Navy shipbuilding program, both for ships now under construction and those to be built. I therefore felt it was essential that the Committee receive testimony from the Defense Department on shipbuilding claims before attempting to decide on a new ship construction program for fiscal year 1977.

EMERGENCY ACTION UNDER PUBLIC LAW 85-804

Secretary Clements has long been sensitive to the Navy ship claims problems and as Deputy Secretary of Defense has had a special responsibility for the management of Navy shipbuilding. In a letter of April 2, 1976 to me as Chairman of the Committee, Secretary Clements stated that in the interests of national defense and fairness he had determined to take action under Public Law 85-804 to rectify the claims situation between the Navy and certain ship builders. Public Law 85-804 authorizes the President or his representative to take extraordinary action to amend or modify contracts without regard to other provisions of law pertaining to Government procurement whenever he determines "such action would facilitate the national defense".

In 1975, 315 actions were approved by the Department of Defense under the authority of Public Law 85-804. Practically all were of relatively small dollar amounts. The law requires that if such authority is used to obligate any amount over \$25 million, the two Armed Services Committees of the Congress must be notified with the opportunity of either the House or Senate, within a 60-day period, to adopt a resolution disapproving the proposed obligation.

The Committee expects to receive a full explanation of the contract problems including claims and Navy shipbuilding, the consequences of no special action on the claims matter and the alternatives available to the Department of Defense and the Congress.

IMPLICATIONS ON FISCAL YEAR 1977 AUTHORIZATION

In addition, the Committee expects to be fully informed on the implications of any proposed solution to ship claims on the fiscal year 1977 authorization request

which includes \$320 million for the settlement of claims and a \$1.3 billion for cost growth and escalation for ships approved prior to fiscal year 1976.

Before initiating a vastly expanded shipbuilding program, the Committee must be convinced that the existing program already underway can be satisfactorily completed. Otherwise, a grave question is raised as to whether an expanded program can be carried out.

Mr. Clements, you may proceed in your own way.

The CHAIRMAN. Mr. Secretary, you may proceed.

Mr. CLEMENTS. Thank you, Senator Stennis. As always I am pleased to be here with your associates.

STATEMENT OF HON. WILLIAM P. CLEMENTS, JR., DEPUTY SECRETARY OF DEFENSE, ACCOMPANIED BY HON. FRANK A. SHRONTZ, ASSISTANT SECRETARY OF DEFENSE FOR INSTALLATIONS AND LOGISTICS; RICHARD A. WILEY, GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE; GARY D. PENISTEN, ASSISTANT SECRETARY OF THE NAVY FOR FINANCIAL MANAGEMENT; ADM. FREDERICK H. MICHAELIS, CHIEF OF NAVAL MATERIAL; VICE ADM. ELI T. REICH, RETIRED, CONSULTANT TO THE DEPUTY SECRETARY OF DEFENSE, AND VICE ADM. R. C. GOODING

Mr. CLEMENTS. I have a rather long statement that has been handed out. I am not going to read it all. I have underlined portions of that statement that I would like to read, to set the tone for our discussion. If I may, I will proceed with your permission along that line.

The CHAIRMAN. You may. Let me emphasize, gentlemen, this is no proforma hearing. These are highly important matters to the Navy, to the Department of Defense, and to the country. We really want you to go into this in depth. We will put all of your statement in the record for the information of the Senate. You just proceed in your own way.

Mr. CLEMENTS. Fine.

As you stated, Senator Stennis, I have brought with me various people from the Navy and from the Office of the Secretary of Defense to support the discussion in whatever form it might take. As you well know, this has been a matter of great concern to me. And I have discussed it with you on many occasions. As I have also discussed it with other members of the committee at various times. It is a highly complex issue.

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

In the intervening 7 years, Mr. Chairman, this program has not lacked oversight, review, studies in detail by the Congress, the GAO, Commission on American Shipbuilding, the Navy, the industry, and others.

As you know, I assumed my present office as Deputy Secretary of Defense in January 1973. From the beginning of my work in the Pentagon, I have been concerned with overseeing the management of the weapons acquisition process. Of all our major systems acquisition programs I believe the problems in the Navy combatant ship acquisition program have been and are long enduring, most vexatious, and very difficult to bring under orderly control and management by the Secretary of the Navy and the Secretary of Defense.

Mr. Chairman, I would like to summarize the scope of the Navy's shipbuilding claims problem for the period January 1, 1969 through April 1, 1976.

In category A (settlements made) there were 54 claims for a claimed amount of \$1,317 million which was settled for \$631 million (or 47.9 percent).

In category B (outstanding REA's or claims) there are eight REA's in hand for a total of \$1,402 million. In addition, there are anticipated REA's for more than \$300 million expected to be filed before the end of 1976.

The category C (Armed Services Board of Contract Appeals) record is very brief. Up to April 1, only two shipbuilders' appeals for relief have been decided.

In category D there are four shipbuilders' appeals before the ABSCA in the total amount of \$149 million.

It can be said that the overall universe of the shipbuilding claims problem since January 1969 to April 1, 1976 amounts to \$3,189 million.

Of this amount, \$1,317 million have been settled and \$1,872 million are pending.

Mr. Chairman, in my letter to you earlier this month (April 2), I said that I had informed the Secretary of the Navy and the Chief of Naval Operations of my determination to take remedial action under Public Law 85-804 because of the threat to our national defense which the unsatisfactory business relations between the Navy and the shipbuilders has brought about. I would like now to briefly comment on several specific situations which in the aggregate have hardened my resolve to seek and direct early remedial action.

The CHAIRMAN. Will you permit this interruption, Mr. Clements. It is not a question, but I believe it would be helpful if you would just briefly explain, what is a claim as you use the word here? An equitable adjustment, just what does that mean as used here. And just give us a word on the Board of Contract Appeals to which you have referred.

Mr. CLEMENTS. We have a process within the Navy—and in the ship construction program—where under those contracts, as the construction phase develops, changes can be made through change orders. In making these changes, it almost invariably involves higher costs—not always, but most of the time, I would say 99 percent of the time.

And then you have to negotiate the price for that change and what that additional cost represents is not only direct labor and material, but also delay and disruption to the yard. Delay in time beyond the date that the ship was originally contracted for, and how far out in time that change extends the delivery dates, imposes additional costs on the contractor in his overhead allocations and escalation costs, and

so forth. The contractor's proposal for a change in price or revision of delivery schedule, or both, is called a "Request for Equitable Adjustment"—an REA.

There are also aspects of it that have to do with Government-furnished equipment (GFE), wherein the Government, under these shipbuilding contracts, always furnishes certain amounts of that equipment, and it will vary according to the ship. In some instances it would run as high as 60 percent of the contract is actually GFE equipment, government furnished equipment. Sometimes these equipments are delayed in their delivery to the shipyard, and that imposes a delay on the shipyards, and additional cost, which would bring about a claim.

And then they have other such things as, in this instance, a contractual provision. And this goes to the very heart of what we are talking about—a contractual provision that sets certain very fixed escalation parameters, criteria, within the contract at a time, like 1965-67, on a fixed delivery day contract, and in no sense could either party anticipate the double-digit inflation that we have gone through during the past 3 or 4 years. And the contract just did not, nor the parties, either party, either the contractor or the Government, anticipate those kinds of inflationary factors. And that has imposed additional cost on the contractors. When Government actions or inactions increase the scope of work but the formal procedures established by the standard contract clause are not followed, the contractor is still entitled to an equitable adjustment for this "constructive change." The contractor's proposal for a change in price or delivery schedule or both, is called a claim. Frequently, the terms "REA" and "claim" are used interchangeably.

That is what we are talking about when we speak of claims.

The CHAIRMAN. I think that makes it clear. The members understand that, but the public will want to understand it, too.

Mr. CLEMENTS. We have this other body which you asked about, the Armed Services Contract Appeals Board, Senator.

This is a Board which adjudicates these claims if the contractor and the contracting officer are unable to come to an agreement. There is an established process whereby these claims are put before this Contract Appeals Board and processed in an orderly fashion. Unfortunately, they have a backlog. It takes unnecessarily long in my opinion for a contractor to get his claim through that Board. And that is part of my statement that we will come to, that we need to review that process and see if we cannot accelerate and bring about a more efficient process for handling these claims in a timely fashion.

The CHAIRMAN. All right, you are on the Newport News Shipbuilding & Dry Dock Co.

Mr. CLEMENTS. The Newport News Shipbuilding & Dry Dock Co. situation.

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

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

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

(a) The inability to this date of both Navy and Newport News to definitize the contract for the construction of the CVN 70 (Vinson) even though, in April 1974, the Navy formally exercised the unpriced option in the CVN 68-69 contract for the construction of the CVN 70. In fact, Newport News has informed me that they will not continue their present work on the CVN 70 project or attempt to negotiate pricing and other terms until and unless the Navy takes positive steps to act on Newport News' requests for equitable adjustment (REA's).

THE ELECTRIC BOAT SITUATION

The Electric Boat Division of General Dynamics Corp. has currently in hand contracts for the SSN-688 class submarines and four Trident submarines. Three additional Trident submarines are programed to be awarded in fiscal year 1978 and 1979. Recently a settlement of \$97 million on a claim for \$232 million was made by the Navy on the first production flight of seven SSN-688 boats. As part of this settlement, Electric Boat was requested to submit by December 1976, the balance of their claim against this contract and any claim against the second production flight of SSN-688's. A multimillion-dollar claim is expected.

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

THE INGALLS SHIPBUILDING/LITTON SITUATION

Currently, Litton has under contract five LHA's and 30 DD-963 class destroyers. Deliveries on both these contracts have just begun. Despite the many problems of management, design, facilities installation, production processing, quality control, work force recruitment and retention, there is now in place at Pascagoula a modern shipbuilding complex which is an unquestioned national asset for defense purposes. However, in a financial sense we are faced with a giant dilemma. It is my understanding that Litton faces up to a \$300 to \$350 million loss in the LHA contract and a minimum profit in the DD-963 contract—although there are some who do not see any profit accruing in the DD-963 contract.

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

In 1960, 14 private shipyards were engaged in the construction of 83 major combatant, amphibious warfare, and large auxiliary naval vessels. Also, naval vessels were being built in five naval shipyards. Fifteen years later, in 1975, over 90 percent of the Navy's shipbuilding program (62 of 66 ships) was concentrated in three yards (Newport News, Electric Boat, and Litton) and no new construction ship project has been assigned to a naval shipyard since 1967.

Mr. Chairman, following the Seapower Subcommittee hearings in 1974, I formed in concert with the Secretary of Commerce, a joint Department of Defense/Department of Commerce Informal Planning Group to implement some of the planning recommendations concerning a reassessment of the mobilization requirements of the United States for shipbuilding, overhaul, repair, and conversion of the naval and commercial ships, and the readiness of the U.S. shipbuilding industry to support these requirements. In addition, the Department of Defense and Commerce/MARAD joined with the Office of Management and Budget in 1975 in a study to develop 5-year projections of subsidized, private unsubsidized, and Navy ship construction in U.S. shipyards.

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

SCOPE

Two projected shipbuilding programs were analyzed. In the first, or base case program, the Navy ship list is similar to that now included in the DOD 5-year defense plan (FYDP), and the MARAD list reflects annual construction differential subsidy (CDS) funding at a rate of \$250 million, which is the currently approved rate. The second program, designated high level, includes Navy ships needed for a buildup to a 600-ship force, and the CDS projection is based on an annual CDS funding level of \$300 million.

CONCLUSIONS

1. Base case and high level programs indicate that there is a sufficient shipyard capacity and materials are potentially available to meet construction requirements.

There is a requirement to improve and expand shipyard labor training programs.

It is also indicated that shipyards will continue to experience high labor turnover.

The availability of trained and trainable workers will present a significantly greater problem at Newport News than in the balance of the industry.

There is need for greater peraward assurance that contract work can be accomplished, particularly in yards with known problems.

Mr. Chairman, in my statement this far one might conclude that I have reached a harsh judgment of the Navy's management of its shipbuilding program over the past 10 years. Such a conclusion is incorrect and simplistic.

The Navy Department leadership have worked earnestly and with dedication to bring about an amelioration of the manifold problems alluded to and to address in an equitable and legal manner the many complaints, claims, and controversies that the shipbuilders have lodged with the Navy. Unfortunately, for a variety of reasons largely identified with the unusual economic conditions of the past 5 years and rigid nature of the contracts signed in the period of 1968-73, their efforts have not been successful.

And I must admit, also, that I have been reluctant to form my present judgment that it is essential that the Secretary of Defense

invoke Public Law 85-804 to deal with this threat to our national defense.

Mr. Chairman, as I informed you in my letter of April 2, I appointed, March 30, a shipbuilding executive committee to guide and monitor all actions necessary by the Navy Department and to advise and assist me to the application of Public Law 85-804. This committee is chaired by Mr. F. A. Shrontz, Assistant Secretary of Defense for Installations and Logistics, who is here today, and has as members, Mr. R. A. Wiley, General Counsel, Department of Defense, who is here; Mr. G. D. Penisten, Assistant Secretary of Navy, Financial Management, who is here; Mr. W. K. Brehm, Assistant Secretary of Defense Legislative Affairs; Adm. F. H. Michaelis, USN, Chief of Naval Material, who is here; and Vice Adm. R. C. Gooding, USN, commander, Naval Sea Systems Command, who is also here.

This committee has been very active since March 30, familiarizing themselves with the Navy's total shipbuilding program, with the contracts which are the subject of claims or requests for equitable adjustment, with the nature and content of these requests, and have been engaging in dialog with the three major contractors, Newport News, Electric Boat and Litton.

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

It appears now that it will require at least another 30 to 45 days for the committee to accomplish its detailed study and negotiations with the shipbuilders, and formulate their firm recommendations. I will come back to it later in our question period.

Shortly after this I should be able to make the formal Public Law 85-804 determination necessary to implement the appropriate contractual actions. On this basis I would hope to have taken such action on or about June 15.

Mr. Chairman, I am mindful of the legal requirement to inform the Committees of Armed Services of the Senate and the House of Representatives in writing of Public Law 85-804 proposals to obligate the United States in any amount in excess of \$25 million. I expect to formally advise both committees of my proposed action in the next few days. It is my present judgment that the largest part of the inequities which we recognize in ongoing contracts signed in the period of 1968-73, can be overcome by a reformation of the provision for escalation. In doing this, the Government would be applying to these older contracts a current and more adequate escalation provision being written into new shipbuilding contracts. I emphasize this. The escalation that we are talking about, the equitable escalation, is the same contract we are giving today. But it was not included because it was not anticipated by either of the parties back in the 1968-1973 period.

The "traditional" clause affords an adequate vehicle to compensate a contractor for changes in the cost of labor and material in an environment where either performance proceeds relatively in accordance with the original expectations of the parties at the time they entered into the contract, or where the parties are able to agree promptly on the

responsibility for variations from the scheduled performance; or where the level of the applicable BLS index is relatively constant or changes at a rate predictable at the time the contract was executed.

In the past, although contractors had performed work after contract delivery dates, there was not a significant financial problem as long as there was only moderate predictable inflation. The "traditional" or formula method of paying escalation provided cash flow to the contractor in some cases prior to the purchase of material. This positive cash flow and the positive aspects considering the time values of money ameliorated the economic and financial disadvantage of performing after expiration of contract escalation coverage. However, when the runaway inflation of 1973 and 1974 occurred, the contractors quickly found that the cash flow advantages of the old escalation clause were quickly and completely overshadowed by the inflation rates experienced in the BLS indexes.

In response to the inequities in the traditional clause, and experience in negotiating new shipbuilding contracts, the Navy has developed in 1975 a new escalation clause for use in new contracts. This clause has the following general characteristics:

(a) Escalation is paid on the basis of actual expenditure phasing.

Senator SYMINGTON. Could I ask what that means?

Mr. CLEMENTS. It means as it is paid, the escalation money is actually paid out as incurred, rather than on the basis of a preestablished or a preset time frame. It is phased with the actual cash flow of the contract.

(b) Escalation is paid on the basis of allowable costs incurred not to exceed ceiling price.

(c) Escalation continues to actual delivery date.

The approach to this clause has many advantages:

(a) It represents an equitable sharing of the contract risk.

(b) It reduces the need for contingency pricing.

(c) It more accurately reflects cost growth due to economic facts.

Nevertheless, the Navy today has 11 major shipbuilding contracts which still contain the old escalation clause. These contracts include virtually every major combatant ship destined for the fleet of the 1980's and beyond. I am satisfied that a major portion of the Navy shipbuilding claims were generated directly or indirectly by this inequitable situation.

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

Senior Navy and Office of the Secretary of Defense personnel have developed a plan in this regard that can be discussed in three parts: First, improving flexibility in contracting. The plans for improving flexibility in contracting have, for the most part, been drawn from contracting practices which have been tried and proven successful, or from practices which have been generated to cope with inflation, shortages, and other similar problems frequently confronting the Navy and its contractors under long term shipbuilding contracts.

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

And third, we are cognizant of several causes of claims which the General Accounting Office recently cited in its 1975 report on shipbuilding claims:

Inadequate or defective specifications.

Defective and late GFI and GFM.

Unanticipated increases in quality assurance requirements.

Failure to identify early potential claim problems.

Mr. Chairman, as I have mentioned before, some might construe my remarks as being largely critical of the Navy. Such a conclusion is only half true, for I firmly believe that the industry also has contributed in a large measure to the present crisis. With this in mind, I would urge the following actions for the shipbuilders toward improving relations with the Navy and bringing about significant efficiencies in our naval ship acquisition program.

(a) Seek to establish in a business like manner, greater visibility between costs and work performed.

(b) Accept the fact that as one part to a contract, private shipbuilders share the responsibility for the excessively adversarial relationship that has existed.

(c) Shipbuilders should carefully examine the adequacy and completeness of the contract plans and specifications. They should raise questions and insist on amplification of the Government's procurement proposals.

(d) As an industry, work to improve the overall attractiveness of the shipbuilding employment.

(e) Increase overall labor productivity.

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

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

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

Significant economic advantages will accrue to the Navy. Much manpower and other resources can be more productively used in ac-

quiring new ships that are currently involved in the complex and time consuming claims processing procedures. Key Navy people, such as the ship acquisition program managers, the supervisors of shipbuilding, the functional and technical support personnel will more readily be able to get in harness with the shipbuilders in achieving the common goal of efficiently rebuilding the Navy.

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

Future shipbuilding claims on these contracts will be minimized. Basic features of new escalation coverage provide strong deterrent to claims in the future.

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

Thank you very much.

[Mr. Clement's prepared statement follows:]

PREPARED STATEMENT OF HON. WILLIAM P. CLEMENTS, DEPUTY SECRETARY
OF DEFENSE

I. INTRODUCTION

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

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

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

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

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

"6. There have been long delays in the settlement of shipbuilders' claims. In part, delays have been due to the necessity of carefully considering each element of complex claims; in part, to the changing nature of contractor submissions; and

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

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

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

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

As you know, I assumed my present office as Deputy Secretary of Defense in January 1973. From the beginning of my work in the Pentagon, I have been concerned with overseeing the management of the weapons acquisition process. Of all our major systems acquisition programs I believe the problems in the Navy combatant ship acquisition program have been and are long enduring, most vexatious, and very difficult to bring under orderly control and management by the Secretary of the Navy and the Secretary of Defense. And while I do not dispute conclusion No. 2 of the Sea Power Subcommittee Report (quoted above), I want to say, Mr. Chairman, that I personally have focused a considerable amount of my working time since taking office on the Navy's shipbuilding program and, more recently I have become heavily occupied with it.

II. BACKGROUND DATA ON THE SHIPBUILDING CLAIMS PROBLEM

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

Category A—Settlements made 1 January 1969–1 April 1976

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

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

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

In Category "A" (settlements made) there were 54 claims for a claimed amount of \$1,317 million which was settled for \$631 million (or 47.9%). About 77% of the settlements were for conventional ships, i.e. aircraft carriers, Destroyers, Destroyer Escorts, Amphibious ships, Fleet tenders, and Fleet auxiliaries. The remainder were for nuclear ships, mainly submarines.

In Category "B" (outstanding REA's or Claims) there are 8 REA's in hand for a total of \$1,402 million. In addition, there are anticipated REA's for more than \$300 million expected to be filed before the end of 1976. About two-thirds of these claims are for nuclear ships. The large LHA claim in the amount of \$505 million forms the bulk of the conventional ship claims.

The Category "C" (ASBCA decisions) record is very brief. Up to 1 April only two shipbuilders' appeals for relief have been decided. The Lockheed Shipbuilding Company claim for \$62 million settlement has been upheld by the Board. The claimed amount of \$24 million by General Dynamics (Quency) was denied. However, General Dynamics has filed suit in the U.S. Court of Claims for increased performance costs of \$12 million found to have been incurred by the ASBCA in its denial decision. It should be noted, however, that very recently on 16 April, the Board awarded Litton \$17 million on a \$30 million claim for the SSN 680 project docketed by the Board in August, 1972.

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

From the foregoing, it can be said that the overall universe of the shipbuilding claims program since January 1969 to 1 April 1976 amounts to \$3,189 million. Of this amount, \$1,317 million have been settled and \$1,872 million are pending. Clearly the most severe claim problem is in current on-going ship construction projects and we have concentrated in this area in developing solutions.

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

III. CRITICAL IMPACT OF PRESENT CONDITIONS IN NAVY SHIPBUILDING PROGRAM ON NATIONAL DEFENSE

Mr. Chairman, in my letter to you earlier this month (2 April), I said that I had informed the Secretary of the Navy and the Chief of Naval Operations of my determination to take remedial action under Public Law 85-804 because of the threat to our national defense which the unsatisfactory business relations between the Navy and the shipbuilders has brought about. I would like now to briefly comment on several specific situations which in the aggregate have hardened my resolve to seek and direct early remedial action.

The Newport News Shipbuilding and Dry Dock Co. Situation

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

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

The statement then went on to say that Newport News would have been bankrupt and "without a prayer for obtaining private capital," had not Tenneco financed the losses, the working capital and the capital improvements requirements. The present profitability and future potential in commercial sales was cited as the rationale for Tenneco's support of the shipyard. The statement concluded, with respect to Newport News' financial situation, as follows: "Summarizing the historical reference for Newport News, the past five years have been bad for the shipyard with its 1969 equity base seriously eroded because of the negative returns on naval shipbuilding. They will be nothing compared to the next five years if the Navy does not provide a sufficient profit base to justify continuing Naval shipbuilding by Newport News."

Examples of the hardening attitude of the management at Newport-News have been:

(a) The inability to this date of both Navy and Newport News to definitize the contract for the construction of the CVN 70 (Vinson), even though, in April 1974, the Navy formally exercised the unpriced option in the CVN 68-69 contract for the construction of the CVN 70. In fact Newport News has informed me that they will not continue their present work on the CVN 70 project or attempt to negotiate pricing and other terms until and unless the Navy takes positive steps to act on Newport News' requests for equitable adjustment (REAs).

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

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

The Electric Boat Situation

The E. B. Division of General Dynamics Corp. has currently in hand contracts for 18 SSN-688 class submarines and 4 Trident submarines. Three additional Trident submarines are programmed to be awarded in FYs 78 and 79.

Recently a settlement of \$97 million on a claim for \$232 million was made by the Navy on the first production flight of 7 SSN 688 boats. As part of this settlement, E.B. was requested to submit by December 1976 the balance of their claim against this contract and any claim against the 2nd production flight of SSN 688's. A multi-million dollar claim is expected.

General Dynamics has recently made a significant capital investment at Electric Boat (about \$140 million) for facilities for Trident production, and the creation and outfitting of the Quonset Point division of E.B. The government has given General Dynamics assurances of pricing arrangements to assist in amortizing this investment as Navy work progresses over the next several years.

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

The Ingalls Shipbuilding/Litton Situation

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

The General Situation as Relates to Other Major Shipbuilders

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

Recently, in connection with the first follow on production of the Navy's F.F.G. program, I was very concerned at the lack of response by the industry to Navy's R.F.P. Although eight companies (BIW, Todd, Newport News, Avondale, Defoe, National Steel, Lockheed, Litton) were tendered RFPs and had received a detailed pre-RFP briefing by the Navy on the planned production program, only 2 contractors responded—BIW and Todd. On inquiry, I learned that Avondale's top management was vehemently opposed to certain Navy policies and practices used in naval ship procurements and, perhaps more importantly, Avondale was psychologically upset with the Navy's handling of their claim for \$169 million for the 27 ship DE production program which had been completed in September 1974. As a result, the Avondale top management, directed by their parent—Ogden Corporation, elected not to participate in the FFG program. Defoe, a smaller shipbuilder, indicated it could not afford the large expense involved in preparation of the bid as outlined in the RFP. Lockheed, National Steel, Litton and Newport News had an assortment of reasons for not participating including: current workload, no real interest in FFG program because they thought it had been locked in to BIW and Todd from the start, current claims settlement problems, etc.

The FY 72 and 73 submarine tender (AS) RFP received limited response from the industry on the basis of the solicitation for a Fixed Price incentive type contract. The Navy finally negotiated for this shipbuilding project on a sole-source, cost type contract, with Lockheed Shipbuilding at Seattle in November 1974.

IV. PRESENT STATUS OF THE NAVY'S SHIPBUILDING PRODUCTION BASE—AN ASSESSMENT

In 1960, 14 private shipyards were engaged in the construction of 83 major combatant, amphibious warfare, and large auxiliary naval vessels. Also, naval vessels were being built in five naval shipyards. Fifteen years later, in 1975, over 90% of the Navy's shipbuilding program (62 of 66 ships) was concentrated in three yards (Newport News, E.B., and Litton) and no new construction ship project has been assigned to a naval shipyard since 1967. This situation resulted

because the Navy had consciously made a policy decision in the late sixties to concentrate their work in a few large yards on the basis that mobilization planning and policies to insure the availability of a broad shipbuilding base to support the Navy in emergencies, was no longer necessary or economically affordable. I believe this was a mistaken policy—then, and certainly today it is.

Mr. Chairman, following the Seapower Subcommittee hearings in 1974, I formed in concert with the Secretary of Commerce, a joint DoD/Department of Commerce Informal Planning Group to implement some of the planning recommendations concerning a re-assessment of the mobilization requirements of the U.S. for shipbuilding, overhaul, repair and conversion of Naval and commercial ships, and the readiness of the U.S. shipbuilding industry to support these requirements. In addition, the DoD and Commerce/MARAD joined with the Office of Management and Budget (OMB) in 1975 in a study to develop five years projections of subsidized, private unsubsidized, and Navy ship construction in U.S. shipyards, to identify potentially conflicting demands for resources among the programs, to recommend possible solutions to identified problems, and to assess predictive techniques. The resource availability analysis was to encompass shipbuilding, shipway space, critical ship components plus steel, and skilled manpower.

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

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

Conclusions

1. Base-Case High-Level Programs:

There is sufficient shipyard capacity and materials are potentially available to meet construction requirements.

There is a requirement to improve and expand shipyard labor training programs.

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

The availability of trained and trainable workers will present a significantly greater problem at Newport News than in the balance of the industry.

While it cannot be predicted with high confidence that there will be no slippage of ship delivery schedules, there is no available evidence that slippage will necessarily occur.

Commitment by shipbuilders of yard capacity needed to do Navy or CDS program shipbuilding work as opposed to other ship or non-ship work, such as drilling rig construction, should be reassessed on a continuing basis.

There is need for greater pre-award assurance that contract work can be accomplished, particularly in yards with known problems.

V. SOME GENERAL PRINCIPLES

Mr. Chairman, in my statement thus far one might conclude that I have reached a harsh judgment of the Navy's management of its shipbuilding program over the past ten years. Such a conclusion is incorrect and simplistic. Most of what I have outlined thus far has been previously well reported here in Congress, publicly by the industry, or in the press. I have reiterated it in order to set the stage for a mutual appreciation by your committee and we in DoD of the overall size of the problem, the many facets involved, and the grave impact it has on our national defense.

The Navy Department leadership—Secretaries Warner and Middendorf; the CNO's, Admiral Zumwalt and Admiral Holloway; the Chiefs of Naval Material, Admiral Kidd and Admiral Michaelis; all of these responsible officials have

worked earnestly and with dedication to bring about an amelioration of the manifold problems alluded to and to address in an equitable and legal manner the many complaints, claims, and controversies that the shipbuilders have lodged with the Navy. Unfortunately, for a variety of reasons largely identified with the unusual economic conditions of the past five years and rigid nature of the contracts signed in the period 1968-1973, their efforts have not been successful.

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

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

General Principles

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

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

Naval construction shall be conducted in private shipyards to the maximum extent consistent with the mobilization requirement for maintenance of Naval shipyards and the capability of private yards to perform in a timely manner. Some new construction would be assigned to the Naval shipyards on a continuing basis.¹

The "lead ship-follow ships" technique should be employed. Unless military exigencies require otherwise, the first ship of a class should be substantially completed before the construction of other ships of the same class is begun so that the class design is finalized and construction problems resolved before subsequent ships are partially completed. Every effort shall be made to insure that contract designs and specifications are complete and adequate prior to award of contract in order to minimize change orders.

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

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

Ship acquisition program managers shall be given the necessary authority and responsibility to manage ships acquisitions effectively and efficiently. The program manager should be the man in charge of all aspects of an acquisition program and should not be restricted by overlapping layers of authority. The on-site government representative (Supervisor of Shipbuilding) should be the direct representative of the program manager.

The Defense Department should insure that contract disputes are settled or decided as speedily and inexpensively as possible consistent with equity and due process. The methods and procedures currently used by the Armed Services

¹ On April 21, 1976, by memo to the Secretary of the Navy, the DepSecDef directed the Navy to submit a plan for the allocation of auxiliary type ship(s) of fiscal year 1977 program to naval shipyard(s).

Board of Contract Appeals (ASBCA) should be examined to determine their effectiveness in accomplishing this goal. In addition, the Secretary of Defense and the Secretaries of the Military Services should examine other alternatives for the expeditious and inexpensive resolution of contract disputes.

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

The United States must adequately fund the Navy shipbuilding program that is deemed required to meet the demands of national security. With the U.S. Navy currently at its lowest level in number of ships since before World War II, it is essential that new ship programs go forward. Problems in acquisition management and unprecedented and unanticipated inflation have created a current situation where the Navy has on hand considerably less funds than are required to complete ships in fiscal year 1975 and prior year programs. The Defense Department, working with the Congress, must develop a straightforward solution to this serious problem.

VI. CURRENT PLAN AND ACTIVITY TO EXERCISE AUTHORITY OF PUBLIC LAW 85-804

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

Mr. R. A. Wiley—General Counsel, Department of Defense.

Mr. G. D. Penisten—Assistant Secretary of Navy (Financial Management).

Mr. W. K. Brehm—Assistant Secretary of Defense (Legislative Affairs).

Admiral F. H. Michaelis, USN, Chief of Naval Material.

Vice Admiral R. C. Gooding, USN, Commander, Naval Sea Systems Command.

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

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

It appears now that it will require at least another 30 to 45 days for the Committee to accomplish its detailed study and negotiation with the shipbuilders, and formulate their firm recommendations. Shortly after this I should be able to make the formal PL 85-804 determination necessary to implement the appropriate contractual actions. On this basis I would hope to have taken such action on or about 15 June.

Mr. Chairman, I am mindful of the legal requirement to inform the Committees of Armed Services of the Senate and the House of Representatives in writing of PL 85-804 proposals to obligate the United States in any amount in excess of \$25,000,000; and of the requirement for a period of 60 days of continuous session of Congress to expire following the date on which such notice was transmitted to such committees and neither House of Congress has adopted within such 60 day period a resolution disapproving such obligation. I expect to formally advise both committees of my proposed action in the next few days.

At this time I can only advise you tentatively concerning the funding that will be required to support this proposed action. The President's 1977 budget request of \$1.6 billion for full funding of FY 75 and prior year programs included \$1,090 million for escalation and \$320 million for claims. Of this amount only \$320 million will be available for solution of the shipbuilding problems we are discussing today. It is our current best estimate that this amount will not be adequate; however, we are not yet prepared to provide a more definitive estimate because discussions with the shipbuilders must develop further.

In this regard, we are concerned about the actions of the House to abandon the full funding concept which we strongly support. The House action would be detrimental to our shipbuilding problems. In any event, I would expect to advise you in more detail and with more certainty in the near future.

VII. ESCALATION FORMS—THE OLD AND THE NEW

In applying the extraordinary broad authority of PL 85-804 I am mindful of the statement in the report of the Committee on Judiciary which accompanied the bill authorizing the making, amendment, and modification of contracts to facilitate the national defense, which became PL 85-804. The Committee report stated: "This broad power is designed to provide the flexibility required by the Government to deal with the variety of situations which will inevitably arise in a multi-billion dollar defense program and for which other statute authority is inadequate. By providing means for dealing expeditiously and fairly with contractors the enactment of this bill will help assure that vital military projects will proceed without the interruptions generated by misunderstandings, ambiguities, and temporary financial difficulties."

It is my present judgment that the largest part of the inequities which we recognize in on-going contracts signed in the period 1968-1973, can be overcome by a reformation of the provision for escalation. In doing this, the government would be applying to these older contracts a current and more adequate escalation provision being written into new shipbuilding contracts.

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

The Old Type (the 1962 Standard Escalation Clause)

The traditional contractual provisions for escalation for shipbuilding contracts, were designed to sustain for the contractor the same incentives he would have under a firm fixed-price contract without escalation. Escalation or economic fluctuation is measured by a single labor index and a single material index. The labor index is computed and published by BLS based upon direct labor data input from approximately 17 different ship-builders spread around the entire nation. The material index is a weighted composite from the BLS publication "Wholesale Prices and Wholesale Price Indices." The weighting is as follows: 45% Iron & Steel; 40% General Purpose Mach. & Equip.; and 15% Elec. Mach. & Equip.

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

To assure that the intent of the parties at the outset is not disrupted during the life of the contract, changes are prices as though there was no provision for escalation in the contract, except, that in the event of a cost decrease change, consideration is given to the amount of escalation which might be paid on those decreased costs as a result of the change.

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

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

When the realities of a shipbuilding program are considered, potential problems with the clause become obvious. The clause may operate with respect to contractors in that:

(1) It exposes the contractor to the risk of inflation whenever performance is extended.

(2) Changed work is excluded from coverage under the clause thereby forcing the contractor and the government to try to predict the effects of future inflation when pricing the changes.

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

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

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

Unfortunately, during the period 1973-75 none of these stable conditions have proved to be the case in Navy shipbuilding contracts. Performance of contracts was delayed for a variety of reasons but also for such uncontrollable events as the oil embargo, international economic dislocation following in the embargo, and raw material shortages. Simultaneously, and for many of the same reasons, the rate of increase in the BLS indices accelerated. The effect of these two factors on contractors was both to increase the likelihood of late performance as well as the contractual penalty it enacted in the form of increased costs of work in a later period which was uncompensated by escalation.

In mid-1972 an inflationary trend began that certainly was not predicted and for which there was no recent experience. During the fiscal years of 1974 and 1975 the Labor Index increased 8.8% and 12.6% while the Material Index increased 22.7% and 15.1%. The impact of these unpredictable changes in past trends had a significant impact on work performed in a time frame after the original contract delivery date for which the contractor could not be compensated by the escalation provisions of the contract. The forward pricing of work added by change orders could not be accomplished because of the lack of confidence in predicted labor and material prices.

In the past, although contractors had performed work after contract delivery dates, there was not a significant financial problem as long as there was only moderate predictable inflation. The "traditional" or formula method of paying escalation provided cash flow to the contractor in some cases prior to the purchase of material. This positive cash flow and the positive aspects considering the time values of money ameliorated the economic and financial disadvantage of performing after expiration of contract escalation coverage. However, when the runaway inflation of 1973 and 1974 occurred, the contractors quickly found that the cash flow advantages of the old escalation clause was quickly and completely overshadowed by the inflation rates experienced in the BLS indices.

The New Standard Escalation Clause

In response to the inequities in the traditional clause, and experience in negotiating new shipbuilding contracts, the Navy has developed in 1975 a new escalation clause for use in new contracts. This clause has the following general characteristics:

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

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

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

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

The approach in this clause has many advantages:

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

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

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

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

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

Nevertheless, the Navy today has 11 major shipbuilding contracts which still contain the old escalation clause. These contracts include virtually every major combatant ship destined for the fleet of the 1980s and beyond. I am satisfied that a major portion of the Navy shipbuilding claims were generated directly or indirectly by this inequitable situation, and that shipbuilders will continue to pursue this laborious avenue of financial relief so long as the fundamental problem is not corrected. While it is not the policy of the Government to relieve contractors from the burdens of unprofitable contracts fairly entered into, neither is it in the Government's interest to persist in attempting to enforce contracts of such importance to the national defense when certain of their terms have proven to be unworkable. Economic events of recent years have far overtaken the pricing structures incorporated in these long-term contracts, and while new contracts will better protect the shipbuilders against such unanticipated business fluctuations, many years of performance still remain under these existing agreements. The litigious atmosphere and mutual distrust spawned by this situation has diverted the efforts of all parties from their primary job of constructing new naval vessels and seriously threatens the success of further shipbuilding construction programs being planned.

VIII. PLANNED STEPS TO IMPROVE NAVY SHIPBUILDING CONTRACTING AND CONTRACT ADMINISTRATION PROCEDURES

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

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

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

Improving Flexibility in Contracting

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

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

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

(a) *Economic Adjustment (Escalation) Clauses.*—The new escalation clause described above, or similar type clauses, affords the contractor substantial pro-

tection for material and labor escalation over the performance period of the contract.

(b) *Use of Cost-Type Contracts for Lead Ships.*—In some cases, it will be desirable to contract for the lead ship of a class under a cost-type contract, in recognition of the very high risk associated with such contracts.

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

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

(e) *Use of Fall-Back Options—Late or Defective Government-Furnished Property.*—This approach entails the idea of planning ahead of time for a fall-back option to another proven item of equipment should the preferred item of Government-furnished property prove to be defective, or so late as to have a devastating effect upon the overall shipbuilding program.

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

(g) *Increased Delivery Time Interval Between Lead and Follow Ships.*—By increasing the delivery time interval between lead and follow ships, a more orderly transmission and communication interval will be provided for covering lead ship plans and all related interfaces and communications.

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

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

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

Strengthening Personnel Staffing in Project and Procurement Offices

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

ect management, shipyard management, contracting officer, and negotiating capabilities.

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

To carry this out I have been assured by the Navy that such an assessment will be made and that actions to carry out necessary replacements or new assignments will be promptly accomplished. To the extent that any implementing actions are required by the Department of Defense to bring about this strengthening of senior military and civilian personnel staffing, I will initiate the necessary steps.

Refinement and Acceleration of Navy Contract Administration Changes

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

Inadequate or defective specifications.

Defective and late GFI and GFM.

Unanticipated increases in quality assurance requirements.

Failure to identify early potential claim problems.

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

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

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

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

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

Suggestions for Industry

Mr. Chairman, as I have mentioned before, some might construe my remarks as being largely critical of the Navy. Such a conclusion is only half true, for I firmly believe that the industry also has contributed in a large measure to the present crisis. With this in mind, I would urge the following actions for the shipbuilders towards improving relations with the Navy and bringing about significant efficiencies in our naval ship acquisition program.

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

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

(c) Prior to entering into a Navy shipbuilding contract, the shipbuilder should carefully review in detail the proposed contract delivery schedules and independently assess the realism of the schedule against his own capacity (i.e., facilities and manpower), the state of his order book, and the projected availability of government furnished information and material. Shipbuilders should not contract to do work to a schedule that is impractical if not impossible.

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

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

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

(g) Increase overall labor productivity. Display of multi-year building programs and encouragement of reasonable profits for capable firms should enable the shipbuilding community to increase overall productivity and reduce the extreme labor intensiveness of naval shipbuilding in the United States. Increasing labor productivity would decrease shipbuilding cost susceptibility to wage rate inflation and would be beneficial for all parties.

IX. CONCLUSION

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

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

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

Significant economic advantages will accrue to the Navy. Much manpower and other resources can be more productively used in acquiring new ships that are currently involved in the complex and time consuming claims processing procedures. Key Navy people, such as the ship acquisition program managers, the supervisors of shipbuilding, the functional and technical support personnel will more readily be able to get in harness with the shipbuilders in achieving the common goal of efficiently rebuilding the Navy.

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

Future shipbuilding claims on these contracts will be minimized. Basic features of new escalation coverage provide strong deterrent to claims in the future.

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

Thank you.

STATISTICAL SUMMARY, NAVY SHIPBUILDING PROGRAM

CLAIMS—REQUESTS FOR EQUITABLE ADJUSTMENT—CATEGORY A—SETTLEMENTS, JAN. 1, 1969—APR. 1, 1976

	Number of claims	In thousands		Settlement as percent- age of claim	Types of vessels
		Claimed amount	Settlement amount		
General Dynamics:					
Electric boat division.....	8	294,600	122,600	41.6	SSN, SSBN
Quincy division.....	8	216,755	190,124	41.6	AE, AS, AOR, LSD
Total.....	16	511,355	212,724	41.6	
Litton systems (Ingalls).....	3	34,119	19,922	58.4	SSN, AE, LPH
Newport News S. & D. D. Co.....	10	145,562	78,220	53.7	CVA, SSBN, SSN, LCC, LKA
Alabama D.D. & S.B. Co.....	1	14,219	4,977	35.0	ASR
Avondale Shipyards.....	2	169,144	80,000	47.3	DE
Bethlehem Steel.....	2	52,178	18,501	35.5	AE, AO
Defoe Shipbuilding.....	5	16,063	4,478	27.9	DDG, DE, AGOR, T-AGS
Lockheed Shipbuilding.....	9	208,923	79,452	38.0	DEG, AO, DE, AGEH, AE, DE, LPD
National Steel & S.B.....	1	49,200	35,300	71.7	LST
Northwest Marine.....	1	2,092	372	17.8	AGOR
Todd Shipbuilding.....	4	114,634	96,890	84.5	DE
Total.....	54	1,317,488	630,836	47.9	
Recapitulation:					
Nuclear.....	14	339,152	144,705	42.7	
Nonnuclear.....	40	978,336	486,131	49.7	
Total.....	54	1,317,488	630,836	47.9	
Percent of total nuclear.....		25.7	22.9		
Percent of total nonnuclear.....		74.3	77.1		
Total.....		100.0	100.0		

¹ Includes \$0 settlement amount for \$25,600,000 claim decision of ASBCA on which ASBCA denied contractor's appeal; ASBCA found that contractor had incurred \$12,282,523 additional costs; contractor's suit for such amount is pending in U.S. court of claims.

² Includes finding of entitlement of \$61,612,158 by ASBCA on claims of \$170,192,538.

STATISTICAL SUMMARY, NAVY SHIPBUILDING PROGRAM

Category B—Requests for equitable adjustment pending as of April 1, 1976

	Amount of claim
Pending as of April 1, 1976: Boland Marine DLG-10 ¹	\$3,297,314
Litton Systems (Ingalls): LHA.....	504,847,301
Newport News Shipbuilding & Dry Dock Co.:	
DLGN 36-37.....	151,040,521
DLGN 38-40.....	159,774,936
SSN-688.....	78,543,149
SSN 6689-91-93-95.....	191,567,199
CVN 68-69.....	221,280,223
SSN 686-87.....	92,099,492
Total.....	\$1,402,450,135
Recapitulation:	
Non-nuclear (36.2 percent).....	508,144,605
Nuclear (63.8 percent).....	894,305,520
Total.....	1,402,450,125

¹ Conversion and modernization contract.

NOTES.—Anticipated to be received in calendar year 1976: General Dynamics Corp. (Electric Boat Division) \$300,000,000 and National Steel & Shipbuilding Co., \$20,000,000.

STATISTICAL SUMMARY, NAVY SHIPBUILDING PROGRAM
CATEGORY C—ASBCA DECISIONS—JAN. 1, 1969—APR. 1, 1976

	Date of ASBCA decision	Claim amount	Amount approved by by ASBCA
General Dynamics Corp (Quincy).....	May 14, 1973	\$23,416,246	¹ 0
Lockheed Shipbuilding Co.....	May 13, 1975 ²	170,192,538	² \$61,612,158
Total.....	Oct. 24, 1973	⁴ 193,608,784	⁴ 61,612,158

¹ ASBCA denied contractor's claim. In an appendix to the ASBCA decision, the Board found the contractor's increased performance costs to be \$12,282,523. Suit has been filed in the U.S. Court of Claims.

² Award made by ASBCA based on tentative agreement between Navy and contractor but lacking "higher authority" approval. Amount of award not yet paid due to allegation of possible fraud.

³ Reaffirmed.

⁴ Does not include decision of ASBCA of Apr. 16, 1976 in which the Board determined the adjusted claim to be \$30,335,136 and in which the Board determined \$17,175,764 to be due the contractor (Litton Systems—Ingalls, SSN 680 claim).

STATISTICAL SUMMARY, NAVY SHIPBUILDING PROGRAM

Category D—Claims pending before the Armed Services Board of Contract Appeals as of April 1, 1976

	Amount of claim (thousands)
Litton Systems (Ingalls):	
Project X.....	\$107,821
SSN-680 (a).....	¹ 31,156
LHA (\$505 million) ²	
Subtotal.....	138,977
Merrit-Chapman & Scott (formerly New York Shipbuilding).....	6,844
Todd Shipbuilding Co.: Agor.....	2,965
Total.....	148,786

¹ ASBCA decision of April 16, 1976, awards contractor \$16,535,771; claim as adjusted stated to be \$30,335,136.

² The LHA claim pending before the ASBCA was withdrawn from the docket to permit further negotiations. The LHA claim is included in the schedule of category B—Requests for equitable adjustment.

The CHAIRMAN. Gentlemen, others have come since I made my brief opening remarks. This particular hearing today grows out of the fact that we seem to all agree that there has to be a forward look in the Navy augmented by modern ships. We disagree some as to just which ships. But basically there has to be a forward movement. And basically I think, moneywise, Navy shipbuilding was neglected during the war in Vietnam. When that was over it was hit in the head with a meat ax by inflation and escalation costs.

So as a prelude to getting into the new program, I think it is an absolute must that we wrestle with the old program that has arisen in the last few years. We will have to meet the things that we don't like about it. We have to get into it and understand it first, and make the judgments as best we can.

Your statement here is rather clear—once we realize how these ship contracts work. It is written into the contract, as I understand it, that adjustments and changes are made by the Navy in the contract. It is recognized that as we go along into the contract that they have to make some changes. And it is written into the contract that there will be negotiations then as to what the additional payment will be, including a loss of time or delay. It is during that long period of these contracts that this special escalation has occurred.

If you get approval of this step that you propose—rather boldly, it

seems to me, if you get that, where is that going to leave you now with reference to staying out of the whole thing in the future?

Mr. CLEMENTS. Senator Stennis, I would like to comment on that. And before I do, I would like to introduce my associates here, for identification purposes.

Admiral Eli Reich, retired, is on the end. He is on my staff.

Richard Wiley is the General Counsel of the Department of Defense.

And next to him Mr. Shrontz, Assistant Secretary for Installations and Logistics.

Gary Penisten is the Assistant Secretary of the Navy for Financial Management.

Admiral Michaelis, Chief of Naval Materiel.

And Admiral Gooding, who is in charge of ship construction for the Navy.

The CHAIRMAN. We are glad to have each of you gentlemen here. We are flattered by such talent. And we know you are going to help find some answers here.

Mr. CLEMENTS. They are. They are a great bunch, and they have worked diligently to help me come to this conclusion to bring this about.

And as you well know, this is not a quickly or easily reached decision. We have been wrestling with this problem for 3 years. And I wanted to avoid like the plague taking this kind of action. But all of us are of the opinion that in the final analysis this is the only solution that makes any sense.

Now, by doing this what do we really accomplish? We clean up these festering sources of these claims that have brought about this adversary position between the shipbuilding industry and the Navy and the Department of Defense. That is one thing that will happen.

We think that by approaching this in the spirit of equity, what is right, what is fair, what was unanticipated by both parties, and trying to bring about a sense of, let's work together in harmony, in partnership, on a reasonable basis, an equitable basis, that we can then move forward with our shipbuilding program in a much more efficient and productive manner.

Our shipbuilding program, as I stated, is concentrated in three yards. This is not healthy. We would like to broaden this base, for one thing, and get it into more yards. We actually have yards, and I could document it for the committee, that are refusing, and have for the past several years, to engage in Navy shipbuilding construction because of these onerous and what they consider not equitable provisions of the contract.

The CHAIRMAN. Be specific on it, because that the very heart of your situation here, as I see it.

Mr. CLEMENTS. Yes sir. There are three major issues involved. One has to do with the inflation clause that we are talking about here. And that is the root cause of the problem, the inflationary clause, how we treated inflation.

The second is the method by which we handle change orders. This has to do with the on-site shipyard project management supervision by the Government and the way that change orders are processed. There is much criticism by the shipbuilders here. And that is more of

an administrative matter which we internally working with Navy can cure.

And the third issue has to do with the way in which R.F.P.'s for ship construction projects are prepared and the way in which shipbuilding contracts are awarded. And between these three major issues we feel that a much better relationship can be established with the shipbuilding industry as a whole. And by taking corrective actions, and by settling these claims and removing this cancer, so to speak, we can bring about a more positive relationship with the industry which will support the Navy.

The CHAIRMAN. I want to get to others so that they can ask questions. I think we all agree that this situation must be cleared up some way. You have a plan that you think is going to work better and do better for future contracts?

Mr. CLEMENTS. Yes.

The CHAIRMAN. Have you already put that new plan to effect in part?

Mr. CLEMENTS. In part, yes.

The CHAIRMAN. By changing the escalation contract clause part of it?

Mr. CLEMENTS. That is exactly what we have done. For instance, the two best examples are the Trident contract which we let with Electric Boat in 1974. That has a different, a completely different escalation clause than heretofore. I know of no shipyard within the industry which objects to that escalation clause. It is completely fair and equitable.

The CHAIRMAN. The new one?

Mr. CLEMENTS. The new one.

The CHAIRMAN. Are they responding to it?

Mr. CLEMENTS. They are responding to it.

The CHAIRMAN. And you you making contracts on it based on it?

Mr. CLEMENTS. Yes; we are. And the other contract, which in turn has a new escalation clause in it and has been similarly accepted by the industry, is the FFG contract that we have recently let for the frigates. And so we have no problem with this new escalation clause. It is this type-clause that we are advocating go into these older contracts.

So it is an equitable clause, and it is one that will work.

The CHAIRMAN. Since we met a year ago in the conference on the bill, you have made some new contracts on submarines, have you not?

Mr. CLEMENTS. That is right.

The CHAIRMAN. One is the Trident that you mentioned, and the other the SSN-688 submarine?

Mr. CLEMENTS. That is right. Both the Trident and the latest SSN-688 production contracts have the new clause, and so does the FFG frigate class.

The CHAIRMAN. And you have the authority to make those new contracts different?

Mr. CLEMENTS. Yes.

The CHAIRMAN. You are here today trying to justify money that will accrue under the old contracts if you backfit the newer type escalation clauses?

Mr. CLEMENTS. That is right.

The CHAIRMAN. In sums that are somewhere in the neighborhood of what you think will finally have to be paid? You don't know the exact amount, but you judge that they will have to be paid to that extent, is that right?

Mr. CLEMENTS. That is correct, Senator Stennis.

The CHAIRMAN. You propose to operate under this law, giving notice to the Congress. And unless it is vetoed within 60 days, you can move along, is that right?

Mr. CLEMENTS. Yes, sir, and we are completely in accord with this provision. We think this is the way it should be.

The CHAIRMAN. And you have used that system before?

Mr. CLEMENTS. Yes, sir.

The CHAIRMAN. My time is up. Senator Thurmond, any questions?

Mr. CLEMENTS. Good morning, Senator Thurmond. It is good to see you.

Senator THURMOND. It is good to see you.

Mr. Secretary, under your proposal here, what is this going to cost the Government to do what you want done and to clear everything up? And what will it cost the industry? As I understand it, you are sharing this situation.

Mr. CLEMENTS. Yes; we are. They have in the total about \$1.8 billion in claims that will be covered by these settlements—

Senator THURMOND. These are claims by the Government?

Mr. CLEMENTS. These are claims on the Government, by the shipyards. The shipyards have made claim on the Government—

Senator THURMOND. Against the Government, against the Navy, under the existing contracts that will fall within the category we are talking about of about—\$1.8 billion, isn't it?

Mr. PENISTEN. I think \$1.5 billion is better, \$1.3 to \$1.8 billion.

Mr. CLEMENTS. We have pending claims that I mentioned in my statement here that would—and we anticipate getting some additional claims by about December 1976—be covered by our settlement. So it could be about \$1.8 billion of claims that we are talking about.

Senator THURMOND. These claims by the shipbuilders against the Government, total \$1.8 billion?

Mr. CLEMENTS. That is correct.

Now, we would negotiate with these contractors—and you can understand why we can't be too definitive about the number that we will settle for—but it will run from what I would judge to be a minimum number for the Government of about \$500 million to a maximum of about \$700 million. And we are going to protect the Government's interest, the Navy's interest, and negotiate just as hard as we know how in an equitable manner under Public Law 85-804, and we will do the best we can. But it will have a range of something like \$500 to \$700 million that we will pay in settlement of about \$1.8 billion in claims.

Senator THURMOND. What authority do you need here from us?

Mr. CLEMENTS. We need you to ask us all the questions that occur to you in explanation of what we are doing.

Senator THURMOND. You have the authority to do what you want to do?

Mr. CLEMENTS. I do. The Department of Defense will notify the Congress of our intention to invoke this Public Law 85-804.

Senator THURMOND. It is already on the books?

Mr. CLEMENTS. It is already on the books, and I explained it to you here today. And then it stays within the Congress for 60 days. And if you don't specifically tell me, don't do it, we will proceed.

Senator THURMOND. In other words, you are not asking for any new law?

Mr. CLEMENTS. No, sir.

Senator THURMOND. What you are doing now is notifying us that you are going to send up some recommendations?

Mr. CLEMENTS. That is right.

Senator THURMOND. And if they are not disapproved by a certain time, then that ends it?

Mr. CLEMENTS. Then we can proceed.

Senator THURMOND. Isn't that what you are trying to say?

Mr. CLEMENTS. Yes, sir, that is exactly it.

Senator THURMOND. There would have to be money in the bill to pay it, wouldn't there?

Mr. CLEMENTS. Yes, sir, there would have to be money in the bill. But in the President's budget, as my statement says here, there are insufficient funds in the President's budget to cover the total amount that we are talking about to achieve full funding. On a full funding basis, it will require approximately \$400 million additional.

Senator THURMOND. Will you ask for any more new money, or will you pay it out of your funds that you now have?

Mr. CLEMENTS. Under our fiscal year 1977 budget request as submitted, there are insufficient funds in there for us to meet this requirement in a full funding sense. However, the President's 1977 budget as submitted has sufficient funds to cover our needs through fiscal year 1977.

Senator THURMOND. So you are not going to ask for any new authorization or any new appropriation?

Mr. CLEMENTS. No, sir, not for fiscal year 1977 unless we are to fully fund the outyear requirement.

Senator THURMOND. You have already included that in your request?

Mr. CLEMENTS. I will forward this information in my formal notice of intent to use Public Law 85-804.

Now, I would also like to say that the additional costs will not be paid in a lump sum; they will be phased over time as the escalation clause is applied to the older contracts. It will not be paid on a lump sum basis.

Senator THURMOND. Someone said the House has taken some unfavorable action on this plan. What is the situation?

Mr. CLEMENTS. I do not know of any such action. And to the contrary, the leadership in the House with whom I have discussed it, as I have discussed it with Senator Stennis—

Senator THURMOND. I understand they cut out the money for the claims.

Mr. CLEMENTS. Let me finish first, Senator Thurmond.

In my discussions with the House leadership, they have all been favorably inclined to what we intend to do.

The CHAIRMAN. If you will yield, you are referring to the request and the 60-day period. I believe Senator Thurmond is referring to the actual money in the fiscal year 1977 budget. And they are two different things.

Mr. CLEMENTS. That is right.

Senator THURMOND. You asked for some money in this year's budget for claims?

Mr. CLEMENTS. Yes; we have.

Senator THURMOND. Is that what the House eliminated?

Mr. CLEMENTS. And the House eliminated that.

Senator THURMOND. But you can now handle this out of your own funds and will not have to depend upon that?

Mr. CLEMENTS. As it would relate to the President's budget as submitted now to both the Senate and the House. But it will take action to restore the President's budget request for claims to give us the escalation that we need.

Senator THURMOND. As the President's budget stands now, it contains enough funds to pay this, as I understand it.

Mr. CLEMENTS. Yes, sir, it does as far as the requirements through fiscal year 1977.

Senator THURMOND. And, therefore, since the House eliminated money for claims over there you wouldn't be affected, then?

The CHAIRMAN. This committee would have to vote the full amount of \$322 million asked for in the budget. It wouldn't be going over the budget.

Senator THURMOND. That is in the budget?

Mr. CLEMENTS. That is right. Is that not the case, that there is in the budget as requested enough money to satisfy the claims? That was my understanding.

Admiral GOODING. That is correct, sir.

Mr. CLEMENTS. Plus the inflation number that is in the budget?

Admiral GOODING. Yes, sir.

Senator THURMOND. As I understand it, since the House eliminated the money for the claims in the budget request, we would have to restore those funds over here in the Senate, isn't that correct?

Admiral GOODING. Yes, sir, that is correct.

Mr. CLEMENTS. Excuse me, would you say it again, please?

Senator THURMOND. The admiral has answered the question. I will see if you think he is correct.

Since the House eliminated—

Mr. CLEMENTS. Admiral Gooding is a very capable individual.

Senator THURMOND. I think so, too. And I think you will confirm his answer.

At any rate, since the House eliminated the money for the claims over there, we would have to restore that over here?

Mr. CLEMENTS. Yes, sir, as requested by the President, that is exactly right.

Senator THURMOND. And so we would then have to put in the money for claims over here?

Mr. CLEMENTS. Yes, sir.

Senator THURMOND. I just wanted to get it straight so that we will have an understanding.

Mr. PENISTEN. We would also need the restoral of the outyear escalation.

Senator THURMOND. You need what?

Mr. PENISTEN. The restoral of the outyear escalation. The President asked for \$1.6 billion for escalation claims and some other minor cost growth. And we are requesting that full amount be restored.

Senator THURMOND. The House eliminated that?

Mr. PENISTEN. They eliminated part of that also.

Senator THURMOND. Mr. Clements, I am trying to get this matter straight.

Mr. CLEMENTS. Yes, sir.

Senator THURMOND. The House eliminated the money for the claims, and you want that restored over here?

Mr. CLEMENTS. We do.

Senator THURMOND. What else did the House eliminate that you want restored over here?

Mr. CLEMENTS. May I ask my colleagues what that number was?

The total is \$1.6 billion. And of that amount, \$1,089 million, almost \$1.1 billion, was for escalation. They reduced that by \$833 million. So that needs to be restored.

Senator THURMOND. That is in addition to the claims money you are talking about, or is that included?

Mr. CLEMENTS. No; that is in addition to it. There is a total in there for escalation program changes, and claims, and that total is \$1.6 billion. And the House took out of that total of \$1.153 million. So that \$1.153 million we are asking to be restored.

Senator THURMOND. In addition to the claims money?

Mr. CLEMENTS. No; that includes it.

Senator THURMOND. That is what I am trying to clear up.

Mr. CLEMENTS. Let me recap. The President's budget in all of these categories included \$1 billion \$623 million, \$1.6 billion. The House took out of this \$1.53 billion. We need that money restored in order for us to satisfy the requirements that are in this category.

Senator THURMOND. And that will take care of it?

Mr. CLEMENTS. Yes, sir, it will for our requirements through fiscal year 1977.

Senator THURMOND. That is all. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Symington, that brings us to you.

Senator SYMINGTON. Mr. Secretary, I have several questions here. I will try to make my questions short, and if you can make your answers short we will cover it. But that is, of course, entirely up to you. And I want to add that I am very glad to see you this morning.

Mr. CLEMENTS. I am very glad to see you, too.

Senator SYMINGTON. A staff member handed me a note: As we understand Secretary Clements' testimony, he is saying that he will formally invoke Public Law 85-804 in the next few days, but he will not know all the details, including how much money to pay the shipbuilders, for another 30 to 45 days. This means the 60-day clock will start running now, but Congress won't know what the Defense Department plans to spend, which could be as much as a \$1.7 billion backlog, it won't know that for 30 to 45 days. Doesn't this procedure make it impossible for Congress to judge the Defense Department proposal until shortly before the 60-day period expires?

Mr. CLEMENTS. Senator Symington, I agree that this is a rather fuzzy area. And what I guess I need is some advice in consultation here. Because our anticipation here is that we really need \$500 to \$700 million to settle this \$1.8 billion of claims. So since this procedure has never been done before in this particular endeavor for the Depart-

ment of Defense, and certainly not by me, I don't know exactly how to proceed in this regard. And we don't want to put a definite number in there, because our negotiations with the shipyards are not complete.

We think we know within reasonable ranges what we are doing and where it is going to come out. But we can't say positively.

I would like to bracket what we ask for under our request for 85-804 and say that we would like to have the authority to go up to \$700 million.

Senator SYMINGTON. I am only asking for information. But the answer to my question would be yes, would it not?

Mr. CLEMENTS. If I had to give that kind of answer, I suppose it would. But I would probably like to have consultation with the committee to say to me, why don't you make—why do we not approach this on the basis of, you come in here and ask us for authority to go up to the \$700 million, and then we will negotiate down. Because the range is \$500 million to \$700 million in our best judgment, all of us agree to that.

Senator SYMINGTON. I am only talking in generalities. I never heard about any of this until this morning, you and I never discussed it. There is no shipbuilding in my State.

What is the difference between the old clause and the new clause?

Mr. CLEMENTS. Well, in my statement I covered that in some considerable detail. And the basic difference is that it uses a different formula to arrive at the escalation to be paid.

And it also moves the escalation cutoff point out to the actual delivery dates, so that as they incur delays in the delivery of these ships, either from their own cause or from our cause, that we just have a new set delivery time, there is an escalation clause then that moves forward with that delivery date. It is not changed beyond the contract date, but they get the escalation that they were getting at the point of the original set date, and they get it on out until actual delivery.

Senator SYMINGTON. Thank you. I will read your statement carefully.

Mr. CLEMENTS. And this makes a significant difference.

Mr. Shrontz.

Mr. SHRONTZ. Senator, there is one other significant difference. The old clause went up to target cost only. The new clause allow escalation on costs up to ceiling. So in addition to extending the time coverage, it also allows escalation on dollars between target and ceiling on the contract.

Senator SYMINGTON. Thank you.

My third question of the five I have here is, have you any strictly Government-owned naval yard that makes it possible to compare your costs as against the private shipbuilders?

Mr. CLEMENTS. Not really. An easy answer would be for me to say, yes, we do. But I don't agree with that answer. Our cost, financial management records in our Navy shipyards, are not adequate for me to be able to give you what I would consider a definitive cost analysis on what it would cost if we were to build in a Navy shipyard. We are working on that. And we are going to have that kind of management system which will allow us to do that. But the most important thing is that since 1967, I believe—isn't it, Admiral Gooding?

Admiral GOODING. Yes sir.

Mr. CLEMENTS. —we have not built any new ships in Navy shipyards. So even if we had the best cost data system in the world it would be out of date at this point.

Senator SYMINGTON. The answer to that is, why haven't you built any?

Mr. CLEMENTS. I want to. And we now have a plan being asked for from the Navy, I have asked for that. And I would like very much to put a small amount of our new construction in Navy shipyards in order for us to have a cost-based data system that would allow us to compare our Navy shipyard work with private shipyard work. And further—and I think even more important, Senator Symington, it would allow us to develop within the Navy and keep ongoing an educational process for our naval architects, our naval engineers, our construction project managers, to where they are literally doing this in Navy shipyards and receiving training and expertise that would enable them to do a better job in the private shipyards. We badly need to do this, in my opinion.

Senator SYMINGTON. The staff tells me that the Navy testimony before stated that new ships in the Navy yard are 35 percent greater in cost than in private yards.

Mr. CLEMENTS. I don't believe that is a good number, and I don't agree with it.

Senator SYMINGTON. My fourth question of five here is, you said that it is not an easy decision that you are making, Mr. Secretary. And following your logic, what is the decision that you are making?

Mr. CLEMENTS. The difficulty in the decision is that rather than going through the historic procedures that are within the Navy, and allowing them to negotiate forever on some of these issues with the shipyards, I have taken it out of their hands, and I have said in effect, the source of the problem is in this inflationary factor, in the escalation clause. And I have overall authority to do this. And retrofit that clause into these old contracts.

Senator SYMINGTON. My final question. Because of the degree of change, as well as the nature of it, what you really turn these contracts into are cost plus contracts, do you not?

Mr. CLEMENTS. No, sir, not really. Because there is no contractor in my judgment that would take these contracts under a cost plus contract that would have a small a yield as these contracts will have. We are talking about doing literally billions of dollars' worth of business at about 1 percent or less than 1 percent profit. And I know of no contractor that would enter into that kind of an arrangement.

Senator SYMINGTON. If it was a cost plus contract it would be illegal, wouldn't it?

Mr. CLEMENTS. Well, we can make a negotiated contract at cost plus, fixed fee.

Senator SYMINGTON. Fixed fee is another thing. I didn't say that. I am not unsympathetic at all, but I am just trying to get the facts out on the table. And I appreciate your testimony.

Mr. CLEMENTS. You bet. I am delighted to be here. Because it is something that we have needed to talk about for a long time.

Admiral Michaelis, would you say that the actions we are taking here under 85-804 is outside your authority, and that you and the Navy are in accord?

Admiral MICHAELIS. It is, of course, outside of the military authority to do this. We were proceeding down the line on the negotiation of claims, but when the decision was made, the Navy Department supports it.

The CHAIRMAN. Are you finished, Senator?

Senator SYMINGTON. Yes. Except that the way that the Admiral answers the question is rather interesting, once the decision is made the Navy supports it.

Did you oppose it before the decision is made?

Admiral MICHAELIS. No sir. We had the opportunity to present several different alternatives to Secretary Clements. Two of them had to do with improving the claim action in which the Navy was involved. A third alternative was the use of Public Law 85-804. At that presentation the decision was made and the Navy supports it. We have a strong Navy team working on this under Secretary Shrontz.

Senator SYMINGTON. Thank you.

Mr. CLEMENTS. Thank you, Senator Symington. I am glad you asked for clarification. I had a little doubt in my mind about that.

The CHAIRMAN. Mr. Secretary, this is an old matter. It is something that must be met. I insisted that it be heard now before we went to the rest of the Navy budget for these new ships, because this is something that is prelude to getting into the new program, as I see it.

Mr. CLEMENTS. I concur in that.

The CHAIRMAN. It would greatly help the committee, and also the Senate.

Now, for clarification, the House took out all of the so-called claims money that is in the fiscal year 1977 budget, approximately \$320 million, is that correct?

Mr. CLEMENTS. Yes, sir.

The CHAIRMAN. That was the claims money. And that is what we are talking about expressly this morning. But the whole picture is involved for the rest of that money?

Mr. CLEMENTS. Yes, sir.

The CHAIRMAN. And in addition to Public Law 85-804 that you refer to in your 60-day notice, are you asking that this \$320 million be restored to the bill?

Mr. CLEMENTS. Yes, sir.

The CHAIRMAN. So that would be asked for regardless of your 60-day notice?

Mr. CLEMENTS. Yes, sir, it would be.

The CHAIRMAN. That is the way I understand it.

Mr. CLEMENTS. And we would also ask for restoration of the escalation amount.

The CHAIRMAN. Senator Leahy.

Senator LEAHY. Thank you, Mr. Chairman.

Admiral, just to follow up on a question that Senator Symington asked you, you said there were a number of proposals made by the Navy in this matter. Were any of the proposals the one that is now being presented by the Secretary?

Admiral MICHAELIS. Yes; that was one approach of about three that were presented as possible routes, in trying to improve our relationships with the contractors and help get a better base for shipbuilding. One of the routes was to define all the administrative and other means

of shortening up the claims process—we called this the accelerated claims process route—and still maintain the quality of the claim process. We have been developing for several years a claims analysis system which we think is very thorough and serves the Government very well. However, it takes time. And we are looking at ways to reduce the time. We had another approach that dealt with provisional payments against the claim. And we had a third one that was this 85–804 resort.

These were the three proposals.

Senator LEAHY. Thank you.

Mr. Secretary, I agree with you that there has been a need to talk about this for a long time. But I am concerned why the plan is really being presented to us without specification, without the final figures. As I understand your testimony, if we don't accept the proposal, we have 60 days to disapprove, is that correct?

Mr. CLEMENTS. That is correct.

Senator LEAHY. And when does that period of 60 days begin?

Mr. CLEMENTS. It will start in a few days, when I officially send over my notification, which I have not done yet.

Senator LEAHY. But will there be more specific figures than we are getting so far?

Mr. Clements. This is what I was discussing with Senator Symington earlier. Were you here then?

Senator LEAHY. I heard you answer that particular one. But I am just trying to find out. Like Senator Symington, I am just a country lawyer.

Mr. CLEMENTS. So am I. All three of us are in the same boat.

There are \$1.8 billion of claims which we are trying to address in this action. Part of that \$1.8 billion are about \$300 million of claims that have not been received yet, but we anticipate getting them, and have been notified by the shipyard concerned that they will be coming in about December of this calendar year.

Senator LEAHY. That was \$300 million?

Mr. CLEMENTS. \$300 million. So we have in hand about \$1.5.

Mr. PENISTEN. That is correct. I would add that there may be even other claims not identified that are not in the \$1.8.

Senator LEAHY. The \$1.5 is spelled out exactly?

Mr. CLEMENTS. Absolutely.

Senator LEAHY. So what we should do is probably disapprove the \$300 million until such time as they come before us.

Mr. CLEMENTS. No; let me finish. I wouldn't agree to that, I mean with your statement there, I don't think that is exactly the way to proceed.

What we are trying to do is to say, all right, we are going to have in toto by our action here claims that will be about \$1.8 billion that will be affected by our action. And by doing what we are going to do then, is to negotiate with four yards—we have not really talked about that fourth yard, but it is in the official statement, it is a small part of the whole—but with these 4 yards, we are going to negotiate to the best of our ability, and we will need overtime during the negotiations with these 4 yards, which will take, hopefully, maybe 90 days, 3 months, or maybe less. But within 90 days we will be able to settle \$1.8 billion in claims with payments that will be probably no less than \$500 million, and no more than \$700 million.

Now, I can't tell you any more definitely that until we actually reach a final settlement with shipyards.

Senator LEAHY. That includes the \$300 million that you won't have until December?

The figures don't seem to jibe. We are going to do this in 90 days, but the \$300 million, we are not going to have the figures until December?

Mr. CLEMENTS. We already have some money that can be used for the purposes of this.

Senator LEAHY. Do they have to waive the claims on those \$300 million?

Mr. CLEMENTS. You bet. This is in settlement of all claims.

Let Mr. Wiley, who is our General Counsel, comment on that.

Senator LEAHY. Let me just make it a little clearer in my own mind. They are going to have to waive that \$300 million?

Mr. CLEMENTS. Only the \$1.8. When we make that settlement we will have waived the \$1.8 billion for the consideration of us paying somewhere between \$500 and \$700 million.

Senator LEAHY. And what we are going to be doing, we are going to be paying \$500 to \$700 million on claims that originally, at least the Department of Defense or the Navy, took the position that we didn't owe at all?

Mr. CLEMENTS. No; that is not the Navy position.

Senator LEAHY. Why didn't we pay them to begin with?

Mr. CLEMENTS. Because we could not agree on the amounts. The Navy's position is, yes, we owe something, there is no question—it is a very good point, I am glad you brought it out, because the Navy—and I am talking about in its broadest sense, not in specific claim—but in the broadest terms, the Navy has never said, no, we don't owe any of the 1.8 billion against those claims. To the contrary, they are saying just the opposite. Yes, we do owe money against those claims, but we are arguing with you about how much we owe.

Senator LEAHY. We are talking about \$300 million that we won't have until December, that is what is supposed to be waived. And that could be waived out anyway.

Mr. CLEMENTS. That is not true.

Senator LEAHY. Let me finish my question.

On the specifics of it, then, the Navy at some point has said, all right, we maintain we owe something on those contracts, is that correct?

Mr. CLEMENTS. That is correct.

Senator LEAHY. And they must have said—at least made a proposal—that they owed a particular amount. Can we get those specifics that the Navy has?

Mr. CLEMENTS. No.

Senator LEAHY. Why not?

Mr. CLEMENTS. Because we have not reached that point. These claims have to go through a very set procedure, and be thoroughly documented. And some of the documentation on these claims would make a 3- or 4-foot-high stack of papers. And then they have to be analyzed, and so forth. And so they have not made a counterproposal, which is what you are asking me, they have not done that.

Senator LEAHY. Are you saying that the \$1.8 billion worth of claims, the Navy hasn't even reached some kind of a conclusion about what they figured they owe on them? And we are going to wrap the thing up in 90 days after we get approval from the Congress? It just doesn't make sense.

Mr. CLEMENTS. It really does.

Senator LEAHY. It must be the Navy is going to be able to move a lot faster than I have ever seen them do in anything else before.

Mr. CLEMENTS. No, sir. Under one procedure those have to be definitized—

Senator LEAHY. I am not familiar with that word. You mean made definitive.

Mr. CLEMENTS. Made definitive. All the i's need to be dotted and the t's crossed. And under those circumstances this is a very tedious procedure. And it takes a long time. But that doesn't alter the fact that they have a general conception of what constitutes that claim. That is why we have a project manager down there in those shipyards. And that is why we have a supervisor of shipbuilding down there. And we are not totally ignorant of what that claim is all about.

Senator LEAHY. I would hope not. But we are talking about here, if you get approval, you are saying that in 90 days you can wrap them all up?

Mr. CLEMENTS. We can.

Senator LEAHY. Let me see if I fully understand you. On this \$1.8 billion worth of claims whatsoever has the Navy even taken a tentative position of what they think we owe?

Mr. CLEMENTS. Yes; we have. We have talked in broad terms to some of these contractors about some of these claims. And there have been some offers made in a general way.

Senator LEAHY. Can we get the figures that you have offers on?

Mr. CLEMENTS. I don't think that that would serve a useful purpose at all.

Senator LEAHY. Mr. Secretary, I realize that in today's world perhaps \$1.8 billion doesn't seem like an awful lot of money.

Mr. CLEMENTS. I disagree with you entirely, it is an awful lot of money. And as a taxpayer I am interested in looking after it to the best extent I can.

Senator LEAHY. What I would like to know is how much money has been offered in these, because I would like to see the original course and the original conclusions reached by the Navy, and how those compare with what you get after we give, in effect, a \$1.8 billion blank check.

Mr. CLEMENTS. We have a history in the Navy of settling these kinds of claims over a long period of time for a range of somewhere between 25 and 35 cents on the dollar.

Senator LEAHY. The point I am making, Mr. Secretary—

Mr. CLEMENTS. I understand.

Senator LEAHY [continuing]. I would like to see what the range is—based on what the Navy claims they owed prior to coming to the Congress—in effect giving you a chance to just wipe the slate clean—and what they paid after they did that. If this can be done up in 90 days, I don't believe that they don't have some preliminary fix to this \$1.8 billion. It just does not make sense. And if they are in the process of

making new proposals, then why not just sit back and wait awhile until we get those new proposals?

Mr. CLEMENTS. I want to comment, and then Secretary Shrontz would like an opportunity to respond to you.

In the first instance, I don't think that it would be constructive for us to make public in a full open hearing, and if I may be allowed, have kibitzing, not from this committee, but from everybody concerned, that would detract in our negotiations with the contractors. I think this would be other than constructive. That is the first point.

Senator LEAHY. So you want us to accept it on faith?

Mr. CLEMENTS. No, I don't at all. We would be pleased to go into, say, an executive session with this group on a basis of confidentiality and talk in terms of what our plans are with respect to this sort of thing. But I think it would not be in the public interest, the taxpayer's interest, to make public those kinds of numbers——

Senator LEAHY. Especially the Navy's interest.

Mr. CLEMENTS. I disagree with that entirely. I don't think it is in the interest of this Government, I don't think it is in their interest at all to make those numbers available to the very people with whom we are negotiating for settlement.

Senator LEAHY. I assume that some of them have already made offers.

Mr. CLEMENTS. If you are the country boy that you manifest to be, you understand that kind of trading.

Senator LEAHY. Mr. Secretary, you said that some of these things have already been made in offers to the contractors. Apparently the Navy knows what they are and the contractors know what they are. The only people that don't know are Congress.

Mr. CLEMENTS. We start just as low as we possibly can, and they start just as high as they can. That is the way I have always traded.

Senator LEAHY. And I certainly appreciate that the Department of Defense is very, very careful in the spending of money.

Mr. CLEMENTS. We are.

Senator LEAHY. And it never allows a cent extra to be spent if it can be avoided. That is a position I have heard before.

Let me just back up a little bit on that. Let me suggest this. How would you feel if after this, assuming that you are given this blank check, how would you feel if after these claims are settled this committee then asked what the original proposals were of the Navy? Because once they were settled it certainly couldn't hurt anything, could it?

Mr. CLEMENTS. The Navy is completely in accord with the way that we are now proceeding to make this settlement.

Senator LEAHY. That wasn't my question. What I am saying is, how would you feel about this committee asking afterward what you originally proposed settling for, and what you eventually settle for?

Mr. CLEMENTS. Senator, I am always pleased to respond to this committee at any time on that subject. So I would feel good about it. Any time you want us to furnish something I would be happy to give it to you.

Senator LEAHY. Well, I have asked you for something before and you said I would rather not give it.

Mr. CLEMENTS. You asked for an honest answer, and I gave you an honest answer, that is, I prefer not to do that.

Senator LEAHY. I am not sure which answer you are giving me. You will give the figures after the fact?

Mr. CLEMENTS. No; we will give them to you right now. We will give you the number that we think within the range that we can make this settlement on.

I would like for Secretary Shrontz to comment on this. He heads this committee that I appointed within the Department of Defense to bring this settlement about.

Mr. SHRONTZ. One of the problems, Senator Leahy, is that many of the claims have just recently been received, 60 or 90 days ago. They have not been analyzed, and one of the problems we have is the time it takes for the process of initial negotiation and adjudication to occur. In fact, in many cases we are talking about several years on a claim-by-claim analysis before we really have a good understanding of what the claim content is, and at least a Navy view as to what its true value is. The purpose of reforming the contracts is partly to avoid the necessity of going through that process, but also to put into the contracts a clause that we would hope in the future would be a deterrent to the generation of a significant number of additional claims. Many of these claims arise from the fact that under the current inflation clause, once the contract schedule is past there is no inflation money which could be allowed under the contract, and yet there are actions of the Navy which in fact do cause delay. That is a very difficult thing to try both to understand and to negotiate. So the purpose would be, not only to try to wipe out the backlog of claims which creates a very legalistic atmosphere between the shipbuilders and the Navy, but hopefully to create a climate in the future where much of the claim generation would be at least alleviated. I am not saying that there wouldn't be future claims, but hopefully not of the magnitude we have seen in recent years.

Senator LEAHY. Let me see if I understand what you are saying, Mr. Secretary. You are talking about the fact that a number of these haven't even come in yet that you are asking for, and in a normal procedure it might take several years to figure out exactly how valid they are and all. And yet you are talking about running these through in about 90 days if we give this authority.

Mr. SHRONTZ. May I correct that. I think what the Secretary is referring to is, it is our judgment that it would take 90 days' work with the shipbuilders in order to resolve a satisfactory arrangement, not to actually negotiate the claims per se. Part of the consideration for our improving the contract coverage in the escalation area, and resolving problems in other areas, would be an agreement on the shipbuilders' part as of the date of settlement to withdraw the current claims and not to submit future claims to the date of settlement. So the outcome would be elimination of the claims. But that isn't necessarily the sole driving force.

Senator SYMINGTON. Would the Senator yield to me for one question?

Could you complete your negotiations and then come to us for the money?

Mr. CLEMENTS. I am not sure, Senator Symington, whether we could or not.

Senator SYMINGTON. You see my point. This would clarify what Senator Leahy is asking us, and also part of the question I asked.

Mr. CLEMENTS. I am not sure that we could get the shipyards to agree to a settlement subject to the approval of the Congress; it puts it in such a nebulous stage.

Senator SYMINGTON. And it would make the full 90 days. That is my point. You might think about it.

Mr. CLEMENTS. Might I try it with you once more, Senator Leahy? I would like to try this again.

What Secretary Shrontz has tried to tell you—and it is very complex, and it has taken me an awful long time to get there, it has taken me 3 years to do it, I am slow on this sort of thing—by adjusting the escalation clause in the sense of equity, to the accepted clauses we are now using in our contracts which have proven to be satisfactory both for us in the judiciary responsibility that we have, and to the shipyards from a contractual standpoint, we can go back on those old contracts and reform them with the new clause. And with that new clause there is a yield to those contracts which can be calculated. It is not a difficult calculation. And we can come to a number. And we literally tried the reformation of that contract on escalation, and we will reform it in respect to change orders, and one or two other areas that are not so important.

But in consideration of our doing that, they drop all these claims that would literally take years to process.

Now, we know within some limits—and they are rather broad limits—what those claims are worth. So does the contractor. But it is a big number, and it goes upward and downward by several million dollars, which makes it a sensitive area of negotiation. And it is a tough negotiation that covers a long period of time. And when it gets into the contract claims appeal board, it takes even longer, sometimes 5 or 6 years, to adjudicate those claims. We are trying to bypass that process. And the consideration for the reformation of the old contracts in equity to give them the fair treatment for escalation and unanticipated by both parties, they drop all those claims.

That is what we are really trying to convey to them. Do you have any comments on that?

Mr. SHRONTZ. I think that is well said; and to be very candid, we are proposing contracts to put the new escalation clause in them under which, at the moment at least, there are no current claims.

In other words, we feel that it is in our interest and in the contractor's interest to have a clause that permits us to get on a better business relationship so that all of the escalation dollars are not borne by the contractor.

The CHAIRMAN. Mr. Clements, something that hasn't been mentioned that I have understood is a problem is what you call cash flow, the availability of cash for these ship contractors.

Now, you say here in your letter to me of April 2, "I am convinced that unless this extraordinary action is taken"—you are referring to Public Law 85-804—"and concurred in by the Congress, currently authorized ships necessary to the security of our Nation will not be completed."

Now, that statement impressed me very much. It made me realize that we had better go into this thing even before we took up the new program.

Do you want to comment on that sentence and explain it a little further?

Mr. CLEMENTS. Yes, sir, I do. The result of these practices that have been brought about by the contracts of the past has been that we have shipyards that are literally financing Navy ship construction.

In the case of both General Dynamics and Newport, each one has approximately—and it is a plus or minus number, but it is about that—\$250 million of their own money tied up in Navy ship construction. And this impacts on their cash flow in a most disadvantageous manner. And they just can't afford to do this.

And that is what I am talking about here. We have been notified in the case of Newport that unless this situation is corrected in an equitable manner, that they are not going to be building those ships. And they have told us this in writing.

So, there is no question about the problem being an acute one. Would you care to comment on that?

Mr. PENISTEN. I would just confirm it.

The CHAIRMAN. On the question of putting the ceiling amount on these claims and all for money in the bill now, as I understand it, you think it is to the Government's interest for you not to be saying just exactly what you will pay?

Mr. PENISTEN. That is correct.

The CHAIRMAN. You used that term negotiation many times. So as I interpret it, you want to reserve your full force of negotiation—

Mr. PENISTEN. That is right.

The CHAIRMAN [continuing]. In settling these claims. Is that your position now?

Mr. PENISTEN. Yes, sir. And I would add that I recognize many shipyard representatives in this room right now. And they are listening very carefully. And we need all of the assets that we can have, and the help that we can have on our side to protect our interests, because I am sure they are going to protect themselves. And I don't want to negotiate in a fish bowl.

The CHAIRMAN. You would expect them to protect their interests. All of us would. I would think that you would not be fulfilling your duty to the Government if you just came out here and announced these figures. Do you think that would be a giveaway of your position if you did that?

Mr. CLEMENTS. That is exactly right.

The CHAIRMAN. It would give away your negotiating power.

Now, I have been hearing about the situation in cash flow or lack of it, and these people telling you, like Newport News, that they would not proceed. And I didn't know exactly how to interpret it at first. But I am convinced that it has a real meaning, I mean it is not just negotiation talk or business talk, they are down to that, and in that position. Is that your belief about it?

Mr. CLEMENTS. Yes, sir.

The CHAIRMAN. You are in far more of a position to judge it than I am.

Mr. CLEMENTS. Senator Stennis, I am convinced that these shipyards that we are now using are at a point of basic decision, which has been cleared with their boards of directors, and the judgment that they intend to maintain the position that they are now in and the notification that they have given us that they are not going to

do certain things unless there is a change, represents a considered judgment on their part, and they are going to stick with that decision. And it is not in the interest of the U.S. Government, and more particularly in the interest of the Navy, for us to have our shipyards in this country saying, we will not build ships for the U.S. Navy.

Now, that is an absurd position for that industry to get into, such an adversary position, that the very companies that we depend upon to build ships for our Navy in the interest of national security are saying to us, the Navy and the Department of Defense and the Congress is unfair, they will not give us what we consider to be an equitable arrangement, and therefore we are not going to build ships.

Now, that is just not a good position. It is not to our interest.

The CHAIRMAN. Mr. Penisten.

Mr. PENISTEN. I was going to comment on the cash flow. I think from a businessman's standpoint that one of the basic inherent sort of things that you look to, it is return on your investment. And I can assure you that in the case of these shipyards they are not receiving a return. And in fact the requirement for investment is increasing every day. And that is a very major part of the problem. And it is a real problem. And they are part of larger corporations. And as a result, they find themselves investing all of their extra capital in these ventures without a return.

So, it is a very real problem, and one that I think we should be addressing.

The CHAIRMAN. And there is a limit, of course, to which they can go. And if they go beyond that, they are jeopardizing the financial soundness of their entire business or company, isn't that correct?

Mr. PENISTEN. That is correct. They have at least a number of limits. They have one limit that relates to the borrowing community, what they will allow them to borrow. The other limit they have is the responsibility they have to their shareowners to return something on their invested capital.

The CHAIRMAN. But before the return of profit it is a matter of not impairing your capital structure too much.

Mr. PENISTEN. Absolutely.

The CHAIRMAN. Senator Thurmond, may I call on you next, please?

Senator THURMOND. Mr. Clements, I am in sympathy with what you recommend. I think it makes a lot of sense. And I can understand why you would not wish to reveal figures publicly when you have got to go out here and negotiate.

There is one thing that I am concerned about. The House has this in their report, for instance, "\$833.1 million was redirected to other shipbuilding programs. And this actually is consistent with the action taken by the Congress in acting on the fiscal year 1976 authorization and appropriation bills."

Now, my understanding is, they diverted this \$833 million approximately to nuclear ships, is that correct?

Mr. CLEMENTS. I think that is correct. They diverted it from one facet of the Navy budget to another item, or items.

Senator THURMOND. To nuclear ships?

Mr. CLEMENTS. Yes, sir.

Senator THURMOND. Admiral Rickover at my request is willing to come here and testify, and I would like to hear what he has to say, and

several other members would too. But if the Senate should vote to put in some nuclear ships, how would that affect this?

Mr. CLEMENTS. I think there are two basic issues here, Senator Thurmond, one being the escalation and the claim problem that we have been talking about and the President's budget as submitted has adequate funds in it to take care of what we are proposing here today. So that is one issue. And that needs to be restored.

And then the other issue has to do with the proposed shipbuilding or ship construction program as submitted in the President's budget. The House changed that considerably. They changed the mix of the ships, they changed the types of ships, and of course they changed the needed allocation of funds to meet the changes that they have brought about.

Now, your committee is going to have to consider those changes in the ship mix and the dollars associated with that mix.

Senator THURMOND. How can we appreciate both? That is what I am driving at.

Mr. CLEMENTS. I am here today to address the one issue that has to do with inflation and claims and change orders, and so forth, that we have been talking about.

Secretary Rumsfeld is now scheduled to appear here, I think it is on Tuesday of next week, to discuss with the committee the types and the numbers and the dollars associated with the ship construction program. And I think that he intends to talk to Senator Stennis in the next day or two about his appearance before this committee next week. And the second part of your question will be addressed at that time.

Senator THURMOND. In other words, I want to help you accomplish what you want.

Mr. CLEMENTS. I know that.

Senator THURMOND. At the same time I want to be flexible to vote for more nuclear ships instead of some conventional ships if I decide to do that.

Mr. CLEMENTS. Senator Thurmond, I think that you know that we are under an intensive pressure of time to bring forward what would be a Navy shipbuilding program that would be on top of that requested by the President or as changed and put forward by the House Subcommittee and House Committee on Ship Construction. We are working on that very, very hard. And we are trying to come forward with a program that would move the ship construction into the period of 1985 and 1990. And that is what Secretary Rumsfeld is scheduled to appear before this committee next week and talk about.

Now, it is our opinion—and Senator Stennis, I feel confident, shares this opinion, and I hope you do too, and the committee—that we have an obligation in the Department of Defense, and more particularly in the Navy, to put our ongoing shipbuilding program in order so far as past and present construction contracts are concerned, before we address new big programs. So that is what we are trying to do.

Senator THURMOND. I will help you all I can on that. But I just want the option later to choose so many nuclear ships instead of a mix of nuclear and conventional.

Mr. CLEMENTS. You will have that option.

Senator THURMOND. Thank you.

The CHAIRMAN. Senator, I think you make a fine point here, that you really can't get into the new shipbuilding program unless we do something one way or the other about the old one.

Senator Leahy.

Senator LEAHY. Thank you, Mr. Chairman.

First off, Mr. Secretary, I want to make it very clear that the figures that I have asked you for are not figures which you are planning in the future to offer, or anything that would be of a confidential nature, or would be giving any kind of an economic advantage to the shipbuilders. I see some of the same shipbuilders here, and some of the same defense lobbyists that I normally see. I understand that point.

The question I was asking was about those amounts that have already been offered and communicated to the shipbuilders within that \$1.8 billion. There are a certain number of offers on these claims that you would have communicated, so that we give away nothing by giving these numbers, am I correct on that?

Mr. PENISTEN. I think the communications have been very, very limited in that regard, because of the magnitude of the claims, and the regency of some of them. That evaluation effort has been at a very low level and internal to the Navy.

Senator LEAHY. Can you give me a ball park idea about the \$1.8 billion, how much we have actually communicated?

Admiral GOODING. May I try my hand at this?

Senator LEAHY. Sure.

Admiral GOODING. On that \$1.5 million or \$1.8 million, which ever figure you use, the Navy has made no offers.

Senator LEAHY. None so far?

Admiral GOODING. None. It is important that you recognize this, that the Navy, without extensive analysis of these claims lasting months and in some cases years, the Navy will be in no position to make any kind of offers. And we have made none.

Senator LEAHY. You have not made any interim offers at all?

Admiral GOODING. No, sir.

Senator LEAHY. Did I misunderstand you, Mr. Secretary, on that?

Mr. CLEMENTS. Yes. Because in my discussions with some of these contractors we have certainly talked about the value of these claims. And I thought that was what you were referring to.

Senator LEAHY. Have you made memos or recommendations to these contractors, what the Department—and I use that in the overall sense, the Department of the Navy or whatever—have you made memos to these contractors that we feel that the value of these claims is such and such, or anything of that nature at all?

Mr. CLEMENTS. A formal offer that you are talking about in writing? The answer is, no.

Senator LEAHY. Have we communicated to them, if not an offer to settle, have we communicated in any way to any of these contractors at least a general understanding from the Government's point of view of what we consider the value of the claim to be?

Mr. CLEMENTS. Sure we have. We have talked in very broad, general terms of percentages that relate to the historic numbers that I gave you awhile ago, that some of these settlements—

Senator LEAHY. Twenty-five, thirty-five?

Mr. CLEMENTS. Yes—that some of these settlements might run as low as 20 cents on the dollar. Some of them I think Admiral Gooding, recently had run over 30 cents on the dollar.

Admiral Gooding. We actually got over 40 on a recent settlement.

Mr. CLEMENTS. So there is a wide range in here. And the contractor knows this just as well as we do, or even better.

Yes; I have heard personally those kinds of very general discussions with contractors. And I am sure that the Navy has also.

Senator LEAHY. So if we call it \$1.5 billion, and leave off that \$300 million, what percentage of that \$1.5 billion have there been even these kind of general discussions on, claims?

Mr. CLEMENTS. I really haven't thought about it, and I am not prepared to put a number to it.

For instance, using a rule of thumb again, a third of a billion and a half is \$500 million. So if it were \$2 billion—and your arithmetic is as good as mine—25 percent on \$2 billion would be \$500 million.

Senator LEAHY. Let me go back. And I am thinking somewhat of Senator Symington's earlier discussion. And I understand it was more of a suggestion than a question. For you to consider the possibility of negotiation and then come back—and I realize as Senator Symington does some of the problems that might arise in that contractors might be bidding against themselves, and that you can't fully make the offer—but as I understand it, if we can get this in, and we get the ability to renegotiate some of the new contracts, and so forth, that these claims can be wrapped up in a relatively short period of time.

Mr. CLEMENTS. In my judgment they can be. And I am asking this committee for their confidence in letting us proceed on this basis.

Senator LEAHY. And you are talking about 90 days?

Mr. CLEMENTS. Yes.

Senator LEAHY. And there is no way for you to go ahead and try to negotiate these under the same circumstances subject to ultimate congressional approval or disapproval?

Mr. CLEMENTS. I don't think that we can, Senator. And I would wonder what purpose it would really serve. Because, is the Congress or the Senate or both going to be in the position of saying to us in effect, a \$500 million settlement, but \$510 million or a \$580 million settlement is not acceptable?

Senator LEAHY. Have you ever been turned down yet?

Mr. CLEMENTS. I don't really believe you are in that position.

Senator LEAHY. As I understand it, approximately \$900 million of the \$1.5 billion of requests for equitable adjustments is on nuclear ship programs, am I correct in that?

Mr. CLEMENTS. I don't have that.

Admiral Gooding, do you have that number? It is a big number, there is no question about it.

Admiral GOODING. It is a little bit higher than that. There are \$900 million of claims alone in round numbers. If you add to that the \$300 million we anticipate from Electric Boat, that becomes \$1.2.

We have in hand from Newport News some \$900 million worth of claims which are on nuclear ships. We anticipate from the Electric Boat Division some \$300 million in claims, also on nuclear ships. So that works out to about two-thirds of the \$1.8 billion.

Senator LEAHY. Why are nuclear programs accounting for such sizeable portions of the claims problems? Is there any thread that runs through the whole thing?

Admiral GOODING. I think the single most significant reason is that we have a large number of nuclear ships under construction.

Senator LEAHY. What is the match that you came out with that, Admiral?

Admiral GOODING. Two-thirds.

Senator LEAHY. How does that relate to our overall shipbuilding, two-thirds of our overall shipbuilding?

Admiral GOODING. In dollars value I think it is probably less than two-thirds.

Senator LEAHY. I have always heard that nuclear programs are better managed. I am just wondering why there would be a higher figure. Is it because of design changes? Are we going into a lot of costly design changes?

Admiral GOODING. The number of design changes is not significantly large. The nuclear programs, like all the other programs, have been caught up in this extraordinary inflation that the Secretary mentioned. It has been impossible for the shipbuilder to complete on time, and they run out of recoverable escalation at the contract delivery rule.

Senator LEAHY. How much of the cost rules and escalation change are the result of the delay in construction caused by program slippage?

Admiral GOODING. I will have to supply that for the record.
[The information follows:]

An estimated \$350 million of the proposed Public Law 85-804 impact can be related to ship slippages.

Mr. CLEMENTS. I think our General Counsel has an observation that he would like to give you.

Mr. WILEY. I would like to make several comments if I could, Senator Leahy.

First, attached is the first exhibit to Secretary Clements' statement which is a schedule of claims settlements actually reached during the period January 1969, through April 1, 1976, which I think will give you a very clear indication of the nature of settlements reached after full evaluation by both parties, or counteroffers and a new negotiation, broken down by nuclear and nonnuclear analysis.

And the second schedule attached is a similar schedule allocated by nuclear or nonnuclear ships showing pending claims.

Senator LEAHY. I understand Secretary Clements' answer to an earlier question by Senator Symington is that the past is not the best yardstick to use, because of the changes of inflation and other problems, not the least which may be the hostility of shipyards and the aversion of shipyards to taking Navy shipbuilding.

Is that a fair analysis?

Mr. CLEMENTS. I am not sure how you would apply it to what Mr. Wiley is talking about. But these are all factors that certainly impact on the negotiations, this is no question about it.

Mr. WILEY. The second point is—I may be wrong here, Senator, but from your comments I am concerned that you may think that during this 60-day period we are going to engage in sort of a quick analysis or settlement of the claims as such. That is not the purpose of the exercise. The purpose of the proposal, and the reason for proceeding

under the extraordinary authority of Public Law 85-804, is basically to improve the climate, the relations between the Navy and the shipbuilders to get on with these current contracts, to refit an escalation clause of the type we are now generally using in brand new contracts, to put these contracts on a basis which in effect would be equitable with the contracts being written today.

That is our present practice. The claims in effect will be thrown in or given up by the contractor simply as part of that basic primary program.

And together to go to another one of your points, the difference between the \$1.5 billion and \$1.8 billion, our intention is to ask each contractor—and we would expect to get it—for a full release as of the effective date of signing the new program from all claims either presently filed or which he might later contemplate filing as arising out of operative facts or events occurring prior to the date of that settlement, so that we would pick up, for example, these additional anticipated \$300 million of claims later this year.

Senator LEAHY. What kind of reaction have you gotten to that so far from the industry?

Mr. CLEMENTS. I don't want us to get into this, Dick. I think this is going beyond the point of reasonableness so far as what we are talking to the contractors about, and what the contractors are talking to us about. And it weakens our position, Senator Stennis. I don't want to do it.

Senator LEAHY. I am not the one who asked your counsel the question, Mr. Secretary. You are the one who suggested that he go on with that.

Mr. CLEMENTS. I would like to drop it at this point.

Senator LEAHY. Thank you.

The CHAIRMAN. That doesn't mean that we have to drop it fully. We can pursue it in executive session if we desire to.

Mr. CLEMENTS. I would be happy to.

Senator LEAHY. Can we also get a figure about how many of the claims are due to dispute over contract changes made after the program was approved by the Congress? Is that a figure that is available, or would that be an impossible figure to get?

Admiral GOODING. I am sorry, I didn't understand.

Mr. CLEMENTS. Would you repeat it. I didn't understand it either.

Senator LEAHY. How much of the claims are due to disputes over contract changes made after the program was approved by the Congress?

Admiral GOODING. We can give you an approximation of that figure for the record.

Senator LEAHY. Thank you. And to the extent possible, what are the reasons for these contract changes, if we can get that?

Admiral GOODING. I can give it to you in general terms now if you would like.

Senator LEAHY. If you would like to add to it and make it more specific for the record, you can do that.

Admiral GOODING. There are in general two categories of changes. One results from an error in the specifications, an error in the drawings, and something has to give. And that results in a change order, so that a piece of pipe will not occupy the same space as a vent.

There is another type of change which is relatively infrequent, which is that type, when the Navy decides to increase the capability of the ship, and therefore to add, for instance, a weapons system, or to modify an existing weapons system. This doesn't happen very often, but it does happen. And that change is a major change, whereas the previous category is generally minor.

Mr. CLEMENTS. Senator Leahy, this last category would relate to technology. And when you start talking about the aircraft carrier class ship, like the *Nimitz* class ship, it was in the yard down there—Admiral Gooding, what, 6 years?

Mr. CLEMENTS. Seven years. But during that period, from the time that it was originally designed, which goes back beyond even the 7 years, there was a change in technology, procedures and weapons systems. And therefore a change is recommended and put into being.

Senator LEAHY. And naturally we would hope during that period of time that advancements are available to enhance the ship and are cost-effective.

Mr. CLEMENTS. Surely.

Senator LEAHY. And of course that goes partly into a management question. How do you feel about the Navy management of the ship-building program? Do we have problems here?

Mr. CLEMENTS. Sure we do. And my statement includes this as one of the categories which we are improving. We have been addressing this issue now for the last 2 years. And we have changed some of our procedures, some of the training of the project managers, and some of the internal structure of management, the discipline accountability. And the Navy is doing better in this regard, there is no question about it. And Admiral Michaelis and I and Admiral Gooding and I have discussed this many times. And this is their direct responsibility. And they are doing better. And they have better people. The program has higher quality to it.

But having said all that, it can be still better. And we are working hard on this. It is one of the things that we must do, and do it better. This relates to the new construction in Navy shipyards that I mentioned earlier. That needs to be a part of this same management skill which I talked about.

I am not talking about now doing a large program in Navy shipyards, I mean a big percentage of our ship construction, I am not talking about that at all. But we need to do enough in there to where we can have, so to speak, a laying on of hands, actually acquire those skills and have a continuity to the program to where we have a cadre of people in the Navy who have had those kinds of experiences. And for many years, now, since 1967, we have not built a Navy ship in a Navy shipyard. And I find great criticism in this.

Senator LEAHY. That is a matter of concern to me, and it is a matter of concern, I think, to all members of this committee. I am not speaking for the chairman, but I know he has expressed a great deal of concern as to our ability to produce ships when we need them. And obviously we have concern if our own shipbuilders are less than eager to take them on. And perhaps this is not the area to go into it. But I am very concerned about just which of these problems are caused by the Government, and which of these problems are caused by the industry itself.

I realize that this could go on for hours and hours. But if the ultimate result is that we want to design and build ships, and we can't do it, then we have a problem. And I think we ought to realize it.

Mr. CLEMENTS. Senator, we have got lots of problems in this whole category of things that relate to shipbuilding. And there is enough blame to go around for everybody.

Senator LEAHY. And nobody acts as a lighting rod, then.

I think, Mr. Secretary, you should be aware that I will be either in this form or otherwise asking subsequently, assuming this is approved, what the range was between our offers and what is finally settled at. Do you have a way of determining in such settlements whether the shipbuilders are making profits on these settlements or not?

Mr. CLEMENTS. Yes, sir, we do. Their accounts are fully audited by our people.

Senator LEAHY. And so that in those final settlements this committee of the Congress, or whatever appropriate committee, would be able to find out precisely what profits or losses resulted?

Mr. CLEMENTS. We will tell you precisely on an audited basis. And we have already made calculations along this line. I was discussing this with that same group no later than just yesterday.

Senator LEAHY. Who makes that time determination, whether there is a profit, us or them?

Mr. CLEMENTS. The figures make a final determination.

Senator LEAHY. Those figures I assume at times will be in dispute? Or am I wrong. Do they always come out the same?

Mr. CLEMENTS. I beg your pardon?

Senator LEAHY. Does the conclusion of whether there is a profit, is it always the same? It is the Defense Department conclusion and the shipbuilders conclusion?

Mr. CLEMENTS. I don't think so. Because they might well use a different allocation of depreciation and amortization of capital investment and that sort of thing than we would. But so far as the numbers are concerned that are being used in the calculation, they are audited, and they should be the same.

Senator LEAHY. I know sometimes conclusions can be different. When April 15 comes around I know some of my conclusions and those of a certain agency here in Washington will be different, as they always are. But I always concur in their judgment.

Mr. CLEMENTS. I don't think that these differences would be substantial. I think that is what you are really getting to.

Senator LEAHY. Along that line, I will ask, if there are times when there are differences I would like to know.

Mr. CLEMENTS. I would be happy to share all this with you any time you would like to have us talk to you.

Mr. PENISTEN. I think there is one other point. As we view it at this point in time we are not looking at a contract by contract solution, making a decision based upon profitability and/or loss on each contract. Rather the negotiation would take place on a total contractor basis. I think that it is at that point that we would try to make some judgment on the appropriate equity for the Government.

Mr. CLEMENTS. And I want to emphasize, Senator, that in no sense whatsoever are we removing the inherent contractual risk from relationship. That contractual risk in undertaking contracts to build ships should be there. There is no effort on our part to remove that risk.

Senator LEAHY. Does the shipbuilding industry feel that we can wipe this slate and start all over again, that this is a precedent for the removal of that risk?

Mr. CLEMENTS. I don't think there is any feeling that the risk will be removed, no sir, I do not think that they feel that.

In fact, I don't know of any of these contractors that we are talking about that want that risk removed. These are good, capable, historically well-established shipyards, and they understand their responsibility. And I have heard none of them say to me, I want a risk-free contract. That is just not their position at all.

Mr. SHRONTZ. They do want, however, to have risk over which they have control rather than risk where they don't have control.

Mr. CLEMENTS. That is right.

Senator LEAHY. Do all Defense contractors share that same view, Mr. Secretary, that they don't want risk-free contracts?

Mr. CLEMENTS. I am not in a position to make such a general statement.

Senator LEAHY. I didn't mean that as a serious question.

The CHAIRMAN. Do you have something else, Senator?

Senator LEAHY. I will have questions to submit for the record, Mr. Chairman, if I might.

The CHAIRMAN. All right without objection.

Mr. Secretary, you show a very fine knowledge of this situation from a practical standpoint. And I know you have taken the lead, so to speak, to get this matter into something firm and positive.

I want to thank you as well as commend you too, not only as to the immediate problem—and it is a problem—but also for clearing the way and clearing out the underbrush, so to speak, with this new program of ships.

Mr. CLEMENTS. Thank you.

The CHAIRMAN. And I think that time will value your services in that way, and give a very clear commendatory verdict.

I want to go back again to a matter that I mentioned in the very beginning about inflation. And it has affected other programs as well as ships. But there are other equally serious matters about these contracts, as I see it, such as the difficulty and the unrealistic delivery schedule which adds to the cost. I know you have been into that. Also these numerous changes from the time a ship is started until it is finished. Have you been able to make any headway, you and the Navy in trying to get those matters resolved?

Mr. CLEMENTS. Yes, I think we have; Senator Stennis and I have discussed these issues many times. An unrealistic delivery today which impacts on the contracts, an unrealistic response to the proposal request, where the buy-in is really evident there for anyone to see if they really look, almost what you might call promiscuous change orders that are initiated and put forward without due thought and due consideration, both as to the cost and to the delay involved—we are well aware of these bad practices. And that is what they are. And the Navy is addressing this. They are taking steps to improve it. They have taken steps. And progress has been made.

And I would like for Admiral Michaelis to talk to this.

The CHAIRMAN. Let me just mention these others, and then he can address all of them.

Another is the problem of underestimating the cost ship initially. I know you can't be exact on all these things. The old C-5 was kicked around here for years, but it ran only about 25 percent, and many of the ships have run 30 or 35 percent. And then there is the lateness in providing Government-furnished equipment. And then there is the design I never have gotten away from the idea that they ought to build a prototype, unless there is some overwhelming reason to the contrary. Because I see the experiences of the LHA, for instance, a new type of ship, new design, and new everything.

There are just so many changes. Will you comment on those and state the prospects for improvement? That is what we want to be able to show to the Senate as a practical matter, in getting the money.

Admiral MICHAELIS. I think we have represented our lessons learned pretty well in recent shipbuilding contracts. In our negotiations we have been associating the kind of contract with the degree of risk that is associated with it. We have clearly looked at need relative to lead ship and follow ship. In providing the kind of contract that is appropriate to risks, we now normally provide some sort of a cost reimbursement type of contract. Also in order to get a good data package we would like to see less concurrency between the lead ship and the follow ship so that we can provide good data base for building the follow ships.

Now, in the FFG contract there is a 2-year period between the lead ships and the follow ships. With a good data base we can then get into the follow ships with a fixed price incentive type of contract.

Some of the other things that we have learned involved cash flow. We are shortening the time intervals for making payments to the contractors. The cost of doing business today is very high.

Let me take the FFG again. In that particular contract we are providing escalation payments every 2 weeks, and we are paying progress payments every week. The frequency of payment is considerably higher than a few years ago. The escalation clause which has come in for a lot of discussion this morning. We think we have an escalation clause in recent contracts that recognizes the principle of paying costs for labor and material at the time the labor is performed, and the cost of material is incurred as opposed to a predetermined payment system. In the "old" system one cannot pay escalation after the delivery date in the contract.

These are some of the things that we have been doing.

Now, as for the question of contractor underestimating—part of it we have already covered relative to the tremendous economic swing that has taken place. This has been exacerbated by the energy problem. As a result of the fuel embargo, a lot of times things got delivered later than they originally contracted for.

There are also productivity problems. The contractors have missed on productivity estimates. They bid contracts based on labor and material and the cost thereof.

The CHAIRMAN. Excuse me, Admiral.

Again, on the markup of the bill particularly the McIntyre subcommittee report, the committee will meet this afternoon at 2:30 in room S. 146 in an effort to complete that markup.

Excuse me, Admiral. Proceed.

Admiral MICHAELIS. I think that just about covers my answers, Mr. Chairman. I wonder if I could ask Admiral Gooding to add anything else. He is our shipbuilder and I depend heavily on him.

The CHAIRMAN. Yes, Admiral.

Admiral GOODING. Mr. Chairman, you mentioned five different things, I made note. Let me take them in the order I heard them.

On the matter of change orders, I don't expect ever to be patted on the head for no change orders. This is not a realistic thing. But the fact is that they are not a large problem. The change order percentage of contract cost is almost invariably less than 5 percent, between 3 and 5 percent, which I submit is not a big problem.

The lateness of the Government-furnished equipment. In recent years our hands are quite clean. We enjoyed and deserved a reputation some years ago of being chronically late in Government-furnished equipment. We no longer deserve that reputation, with exceptions here and there.

On the subject of underestimates, since I am the naval officer who is responsible for the estimates and the shipbuilding program, and they are not changed once they leave my desk by anybody in the chain let me talk to that. It has turned out that in past years we have indeed after the fact found out that we had underestimated. And let me talk about where we are bad and where we are good.

We are good in estimating reasonably close the number of man-hours required to build that ship. We are good at estimating quite closely the number of tons of steel or feet of wire or pipe necessary to go into that ship. Where we are not good, along with everybody in this country, is forecasting the future. I happen to think that my command is a little bit better than most of the economists in the country, but none of us is good, none of us have forecast the future with any accuracy whatever. And when we price a ship we are trying to forecast the future with any accuracy whatever. And when we price a ship we are trying to forecast the future some 3 to 7 years. And I submit, that is a very difficult job. And I don't know how to do it any better than we do. And we haven't done very well.

The CHAIRMAN. I have done as well, I think, on that forecast of 3 to 7 years as many others.

Gentlemen, when I became chairman of the committee I had made a great many suggestions to the Department of Defense and to the services. And I have been diligently looking for one that was carried out, and I haven't found it yet. But I want to emphasize now one that I did make the suggestion to the services to put more of their talent and more of their promotions in the procurement field. I am talking about your uniformed talent now, I think that the talent represented here this morning both in and out of uniform illustrates the ability and the dedication of the unsung heroes in a measure in taking all the kicks and knocks and everything that goes with it. You are certainly entitled to a lot of credit in my book.

Senator LEAHY. Mr. Chairman, as the more junior member in the committee, and knowing how far my suggestions goes with the Pentagon, our committee, I might say, but especially the Pentagon, I don't know whether I should be discouraged or encouraged to hear that you had a little bit of trouble yourself.

The CHAIRMAN. I have got one in sight now. And I will let you know if it develops.

I have one question now, and then we will come back to Senator Leahy.

Mr. Secretary, the committee may authorize new ships on a line item basis rather than the lump sum for the entire account.

Now, this points up the necessity of really submitting realistic cost estimates at the beginning. You see, if we go to the line item basis here, that puts it in a groove. And if I may, do you think that would help in making the estimates?

Mr. CLEMENTS. No. I have complete confidence that Admiral Gooding and his people, both on the uniform and on the civilian side, are doing the best that they know how to do. And I think that Bob Gooding would confirm that. And whether you lump that together as a lump sum representing a program which has been thoroughly discussed with you and your committee on specific ships, and whether that is presented as a total, or whether it is presented as a line item unit basis, I would suggest to you—and I think Bob will confirm it—that the number will be the same. He is going to do his best either way, isn't that right, Admiral Gooding? It better be.

Admiral GOODING. Not completely, sir. I am sorry. I have had extensive discussions with the staff of this committee on this subject, Mr. Chairman. I see little to be gained by line items. And I think a good deal of administrative nightmare could be lost. I think if I were forced to budget by line item I would feel some pressure on me to put a pad on the cost of that ship to avoid some of the administrative Mickey Mouse. I would not particularly like to feel that pressure. The estimate we put into the budget have for the last many years been thoroughly honest estimates, they turned out in many cases to be wrong, but they are honest. I would not like pressure to change that stand.

The CHAIRMAN. I know. What I said was not a reflection on you gentlemen or anything like that. I was saying, would it help any with the contractors, or would it hurt with the contractors? A lot of people asked me about this, Senators ask me about it, you see, from time to time, why we don't put it to a line item basis.

Admiral GOODING. It is not obvious, Mr. Chairman, that it would have any benefit or hurt to the contractors.

Mr. CLEMENTS. I can't see that it would. What I would suggest to you as being a change for an improvement—and I mean a significant improvement in this procedure—would be that we have multiyear authorizations for shipbuilding, approve a program as opposed to coming in here yearly and talking about the ships, and having the dips and starts and the slow-downs and the cuts from the programs, which just is devastating to the contractor, and it is also a terrible administrative management problem in the Pentagon, in the Navy.

The CHAIRMAN. A legislative nightmare sometimes.

So if we could get continuity in a program on a multiyear authorization for a particular set of ships, this would be more helpful and highly constructive. I would certainly like to see that happen. I would not in any way say, don't review it each year. We would welcome the review. But at least give the contractor the confidence of the continuity of the program, and let the Navy make the kind of planning that they need to do on an other than 1-year-at-a-time basis.

Secretary CLEMENTS. And I would suggest to you, Senator Stennis, that no one can really in the private sector run their business on that

kind of basis, you just don't do it. And I don't think that we can do it frankly.

The CHAIRMAN. One other thing. The Post quoted Admiral Rickover as saying that if the Pentagon was going to use Public Law 85-804, that they should just take legal title to these private shipyards. Do you agree to that?

Mr. CLEMENTS. I am unalterably opposed to that. I think it would be a disaster. And the Navy has more shipyards right now than we probably can say grace over properly. And we would make a bad, bad mistake in my judgment by talking in terms of taking over these private yards or trying to run them as a Navy operation. I just don't agree with that at all. And I have told Admiral Rickover this as we have discussed it between us.

The CHAIRMAN. You mean the Navy would fare better if that step is not taken?

Mr. CLEMENTS. Yes, sir.

The CHAIRMAN. And the Government would fare better?

Mr. CLEMENTS. Yes, sir, that is my opinion.

Admiral Michaelis, do you have any comments?

The CHAIRMAN. Do you want to comment on that?

Admiral MICHAELIS. Yes, sir, I certainly support that statement.

Mr. CLEMENTS. Admiral Gooding.

Admiral GOODING. I have got enough problems.

The CHAIRMAN. This is trying to get at the heart of these matters.

Mr. CLEMENTS. What do you mean you have enough problems?

Admiral GOODING. I have enough problems right now without having to administer three Government-owned, private shipyards.

The CHAIRMAN. I see what you mean.

Mr. PENNISTEN. May I say that we feel very strongly that these shipyards should remain private, and we have no interest in taking them over.

The CHAIRMAN. I am glad to hear you say that. I would think so.

Senator LEAHY. I agree with the chairman. We discussed this before.

The CHAIRMAN. All right, Senator Leahy, do you have something?

Senator LEAHY. Just one last question. I will submit the rest for the record.

And I want to make sure that I understand your answer to one of Senator Symington's questions. You said that there was about a \$250-million backlog of claims at both Newport News and Electric Boat. What were those figures?

Mr. CLEMENTS. The \$250 million was money that in each instance Electric Boat and Newport had invested in Navy shipyard work, and that this impacted on their financial resources available for doing Navy work, and it certainly affected their cash flow.

Senator LEAHY. I understand. Have any of these shipyards told the Department of Defense that they would go under if they don't come through with the proposal that you have submitted to the Congress.

Mr. CLEMENTS. We have had one shipyard make the representation to us that the settlement of these claims was necessary—and that is in my statement—to their financial well-being, which is a little different than what you phrase. I would rather go to the extreme that you did.

But it probably would head in the direction that you indicated. That is one of them.

The other, which was Newport, was in the posture of saying to us, we will do no more Navy work, and we will not build that carrier down there for you if we don't get on a more equitable basis. And we also had then, two yards say to us, for God's sake, get this straightened out, or take over our yards. And that is part of the origin of Admiral Rickover's statement.

Senator LEAHY. I understand.

Thank you, Mr. Chairman.

The CHAIRMAN. Without objection Senator Leahy's additional questions will be included in the record for your attention, gentlemen, and provide your answers as soon as you can.

ADDITIONAL QUESTIONS SUBMITTED BY SENATOR LEAHY

Question. Mr. Secretary, on page 21 of your prepared testimony, you state that the Shipbuilding Executive Committee needs another 30-45 days to accomplish its detailed study and negotiation with the shipbuilders, and formulate their firm recommendations. What additional information will you have at the end of that 30-45 day period?

Answer. Based on progress thus far, only the broad parameters of the plan can be discussed. Later, a more definitive estimate of the ultimate cost to the government in revising escalation coverage in certain ship building contracts can be provided. In addition, we should have confirmed a more detailed description of all the other provisions of the proposed agreements with each of the involved shipbuilders.

Question. Why not wait until then to submit this proposal?

Answer. (1) We need to insure Congressional review in this session of Congress.

(2) Failure to gain consideration will result in further serious deterioration of Navy/Shipbuilder relations in the form of additional issues.

Question. It is known that the current estimated delivery dates on most ships authorized by Congress in previous years, and not yet delivered to the Navy, are later than the estimated delivery dates presented to Congress when the ships were originally requested. Some are four-five years late, with even more delays possible. Why has the Department of Defense been completely unable to provide Congress with realistic estimates of ship delivery dates?

Answer: The ship delivery schedules provided to the Congress in support of the requested shipbuilding programs are planning dates. They are based on a number of assumptions, including the dates funds will become available, authority for award will be obtained, etc. These dates are feasible and attainable, allowing adequate time for the preparation of working drawings, obtaining of material when required to support a production schedule which has been developed based on efficient manning levels. The schedules are not necessarily based on production in any particular yard, rather they are generally based on a cross section of qualified shipyards. These schedules are often adjusted prior to award of the ship construction contracts to reflect activity circumstances at the time of award. Therefore, a more meaningful measure of ship slippage is the amount of slippage beyond the delivery schedule initially called for in the contract. The current situation with respect to those dates is summarized as follows:

As of April 1976 there were 91 Navy new construction ships under contract with ten private shipbuilders. Fifty-nine of these were under construction.

Twenty-seven out of the 91 ships were maintaining contractual schedules. The remaining 64 ships have identified delinquencies to original contract schedules from three to 52 months, with further slippage of some schedules anticipated.

These slippages have resulted from many causes, all of which combine to prevent the Navy from presenting to Congress at the time of the budget submission firm delivery dates which are not susceptible to subsequent adjustments. The dates provided to the Congress must be recognized as planning dates and generally represent attainable delivery schedule for the ships in question, allowing for no delays in the complex process from budget submission to delivery of the ship to the Fleet.

Question. What has caused this problem? Can you cite specific causes?

Answer. The apparent problem has been caused by a combination of many factors. Some of these reasons for schedule adjustments prior to contract award have been addressed in the response to the preceding question. The reason for schedule slippages subsequent to contract award are varied and considerably more complex. For instance, several specific problems which have occurred and have so clearly manifested the problem;

1. The five LHA's and 30 DD 963 class ships at Ingalls which have been or are expected to be delayed well beyond their original contract delivery schedules.

The delays which have occurred in these ships and those anticipated delays which have been reported were the result of actions taken in the 1968 and 1970 time frame and were inherent in the programs at time of award. First, new procurement procedures had been invoked for these two contracts. Procedures which did not work and have since been discontinued. Second, the start-up problems for a new shipyard, with new production technicians, which occurred were anticipated neither by Ingalls nor the Navy. Third, the construction times allowed and the estimates of manhours required to complete these ships were overly optimistic and were based more on assumptions concerning the capabilities at the new facility than on knowledge of what could be accomplished.

2. Another example of significant schedule delays involved the CVN, CGN, and SSN 688 class construction program at Newport News. Newport News suffered a major cutback of its work force in 1969 and 1970 due to lack of work, followed by a rapid buildup in 1971-1973 as the result of a number of new contracts. Much of the old work force which was lost had to be replaced by new, inexperienced, and non-efficient labor. This caused a major drop in productivity at Newport News, rendering the company's original manpower estimate or forecasts inadequate. This situation, combined with the construction of three classes of new design ships, caused major delays in these programs.

3. The delays experienced by Electric Boat on the SSN 688 class submarines subsequent to the lead ship were more the result of the lead ship problems being suffered by Newport News than of a lack of manpower at Electric Boat Division. Electric Boat has also experienced problems achieving predicted productivity. Electric Boat has thus extended schedules on the follow SSN 688 ships, as the Navy and Electric Boat recognized that a longer construction period and much more manpower was required to build these ships than they originally estimated.

Another influence which disrupted Navy planning and which increased contract intervals, thereby causing slippages in delivery dates reported to the Congress, was the totally unanticipated major increase in manufacturing lead times for major components. This situation was caused by a combination of factors, including the country's extreme inflation, the influence of new Government regulations from agencies such as EPA and OSHA, as well as the energy crisis.

Problems in shipyard productivity, labor instability, etc., many of them aggravated by the lack of a stable shipbuilding program, have added to the problems of predicting schedule slippage.

Question. What is being done to correct this problem? Do you have any specific proposals?

Answer. The problem addressed by the earlier questions as can be seen by the responses is extremely complex with no simple solutions. The Navy is trying to ameliorate the problem to the extent practical. Planning has become more coordinated, ship construction contract intervals have been adjusted to reflect the influences causing slippages, and more stringent pre-award surveys prior to award have been instituted in an attempt to insure that the production schedules can be met by the successful offerer. However, because of the long lead times for ships, it will be several years before we can determine the effectiveness of the Navy efforts, even though instituted over the past several years.

The Navy is actively seeking, with the participation of industry, ways to improve productivity, improve communication, and resolve the many problems with which both management and the shipyard work force are confronted.

The most significant contribution that the Congress can make toward solving this problem is to authorize a stable long-range Navy shipbuilding program to which both the Navy and industry can plan.

Question. Do you feel that the estimated delivery dates on the FY 1977 shipbuilding programs are realistic?

Answer. The estimated delivery dates for the FY 1977 program ships provided to Congress are, as previously stated, planning dates. These delivery schedules are realistic and are achievable. However, these schedules are exposed to the same influences discussed in response to earlier questions, such as when the Congress appropriates funds, and will undoubtedly be adjusted to reflect actual circumstances at the time of award.

ADDITIONAL INFORMATION SUPPLIED BY THE DEPUTY SECRETARY OF DEFENSE

THE DEPUTY SECRETARY OF DEFENSE,
Washington, D.C., May 11, 1976.

Hon. JOHN C. STENNIS,
Chairman, Committee on Armed Services, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reference to your letter of May 7, 1976 with regard to my presentation to the Committee of the various problems that currently involve the Navy's shipbuilding program and our proposed approach towards solving them.

I cannot overemphasize the urgency of taking immediate action to correct the situation. As I stated in my testimony before the Committee on April 29, there is a very serious threat to the Navy's current and future shipbuilding programs with its consequent adverse impact on the national defense because of the unsatisfactory business relations which exist with our key shipbuilders today.

Controversy and litigation exist with respect to the majority of our contracts for major combatant vessels. It has reached such an extreme that, in one case, for example, only under court order is construction proceeding on a very key ship, the DLGN-41, on a temporary basis. Newport News stopped work in August of 1975 on the DLGN-41 project because they doubted the validity of the option the Navy exercised in the DLGN 38-40 contract. Under the terms the Navy wanted in this option, Newport News firmly believed that it would lead to a serious "loss contract" for them. Navy sought and got injunction from U.S. District Court which provides a method of operation for 12 months on a cost plus fixed fee basis. This matter will be open for dispute again in a few months. In another situation, the construction of a nuclear carrier, the CVN 70, is continuing on a day-to-day basis under an undefinitized contract option, with the shipbuilder expressing an unwillingness to continue without a substantial resolution of the controversies which exist under several contracts it has with the Navy. The letter from the President of Newport News Shipbuilding Co. dated March 16, 1976 and reproduced in the Congressional Record of March 18, 1976 (copy enclosed) makes this contractor's attitude quite clear.

We cannot afford to wait any longer for a resolution of these matters through the normal process. I am speaking now particularly of the enormous claims which have served to exacerbate business relations between the Navy and the shipbuilders. The necessity to improve these relationships in order to get presently pending and future ships built simply cannot await the time required to work through those claims even with the increased claims efforts of the Navy. Based on the experience of 48 negotiated shipbuilding claims in the period January 1969 to April 1976, half were settled in under two years time, and half required two to more than four years time. Concerning the 10 shipbuilding claim cases taken on appeal to the ASBCA since 1969, it has taken five or more years for a decision from the date the claim was originally filed in the first instance with the contracting officer. Given the complexity and large dollar size of certain of the pending claims, it appears the ASBCA will require three to five years to process these cases.

I have come to my conclusion to act under Public Law 85-804 reluctantly but have done so after weighing considerations to the national defense and the need for a strongly based program to meet the Navy shipbuilding requirements through the next decade. The contracts must be amended now to assure the shipbuilders that their continuing the construction of the present vessels, and undertaking new construction contracts, makes business sense.

Further, the current heavy expenditure of critical manpower and funds engaged in the present controversies has got to stop. The Navy currently has (or is planning to have) about 600 personnel (military, civil service, and contract hire) working the Litton and Newport News claims. This effort is expected to take

18-22 months and cost about \$24 million. The shipbuilders involved are estimated to be using about 400 people in this effort. It is essential that the technical and administrative manpower resources of both the Government and contractors be fully directed back again to the design and production of ships for which authorization and appropriations have already been provided by the Congress as well as those which the Congress currently is considering in connection with FY 1977 and future years.

On April 30, 1976, I provided the Armed Services Committees of both the Senate and the House a formal notification under Public Law 85-804 of my intention to use the authority of that statute to bring about early remedial actions correcting the state of contract relations between the Navy and the shipbuilders which I find now to constitute a major threat to the national defense. In my letter of notification I stated that the exact terms of the agreements with the shipbuilders under Public Law 85-804 to correct the situation could not be determined until negotiations with them had been completed.

I appreciate the difficulty that this creates for the Committees and the Congress in evaluating the proposed plan during the 60-day waiting period provided by the law. The Congress and the Executive Branch must be partners in mutually solving this problem, and Congress in its role is entitled to the fullest information available. However, in view of the pressing requirements of present and future Navy ship construction, and for the reasons set forth earlier as the necessity for using Public Law 85-804, action must be completed during this session of Congress. Preliminary discussions have been held with the shipbuilders, and further discussions will be undertaken promptly. I have every expectation of full and prompt cooperation from the shipbuilders. They know that they have as much at stake as the Government in a prompt and sound resolution of this entire situation.

In order to provide both Committees with a reasonable opportunity before the expiration of the statutory 60-day period to further evaluate our proposed actions, I intend between the 5th and 10th of June to be in a position of providing, in the form of agreements in principle committed to by top management of the companies involved, the principal details of the proposed amendments of the contracts identified in my 30 April letter involving new escalation arrangements, as well as the release of the contractors' claims to be waived in consideration of those contract amendments. It is expected that such waivers by the contractors will apply to both claims currently filed with the Navy under the contracts to be modified, as well as any future claims under such contracts based on events occurring prior to the dates of the settlement agreements. It is also anticipated that the effect of the new escalation clauses will reduce substantially the likelihood of similar claims in the future under these same contracts.

Based on our analysis and efforts since the date of that letter, I presently anticipate that the program contemplated under Public Law 85-804 would result in about \$1.5 billion of claims being resolved in consideration of the contract amendments, with a reasonable expectable eventual outlay to the Government in the general range of from approximately \$500 to \$700 million. It is possible that certain other disputes between the Navy and the contractors will be made a part of the overall Public Law 85-804 plan on a similar basis.

I should respond to certain questions which have been raised regarding this particular Public Law 85-804 plan. First, the plan is not submitted on an assumption of negative financial condition of the contractors involved. Rather, as indicated earlier, the assumption calling for action is the strained relationships stemming from the unanticipated impact of the present escalation clauses and the consequent volume of claims filed. Second, the proposed action should not be regarded as a precedent which will precipitate requests from other contractors for similar action. Ship construction contracts are virtually unique in the unusually extended time required for their performance and the nature and extent of changes, and the degree of increase in unanticipated costs of those changes which are especially aggravated because of the long contract performance time.

In essence, balancing these contemplated terms of the Public Law 85-804 plan against the alternative of painstaking examination of claims, with the consequent heavy investment in time, money and exacerbated relations which would result, it is expected that the proposed plan will result in no ultimate net increased, and perhaps a lesser, cost to the Government than to continue to proceed as we have in the recent past. In addition, we can all get back to completing ships.

I wish to reiterate and assure your Committee that our efforts will be accel-

erated in order to provide you additional details concerning each shipbuilder and each contract next month within the period I have indicated.

Sincerely,

W. P. CLEMENTS, JR.

Enclosure.

[From the Congressional Record, Mar. 18, 1976, p. E1382]

ADDITIONAL NAVY SHIPS

(By Hon. Thomas N. Downing of Virginia, in the House of Representatives)

Mr. Downing of Virginia. Mr. Speaker, I have always been a fervent supporter of the military and I was delighted when the House Armed Services Committee recommended the authorization of additional Navy ships.

While I commend this action, I am distressed to learn the Navy does not have available funds to pay what they already owe to various shipyards throughout the country. If this is true, it is an intolerable situation which must be quickly corrected.

There are other serious problems regarding the Navy's shipbuilding program which must also be resolved.

I include a letter addressed to me dated March 13, 1976, and signed by Mr. J. P. Diesel, president of Newport News Shipbuilding Co. in these present remarks. In his letter, Mr. Diesel states:

"These issues threaten not only the future naval shipbuilding program but the one which is already underway."

He also says:

"Time has run out."

I will also include a memorandum written by Mr. Gordon Rule, a senior Navy civilian for contract matters, along with my present remarks.

The Rule memorandum is an important document which must be read by those people in Government who are concerned about the future of the U.S. Navy. Action must be taken and it must be taken now.

The material follows:

MARCH 15, 1976.

HON. THOMAS N. DOWNING,
Rayburn Building,
Washington, D.C.

DEAR MR. DOWNING: The House Armed Services Committee recently recommended the authorization of additional Navy ships. However, you should be aware, as the Representative of the First District of Virginia, that it is a great frustration to Newport News Shipbuilding to find the Congress becoming aware of the need for future ships when the Navy has not yet come to grips with what they already owe to their shipbuilders.

I emphasize the question of the availability of funds and the question of the Navy's willingness or capability to promptly deal with the economic problems underlying its Naval shipbuilding program. These issues threaten not only the future Naval shipbuilding program but the one which is already under way. This situation is so severe that last summer we found it necessary to stop work on the DLGN41. We are now seriously considering similar action on the CVN70. We cannot see how it is reasonable or prudent to plow ahead with a project the size of the CVN70 in the present situation. Not only are the other Carriers not current in terms of pricing, but every other Naval shipbuilding program at Newport News is also seriously in arrears. Everyone knowledgeable appears to recognize this. I have received repeated assurances that the Navy recognizes that it does have significant financial obligations to us but nothing is done to resolve the underlying problems.

Recently the senior Navy civilian for contract matters, Mr. Gordon Rule, wrote a memorandum to the General Counsel of the Department of Defense, at that gentleman's request, to outline Mr. Rule's views of the problems with Navy shipbuilding. I have attached a copy. While I might not agree with the entirety of this memorandum, its thrust is correct and it describes fairly some causes of the Navy's problem with the shipbuilding industry. While this memorandum does not indicate Newport News' specific problem, I am sure you can appreciate them from our discussions.

I need to bring all the pressure to bear that I can for a prompt and equitable resolution of the differences between the Company and the Navy. Time has run

out. For this reason, it is requested that the Rule memorandum be inserted in the Congressional Record. I, of course, will defer to you on how to do that. But we need this in the public domain, and we need it there quickly.

Sincerely,

J. P. DIESEL,
President.

NAVY SHIPBUILDING IN THE UNITED STATES—VIEWS OF GORDON W. RULE

Major Premise.—where will the Navy find shipbuilding capacity to produce our country's known requirements for ships?

Minor Premise. If such capacity can be found, under what terms and conditions will it be available to the Navy?

MAJOR PREMISE

It seems reasonable to ask SECNAV and CNO who continue to say our Navy needs X number of new ships for the fleet by Y years, if they have a plan or blueprint of where they expect to get those X ships built.

I suggest two things greatly affect any answer to this major premise:

- (i) We have no mobilization base in the United States for Navy shipbuilding.
- (ii) The Navy plays games and places ships in predetermined yards under the guise of competition. (Examples are Trident submarines to EB and FFG's to Bath and Todd. Newport News is smart enough to know where Admiral Rickover wants the Tridents built and that they are only being asked to bid for windowdressing. Similarly, all signs clearly point to NAVSEA wanting both Todd yards building FFG's and again the rest of the industry are smart enough to know this.)

When I was in the Bureau of Ships—now NAVSEA—the Navy had a well recognized policy of keeping five building yards in business for Navy new construction work, Beth-Quincy, Electric Boat, New York Ship, Newport News and I forget the fifth yard.

The Maritime Commission had a comparable list of yards for their ships. We kept them in business by allocating ships to them.

When I returned to the Navy in 1963 in my present job, the then ASN(I&L) told me no such policy existed any longer and any yard could go out of existence. We are now paying the price for that shortsightedness. ASD(I&L) had a group working on mobilization planning and many times I asked our representative on that group why they wouldn't develop a mob plan for shipbuilding. A satisfactory answer was never forthcoming.

Were I Secretary of the Navy I would determine if any realistic plan was in existence for building the ships in the FYDP. If no such plan existed, and I mean good, sound long range planning, acceptable to the industry and understood by all, disciplinary action would surely be undertaken.

This apparent lack of planning was so obvious to me that I wrote a letter dated 8 March 1974 to the Chairman of the Senate Armed Services Committee, Senator Stennis, which letter stated in part:

"The foregoing is set out in order to better understand the situation facing the Navy—and a newly minted CNO. In capsule, the Navy is in an almost unbelievable situation. Unless a CNO is selected and confirmed by your Committee who fully understands the seriousness of this situation and has plans to cope with and remedy it in the very near future, the U.S. Navy will be in very deep trouble indeed.

"The serious situation I speak of is that the shipbuilding industry in the United States does not want to build ships for the Navy. That is not just my personal view, it is the attitude of shipbuilders in this country and Secretary Warner knows it. There is no evidence that the CNO understands this situation or has any plans for corrective action.

"It is very interesting for the present CNO to outline to your Committee the Navy's future ship requirements and how strong our Navy must be, but he should be asked where these ships will be built, etc. He should be questioned about the lack of competition and indeed no bids at all for specific ships presently required by the Navy and funded by the Congress.

"This is the situation facing the new SECNAV and CNO. Your Committee may wish to discuss with these new appointees their comprehension of this problem and what they intend to do about it."

ASN(I&L) Bowers stated in a recent meeting that he had been working with the Maritime Commission for a year looking toward a mutual agreeable mobilization plan for building ships. It's about time. Additionally, Admiral Kidd wanted to reopen Mare Island and Philadelphia Naval Shipyard well over two years ago in order to obtain additional needed capacity for new construction, but nothing happened.

MINOR PREMISE

If such capacity can be found, under what terms and conditions will it be available to the Navy?

Two things here are irrefutable. First, the Navy must get the required ships built without recourse to the Defense Production Act and second, the shipbuilding industry must be assured of fair contracts and treatment by the Navy, and a reasonable opportunity to earn a good profit for building the most complicated piece of hardware the Navy buys. The Navy should realize that one way or another, these shipyards will get paid what they are entitled to via changes, equitable adjustments under their contracts, claims or P.L. 85-804. There are enough good claims lawyers—many of whom worked for the Navy and know our weaknesses—to assure that.

Additionally, the following points must be considered in connection with this premise:

(i) The building of a Navy combatant ship always involves concurrent development and production. There is no engineering development phase in shipbuilding as there is in every other piece of hardware the Navy procures.

(ii) When the Navy is designing a ship and having it built concurrently, the result is massive changes—both authorized and constructive—requiring fair and prompt adjudication or they can develop into claims. It should be recognized that concurrency, rather than development, pilot production and then production will add at least twenty-five percent more to the cost of a procurement.

(iii) When the Navy utilizes the lead/follow yard method of ship procurement, claims and delays are inherent—they always have been.

(iv) Shipbuilding labor is 30-35% nonproductive or inefficient.

(v) The Navy makes unfair contracts for building the ships it requires and the industry knows and resents this. (Type of contract, delivery dates, pricing to meet an erroneous budget estimate, are prime examples of this.)

(vi) These unfair contracts have, of necessity, led to claims against the Navy, and although some of these claims are of dubious validity, those that are valid are not settled as promptly as they should be.

(vii) A review of shipbuilding claims—or requests for equitable adjustment—as they are sometimes termed for statistical purposes, will show that the Navy hasn't learned many lessons in recent years and that our track record of ship contracting has been disgraceful.

(viii) The Navy recently went to Court to sue our best surface ship builder, Newport News. When the Navy does this, and then is told by the Judge to negotiate your differences and report back to the Court—which is what the Navy should have been able to do without going to Court—it is obvious something is very wrong.

So much for the description of what this minor premise involves. Now, what needs to be done.

It is suggested that before the Navy can hope to have a successful shipbuilding program, there must be a reestablishment of mutual respect and trust with the shipbuilding industry in the United States. This can only be accomplished by deeds, not words. Instead of litigating and awarding claim inducing contracts providing fees for law firms, the following course of action is proposed:

(i) Recognize that our track record of ship procurement is very poor indeed and that at least 50% of the blame for that record is properly chargeable to the Navy. (The most important thing wrong with the Navy today—not the fleet but the producer side of the Navy—is that we will never admit we made a mistake.) Thus, it is essential that we recognize our deficiencies before we can hope to take corrective action.

(ii) The Navy today needs new faces to properly and intelligently provide the required climate for dealing with the shipbuilding industry and indeed for properly evaluating our own mistakes. Today people are polarized and captives of the ways and prejudices that have produced the conflicts, claims, etc. Someone must be found who will take hold of this problem and provide the new philosophy of complete fairness in all our dealings with the shipbuilding industry, both in the making and administration of our contracts. This result is achievable—by

the right, tough-minded person or persons—without any loss of firmness and protection of the Government's best interests. What the goal here must be is simply fairness and respect for each other's position as distinguished from the current dug-in positions that produce adversary relationships without flexibility or reasonable fall back positions. That is what negotiation—to reach mutual agreement—is all about. It is fashionable for some persons in authority in the Navy to moan about how shipyards that formerly were privately owned and operated are now owned and operated by large conglomerates that are only interested in making a profit. This mentality probably still looks for a corner grocer instead of going to a chain store.

(iii) The most important short term objective must be the settlement of the Litton and Newport News problems. I submit the Litton yard is a national asset for future Navy new ship construction and we should recognize this as a fact. The Navy and DOD actively encouraged Litton to build this yard in Mississippi and the first Navy contract through that new yard—the LHA's—should have been a cost type contract, at least for the first ship. This Litton LHA matter should be settled under P.L. 85-804 as was Lockheed (C5A) and Grumman (F14) by reformation of the contract to cost type on the supportable theory of essentiality to the national defense. In my opinion, Litton is more deserving of 85-804 reformation treatment than Grumman ever was. Litton did not buy-in on the LHA contract and Grumman did. We need that modern yard for Navy work and we should be planning right now to put work in there. Newport News must be negotiated to settlement and I believe that can be accomplished if handled cooperatively by negotiation and not litigation. It is fully realized that any settlement over \$25 million must be approved by the Congress. Thus, I would go to the Chairmen of the Armed Services and Appropriations Committees and fully apprise them of the planned settlement procedures and get their blessing in advance. I feel confident they would approve.

(iv) The most important short and long range objective must be the making of right type of ship construction contracts. A review of our track record in using firm fixed price contracts and later fixed price incentive contracts (incentive on cost only) for building Navy ships says loud and clear that it's about time we woke up to the fact that changes and improvements must be made. More specifically, it is recommended that the following suggestions be considered and if necessary, discussed with the shipbuilding industry via the Shipbuilders Council of America:

a. New construction Navy ships should be allocated to building yards under an approved shipbuilding mobilization plan. This would eliminate the specious competitive exercises we go through and would recognize the almost impossible task of competitively pricing the unknowns involved in the concurrency of development and construction of a ship or ships. The Navy allocates submarine overhauls by planning years ahead where each ship be assigned. It is suggested that this same procedure would be prudent for the upcoming DE 1052 class overhauls rather than compete these overhauls.

b. With both the Seapower Subcommittee and the GAO taking positions against cost type contracts for shipbuilding, it appears the Navy will continue to utilize fixed price incentive contracts (cost only incentive) for Navy shipbuilding. This FPI type of contract can be made a satisfactory contractual instrument. It is not today because of the tortured manner in which we structure them. The basic test of a soundly structured FPI contract—and indeed a CPIF contract—is the credibility of the target cost. The target cost should really be called "most probable cost" and should be that figure which the contractor has a 50/50 chance of overrunning or underrunning. This is fundamental in incentive contracting. It is this precise point—target cost—where the Navy starts the process of making unfair contracts. When the Navy negotiates a 95/5 share above target cost for the first 26 million of overrun of target, the target cost figure is patently phoney. Moreover, when the Navy negotiates a 95/5 share and then also a 152% ceiling, the target cost figure is patently ridiculous. First priority for the future must be the negotiation of more reasonable target costs for our FPI shipbuilding contracts and if the budget has to be changed, then change it.

c. When our ships are allocated rather than price competed, I would start the contractor to work by means of a cost-no-fee contract to be definitized to an FPI contract by an agreed upon date. The difference between a cost-no-fee interim contract and a letter contract is that the contractor will be paid 100% of his costs vice 80-85%, which is of great benefit from a cash flow point of view and also from an interest standpoint. The cost-no-fee interim contract would con-

tain the unilateral definitization clause used in letter contracts and would provide that if it is not definitized by the agreed upon date the 100% of cost payments would revert to 80-85%. The reason for this is obvious.

d. The contractor would submit his proposal to definitize to an FPI contract and not competing for the contract price-wise, the likelihood is a more honest proposal. This will then be compared to our official Navy estimate for that particular building yard and a far more realistic target cost negotiated. At this point of definitization we would also have much more reliable subcontract costs available than trying to fully forward price. Consideration should also be given to a redetermination of price at say 60% completion as the Navy used to do.

e. With the negotiation of a realistic target cost, instead of dictated labor hours and costs—as we have done to meet a budget figure—the target profit, share and ceiling matrix would fall into place without having to be tortured to make up for an unrealistic target cost. With respect to profit, it is essential that a new and broadened philosophy be utilized, one which recognizes the shipbuilders' entitlement to a good/reasonable profit for building the most complicated hardware the Navy procures. If it should eventuate that a shipbuilder realized excessive profits then we should rely on the Renegotiation Board to take appropriate action.

I firmly believe this suggested outline would work, given the will to make it work on the part of the Navy and would provide the necessary inducement to industry to actively and willingly participate in our shipbuilding programs. Today, I believe these shipbuilders have reason to suspect that we are being unfair to them when we make our contracts. This feeling must be negated and I respectfully submit my approach would do it and would also comply with Secretary Clements' desires and objectives.

NAVY SHIPBUILDING IN THE UNITED STATES—ADDITIONAL VIEWS OF GORDON W. RULE

The views set out herein supplement those dated 4 March 1976, same subject. These supplemental views result from a review of the minutes of a 9 March 1976 meeting of private shipyard executives with Mr. Clements, Deputy Secretary of Defense.

What emerges from my review of these minutes is the substantive difference in the attitudes and complaints of the nuclear building yards—both surface and submarine—vs. the attitude and complaints of the non-nuclear building yards—both combatant and non-combatant. The basic difference is the difference between "cause for concern" and "cause for alarm".

Many of the industry complaints, some reiterative, are common to the non-nuclear and nuclear building yards, i.e.,

- Quality Assurance
- 7000.2 Requirements
- CAS—Prime and Sub Level
- WBS
- Vendors' Costs
- Pricing of Changes
- Proposal Cost

These complaints, while cause for concern to the Navy, are manageable in my opinion.

Contra, I believe that the following comments by the President of Newport News and the General Manager of Electric Boat Division, are cause for alarm by the Navy, DOD and the Congress:

Mr. Diesel, President of Newport News, stated that he believes the Navy's primary problem is whether there is going to be a private sector to do Navy shipbuilding.

Mr. Pierce, General Manager, Electric Boat, stated the company is not going to let the Navy run its business. He said "the Navy wants to run our business." He stated that nuclear submarines for the navy are their only business. He said situation worse in last two years.

Because of the positions Newport News and Electric Boat occupy in building nuclear surface ships and submarines for the Navy, it is strongly urged that the proper officials take their comments seriously. There are those presently connected with Navy nuclear shipbuilding contractual matters who advise that these companies are bluffing in their stated warnings to the Navy concerning their part in future shipbuilding. Please do not succumb to that advice.

With the Congressional emphasis on nuclear combatant naval ships for the fleet of the future, I consider the Navy's number one priority to be the resolution of the causes of this situation and the reasons for the \$1,097.2 billion in Requests for Equitable Adjustments (REA) for nuclear submarines and surface ships that have been submitted since 1 January 1975 and the millions more to come from these two nuclear building yards.

I have concluded from my review of the minutes of the 9 March 1976 meeting and the historical information available regarding claims that the Navy wants many things from the builders of our complicated combatant ships that we seem reluctant to pay for. Examples of these are set out above under industry complaints. This entire area goes to the climate that must be changed by deeds, not words.

In the 4 March 1976 paper I recommended :

(i) Allocation under an approved mobilization plan, not price competition for combatant warships.

(ii) Do not forward price but commence work under a cost-no-fee contract to be definitized to a fixed price incentive contract at some agreed upon future time. Under the cost-no-fee contract the contractor would bill for 100% of cost incurred.

More specifically, if this method of ship contracting were adopted the following problem areas would be accommodated, and properly so :

(i) The costs of preparing the proposal to definitize the cost-no-fee interim contract would be a reimbursed cost.

(ii) During the life of the interim cost-no-fee contract the shipbuilder could determine and negotiate the costs of compliance with 7000.2, CAS, Q. A. and the WBS and charge them to the contract.

(iii) There would be no interest costs during the interim cost-no-fee contract and more realistic progress payment provisions after definitization could negate interest as a problem.

(iv) The problem of vendors' certification of costs prior to issuance of a fully forward priced prime contract would be avoided by the definitization of the prime contract at a later date when vendors would be able to provide the required certificate.

If the Navy chooses to continue the practice of price competition for combatant ships, these areas could not be accommodated because of the impossibility to realistically foresee and price the unknowns of concurrent development and building of a combatant Navy ship.

Contra, if the Navy changes from price competition and full forward pricing of ships to allocation via a two-step contract procedure, I feel many of the problem areas of pricing would be moved "up front" and not left to later controversy, hard feelings and claims. I also feel strongly that the pricing of the shipbuilding contract will be far more realistic and credible.

Change orders and claims negotiations require attention. Both claims and changes settlements involve people and people are hard to come by these days, especially good people, and particularly in the Sunship offices.

I am convinced, from experience and observations, that the Navy has allowed itself in recent years to be backed into a position whereby we have lost much of the required flexibility to exercise judgment and make more timely decisions in these two areas.

In 1969, I approved a claim settlement to Todd Shipbuilding Corporation for \$96 million on DE 1062 Class ships. I had a legal memorandum of entitlement, an audit report, a technical report and a good claims team recommendation. I exercised judgment and approved it.

That action worried some of our lawyers so much that they had the ground rules changed to require the lawyers to agree on the quantum of the settlement as well as legal entitlement. That move effectively restricted judgment by the contracting officer and greatly expanded the time required for settlement of claims. I certainly appreciate the role of the lawyers in claim matters, but I do feel we swing the pendulum to the extreme and that it should be swung back closer to center. I am not advocating getting the lawyers out of claims, I am advocating that they perform their proper function in the settlement of claims. Judgment and flexibility for the contracting officer must be restored if more prompt settlements are to evaluate. Today many young lawyers tend to fancy themselves as contracting officers when theirs should be an advisory function.

Changes should be fully priced at time of issuance or max priced to be definitized downward only at a later date. We keep saying this but not practicing it.

I have one overall suggestion to make with respect to the adjudication of

changes and claims. This suggestion would probably require action by the Congress:

In preparation for the conclusion of World War II, the Congress enacted a very farsighted piece of legislation entitled the "Contract Settlement Act of 1944." The basic objective of this Act was to enable industry to make the transition from defense production back to peacetime production as expeditiously as possible. History of the time shows that it worked very well indeed in achieving its objectives.

One of the provisions of that Act was directed to the settlement of termination claims occasioned by the cessation of first, VE Day and subsequently VJ Day, when thousands of defense contracts were terminated overnight for the convenience of the Government. The Congress anticipated that the settlement of those termination claims would be difficult and time consuming to the possible detriment of the private contractors involved and the early restoration of the peacetime economy.

Section 106(f) of the Contract Settlement Act of 1944 (U.S.C.A. Title 41) provides as follows:

"(f) Each contracting agency shall allow and pay interest on the amount due and unpaid from time to time on any termination claim under a prime contract at the rate of 2½ per centum per annum for the period beginning thirty days after the date fixed for termination and ending with the date of final payment, except that (1) if the prime contractor unreasonably delays the settlement of his claim, interest shall not accrue for the period of such delay, etc. * * * In approving, ratifying, authorizing, or making termination settlements with subcontractors, each contracting agency shall allow interest on the termination claim of the subcontractor on the same basis and subject to the same conditions as are applicable to a prime contractor."

While this Congressional policy of paying interest on termination claims is not entirely analogous to claims and change orders under Navy shipbuilding contracts, I suggest it may be an appropriate method of encouraging settlements of those claims and changes that have exceeded a reasonable period of time. The possibility should be explored.

As stated at the outset, the contents of this paper supplement the 4 March 1976 views by me.

HOW SHOULD THE NAVY ACQUIRE SHIPS IN THE FUTURE?—VIEWS OF GORDON W. RULE

The Navy today is in the position of enjoying a strong pro-Navy climate—both in the Congress and the Department of Defense—for an expanded program of new construction ships, mainly nuclear. Ironically, this strong pro-Navy shipbuilding climate comes at a time when the Navy's relations with the hard core private shipbuilding capability of the United States has deteriorated to such an extent that the Office of the Secretary of Defense has found it necessary to assume direction of the Navy's shipbuilding problems.

Add to this recognized unsatisfactory relationship the existence of over a billion dollars in unsettled claims/REA's mostly nuclear—and the dimensions of the Navy's overall problem is clearly in focus.

Realizing that the existing unsatisfactory relations between the Navy and the private shipbuilders—particularly nuclear building yards—cannot be permitted to continue, a decision has been made in the Office of the Secretary of Defense to utilize the extralegal powers conferred by P.L. 85-804 in an attempt to reduce this backlog of claims/REA's. This decision is obviously constrained by (i) the extent such powers are deemed necessary and (ii) the extent reasonable agreements can be negotiated with the shipyards.

The ship construction capability for nuclear warships—submarine and surface—is concentrated in two building yards, Electric Boat and Newport News. These two yards presently have claims pending against the Navy in the approximate magnitude of one billion dollars and both of these yards are disenchanted with their contractual treatment by the Navy.

The existence of this situation is considered to be a serious threat to the national defense and therefore the decision to use P.L. 85-804, where necessary, is viewed as not only desirable but necessary.

Assuming that this claim situation can be settled amicably and to the satisfaction of the Congress, the Navy and the shipyards, the overall problem will be

only partially resolved. In short, the Navy must recognize mistakes of the past which have led to the claims—both nuclear and non-nuclear—and take positive steps to preclude these mistakes in contracting for ships in the future.

I consider both Electric Boat and Newport News to be honorable shipbuilders and I suggest they are probably as concerned with the Navy's contracting practices in the future, as they are in their claims settlements of today.

To preclude another mountain of shipbuilding claims and to dispel the adversary relationship that exists today, the Navy must do two things which will be quite unpalatable, (i) admit the past mistakes in ship construction contracting and (ii) embrace entirely new concepts for future ship construction contracting. These two points encompass both nuclear and non-nuclear ship contracts.

It is my opinion that the unsatisfactory track record of Navy ship contracting can be traced to the use of one or more of the following causes:

- (i) Price competition for warships.
- (ii) Forward pricing of fixed price type contracts.
- (iii) Use of unrealistic delivery dates.
- (iv) Misjudging the economic impact of normal and abnormal inflation on our ship contracts.
- (v) Wrong type of contract.
- (vi) Unfair matrix in contracts, i.e., target cost, share, ceiling, etc.
- (vii) Unfair or inappropriate escalation clauses.
- (viii) Contracting to meet budget estimates.
- (ix) Late GFE and GFI.
- (x) Failure of Navy to properly recognize a nationwide shortage of shipbuilding labor force.

The negotiation of Navy shipbuilding contracts in the future must be bottomed on two elements absolutely essential to fair contracts, namely, good faith and a genuine desire by both parties to negotiate a mutually agreeable contract. In the future there can be no place for any individual connected with the making and administering of a ship contract who does not fully subscribe to these tenets—regardless of who or where that individual may be.

Future contracts for Navy new construction ships should be structured within the following cornerstones:

- (i) Recognition of the fact that the building of a Naval warship always involves concurrent development and production, with all the unknowns inherent in such concurrency. The past practice of forward pricing fixed price type contracts to build ships requiring a building period of many years has been shown to be unrealistic, imprudent and claim producing. Reasonable risk assessments at the outset of such a contract I consider most impractical, if not impossible.
- (ii) In the future, we should allocate combatant warships, auxiliaries and overhauls to building yards under an approved shipbuilding plan in this country. Price competition for warships has proven to be a failure. This would obviate the spending of large sums of money preparing so-called competitive price proposals.
- (iii) The lead ship of a class should be built under a cost type contract.
- (iv) The Navy should not contract for whole programs of ships but should build one or two before committing the program.
- (v) When Navy ships are allocated to planned building yards, the work will be commenced by means of an interim cost type contract, preferably cost-no-fee. By an agreed upon date, the contractor will submit a proposal to build the ship or ships and for other than the lead ship, a definitive fixed price incentive type contract with provision for escalation, will be negotiated which will absorb the interim cost type contract. The cost of preparing the proposal will be paid by the Navy and because it will be a non-competitive proposal it will be more realistic. Moreover, by the time the interim cost type contract is definitized to a fixed price incentive contract, most or all subcontracts will be firmed.
- (vi) If the budget estimate is insufficient to meet a realistic cost, then the Congress should be requested to provide additional funds at the outset, rather than the present practice of getting started with a known money cost figure and down the road acting surprised and blaming it on the shipbuilder.
- (vii) The target cost of the fixed price incentive definitive contract must be a figure the contractor has a 50/50 chance of overrunning or underrunning. This is not the case today where the shipbuilders have no possibility of underrunning target cost.

(viii) During the life of the interim cost type contract, the shipbuilder will determine and negotiate the costs of whatever the Navy wants, i.e., 7000.2 reporting, Cost Accounting Standards, Quality Assurance, Work Breakdown Structure, etc. and such costs will be included in the contract.

(ix) Do away with unilateral changes. Knock heads with the shipyard representatives and work nights, but come up with an agreed-on cost/delivery change before proceeding.

Despite the fact that Navy/nuclear shipbuilder relationships are now considered a serious threat to the national defense, I am not at all sanguine that any significant changes in our relations with the nuclear building yards will be forthcoming or that the necessary changes in our contracting practices with nuclear yards will be adopted.

Admiral Rickover is known for his outspoken criticism of corporate shipyard management and it is well recognized that he does attempt to usurp corporate management functions at these shipyards. His activities have reached the point where the two major nuclear yards have made it very clear indeed they no longer are going to tolerate his interference and dictatorial contracting attitude and philosophy. In my opinion, he knows this, hence his proposal to nationalize the private shipbuilding yards.

In addition to the above suggested changes in our ship contracting practices and procedures, I suggest that a very thorough study be made of the ship design capability of the Navy. This study should examine particularly the lead-follow yard concept of designing and building Navy ships. For example, Newport News designed the SSN 688 Class submarines under a design contract and are building the lead SSN 688 under another contract. Electric Boat is the only follow yard building SSN 688 Class ships other than Newport News. When Newport News delivers the drawings, plans, etc. to the Navy under their design contract, they become Government owned and then are Government furnished information (GFI) supplied by the Navy to Electric Boat and Newport News and both yards end up with large claims for late and defective plans (GFI) from the Navy. There must be a better way to design and build Navy ships.

NOTES FOR DISCUSSION WITH SECRETARY CLEMENTS

Subject: Shipbuilding claims

1. I understand that you have decided to provide shipbuilders extra-contractual relief under Public Law 85-804 in an effort to improve relations with shipbuilders and dispose of the backlog of shipbuilding claims.

2. I have always advocated strict enforcement of defense contracts and settlement of claims on their legal merits. However, I have also testified to Congress that if senior defense officials decide that claims should be settled on other than their legal merits, they have the authority to provide extra-contractual relief under P.L. 85-804.

3. The application of P.L. 85-804 relief in this area will, of course, create new problems: e.g. how to handle other defense contractors and subcontractors when they request extra-contractual relief; how to get Congressional support for extra-contractual payments to large conglomerates who are reporting high profits; how to negotiate P.L. 85-804 settlements if one contractor demands a profit regardless of circumstances or financial need, and another is willing to absorb a loss; how to determine the form and amount of what is to be given to the contractors in order to get them to drop their claims.

I presume the Shipbuilding Executive Committee which you have appointed to guide and monitor such settlements is considering these problems.

4. I believe that the contemplated, one-time granting of extra-contractual relief will not eliminate the basic problem. In fact, it may be more difficult to conduct future Defense business because contractors may believe the Navy will henceforth ensure their future profitability regardless of their contract performance. Specifically:

a. Shipbuilders may conclude that their present approach of accumulating large backlogs of unpriced changes and alleged constructive changes to serve as a basis for claims is highly effective. Even after they have been given extra-contractual relief on present contracts, when present or future contracts turn out to be less profitable than anticipated, new claims can be expected. One major

factor in the Navy's relations with Newport News, for example, has been the company's refusal to pre-price changes or to conduct other day-to-day business in a normal manner. I am not optimistic that paying off all present claims will eliminate this problem in the future. The yards manpower availability problem is still acute. The financial incentive to divert manpower from Navy work to the expanding commercial work will increase if the Navy pays for the delays on Navy work while delays on commercial work are subject to delivery penalties.

b. Since the Navy is presently dependent upon a few private shipyards and the decision has been made not to enforce the present contracts, the Navy will continue to be vulnerable to shipbuilder assertions that they will not perform Navy shipbuilding contracts unless claims are settled to their satisfaction. For example, Newport News has refused to honor the DLGN 41 contract; announced that it was considering stopping work on the CVN 70 and not entering into new Navy shipbuilding contracts. Such actions underline the Navy's vulnerability to threats of work stoppage, regardless of the legal merits of the shipbuilder's contentions.

c. Navy personnel will still have to devote considerable time and manpower to negotiating and administering fixed priced shipbuilding contracts, trying to pre-price changes, and contesting unwarranted claims—all the while knowing that if the contract overruns, the contractor has a good chance of again getting financial relief by appealing to higher authority.

5. Providing financial relief by reforming escalation clauses on shipbuilding contracts is only a temporary remedy. Although the current claims backlog may be eliminated, similar future problems will not be eliminated. It is not that the escalation clauses on Navy shipbuilding contracts were inequitable. They provided better protection during the period of high inflation than the vast majority of defense contracts which contained no escalation clauses. The only time the Navy's shipbuilding contracts did not protect shipbuilders against the effects of inflation was in cases where delays or increased costs were the responsibility of the contractor. The fundamental problem is that some shipbuilders upon whom we must depend apparently will honor contracts only to the extent they are satisfied with the financial outcome.

6. For the above reasons, where extra-contractual relief is provided to one or more of the major shipbuilders, I recommend the following:

a. The Government should acquire title to the shipyard as a condition of the P.L. 85-804 settlement. This would ensure adequate facilities for Navy shipbuilding requirements regardless of market demands for commercial ships, and eliminate contractor threats of diverting these resources to other work. In the case of Newport News, special arrangements could be made to complete existing non-defense work. Several shipbuilders have complained that profits are too low on Navy shipbuilding contracts in relation to their investment. They may be willing to liquidate this investment in settlement of their shipbuilding claims. In addition, more members of Congress might support the Public Law 85-804 approach if the Government ends up owning the shipyard.

b. Once title vests in the Government, operates these shipyards as government-owned, contractor-operated plants along the lines the Atomic Energy Commission and its successor, the Energy Research and Development Administration have used successfully for 30 years to operate its facilities and laboratories. Award long term operating contracts, with provisions for replacement of the operating contractor at the Government's discretion. The operating contract should be on a cost reimbursement basis with a sliding fee scale based on volume of work. By providing a guaranteed profit for little or no investment, such an arrangement should make shipbuilding work financially attractive to contractors. It would enable the contractor and government personnel to devote their entire efforts to the difficult task of building ships, instead of the situation at present where far too much of the time of contractor and Government personnel is engaged in contracting disputes.

6. In the past I have opposed the use of cost-plus contracts for shipbuilding because they tend to destroy contractor incentive to control costs. However, much of the contractor's incentive to control cost under fixed priced contracts is negated when extra-contractual relief is granted. Moreover, it appears we are unable or unwilling to enforce fixed priced contracts with much of the shipbuilding industry. If the Government owns the shipyards; if they are devoted solely to Government work; and if the Government exercises close surveillance I believe that they could be operated at no greater cost to the Government; probably at a lower cost. As a minimum we would eliminate the overhead currently expended in contract disputes between shipbuilders and the Navy. The

comparison will, of course, be made with Navy yards. But it must be recognized that these yards have functions which are not performed by private yards. Also, they are bound by Civil Service rules.

7. I continue to advocate strict enforcement of contract terms and settlement of claims on their legal merits. However, on the basis that a decision has been made to grant P.L. 85-804 relief, I recommend that the contemplated extra-contractual settlements with shipbuilders provide for future operation of the shipyards involved on a Government-owned, contractor-operated basis. Under the circumstances this approach offers the best possibility of a permanent solution to the shipbuilding claims problem and has the greatest likelihood of winning Congressional support.

The CHAIRMAN. Thank you very much for being here. I have already addressed myself as to the value of these matters.

[Whereupon, at 12:50 p.m. the committee recessed to reconvene at 2:30 p.m. the same day.]

