

GAO

Testimony

For Release
on Delivery
1:00 p.m.
Tuesday
December 8,
1987

Navy Ship Construction Contracts

Statement of
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and Reporting
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Before the
Subcommittee on Merchant Marine
Committee on Merchant Marine and Fisheries
House of Representatives



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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our report on selected ship construction contracts.¹ Our report was prepared at the request of the Chairman, Subcommittee on Defense, House Committee on Appropriations.

We reviewed selected shipbuilding contracts to determine: (1) whether the contracts can be executed within the funding appropriated; (2) whether the awards could result in future claims against the Government; (3) actions the Navy is taking to address current and anticipated claims; and (4) whether the Navy's Supervisor of Shipbuilding, Conversion, and Repair (SUPSHIP) activities is providing effective oversight of the contracts. In particular, we reviewed 22 fixed-price incentive contracts, which were competitively-awarded over the past few years. The contracts covered 69 vessels involving 9 combatant and noncombatant ship programs at 10 private shipyards.

ADEQUACY OF FUNDING

Our review showed that the Navy policy of competing ship construction contracts has generally resulted in lower and declining contract prices. However, at the completion of our work in July 1987, the Navy was projecting cost overruns totalling about

¹Navy Contracting: Cost Overruns and Claims Potential on Navy Shipbuilding Contracts, October 16, 1987, GAO/NSIAD-88-15.

\$1.4 billion, or about 16 percent over the target costs, for 19 of the 22 contracts. Some of these contracts are also experiencing schedule slippages and delivery delays.

On fixed-price incentive contracts, the Navy shares a portion (generally 50 percent) of overruns exceeding the target costs, up to a ceiling price. If final costs come in at the current estimates, the Navy will have to fund about \$706 million for overruns. The Navy, in most cases, has sufficient program account funds to cover the Navy portion of the cost overruns. For a few programs, the Navy anticipates submitting reprogramming requests to cover its share of estimated overruns.

Costs above the ceiling price are borne entirely by the contractor. The estimated completion costs for many of the 22 contracts are close to, at, or above the ceiling price. Nine contracts had estimates of at least 90 percent of ceiling, and four had projected costs at or above the ceiling.

In April 1987 we testified before the Subcommittee on Defense, House Committee on Appropriations and reported that 5 of the 22 contracts were underrunning target costs by about \$60 million, apparently because anticipated production efficiencies were being realized and construction costs were being reduced. By July 1987, however, this had changed and only 3 contracts were projected to

underrun the target costs by about \$26 million. In these types of cases, the savings are shared equally by the Navy and shipbuilders.

The causes for the projected overruns are many and varied. On some contracts, shipbuilders are experiencing labor productivity problems and shipyard inefficiencies; on others, the shipyards appear to have underestimated the complexities of construction. Some contracts have experienced a large amount of design changes and are being affected by external problems such as late Government furnished equipment and data.

It appears, however, that the overruns can be primarily attributed to optimistic bidding fostered by a competitive environment, anticipated production efficiencies which have not materialized and unrealistically low labor hour estimates.

Our analysis of the contracts showed that some proposed prices were identified by the Navy, at the time of the award, to be optimistic. The proposed prices were below the government estimates, and the Navy believed they presented a risk of cost overruns.

We interviewed five shipbuilders to obtain their views on the business environment. There was a general agreement that the industry is currently competing in a "low ball" or close to a marginal profit environment on Navy ship construction contracts. Although the shipbuilders supported the competitive process and

fixed-price contracts for follow-on ships, they were concerned about the long range effects of the Navy's emphasis on price competition on the weak shipbuilding industry. In their view, the competitive environment forces shipbuilders to bid aggressively for the limited work, because the lowest price is the Navy's principal determining factor for awarding contracts.

According to the shipbuilders, the Navy has not put adequate weight on price realism and the shipyards' ability to meet the price. They believe this leads to low bids with a likelihood for overruns.

I should note that there is nothing to prevent an offeror from reducing its prices for competitive purposes. As long as the proposal is technically acceptable, and the contractor is determined to be responsible, the contract may be awarded to that offeror. The contracting officer must, however, assure that change orders or follow-on procurements are not used to recover amounts of below-cost bids.

Our analysis showed that, although price was the highest-weighted factor in all 22 procurements, the Navy in its evaluation of the offers, did consider other technical and management factors. Where necessary, pre-award surveys were performed and, in all cases, a determination of contractor responsibility was made.

CLAIMS AGAINST THE GOVERNMENT

Where there are significant contract cost overruns there is an increased likelihood of contractor claims against the government or Requests for Equitable Adjustment (REAs). An REA is a request for monetary payment, extension of the delivery schedule, or both, which is not in dispute at the time the Government receives it. Whenever a dispute cannot be settled by an agreement, the contractor may file a claim relating to the dispute. As of July 1987, contractors were attempting to recover, or anticipated submitting REAs or claims for 8 of the 19 contracts projecting cost overruns.

For example, Bath Iron Works (BIW) submitted an REA in November 1986 on three CG-47 Aegis cruiser contracts to cover cost overruns. The REA stated that BIW's and the Navy's projected cost to the Aegis cruiser program has changed for many reasons including: government changes, delays, disruptions, a shipyard strike, and shipyard performance problems.

As a result of these and other variances, BIW stated that both parties needed to re-establish cost, schedule and technical baselines. The REA assigned responsibilities for the cost increases and computed a proposed contract adjustment of about \$100 million. In December 1986, BIW responded to a Navy request and provided additional supporting data to facilitate the Navy's

analysis of the REA. In May 1987, BIW submitted a revised REA that completely replaced the November 1986 submission. The contractor requested an adjustment of about \$134 million. The Navy has recently increased the contracts by \$37.5 million.

The Naval Sea System Command (NAVSEA) has policies and procedures for preventing, avoiding, and reducing contractor claims for price increases on ship contracts. These measures are required to be implemented at the SUPSHIP organizations that interface with the shipbuilder where many of the incidents resulting in claims occur. The SUPSHIP activities we visited have implemented claims avoidance or prevention programs. An important aspect of these programs is maintaining a documented record of significant events during each contract: delivery schedule changes or problems, differences in interpretation of contract provisions, changes in the method or sequence of work, contractor errors, and non-compliance with contract terms.

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In summary, Mr. Chairman, our work indicates that over the past few years, the U.S. shipbuilding industry, faced with a weak and declining commercial market, has been intensely competing for limited Navy ship construction work. While highly-competitive bidding on Navy contracts has produced favorable contract prices it

is contributing to cost overruns that could present future problems to the shipbuilders and the Navy.

Mr. Chairman, that concludes my statement. I will be pleased to answer any questions you may have.