THE ACQUISITION OF WEAPONS SYSTEMS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON PRIORITIES AND ECONOMY IN GOVERNMENT

OF THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-SECOND CONGRESS

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MONDAY, MAY 24, 1971

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON PRIORITIES AND
ECONOMY IN GOVERNMENT OF THE
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room S-407, the Capitol, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire and Representative Brown.

Also present: Ross F. Hamachek and Richard F. Kaufman, economists; and A. Ernest Fitzgerald, consultant.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The subcommittee will come to order.

Today the Subcommittee on Priorities and Economy in Government resumes part III of the hearings on the Acquisition of Weapons Systems.

A few weeks ago, on April 28 and 29, the subcommittee received testimony from two of the Government's outstanding experts on military procurement: Admiral H. G. Rickover and Elmer B. Staats, the Comptroller General. Both witnesses reinforced the need for taking a close, hard look at a number of defense contracting issues that have been sources of continuing problems.

Admiral Rickover was especially critical of the renegotiation process and the handling of shipbuilders' claims against the Navy. The Comptroller General reinforced the Admiral's concern and this subcommittee's concern over defense profits and shipbuilders' claims with well documented testimony on both questions.

It seems to me that there can no longer be a question of whether or not profits on defense contracts are too high. In many cases—not in all cases, but in many cases—defense profits are too high. The report of the General Accounting Office and the testimony of individuals such as Admiral Rickover make that point crystal clear.

To cite a few examples from the GAO report, one defense contractor made 96-percent profits on his total capital invested in 1969. That is, a 96-percent profit on all his business with the Pentagon, not just on one contract. One firm in 1968, made 81-percent profit on total capital investment. Another, in 1967, made 85 percent. Again, these profits represent the overall annual defense business of the contractors, not merely a few isolated contracts. Undoubtedly, if the individual contracts of these firms were examined some of them would show much

higher rates of return. Furthermore, the individuals taking these exorbitant profits were among the 74 largest Pentagon contractors. They were not small businessmen.

It is true that some contractors made very little profits in those years, according to the GAO report. Some may have lost money. That is all the more reason for correcting the problem. The question, then, is which contractors are making excessive defense profits, and what is to be done about it?

In addition, the matter of shipbuilders; claims have reached monumental and critical dimensions. When this subcommittee first heard testimony on this matter a year and a half ago, about $800 million worth of shipbuilders' claims had been filed or were about to be filed against the Navy. Today, according to my information, the figure is approximately the same despite the fact that over $115 million of the older claims have been settled. In other words, the claims are coming in as fast as they are being disposed of, perhaps faster. The problem of preventing claims before they arise is not being solved.

The disposition of the claims also leaves a great deal to be desired. According to the evidence settlements are being negotiated in multimillion dollar disputes without the requisite legal, technical, or auditing analyses. If this is true, contractors may be receiving millions of dollars of taxpayers' money with little or no entitlement. Any such payment seriously aggravates the problem of defense profits. They are, in effect, hidden profits that would not show up in any audit or profit study.

We are fortunate to have before us two men who are in a position to answer some of these questions. Our first witness, Lawrence E. Hartwig, has been Chairman of the Renegotiation Board since 1961, and has been a member of the Board since 1951.

Mr. Hartwig, as you know, Admiral Rickover has been very critical of the Board's activities. He stated on April 28th, that "we have the semblance not the substance of effective renegotiation."

I note that you have a prepared statement and you may proceed with it in any way you wish.

STATEMENT OF HON. LAWRENCE E. HARTWIG, CHAIRMAN, RENEGOTIATION BOARD, ACCOMPANIED BY HOWARD W. FENSTERSTOCK, GENERAL COUNSEL; GEORGE LENCHES, ECONOMIC ADVISER; AND ROSS M. GIRARD, DIRECTOR, OFFICE OF ACCOUNTING

Mr. HARTWIG. Mr. Chairman, I would like to read the statement, if I may.

Chairman PROXMIRE. Will you identify the gentlemen who are with you.

Mr. HARTWIG. Mr. Howard Fensterstock, general counsel, is on my right.

Mr. George Lenches, economic adviser, is on my left.

And on his left, Mr. Ross Girard, Director of the Accounting Division.

Mr. Chairman, we are pleased to be here to discuss with you the role that renegotiation plays in the complex area of Government-industry

relationship, which developed during the past decades as a result of a continuing high volume of military-space expenditures.

The concept of renegotiation, as it is known today, originated with the Renegotiation Act of 1942. That act provided for the renegotiation of individual contracts and subcontracts. But it became apparent almost immediately that the hundreds of thousands of war contracts and subcontracts could not be individually reviewed and renegotiated within any reasonable period of time. Thus, practically from the beginning, contracts were renegotiated in groups, mostly on a fiscal year basis. The principle of fiscal year renegotiation was established in the Renegotiation Act of 1943, and was carried over to the Renegotiation Act of 1951, which is still in force today.

The change from contract-by-contract renegotiation to fiscal year renegotiation was fundamental. With that change, renegotiation ceased to be a repricing technique; it became, rather, a separate and distinct method of eliminating excessive profits realized by contractors on the totality of their renegotiable business. Congress in 1951 vested the power of renegotiation in an independent board, the present Renegotiation Board, as contrasted with the departmental boards of World War II and under the 1948 act. The aim was to attain objectivity and uniformity in renegotiation decisions.

THE RENEGOTIATION PROCESS

Renegotiation is conducted not with respect to individual contracts, but with respect to the receipts or accurals under all renegotiable contracts and subcontracts of a contractor in the contractor's fiscal year. Accordingly, aggregate renegotiable profits in any given fiscal year of a contractor will often reflect the performance of several contracts in different stages of completion, and may result from an offset of losses or low profits on some contracts against high or even excessive profits on others. The basic concept is that a contractor has not realized excessive profits unless the profits on all his renegotiable business are excessive.

All contractors whose renegotiable sales, on a fiscal year basis, exceed the $1 million statutory "floor" must file a report with the Board. The act applies only to contracts—and related subcontracts—with the Departments of Defense, the Army, the Navy, and the Air Force, the Maritime Administration, the Federal Maritime Board, the General Services Administration, the National Aeronautics and Space Administration, the Atomic Energy Commission, and the Federal Aviation Agency. But certain contracts even with these agencies are exempt from renegotiation.

The major exemptions in the act are those relating to contracts and subcontracts for raw materials or agricultural commodities, contracts and subcontracts with common carriers, public utilities and tax-exempt organizations, competitively bid construction contracts, and prime contracts which the Board determines do not have a direct and immediate connection with the national defense.

Contracts and subcontracts for the sale of new durable productive equipment are partially exempt, and contracts and subcontracts for the sale of commercial articles or services are exempt under certain circumstances.

For purposes of renegotiation, profits are defined as the excess of the amount received or accrued under renegotiable contracts and subcontracts over the costs paid or incurred with respect thereto and determined to be allocable thereto. All items estimated to be allowed as deductions and exclusions under chapter I of the Internal Revenue Code (excluding taxes measured by income) must, to the extent allocable to renegotiable business, be allowed as items of cost. Thus in renegotiation the costs generally allowed are the proper costs of a going concern, to the extent they are allocable to renegotiable business. This is so because renegotiation is concerned with the aggregate renegotiable profits of a contractor in a fiscal year.

What part, if any, of the profits thus arrived at is excessive, is determined on the basis of certain factors prescribed in the act. These factors are: Efficiency, reasonableness of costs and profits, the net worth, risk, nature and extent of contribution to the defense effort, and character of the business. No formulas or preestablished rates are used to determine whether profits are, or are not, excessive in any given case. Rather, the determination in each instance reflects the judgment of the Board on the application of the statutory factors to the facts of that case.

NEED FOR RENEGOTIATION

By June 30, 1971, which is the present termination date of the act, renegotiation in its present form will have been in force for 20 years. Over these years the continuing need for renegotiation has been repeatedly affirmed. President Eisenhower, recommending the extension of the act, said on March 7, 1955: "In spite of major improvements, which we have achieved in our contracting and price redetermination operations, there nevertheless remains an area in which only renegotiation can be effective to assure that the United States gets what it needs for defense at fair prices."

Eleven years later President Johnson commented, upon signing another extension of the act: "We need this vital measure. It is another important tool in our constant quest to get a dollar's worth of value for every defense dollar spent."

The search for better ways to procure for defense and space needs has continued to the present time. However, no conceivable improvement in the procurement process can alter two fundamental characteristics of that process: (1) Lack of a traditional marketplace to guide the pricing of most procurement, and (2) the fact that procurement is on a contract-by-contract basis. There are significant differences between the defense-space market and the private competitive market. In the private market firms usually compete with each other in terms of quality and price and produce goods with a known technology and cost.

These conditions are not usually found in major segments of the defense-space market. Novel, costly, and complex aircraft, missiles, space vehicles, and other specialized items, which incorporate the latest advances in a rapidly changing technology, are purchased in that market. Hence, in the procurement of defense-space items, reliable production and cost experience is not usually available for accurately forecasting costs. Contract costs are therefore but estimates; that is,

predictions of future events. Like all predictions, they are subject to change by later developments.

Even in the procurement of products similar to those traded in commercial markets, where price competition would seem to be feasible, a reasonable profit outcome is not always assured. Notwithstanding a basic similarity, such defense-space items are often specialized; demand for them is often irregular and, in some cases, geographically concentrated. Under such circumstances, price competition may be limited and ineffective. This lack of adequate price competition is a possibility even under quite "normal" conditions. In time of war or national emergency, with sudden surges in the volume of procurement, this possibility is much greater. The conclusion is thus inevitable: vast governmental expenditures are being made in the defense-space field under circumstances where, regardless of the diligence of procurement officials, there is no guarantee against excessive profits.

The opportunity for contractors to realize excessive profits on Government business is further enhanced by the fact that all such business is awarded on a contract-by-contract basis. This aspect of Government contracting cannot be emphasized enough because an individual price that has been most carefully arrived at may, as a result of unforeseen developments, produce excessive profits.

Procurement agencies price each contract separately and independently. Renegotiation, on the other hand, reviews the profit results of contracts after the fact on a fiscal year basis. This is so because the profitability of a contractor's participation in defense-space business can only be judged retrospectively on the basis of his aggregate profits.

RESULTS OF RENEGOTIATION

The need for renegotiation is well attested by its achievements. Excessive profits determinations made by the Renegotiation Board from its inception amounted to more than $1 billion as of June 30, 1970. This amount is before Federal income tax credits; net recoveries by the Government as a result of the Boards determinations amounted to $413 million as of the end of the last fiscal year.

For some time now, the Board has been heavily engaged in renegotiation proceedings reflecting the impact of the large procurement buildup for the Vietnam conflict. In fiscal 1970, the Board made 123 determinations amounting to more than $33 million, the largest in a decade. In the same year contractors reported voluntary refunds and price reductions in the amount of $18 million.

These determinations involved contractors in a wide variety of industrial fields such as: Textile-apparel, metals. ordnance, aircraft parts, machinery, and electronic components. In the current fiscal year, determinations will be substantially in excess of the 1970 amount. In addition, the Board has a large number of cases awaiting further development, including many in which substantial amounts of excessive profits are likely to be found.

The material benefits of renegotiation cannot be measured solely in terms of recovery. From the inception of the act through June 30. 1970, contractors and subcontractors reported to the Board more than $1.3 billion of voluntary refunds and voluntary price reductions. We be-

lieve that such actions by contractors are induced, at least in part, by the existence of renegotiation.

Renegotiation also has an impact on procurement as a deterrent against overpricing. Over the years, procurement officials have repeatedly testified to the value of renegotiation in this respect. The Senate Committee on Finance also recognized this point when it said in 1966:

> * * * the renegotiation process has had a deterrent effect on overpricing on Government contracts because of the realization that renegotiation is backstopping the allowable profits. (S. Rept. No. 1295, 89th Cong., 2d Sess. 2 (1966).)

There is no way to estimate the savings that accrue to the Government as a result of this deterrent effect, but in all likelihood the amount is substantial.

It may be helpful to the committee, in its consideration of defense procurement, if I discuss the relationship of renegotiation to the Truth in Negotiations Act, and the treatment of cost overruns and industrial conglomerates in renegotiation.

TRUTH IN NEGOTIATIONS

The Truth in Negotiations Act requires that, in certain circumstances, contractors shall submit cost or pricing data prior to award, and shall certify that the data submitted is accurate, complete, and current. It provides further that the contract price shall be reduced to exclude any significant amount included therein as a result of defective cost or pricing data.

The Armed Services Procurement Regulation (ASPR 3–807.3(f), as amended by Defense Procurement Circular No. 74) makes it clear that the certificate required under the act does not cover errors in judgment. It says:

> (f) "Cost or pricing data" as used in this Part consists of all facts existing up to the time of agreement on price which prudent buyers and sellers would reasonably expect to have a significant effect on the price negotiations. * * * Cost or pricing data, being factual, is that type of information which can be verified. Because the contractor's certificate pertains to "cost or pricing data," it does not make representations as to the accuracy of the contractor's judgment on the estimated portion of future costs or projections. It does, however, apply to the data upon which the contractor's judgment is based. This distinction between fact and judgment should be clearly understood.

Thus, defective pricing under the truth in negotiations law does not exist where contingencies are provided for, but do not materialize; or where a contractor discloses the facts on historical costs, but projects higher costs for the future and they prove to be lower than the projections; or where estimates turn out to be wrong, for example, labor productivity proves to be higher than anticipated, or a material cost proves to be less than anticipated.

Renegotiation serves a distinctly different and broader purpose than the truth in negotiations law. That law affords no protection against errors of judgment or unforeseen developments. Renegotiation concerns itself with the very matters which are beyond the purview of the Truth in Negotiations Act. The one is a tool of procurement, an integral part of the contracting process itself; the other is an after-the-fact review of the profit results of that process on an overall basis. Thus

the Truth in Negotiations Act does not obviate the need for renegotiation.

COST OVERRUNS

The control of cost overruns is a matter for the procurement authorities; they are not controllable by the Renegotiation Board. Under the Renegotiation Act, the actual costs incurred by a contractor, if they are good tax deductions and are allocable to renegotiable business, must be allowed. It must be remembered that a cost overrun has already occurred when a contractor files with the Board.

An overrun, of course, will depress profits and may even result in an overall loss on renegotiable business. In evaluating a contractor's renegotiable profits to determine whether they are excessive, the Board considers, among the other factors, reasonableness of costs and efficiency. If a cost overrun significantly affects the overall profits and is attributable to inefficient management, these facts are considered unfavorable to the contractor in our evaluation.

CONGLOMERATES

Many large corporations market a variety of products or services through separate, subsidiary corporations bound together in a so-called conglomerate. Under the Renegotiation Act, as under the Internal Revenue Code, such corporations are entitled to be treated on a consolidated basis; and it is upon the totality of the profit that the Board's determination must be based.

This does not mean, however, that the evaluation—the analytical process—preceding a Board determination is also conducted on aggregate lines. Quite the contrary. A conglomerate is required to provide the Board with a separate statement of the renegotiable sales, costs, and profits of each corporate entity in the group, together with information sufficient to enable the Board to evaluate the activities of each such entity separately under the statutory factors. If the profits of a member of the group are found to be excessive, they are considered as such in the overall determination and can be offset only by a showing of losses or deficient profits of other members of the group.

Thus, excessive profits realized by a member of a conglomerate are not hidden or unknown, but are uncovered, and they have their full impact upon the final determination. This method of analyzing related corporations operating as a conglomerate is equally applicable, of course to a single large corporation operating in diverse fields through division.

The attention of this subcommittee has been called in particular to the problem of conglomerates in the shipbuilding industry. It was stated that the Renegotiation Board "no longer sees shipbuilding profits because they are averaged with profits or missiles or electronics or with any other defense activities of the parent corporation." That is not so. The renegotiable sales, costs, and profits of every major shipbuilder are reported regularly to the Board, not only as a part of the consolidated aggregate figures of the conglomerate to which he belongs, but also separately. Thus, the Board does know what profits are being made on shipbuilding contracts with the Government.

CONCLUSION

I submit that the role of renegotiation is essential; that it supplements, but by no means duplicates, the techniques of the procurement process itself; and that it has been effective in eliminating excessive profits.

Thank you.

CONGLOMERATES

Chairman PROXMIRE. Thank you very much Mr. Hartwig.

Mr. Hartwig, apropos of your last section on conglomerates, on April 20 Admiral Rickover told this committee that most of the Navy's shipbuilders have been taken over by large conglomerates, and as a result, the Renegotiation Board doesn't see shipbuilding profits separately anymore. That is what he said. Your statement says that the Renegotiation Board does see shipbuilders' profits, so that you can recoup excess profits earned on Navy shipbuilding contracts. But from the discussion in your statement it seems that when a shipyard is taken over by a conglomerate, the shipbuilding profits will be averaged with the earnings of the parent corporation in renegotiation. Thus, the Renegotiation Board may see shipbuilders' profits, without being able to do anything in cases of excessive shipbuilders' profits.

Admiral Rickover told this committee about one shipyard, a division of the large conglomerate, that earned profits of about 50 percent on investment last year. That much profit seems excessive to me. But isn't it possible you might not recoup anything from this shipbuilder because of offsets to the parent company?

Mr. HARTWIG. In the first place, we have been unable to identify that company, Senator Proxmire.

Chairman PROXMIRE. You can't find a company that meets that criteria?

Mr. HARTWIG. No.

Chairman PROXMIRE. All right, we will be delighted to supply you that information.

Mr. HARTWIG. All right.

In the second place, if a member of a conglomerate had excessive profits, in our analysis of the case that would be carried into the total determination, and the group would not receive an overall clearance unless there were deficient profits or losses in other members of the conglomerate.

Chairman PROXMIRE. There are several questions that this poses. I know that you are abiding by the law. After all, you don't make the law, you execute it. I take it that your interpretation of the law is that this is your only alternative, to do it this way.

Mr. HARTWIG. Yes, sir.

Chairman PROXMIRE. It seems, however, that there is an incentive when you have this kind of a situation, No. 1, for the conglomerate to be in a position where it can buy into a contract even though it might not be able to qualify otherwise, to buy in because it knows that it is in a position to have excessive profits in some areas and write those off against any losses it might sustain?

Mr. HARTWIG. Whatever motivates conglomerates or other companies to buy in, I don't think that the chief motivation is renegotiation. There are other reasons for buying in—tax reasons, and others.

If the formation of conglomerates is a social evil, perhaps a direct attack through antitrust enforcement or perhaps through amendment of the tax laws, would be the way to face up to the problem.

Chairman PROXMIRE. I was struck by the fact—I know you are a very able man, and I greatly admire the people in your organization, as you know, I fought hard to try to get you a bigger staff than you have, and I think you ought to have it—but when I look at the size of your staff and the number of people you have working in this area and the colossal size of Federal procurement and the great complexity of the problems you have to face, it seems to me that there is an incentive here for contractors to take a chance, in view of the fact—I would think you would hate to operate on pretty much of a spot basis, you can't make a comprehensive investigation of every contract of every firm, and you have to do it on a very selective basis which would often, it would seem to me, provide an opportunity for many contractors to be able to get away without having their situation scrutinized.

Mr. HARTWIG. It is obvious that we couldn't, Mr. Chairman. In 1970, I believe, there were 28,000 prime contract actions involving $100,000 or more. When you consider that there were, in addition, tens of thousands of subcontracts under those prime contracts, it would take an organization much greater than ours to examine the details of all those transactions.

Chairman PROXMIRE. Under ordinary circumstances an independent shipbuilding firm, distinguished from one owned by a conglomerate, that earned overall profits of 50 percent would probably lose some of this amount in renegotiation. But the shipyard, as Admiral Rickover mentioned it, may be able to protect all of its earnings because of the offset in the other branches of the conglomerate.

Let me illustrate that. If that shipyard were an independent concern it would probably surrender some of that profit in renegotiation. Now, suppose in 1971 the same firm was owned by a conglomerate. It could earn 50 percent profit again, but at this time it would have a good chance of surviving renegotiation without losing a penny, because the shipyard's profits would only be one part of the conglomerate's aggregate earnings. So we have the same shipyard earning the same profit in two different years, but receiving a different treatment in renegotiation. That doesn't seem to be reasonable. Among other advantages that accrue to conglomerates under this system of averaging profits, one business might be buying into a new line of defense work with ridiculously low bids, knowing that the low profits or even losses that result will be averaged in with the excess profits of its shipbuilding contracts.

I think you have answered that in part, but I just wondered whether you would want to tell me or not wouldn't this give an advantage to large conglomerates at the expense of smaller independent companies.

Mr. HARTWIG. There is no question but that diversified companies have an advantage over the nondiversified companies.

Chairman PROXMIRE. Wouldn't you say this would be a maior reason for the fact that independent shipbuilders have had to sell out to conglomerates?

Mr. HARTWIG. It might be one of the reasons.

RENEGOTIATION BOARD STRONGER DURING KOREAN WAR

Chairman PROXMIRE. Do you agree that the Board was stronger during the Korean war than it is today.

Mr. HARTWIG. Our jurisdiction was much broader in the Korean period than it is today.

Chairman PROXMIRE. At that time you had 742 employees, and today you have 232, is that right?

Mr. HARTWIG. We have a ceiling of 250.

Chairman PROXMIRE. You are spending about 20 percent less funds, and a much greater decline would appear if inflation were taken into account. In addition, there have been numerous restrictions placed on the Board, the floor for filing has been substantially increased, and a number of exemptions or loopholes have been built into the act. So isn't the Board essentially weaker today than it was 20 years ago?

Mr. HARTWIG. In the sense that we have less jurisdiction we are weaker, but I think we are doing a better job of analysis today than we did in the Korean period.

Chairman PROXMIRE. How do you do a better job when you have about one-third of the staff?

Mr. HARTWIG. I am talking about the quality of the work.

Chairman PROXMIRE. I don't doubt that you have people who are able, and work hard. But again my question is; In view of the size of the job that you have to do and the number of people that you have available, isn't it true that you can't be as effective as you were?

Mr. HARTWIG. I mentioned the change in jurisdiction. That is one of the reasons for a smaller staff. Another reason is that the procurement buildup for Korea was much faster and more substantial than it was for Vietnam. There was more crash procurement then. Hence there was a greater possibility of excessive profits at that time than there has been during the Vietnam period.

PROFITS UNDERSTATED BY 27 PERCENT

Chairman PROXMIRE. I understand that in fiscal year 1970 the regional accounting division made a net adjustment of profits reported by the contractors of $191.3 million. In other words, the contractors reported profits of $714 million for that year, but they were almost $200 million or 27 percent higher. Is that correct?

Mr. HARTWIG. That is correct.

Chairman PROXMIRE. Was the net adjustment in 1970 extraordinary, or are profits understated by this amount every year?

Mr. HARTWIG. I couldn't answer that. But I would assume that this might be our usual experience. We made that special study because of the allegation that we accept contractors' reports at face value. We ordinarily don't make that kind of a study, because it involves many man-hours. But I have no reason to think that 1970 was an exceptional year in this respect.

Chairman PROXMIRE. So you think generally they may understate their profits by 30 percent or more?

Mr. HARTWIG. The actual amount will vary.

Chairman PROXMIRE. The net adjustment in 1970, with profits understated by that amount and, on the basis of your study we would

have no reason to assume that wasn't fairly typical, is that right?

Mr. HARTWIG. I think that perhaps we may have the same experience in 1971, because we are now cutting into the Vietnam backlog.

Chairman PROXMIRE. How are the understated profits detected?

Mr. HARTWIG. Our accountants examine the reports of contractors.

Chairman PROXMIRE. Are their books audited?

Mr. HARTWIG. Audited, yes.

Chairman PROXMIRE. I don't mean examined, I mean audited. Did you go behind the contractor's books?

Mr. HARTWIG. We didn't go behind them.

Chairman PROXMIRE. You accepted their figures?

Mr. HARTWIG. No, sir. Many times we went to contractors' plants to examine the records.

Chairman PROXMIRE. You did audit the books in the sense that you examined the records?

Mr. HARTWIG. Yes, in that sense—in many cases, not all.

Chairman PROXMIRE. You didn't try to verify the cost figures or other elements?

Mr. HARTWIG. I would like to have Mr. Girard respond to that. He is the Accounting Director.

Chairman PROXMIRE. Yes, sir.

Mr. GIRARD. In many cases we make a visit to the contractor's corporate office or plant. We investigate the authenticity of the figures in his filing. We check his cost record allocations and verify various other accounts in his general ledger. From that standpoint we audit. But we do not go into the whole tick and holler audit procedure of ticking off each invoice.

Chairman PROXMIRE. The hoot and holler can be very helpful in determining whether or not the contractor's books are accurate.

Mr. GIRARD. That would be so, sir. But with the millions of invoices in a big corporation——

Chairman PROXMIRE. I don't say that you don't do as much as you possibly could, but if you did have more manpower and did more you might be able to better determine that profits are higher than you are able to this way.

Mr. GIRARD. That possibility exists. But we think we get everything.

EXCESSIVE PROFITS RECOVERIES

Chairman PROXMIRE. Doesn't there seem to you to be a wide disparity between the amount of understated profits found by the Board and the amount actually recovered by the Board?

Mr. HARTWIG. I don't think so. We feel that we are recouping excessive profits in the cases where they exist.

Chairman PROXMIRE. How much did you recover last year?

Mr. HARTWIG. $33 million.

Chairman PROXMIRE. How much?

Mr. HARTWIG. $33 million.

Chairman PROXMIRE. They are understated by $200 million, and you only recovered $33 million?

Mr. HARTWIG. The adjustment in profits did not necessarily produce excessive profits. We adjusted the figures, and in some of the cases determined that the profits were excessive. Not all of the cases have been completed.

NUMBER OF PROFESSIONALS IN OFFICE OF ACCOUNTING

Chairman PROXMIRE. Tell me something about the Office of Accounting. How many persons are assigned to this office, how many are professionals, and what are their duties?

Mr. GIRARD. In the Office of Accounting at headquarters we have seven accountants, in addition to the Director and his Deputy. Their duties are to perform the accounting in the screening process, and also to review the accounting in cases which come in from the regional boards.

Chairman PROXMIRE. You have seven accountants?

Mr. GIRARD. Seven accountants.

Chairman PROXMIRE. And they have the responsibility for reveiwing all the cases?

Mr. GIRARD. Right, that are processed at headquarters.

Chairman PROXMIRE. What proportion of the cases are processed at headquarters?

Mr. GIRARD. All the screening cases, the nearly 5,000 which are processed through the headquarters office.

Chairman PROXMIRE. That means they have to process an average of three a day, as I calculate it.

Mr. GIRARD. In that neighborhood. But many of these filings are on a consolidated basis, and are grouped together. Also many contractors report losses. These do not require too much time, especially when the contractor shows a loss on his total business.

Chairman PROXMIRE. How do you know the losses exist?

Mr. GIRARD. By the reporting which is made.

Chairman PROXMIRE. But if they are handling three a day, that means they have to do this in 2½ hours for each of these. And I would think that many of these would be very complicated.

Mr. GIRARD. They are complicated.

Chairman PROXMIRE. If you are handling something like Lockheed or Boeing, or any number of firms.

Mr. GIRARD. Such companies are usually assigned to the field for the field accountants to make their investigations. We don't spend too much time on those in the screening operation, because it would be a duplication of effort.

Chairman PROXMIRE. They are reviewed in Washington, aren't they?

Mr. GIRARD. They are reviewed when they come back.

Chairman PROXMIRE. And by this board of only seven accountants?

Mr. GIRARD. Yes.

Chairman PROXMIRE. And those gentlemen are the ones responsible for reviewing our entire $40 billion procurement program?

Mr. HARTWIG. Mr. Chairman, the cases that Mr. Girard is talking about, are not initially analyzed in depth at headquarters, because they are sent to the regions for full development. We have made a study of the cases that went through the screening process at headquarters in 1970. Out of 4,853 filings screened, there actually were

3,590 cases, counting a consolidation as a single case. A consolidation will consist of more than one filing. Out of 3,590 cases, 603 were assigned to the regional boards for full development. Those did not take much time at headquarters.

Chairman PROXMIRE. In order to assign them there they had to review them and make a judgment, didn't they?

Mr. HARTWIG. When you see a Boeing or a Lockheed, you don't spend much time on it at headquarters, because you know it is going to be assigned to the field.

Chairman PROXMIRE. First, let me say that as I get it, all the filings represent at least $1 million in renegotiable sales, many represent tens of millions or hundreds of millions of dollars. You say in your description of the function in "Justifications for Estimates of Salaries and Expenses Fiscal Year 1972":

> The office reviews above the "floor" within filings in the screening process, and passes on the adequacy and correctness of the segregation of sales and allocations of costs and expenses. In these review activities, the Office of Accounting processed 4,952 filings during FY 1970. For each fiscal years 1971 and 1972, it is estimated that the Office of Accounting will process 4,700 and 4,400 filings respectively.
>
> It also reviews cases completed by the Regional Boards for adherence to the Board regulations, accounting principles and consistent treatment of accounting matters, and conducts complete accounting reviews of cases subject to final approval by the Statutory Board, including cases assigned to the Board. It advises on the need for, substance of, special accounting agreements for renegotiation and collaborates with the Department of Justice on accounting matters pertaining to tax cases.

I am not one of those who think that everybody in the executive branch of the Government works too hard by any means. But I do think we have an example here of seven men who seem to have a task which is so enormous that it would be very hard for them to do a complete, comprehensive and responsible job.

Mr. HARTWIG. Just to complete the record on the types of cases that go through the screening process. As I said, out of 3,590 cases that were screened in 1970, 603 were assigned to the regions; 830 showed outright losses; 115 had losses because of the loss carry-forward provision in the act.

Going into Vietnam, contractors had a $960 million loss carry-forward. This has had an impact on the screening process; 95 percent or more of the sales were renegotiable in 311 cases. In such cases there are no serious allocation problems; 346 cases involved renegotiable sales of $250,000 or less; 134 had sales margins of 1 percent or less, and 154 had sales margins of 1 to 2 percent.

Representative BROWN. Is it possible to get a copy of this so that we can see what you are reading from? It is a little difficult to follow.

Chairman PROXMIRE. I think if you would put this in the record it would be very helpful to us.

Representative BROWN. It would be nice also to have a copy.

(The material referred to follows:)

SCREENINGS, FISCAL YEARS 1969 AND 1970

[Cases]

	1969	1970
Number of filings screened	4,828	4,853
Number of screenings (cases)	3,753	3,590
Less:		
Assigned	763	603
Outright loss	668	830
Loss due to loss carry forward	186	115
95 percent or more renegotiable	339	311
$250,000 or less renegotiable sales	306	346
Sales margin of 1 percent or less [1]	146	134
Sales margin of 1 to 2 percent [1]	134	154
Sales ratio allocation	227	193
Total	2,769	2,686
Not eliminated	984	904

[1] With or without loss carry forward.

Chairman PROXMIRE. My time is up. The only question I would like to ask as I conclude is, what civil service rating do these seven very critical and vital men have?

Mr. HARTWIG. GS–14——

Mr. GIRARD. We have got one 16 and one 17.

Mr. HARTWIG. GS–17, GS–16, and seven GS–14's.

Chairman PROXMIRE. Thank you very much.

Mr. Brown.

PURPOSE OF RENEGOTIATION

Representative BROWN. Mr. Hartwig, I'm not altogether this familiar with the operation that you head. Is it my understanding that you renegotiate profits rather than contracts? In other words, do you go through a contract and say how that contract should have been altered; or on this annual basis of renegotiating profits, do you renegotiate when a company is permitted to make the contracts which it has?

Mr. HARTWIG. You understand it correctly. We renegotiate the overall profits. We do not renegotiate individual contracts. Some people have a misconception about the renegotiation process, because they look at us as though we were a repricing adjunct of the Defense Department. We are not.

Representative BROWN. You are kind of a watch and ward society of who is making too much money out of their defense contracts, isn't that what I am to understand?

Mr. HARTWIG. That is right, on an overall basis.

Representative BROWN. You don't actually get into the contract?

Mr. HARTWIG. We don't actually get into the contract, except that in the analysis of a case we get information with respect to the profits on major contracts. To that extent we get information from the contractor and the procurement departments with respect to costing, contract terms, and contract results.

Representative BROWN. How does this have an effect then on future contracts? Somebody down the line in the Air Force or the Navy or the Army is writing these contracts, some civilian or military type, I suppose, with a company. Suppose they have written a contract which allows the company to make a long profit, and then you criticize that profit as a part of the total picture of the company doing business with the Defense Department, as I understand it correctly.

How does the guy who wrote that individual contract in which there was a big profit margin for the company get his? How does he get alerted to the fact that maybe he has written just the oddest contract in the interest of the American taxpayer?

Mr. HARTWIG. There are instances where a particular contract will be a major contributor to excessive profits.

If we think our information would be useful to the procurement agencies, we furnish it to them for their use in future procurement.

Representative BROWN. You say when the contract is. What else would there be that would contribute to the profits except the contract?

Mr. HARTWIG. I said, a major contract. If the contract was small in the total picture, the contracting officer may not learn much from our determination. Let's say there were a number of contracts that a contractor was performing simultaneously, including one small contract, so small that in the total picture it didn't have much of an impact on the total profit. A contracting officer wouldn't learn much about that contract from renegotiation. But if the contract was a major contract in the fiscal year, or if the contractor was performing only one or two contracts, then a contracting officer could learn from the results of the board. We had a case only recently where we informed the Defense Department about the profit that had been realized on certain products. As a result, they secured a price reduction.

COMMERCIAL ARTICLE EXEMPTION

Representative BROWN. That was on the basis of a negotiated contract. You raise another point—maybe I am following an alley that I shouldn't get into—but what about the sale of potato chips to the Government, or a certain kind of screw, nut and bolt kind of thing, what about that, the shelf items? Do you renegotiate those contracts?

Mr. HARTWIG. No. They are for the most part exempt.

Representative BROWN. Why would they be exempt?

Mr. HARTWIG. The commercial article exemption.

Representative BROWN. Why? What is the rationale behind it?

Mr. HARTWIG. The rationale behind the exemption is that if an article is sold from stock or in accordance with a published price schedule, and if 55 percent of the sales of that article are in nonrenegotiable channels, the price to the Government is reasonable.

Representative BROWN. In other words, then, if they are charging the Government the same as the commercial price the competitive market sets, then those are not covered by your renegotiation board; is that correct?

Mr. HARTWIG. That is the assumption back of the exemption.

Representative BROWN. What is the dollar percentage of Federal procurement that falls in that category?

Mr. HARTWIG. In 1970 the commercial article exemption exempted about $1 billion.

Representative BROWN. How much procurement, what percentage?

Mr. HARTWIG. I don't know.

Representative BROWN. $30 million, $40 million?

Mr. HARTWIG. I don't know the total amount of commercial article purchases.

Representative BROWN. What do you have, then? You say there is $1.3 or $1.5 billion?

Mr. HARTWIG. Which is exempt.

Representative BROWN. Which is exempt, that is, not covered by the renegotiation?

Mr. HARTWIG. Right.

Representative BROWN. And how much again is the volume you are handling?

Mr. HARTWIG. Last year it was $48 billion.

Representative BROWN. $48 billion?

Mr. HARTWIG. Yes.

Representative BROWN. So this is about 2 or 3 percent—3 percent roughly?

Mr. HARTWIG. Right.

5-YEAR LOSS CARRY FORWARD PROVISION

Representative BROWN. How about the losses renegotiated?

Mr. HARTWIG. If a contractor has a loss on one contract and high profits on another, the two are offset within the fiscal year.

Representative BROWN. What if it doesn't happen in the fiscal year? Suppose I have got a little company that for a number of years has been bidding on Government contracts, and I lose my shirt. Then those covered in 1 fiscal year renegotiation; in which you study my contracts, and I go back and pick up those like I did on the taxes?

Mr. HARTWIG. Right. The law provides a 5-year loss carry forward.

Representative BROWN. So it works out on the same principle as the tax system, is that right?

Mr. HARTWIG. Right.

Representative BROWN. If I make a substantial profit then, for a period of 5 years, and you consider it is excessive on the basis of the contract, that is why I get tagged with—what?

Mr. HARTWIG. The loss carry forward might wipe out the excessive profits.

Representative BROWN. If I don't have that loss carried forward, though?

Mr. HARTWIG. If you don't have the loss carry forward you get tagged with a determination of the Board for a refund.

Representative BROWN. What is the appeal from that?

Mr. HARTWIG. The Tax Court.

DETERMINATIONS OF EXCESS PROFITS

Representative BROWN. Can you give me some kind of a judgment here as to how those determinations are made, as to what the amount is, that is considered excessive? What do you base it on?

Mr. HARTWIG. The statutory factors.

Representative BROWN. And they are——

Mr. HARTWIG. Efficiency——

Representative BROWN. What does that mean?

Mr. HARTWIG. What does efficiency mean?

Let me recite the factors.

Representative BROWN. OK.

Mr. HARTWIG. Efficiency, reasonableness of cost and profits, net worth, risk——

Representative BROWN. You are going too fast for me. Efficiency——

Mr. HARTWIG. Reasonableness of costs and profits, net worth, risk,

nature and extent of contribution to the defense effort, and character of business.

Representative BROWN. What do you mean by character of the business?

Mr. HARTWIG. Whether, for example, a business is integrated or not; whether the contractor subcontracts a lot of the work, or does the work in his own plant.

Representative BROWN. You mean if I do all the work, and this is the only thing that I do, and I don't have other activities that would ameliorate whatever profit I would make or loss that I would make—in other words, I am sort of out there making it alone?

Mr. HARTWIG. Generally a contractor who adds all of the value to a product is entitled to more profit than a contractor who does not, a contractor who subcontracts the work out. This is one of the important items under character of business.

Obviously, a contractor should not earn as much profit on work that is subcontracted out as he would on work that he does in his own plant.

Representative BROWN. In other words, if I do all the work myself in this operation, and if this is the only thing that I do, and I don't have other activities in my business, you are likely to let me get by with a little more profit than a guy who subcontracts it out, who really is just a broker in this operation, is that right?

Mr. HARTWIG. Yes.

Let me just give you a little more detail. This is in the act: "Character of business, including source and nature of materials, complexity of manufacturing technique, character and extent of subcontracting, and rate of turnover."

Representative BROWN. So much for the character of the business.

My time is up. I will come back and ask you about some of these others.

PUBLIC DISCLOSURE

Chairman PROXMIRE. I notice that the Board, Mr. Hartwig, is releasing more information under the Freedom of Information Act than it used to. But according to your annual statement, names of contractors and identifying details are left out of the documents that the Board now discloses. Doesn't this really defeat the purpose of public disclosure? What good are the documents without the names and the figures? Why shouldn't the public know which companies are making excess defense profits?

Mr. HARTWIG. That is the holding of the Court of Appeals in the Grumman Case.

Chairman PROXMIRE. We have to change the law, too.

Mr. HARTWIG. Yes, you would.

Chairman PROXMIRE. How do you feel about that? Do you have an opinion?

Mr. HARTWIG. It seems to me that if the law were to be changed, the extent of disclosure would have to be considered. We receive a lot of confidential data. For example, all of our filings tie in with the tax return. We receive tax data. And we receive other information which contractors generally do not disclose.

Chairman PROXMIRE. What we're talking about is the profits on negotiated contracts. Now, corporations are very happy to report their profits to the stockholders. We all know that they are disclosed in their

public statements, and they are required to be if they have any public stock issues of any kind, which the overwhelming majority of big corporations have. Why shouldn't the taxpayer know how much is being made on Government business?

Mr. HARTWIG. I see no objection to it. I have here a list of——

Chairman PROXMIRE. Why wouldn't that be positively good, not only a matter of no objection, but positively good? If we are going to be in a position to evaluate this and judge it, and if you are going to get any public opinion mobilized on this one way or the other, it seems to me that we have to know what we are talking about and have those figures available. It may be that the profits they are earning on defense contracts are not excessive, but we ought to know it.

Mr. HARTWIG. We do have quite an exposure, of course, in the cases involved in the Tax Court. I have compiled a list——

Chairman PROXMIRE. Of course, that is often ancient history by the time it develops. It takes a lot of time.

Mr. HARTWIG. Many of these are recent appeals involving Vietnam cases. This list shows quite a cross section of the areas in which excessive profits have been realized within the last couple of years.

Chairman PROXMIRE. Would you support an amendment to provide a full disclosure, the kind I am talking about, including the names of the companies and the amounts.

Mr. HARTWIG. It would be limited to that, would it?

Chairman PROXMIRE. That would be the main thrusts. There might be others.

Mr. HARTWIG. I think you might also have to amend the act to eliminate the provision that the Board shall endeavor to reach agreements. I think that if we were to publish the name and the amount of refund a contractor might be less likely to enter into an agreement. Thus, publication might tend to encourage litigation.

Chairman PROXMIRE. Why eliminate the possibility of agreement?

Mr. HARTWIG. It would be more difficult for us to reach agreements. Why would a contractor want to admit in public by agreement that he had made excessive profits?

Chairman PROXMIRE. Well, if the law requires this, then it seems to me you have discipline, both on the Board and on the contractor. I think you would have a much stronger disincentive than any we have under present arrangements where it is all secret and where the Board can take its chances—where the contractor can take his chances with a Board which is in my view understaffed and can only provide under some circumstances very limited review. If you had this kind of public disclosure, it seems to me it is a very strong disciplinary factor which would cost no more. And you also might have to pay less than if you took them to court.

LIST OF 94 TAX COURT CASES

Mr. HARTWIG. I am of two minds on this. The newspapers don't seem to be particularly interested in those cases where they have access to the names. I don't know why. As I said, I have a list here of 94 Tax Court cases involving $60 million of determinations. And as far as I know, newspapers have not paid much attention to them.

Chairman PROXMIRE. Will you give that to us right now?

Mr. HARTWIG. Yes, sir.

(The list referred to above follows:)

RENEGOTIATION CASES PENDING BEFORE THE U.S. TAX COURT AS OF MAY 1, 1971

Name of contractor	FYE	Gross amount, board's determination	Products
Erie Forge & Steel Co	Apr. 30, 1953	$400,000	Forgings.
Gibco, Inc	Sept. 30, 1955	200,000	Aircraft parts.
Do	Sept. 30, 1956	250,000	Do.
Applied Research, Inc	July 31, 1962	75,000	Electronic subsystems.
Page-River-Curran, JV	Dec. 31, 1963	1,200,000	Construction.
Data Control Systems, Inc	Sept. 30, 1964	175,000	Electronic subsystems.
Computer Instruments Corp	Dec. 31, 1961	200,000	Precision potentiometers.
Transducer Patents Co	(1)	770,000	Royalties.
Scientific Data Systems, Inc	Dec. 31, 1963	200,000	Computers.
McDonnell-Douglas Corp	June 30, 1965	8,000,000	Aircraft and space vehicles.
Grumman Aircraft Engineering Corp	Dec. 31, 1965	7,500,000	Do.
Cometa Co	(2)	480,000	Fuel storage.
Holly Corp	July 31, 1960	1,850,000	Do.
Winfield Manufacturing Co	June 30, 1966	275,000	Trousers.
Transducer Patents Co	(3)	305,000	Royalties.
Systron-Donner Corp	July 31, 1961	225,000	Instruments.
Mills Manufacturing Corp	June 30, 1967	500,000	Parachutes.
The B. Jahn Manufacturing Co	Dec. 31, 1966	1,000,000	Carbine parts.
North American Rockwell Corp	Sept. 30, 1964	9,000,000	Aircraft and space vehicles.
Galion Amco, Inc	Feb. 28, 1967	500,000	Fuze parts.
Cometa Co	(4)	534,000	Fuel storage.
Wells Marine, Inc	Nov. 26, 1966	325,000	Fuze assembly.
Amco Electric	Apr. 30, 1964	300,000	Electrical contracting.
Western-Atlantic-Standard-Raymond	Dec. 31, 1964	500,000	Dredging.
Landis Clothes, Inc	Aug. 31, 1967	300,000	Blouses.
Franklin Clothes, Inc	Dec. 31, 1967	600,000	Coats.
Western Contracting Corp	Dec. 31, 1964	200,000	Equipment rental.
Standard Dredging Corp	do	250,000	Do.
Atlantic, Gulf & Pacific Co	do	500,000	Do
The Peoples Co	Nov. 30, 1966	150,000	Tents.
Computer Instruments Corp	Dec. 31, 1962	150,000	Electrical instruments.
Holly Corp	July 31, 1961	1,500,000	Storage of petroleum products.
A. C. Ball Co	Aug. 31, 1967	250,000	Motor vehicle parts.
Aero Spacelines, Inc	Dec. 31, 1966	250,000	Air transportation.
Alton Iron Works, Inc	Dec. 31, 1967	100,000	Metal products.
The Zeller Corp	Dec. 31, 1966	75,000	Small arms ammunition.
American Diversified Corp	June 30, 1967	1,000,000	Tents.
Jon-Dell, Inc	Mar. 31, 1967	175,000	Canvas products.
Lykes Bros. Steamship Co., Inc	Dec. 31, 1967	1,750,000	Ocean transportation.
Kings Point Industries, Inc	Apr. 30, 1966	125,000	Miscellaneous fabricated textile products.
Tennessee Overall Co	Dec. 31, 1966	115,000	Trousers.
Allen electric & Equipment Co	Dec. 31, 1964	200,000	Aircraft parts.
Gilbraltar Manufacturing Co	June 30, 1967	125,000	Motor vehicle parts.
Mancon Liquidating Corp	July 31, 1967	1,500,000	Bomb bodies.
Dayton T. Brown, Inc	Dec. 31, 1966	150,000	Testing services.
Pacific Ventures, Inc	do	60,000	Restoration of buildings.
Pacific General Construction Co., Inc	June 30, 1966	200,000	Do.
Standard Container Co	Sept. 24, 1967	175,000	Ammunition boxes.
Blue Bell, Inc	Oct. 31, 1967	275,000	Trousers.
Glenn Berry Manufactures, Inc	Sept. 29, 1967	250,000	Do.
Amazon Cotton Mills Co	Sept. 30, 1967	400,000	Yarn.
Langson Manufacturing Co	do	600,000	Shell primers.
Mills Manufacturing Corp	June 30, 1968	550,000	Parachutes.
Camel Manufacturing Co	Aug. 31, 1966	200,000	Tents.
Winfield Manufacturing Co	June 30, 1967	2,100,000	Trousers.
M. L. W. Corp	Oct. 31, 1967	75,000	Do.
Talley Industries, Inc	Mar. 31, 1967	500,000	Miscellaneous ordnance.
Ballston Machine Tool Co., Inc	June 30, 1968	175,000	Bolts.
N. & D. Manufacturing Co., Inc	Mar. 31, 1968	175,000	Machining.
Ballston Precision Corp	Aug. 31, 1967	207,212	Bolts.
Ballston Precision Corp	Aug. 31, 1968	225,000	Do.
Mason & Hanger-Silas Mason Co, Inc	Dec. 31, 1967	500,000	Operation of Government plants.
Coloney Pine Co., Inc	do	1,350,000	Ammunition boxes.
Barron Industries, Inc	June 30, 1967	250,000	Coolers.
South Jersey Clothing Co	Dec. 31, 1967	85,000	Coats.
Hitco	Dec. 31, 1964	250,000	Fairings.
The Dyson-Kissner Corp	Dec. 31, 1965	75,000	Screw machine products.
Consolidated Box Co., Inc	Dec. 31, 1967	850,000	Ammunition containers.
Landis Clothes, Inc	Aug. 31, 1968	100,000	Coats.
Jackes-Evans Manufacturing Co	Nov. 30, 1966	75,000	Gun belt links.
Stewart Avionics, Inc	Apr. 30, 1967	200,000	Mobile generating plants.
Guy H. James Industries, Inc	Sept. 30, 1966	350,000	Shirts and trousers.
The Amerbelle Corp	Dec. 31, 1967	100,000	Dyeing and finishing.
The Peoples Co	Nov. 30, 1967	900,000	Tents.
Gyrodyne Co. of America	Apr. 30, 1966	800,000	Drone helicopters.
Whittaker Corp	Aug. 31, 1968	1,000,000	Bomb fins.
Xerox Corp	Dec. 31, 1964	800,000	Computers.
Comprehensive Designers, Inc	Apr. 30, 1967	1,750,000	Engineering services.

[1] Feb. 28, 1957 through Feb. 29, 1964 (8 cases).
[2] Dec. 31, 1959 through Dec. 31, 1961 (3 cases).
[3] Feb. 28, 1965 through Feb. 28, 1967 (3 cases).
[4] Dec. 31, 1962 through Dec. 31, 1967 (6 cases).

Chairman PROXMIRE. We will make it available to the press.

Is it possible for companies to report to the Board lower levels of profit than they report to the Internal Revenue Service for taxation purposes? Are IRS tax forms used for screening purposes at the Board?

Mr. GIRARD. It is not possible to report lower profits than they report for tax purposes. IRS forms are not used for screening purposes by the Board. We have an established form of our own, that the contractor must complete, which breaks out the business between renegotiable and nonrenegotiable. It is reconciled to his tax return.

Chairman PROXMIRE. So they cannot submit lower profits to the Board than they do to the Internal Revenue Service?

Mr. GIRARD. That is correct.

UNALLOWABLE COSTS ALLOWED BY RENEGOTIATION BOARD

Chairman PROXMIRE. In your statement you point out that in renegotiation all cost allowed under the Internal Revenue Code are allowed as cost by the Board. Doesn't this mean that the Board in its evaluation of defense profits allows the contractors costs that are unallowable on defense contracts, such as interest payments, advertising, and entertainment expenses?

Mr. GIRARD. Interest expense is not an allowable cost in procurement, as you know. But it is a cost of doing business and it is allowed in renegotiation to the extent allocable.

As for advertising, we have specific regulations which govern the allocation of advertising to renegotiable business, in accordance with congressional edict. In general, advertising is not allowed against prime contract business.

Chairman PROXMIRE. How about entertainment?

Mr. GIRARD. Entertainment is allowed if it is reasonable for the size of the company involved. If we find that it includes something of an extraordinary nature, we may disallow it.

Chairman PROXMIRE. Now, on the first element I can see a particular disproportion. If you are allowed interest payments as a matter of cost, and then you figure your return on invested capital, after all, you get an inaccurate picture. The interest payments are part of your return. That is why, as I understand it, they are generally set aside, because the return on invested capital should be computed before you figure your interest cost. Of course, also, if you are allowed to figure entertainment in, and your advertising cost in, in a sense that would also distort your profit figure and make it lower than it actually is.

Mr. GIRARD. We disallow certain advertising expense. We endeavor to allocate the capital and net worth to the extent that it is used in the renegotiable business.

Chairman PROXMIRE. If you figure your return on the net worth, it would agree. But if you figure your return on net capital, then allowing interest costs would distort it.

Mr. GIRARD. It would distort it. But whoever uses a return on capital certainly ought to know what data was used in compiling the figures.

Chairman PROXMIRE. That interest cost should not be allowed if you are going to compute a return on total capital. A part of that total capital, of course, is borrowed.

Mr. GIRARD. If that is the type of approach you want to take; yes.

GRUMMAN AND M'DONNELL DOUGLAS CASES

Chairman PROXMIRE. In two cases before the U.S. Tax Court, involving Grumman Aircraft and McDonnell Douglas, the Renegotiation Board has asked for returns on capital of 21.2 percent and 29.4 percent. Are these typical of what the Board normally allows in earnings by major aerospace contractors?

Mr. HARTWIG. We don't like the word "allow." We are not a regulatory agency. We do look at these returns to see whether or not they seem to be excessive. But we do not consider that we are in the business of bringing contractors down to a certain fixed level. In the first place, the lack of a uniform system of accounts makes it impossible for us to operate like a regulatory commission.

Chairman PROXMIRE. We try to overcome that, as you know, we have legislation that goes into that.

Mr. HARTWIG. Yes. And the other things, of course——

Chairman PROXMIRE. But if you feel you can't bring them down to the level of others, what kind of criteria do you use?

Mr. HARTWIG. We do not limit contractors to predetermined levels. This is a judgment statute, as you can understand. And when you consider the broad factors that the Board applies——

Chairman PROXMIRE. So that 21 percent and 29 percent are fairly typical for aerospace?

Mr. HARTWIG. More or less, yes.

Chairman PROXMIRE. That is a return of stockholders' equity?

Mr. HARTWIG. No, that is the return on total assets.

RETURN ON INVESTMENT

Chairman PROXMIRE. Return on assets. And I am shocked and surprised that it is that high, because I have here the 500 largest corporations, and the return on equity—which is high, of course, because you have a smaller figure you are computing it on—shows that you get a return like this: For 1969 and 1970 fiscal years and 6 percent, 2 percent, 9 percent, 17 percent, 10 percent, 12 percent, 13 percent, 10 percent, 10 percent, 4 percent, and 3 percent. And you won't find any among the top 50 which have a return of more than 17 percent, and typically it runs around 10 or 13 percent.

Now, if you allow 21 percent and 29 percent, you say it is a rough figure, a rough criteria. It would seem to me you can make a very forceful argument that these are highly excessive profits which you allow.

Mr. LENCHES. Mr. Chairman, as Mr. Hartwig said, we do not look at the figures in a cold statistical sense.

Chairman PROXMIRE. That is the best way to look at them.

Mr. LENCHES. We cannot make in a statistical sense neat and reliable comparisons. In evaluating an aerospace firm like Lockheed, or any of the others, the complications are great because of the contract mix, for instance, or because of the presence or the absence of Government capital in varying degrees. Some aerospace contractors may have Government capital in the form of fixed assets, and others may have twice or three times as much. Also, aerospace contractors get great amounts of progress payments; some use leased equipment and others don't. So, although it may be true that a 22- to 29-percent return on

total assets is what the Board might leave an aerospace contractor with, it is by no means true that such a ratio is a measure of the contractor's profits in the same sense as the Fortune 500 ratios.

Chairman PROXMIRE. It seems to me that if you are going to use the Government's plants and equipment, and so forth, then of course, that is a great advantage. And the logical comparison would be the return on whatever your own capital may be, your own total capital may be, or your own equity may be. In either case it seems to be far, far higher than the return by American industry on their overall profits.

Mr. LENCHES. Yes, sir. But may I add a conceptual remark.

In normal commercial business the profit which corporations make is the reward for all the activities they undertake. In other words, the businessman provides all the assets, and he gets paid for that. The profit is his return on capital, plus his reward for managerial activities.

Now, in defense business, all aerospace contractors use a great amount of Government fixed assets. It is my personal opinion—and I am not speaking for the Board—that it would not be fair for the Board to allow them the same rate of return, figured either on the net worth or on the total assets, as it would a corporation which does not have managerial responsibility for millions of dollars of Government assets.

Chairman PROXMIRE. I look at it the other way. It seems to me that what you are doing by taking 20 to 30 percent, you are allowing profits that are just about twice as high as the 10- to 15-percent return which is typical in commercial industry, you are allowing 20- to 30-percent return on capital. You say that is because they have the responsibility of using Government property. That is one way of looking at it. And the other way is, they have great advantage. We see documented over and over again the fact that they can use that Government property in their commercial operations with very little discipline, and the limitations are extraordinarily loose and easy. And we have had, for instance, the tool and die people in this room who testified before us and said that they are at a tremendous disadvantage because Government equipment is being used on commercial contracts to compete with them.

So this seems to me, far from being a liability, to be a great asset.

Mr. LENCHES. I misspoke if I implied it is a liability. Undoubtedly having Government assets is beneficial to contractors. What I was trying to make clear is that an aerospace corporation should get, in comparison with the Fortune 500, first, a proper rate of return for the use if its own assets; and, second, some reward for using the Government-furnished assets in a productive fashion. And I am sure that we take into consideration that the presence of these assets provided by the Government also benefits the contractor to a very great extent. But at least in my opinion, he should not be denied any reward at all for managing the assets.

Chairman PROXMIRE. It is a matter of whether or not 100 percent over the typical return is excessive or not.

My time is up.

Mr. Brown.

Representative BROWN. What you are saying in effect is that if the assets are not owned that are being used, that is, if the capital assets that are being used to do the Government work are Government owned, they are not the part of the company's assets, and therefore on a prodigious volume of business where the assets from the Government may be equivalent to half of the assets of the company, that the company should not be denied a profit on the use of those assets, is that correct?

Mr. LENCHES. That is right, sir.

Representative BROWN. Let me pursue the question a little bit further.

If this 20- to 30-percent figure is used, what is the percentage of Government-owned assets that make up a part of that base? In other words, if you included the Government-owned assets as if they were company-owned assets, then what would the percentage be? Do you have any idea?

Mr. LENCHES. It would be considerably less than the 21 or 29.

Representative BROWN. I am sure that it would be considerably less than the 21 or 29, but how does it relate to the question that the Senator raises of the top Government corporations? Is it more or less than their average, and if so, whatever it is, why?

Mr. LENCHES. Each of the two examples which Mr. Hartwig has cited was an excessive profits situation, and we left the contractor with profits that we thought were nonexcessive. If we made a pro forma recalculation of the return on total assets, including the Government assets for all the corporations that had Government assets, I don't think that the results in the excessive profits cases on the average would be too far off from the Fortune picture.

Representative BROWN. You tell me that 21 to 29 percent is not an average, though, those are exceptional cases?

Mr. LENCHES. No, they are not.

Representative BROWN. What would you say is the average throughout this study?

Mr. LENCHES. I am climbing out on a long limb, but it is my recollection from just looking at the figures, overall, year after year, of all the contractors that we see, that the average is something like the Fortune 500.

Representative BROWN. And if you fold in the Government-owned assets, what does that do to it?

Mr. LENCHES. I don't know.

Representative BROWN. Is it possible to get that information?

Mr. LENCHES. I'm afraid not, sir. Neither the Government nor the contractor has precise Government asset figures. We do get, in each case that goes to the field, as good a figure on Government assets as we can. But this is on an original-cost basis, not on a depreciated basis, which is not available.

Representative BROWN. Would you say that industrial contractors that are involved in defense industries have a higher asset base than the average of the large corporations, or lower, or what?

Mr. LENCHES. I would have to say that those corporations which are primarily in the defense business and which are making use of Government assets, by definition would have a somewhat narrower asset base; otherwise they would not be using the Government assets.

Representative BROWN. What I am trying to ask is, you don't have an awful lot of assets to practice law, you have a desk and some books, and so forth and so on. And so your profit on the basis of assets can be quite high, is that right?

Mr. LENCHES. Yes, sir.

Representative BROWN. If you are manufacturing airplanes, your profits on the basis of your assets are likely to be somewhat smaller.

Mr. LENCHES. Yes, sir. And we do renegotiate contractors who provide services, not lawyers, but architect-engineers, where the asset base is minimal, in which case neither the return on assets nor the return on net worth is very significant.

Representative BROWN. Let me get back to the area of what the criteria are for, the stand—what is the term that you used?

Mr. HARTWIG. Statutory factors, Representative Brown.

Representative BROWN. Statutory factors—in consideration of what is allowable in these contracts. Now, we have talked about the character of the business. And I assume that the character of the business relates to this question I just raised about whether you are an architect with some blueprint tables and a couple of T-squares.

Mr. HARTWIG. That is right, we ascertain whether it is a capital intensive company or not.

Representative BROWN. Whether you are a capital intensive company, and what that percentage should be.

What about the nature of the contribution? That seems to be a blue-book kind of definition; isn't it?

Mr. HARTWIG. That is a significant factor. I don't know that you can formulate objective standards to measure contribution. Generally, it is what the economist calls innovation.

Representative BROWN. The guy that was hurrying up to produce a Norden bombsight, for instance, at the beginning of the war, is that what you are talking about when you say the nature of the contribution?

Mr. HARTWIG. Something very exceptional like inventing something new.

Representative BROWN. You are talking about breakthroughs here?

Mr. HARTWIG. Yes.

Representative BROWN. Technological breakthroughs where you have to have it in order to get a military advantage?

Mr. HARTWIG. Right.

The classic example—I wasn't in World War II renegotiation—is the proximity fuse. Perhaps another way of describing it is to say that there are a lot of stars in Hollywood, but only a few get Oscars.

But even that perhaps isn't a good analogy.

Representative BROWN. I'm going to leave it alone, I will tell you that.

Risk was one of the factors. Now, what are you talking about here? What are the risks involved that are assessed? Is it the risk in total dollar investment?

Mr. HARTWIG. That is one of the risks.

Representative BROWN. Let me ask you this. Suppose somebody contracts to put together people and not machinery, in other words to bring together a lot of skills. You go out and hire a lot of MIT graduates, and you contract with them for a period of time, and start

your business on the basis of that, and whatever machinery the consideration seems to require. How is that risk taken into account, or is it?

Mr. HARTWIG. The risk——

Representative BROWN. A risk that is not a capital risk.

Mr. HARTWIG. I suppose to some extent the contractor might risk his reputation, in that they might not do a good job.

Representative BROWN. Let's stay with the example that I cited. I am talking about a risk of putting together the people that can do a job, and being obligated to them for a period of time under a contract. And now, is that risk taken into account or is the risk primarily in the capital goods area and the amount of money you invest in capital goods?

Mr. HARTWIG. That risk is taken into account. But I would say it is minimal. How great a risk does an entrepreneur have when he only assembles an organization?

Representative BROWN. I can tell you as a businessman that it is a lot easier to find the equipment than it is to find people to run it.

Mr. HARTWIG. That is true. But is that risk or some other factor?

Representative BROWN. It is a part of the investment. That is what I am asking. What is the Board's attitude about this?

Mr. HARTWIG. So far as know how or management skill is concerned, these are factors that we evaluate. If we find good management, good organization, this entitles the concern to favorable consideration under the efficiency factor, but not under the risk factor.

Representative BROWN. Let me push that question just one step further. If I am a company and I go out and bid on a military contract and I don't have the personnel that are capable of doing that job, and say, well, I will hire men after I get the contract, is that easily allowed in the military contracts or in Government contracts?

Mr. HARTWIG. That is an exceptional situation.

Representative BROWN. So you have to have the personnel to start with?

Mr. HARTWIG. You have to have the organization to start with.

EFFICIENCY

Representative BROWN. The question of capital investment we have been through, I guess, further than is productive. But what about efficiency? Does that relate to capital investment? I am not sure what you are talking about when you talk about efficiency.

Mr. HARTWIG. Efficiency—this is what the act says—"efficiency of a contractor with particular regard to attainment of quantity and quality production, reduction of costs, and economy in the use of materials, facilities, and manpower."

Representative BROWN. Can we relate that to something in terms of specifics? Suppose there are specification changes for the Federal Government. It is like building a house. That seems to me to be an obligation of the purchaser rather than the purveyor of the service. But if he is efficient in adapting to that change and holding costs down, is that part of the judgment of his efficiency?

Mr. HARTWIG. If he can hold his costs down?

May I give you a specific case to see——

Representative BROWN. I would like one, because I am not sure I understand the answer.

Mr. HARTWIG. Many years ago we had a contractor who in our judgment had made excessive profits. In the year we were looking at, the sales ratio went up and the returns on capital and net worth went up over preceding years. And his volume had increased because he had taken on a lot of Government business. He came in and argued that this increase in his profit was due to his increased efficiency.

He showed us that he had purchased a new machine which he said had made him more efficient.

He had introduced training methods so that the help were more skilled than they had been.

And he had a rather convincing story of increased efficiency in this year versus the prior year.

But, I peeked over the fence and saw that in the following year the volume went down and the profits declined to a very low level.

And so, I asked him:

How is it that you became so efficient on January 1, and so inefficient on December 31?

And he said:

Do you really want to know the truth? The truth is that we got so fat on these Government contracts we forgot how to compete.

So you have to put together a lot of factors to evaluate efficiency.

It is perfectly obvious that we don't have the staff to send out teams to make time and motion studies. We just couldn't do that. So for the most part, we have to rely upon opinion evidence, and upon such analysis of the facts as we can make.

Representative BROWN. My time is up but I will come to this.

Chairman PROXMIRE. Because we have Mr. Rule waiting—and I would like to have Mr. Rule come forward now, it is 11:30—I think we probably should wind up, Mr. Brown, if that is all right with you.

Representative BROWN. There are a couple of other questions I would like to ask.

Chairman PROXMIRE. If you ask them in a hurry, all right.

Representative BROWN. The only question I have is—because it seems to fall into the line of concerns that we are getting into here—the judgments that you make, are they related to the Internal Revenue Service regulations? In other words, the charging of interest, and advertising, and contributions, and the training of personnel, and this sort of thing? Or is there a double standard here between the Renegotiation Board and the Internal Revenue Service?

Mr. HARTWIG. We allow those costs that are good cost deductions——

Representative BROWN. You use the same degree of judgment that IRS uses?

Mr. HARTWIG (continuing). To the extent that they are allocable to renegotiable business. We have special rules of allocability that do not apply for tax purposes.

GAO PROFITS REPORT DOES NOT RELATE TO BOARD'S FIGURES

Representative BROWN. Based on one of the things that came out of the earlier stages of the hearing, the 146 contracts studied by the GAO, are those typical of defense contracts, do you think? Or were those unique in any particular way?

Mr. LENCHES. Mr. Brown, we have studied the GAO report. But we cannot relate it to our figures since the GAO studied 146 contracts as such. But since they are a part of the cases we have, obviously they are a part of our picture.

Representative BROWN. You said the cases you have. You are talking about the 4,800?

Mr. LENCHES. Yes. The 146 contracts were held by defense contractors, who had to file with us. But we have no way of comparing their records or any other contractor records compiled on a contract by contract basis because we just don't work that way. We do not prepare statistics on a contract-by-contract basis.

Representative BROWN. I would like to get a little more elaborate explanation of this than what you gave.

Chairman PROXMIRE. Will you give that to us for the record? We would appreciate it.

(The following information was subsequently supplied for the record:)

In fiscal 1970, 4,853 filings were screened by the Board. These filings represented, after consolidations, 3,590 cases.

Of the 3,590 cases, 603 were assigned to the regional boards for full-scale renegotiation. Such assignments are made if the contractors' filings show a possibility of excessive profits, or indicate the presence of accounting, legal or other technical problems that can best be resolved in the field. An in-depth, time-consuming review of such filings at Headquarters prior to assignment would be a duplication of the subsequent field effort and would not be warranted.

Of the cases not assigned to the field, 830 showed an outright loss on renegotiable business and an additional group of 115 showed a loss after loss carryforward from previous years. In such cases a detailed study is usually not warranted because the possibility of finding excessive profits is extremely remote. With many such contractors the Board will have had prior experience, often involving repeated in-depth evaluation.

Essentially the same reasoning applies to cases where contractors report minimal profits. In fiscal 1970, 134 contractors had a sales margin of 1 percent or less, and 154, a margin between 1 and 2 percent (including cases involving loss carryforwards).

The filings of contractors who are wholly or almost wholly renegotiable require much less analytical work than filings of contractors with sizeable commercial business. In fiscal 1970, of the cases not included in the groups already cited, 311 were cases in which the sales were renegotiable to the extent of 95 percent or more.

Although the statutory floor is $1 million, the Board receives a great number of filings below that amount because of the common control provisions of the Act. When these filings show very small amounts or renegotiable sales, their processing requires relative little time. Of the cases not included in any of the above groups, 346 had renegotiable sales of $250,000 or less in fiscal 1970.

Accounting problems in renegotiation relate principally to the allocation of costs. When the nature of the contractor's business is such that the sales ratio method of allocation is properly employed, the processing of the case is greatly facilitated. In fiscal 1970, this method was used in 193 of the cases not included in the above groups.

The cases in the various categories discussed above were of such nature that extensive, time-consuming accounting analysis and verification were, as a rule, not necessary or practical. On the other hand, the remaining 904 cases screened in fiscal 1970 usually required fuller development. It was on this group of cases that accounting personnel engaged in the screening process spent the greatest amount of their time and effort.

The overwhelming majority of contractors whose cases were screened in 1970 had filed with the Board for earlier years. Therefore, all material previously submitted with respect to their business and cost systems was available for use in processing the cases. Problems arising in the study of the cases were resolved by communication with the contractors involved.

Chairman PROXMIRE. I would like to get together with you, Mr. Hartwig, on working out an amendment so that we can have full disclosure of profits.

And we would also like a study, if you can give it to us, of your assertion, Mr. Lenches, that the returns that you usually allow, and beyond which you consider the returns excessive, are substantially below 20 percent to 30 percent, I would like to see any study you have indicating what you do allow.

(The following information was subsequently supplied for the record):

The Board does not have a study embodying the information requested. However, we have examined our records with regard to nine major aerospace contractors and have ascertained that such companies, for their 1968 and 1969 fiscal years, now in process, reported the following returns on capital (total assets) allocated to renegotiable business as follows:

Contractor	Fiscal year	Percent on renegotiable capital
1	1968	(1)
	1969	(1)
2	1968	7.0
	1969	.9
3	1968	(1)
	1969	(1)
4	1968	8.4
	1969	.8
5	1968	9.6
	1969	8.3
6	1968	7.7
	1969	6.5
7	1968	13.8
	1969	10.0
8	1968	24.0
	1969	18.4
9	1968	9.1
	1969	10.5

[1] Loss.

Chairman PROXMIRE. Thank you very much, gentlemen.

Our next witness is Mr. Gordon Rule. We are very honored and happy to have him.

And as Mr. Rule comes forward, I will say that he has been awarded within the last couple of months the Navy Distinguished Civil Service Award, which is the highest award that any civilian can receive from the Navy. I would like to read very briefly from the award, because I think it is a tribute to a man who has served his country very well. It says:

Mr. Rule has consistently demonstrated extraordinary acumen, judgment, initiative, and integrity in developing significant advances in the field of defense procurement. He has personally handled with extreme professional skill the most complex and significant procurement problems of the Navy.

There is much more.

And I would also like to read just two short paragraphs of what Mr. Rule said when he received the award. He said:

I suggest that if we in the Navy Procurement would like to leave any monument to Jim Bannerman it could be a dedication to being candid in our business. Today, too many people in the Navy are salesmen trying to sell a project and rarely, if at all does anyone play the role of Devil's advocate.

Let me point out however, that this candid exercise is a two-sided coin. For example, it will do little good for me to be candid with my superiors if they are unreceptive to candor. What is needed is candor on both sides—the giver and the receiver—and I urge that we all take part in this effort of being completely candid with each other at all levels and reverse the unhealthy trend that exists today in our dealings.

I have found you to be a very candid witness, Mr. Rule, and I know this will be no exception.

I understand you have no prepared statement. You may proceed in any way you wish.

STATEMENT OF HON. GORDON W. RULE, CHAIRMAN, CONTRACT CLAIMS CONTROL AND SURVEILLANCE GROUP, NAVAL MATERIEL COMMAND HEADQUARTERS

Mr. RULE. Thank you very much, Senator Proxmire, for inviting me up here.

Good morning, Mr. Brown.

Thank you for reading that citation. Needless to say, for all the things I have said about the boys in blue, I was a little surprised to get it. But I was very happy, because I could have been sitting over there with Ernie Fitzgerald, if it wasn't for that.

Chairman PROXMIRE. We would be happy to have you join them at any time, Gordon.

Mr. RULE. But I do think it shows the Navy is a little more enlightened than the Air Force.

Senator, you asked that I come up specifically to talk about claims, shipbuilding claims.

AMOUNT OF SHIPBUILDERS' CLAIMS PENDING

First, on statistics, you were just about 100 percent accurate when you said that there are dollarwise as many claims pending today as there were in November and December of 1969 when I was up here before. Claims in hand, and that we know are coming in amount to $790 million today. And it was $795 million when I was up in December 1969.

To get the overall picture in the Navy you add another $130 million to that for claims other than ship claims. And I am speaking now about claims of $5 million. So that would give you the magnitude.

Those figures also show one other thing, I think, Senator. It is obvious that we haven't settled many claims in the year and a half since I testified. So that no one can say that we have rushed this claim settlement business. On the contrary, we are going very slowly, much more slowly than we thought we would.

But I want to point out that we have not rushed claims through. This is for a lot of reasons. We are having a lot of problems with them. But I can assure you, and I can assure the GAO and Admiral Rickover and anybody else who is interested, that your fears are not well founded that we are not kicking these claims around or bargaining them or settling them on a percentage basis, because if we are doing that, the figures would be a little different than they actually are today.

Now, I will admit to you that there are people in the Navy that are handling these claims that would settle them just about the way you fear they are being settled. But those people are not getting their way. They have tried it. But all of these claims over $5 million have to go through this group that Admiral Galantin, the Chief of Naval Mate-

rials, set up, this Special Claims Review Group. And they haven't gone through there, and they are not going to go through this group, until or unless, as you and Admiral Rickover and the GAO have said, every dollar is factually supportable and legal entitlement is found. I promised you that a year and a half ago. And, Senator, I have not gone back on that promise. And we are going to get claims that are going to have in them this element that you fear so much. But these claims are going to really have rough sledding. We are going to get them pretty soon, now. You are going to get, in answer to your May 12 letter to Mr. Chafee, some information along this line, along the line of claims that have been negotiated, for example, without a fully structured legal memorandum of entitlement, which should never have been done. But those claims have not gone up to my group yet. And they won't get through unless they are 100 percent legally entitled and factually supportable.

So I do suggest that the picture is not bad, despite the fact that there are these people around who would settle them just exactly the way you fear they are going to be settled—were going to be settled.

CLAIM-FREE CLAUSE

I would like to say that in the area of what we have done about trying to preclude claims—I would like to call your attention to the fact that in the nuclear area Admiral Rickover's group came up with what appears to be a good innovation, going to the point of late delivery of Government-furnished material, which is, as you know, always a big element in these claims. Admiral Rickover's people came up with what we call a claim-free clause. If the ship delivery date, for example, is December of this year, and there is doubt that nuclear components will get to the shipyard in time to meet that delivery date, we have asked contractors in the nuclear area to give us their estimate of a claim-free period, for example, 6 months or a year, if our Government-furnished material is late, how much it will cost us, and then they won't have a claim. It has been tried in two or three cases. It is a little too early to tell how it is going to work out. But it is a step in the right direction, and I think that Admiral Rickover's people are to be commended for coming up with this idea.

LAWYERS TEND TO BE BY-PASSED

The reason we haven't settled claims, Senator, and the reason we still have such a backlog, is because of in-house problems that we have. And these in-house problems relate largely to the role of the contracting officer in the settlement of claims, the role of the lawyers in the settlement of claims, and to be sure, the role of the commander himself of the Naval Ship Systems Command in the settling of claims.

There has been a lot of pulling and tugging back and forth on these various roles. And as you know, in procurement the contracting officer is the man who makes the decisions. The lawyers have very little to do with pricing of a normal procurement. However, when we get into the claim areas there has been a failure to recognize the fact that in claims when you mention a claim against the Government, the first thing you ought to think of is a lawyer. And this has

not been so. They have tended to bypass the lawyers. And it has caught up with them. There are two cases now where the negotiated agreement was made with the contractors, in December 1970, and one in January 1971. And those cases haven't come to us yet, because although they have been negotiated now comes the job of substantiating what they negotiated. And that is just exactly the wrong way to do it.

You ought to have, as Admiral Rickover, says, the legal entitlement clearly spelled out, the audit report clearly spelled out, and the technical report on which to base the amount of the negotiated settlement. It has been done exactly as you say, the wrong way.

COMMANDER SHOULD NOT NEGOTIATE SETTLEMENT

Added to that, I must say that in my opinion, it has been wrong in the last year for the commander of the Naval Ship Systems Command to personally inject himself into and negotiate these settlements himself. I think he should stay out of them.

The other systems commanders, they stay out of these claim matters and let the people who are knowledgeable of all the facts get in and do the negotiating.

He should hold himself in a position of appeal, if you please, with the Systems Command, rather than negotiating these things himself.

One of our recommendations at the conclusion is going to be that in the future the systems commanders stay out of these things.

But he wanted in the shipbuilding claims, the Commander felt that he wanted to get them settled speedily. So he charged ahead and made a couple of negotiated settlements. Now he is having a hard time justifying them. I think this is wrong.

I think that is an up-to-date report, sir, on where we stand. We've had problems. But those problems have not meant that the Navy has settled any claims improperly, because they just haven't been settled, as you can see, from those figures. And they are not going to be settled improperly.

LEGAL MEMORANDUM OF ENTITLEMENT NOT PROVIDED

Chairman PROXMIRE. I am very reassured to hear that. In view of your well-deserved reputation, it seems that you do have your finger firmly in the dike. But isn't it true that the Naval Ship Systems Command, the one headed by Admiral Sonenshein, which is responsible for negotiating the settlement of shipbuilding claims, has refused to furnish your office a legal memorandum of entitlement on at least two major claims, although both claims have been negotiated months ago? Doesn't this mean that the Naval Ship Systems Command is agreeing with the contractors on the amount of the settlements before obtaining legal analyses of the claims?

Mr. RULE. Well, in the two cases you mentioned, Senator, Admiral Sonenshein has not refused to give his legal memorandum of entitlement, he just didn't have it to give us. That is what we are waiting for. If he had it, I am sure he would give it to us but the point is, after 5 and 6 months of having arrived at the negotiated figure, he doesn't have a memorandum of legal entitlement.

Chairman PROXMIRE. How can you arrive at a figure without having legal analysis to support it?

Mr. RULE. That would be a very good question to call him up and ask him, wouldn't it?

Chairman PROXMIRE. I appreciate the proposal.

Mr. RULE. I would be interested in the answer to that too.

Chairman PROXMIRE. I take it that the implication, of course, of your response, is that you shouldn't negotiate a figure until the legal support for it is obtained in this case specifically.

Mr. RULE. Let me underscore what I said before. When you talk about claims against the Navy and against the Government, the first person you ought to think of is the lawyer. It is a lawyer's role in these claims to make a determination of entitlement. And until or unless he does, nobody should come up with a figure for negotiation, and certainly no negotiation should take place. To the extent that a negotiation in these two cases has taken place without a memorandum of legal entitlement, it is just backwards.

LITTON CLAIM

Chairman PROXMIRE. The Ingalls Shipbuilding Division of Litton Industries is one of the Navy's principal shipbuilders. Ingalls has the DD–963 program, the LHA, and other shipbuilding work. According to my information, Ingalls just submitted a $94 million claim. What is the basis of that claim, and for what program was it filed?

Mr. RULE. That $94 million claim that came in, came in technically from the Ingalls Shipyard, which was bought by Litton. It came in for a variety of ships that Ingalls has been building or has built. It is a subsidiary of the Litton yard. But the claim came in on older contracts, a variety of them, submarines and others. It just came in this month.

Chairman PROXMIRE. Is that the first claim Ingalls has submitted? Have they been in the claims act before?

Mr. RULE. I don't remember any.

I would certainly guess that they have submitted them before. And I understand one is coming in from Litton, we have been advised, not on the 963, but on the LHA.

Chairman PROXMIRE. On the LHA?

Mr. RULE. Yes.

Chairman PROXMIRE. What is the amount?

Mr. RULE. I don't know. I am trying to find out the amount and the basis for it.

Chairman PROXMIRE. Will you tell us when you get it?

Mr. RULE. Yes, sir.

EFFECTS OF CONGLOMERATE TAKEOVERS

Chairman PROXMIRE. I understand that Puget Sound Bridge and Drydock Co., a division of Lockheed and Ingalls Shipbuilding Division of Litton Industries, two shipbuilders that have been taken over by conglomerates that are heavily involved in aerospace, have large outstanding claims. The aerospace firms have coincidently, come upon harder times financially. Do you believe that current financial difficul-

ties of these firms under the basic attitude that has come to characterize the whole aerospace industry have contributed to the claims problem?

Mr. RULE. Senator, if I understood your question correctly, I think the answer is yes. I think that there has been this very definite tendency, as Admiral Rickover pointed out, these conglomerates have taken over our shipyards. I don't know of any of any size that are any longer family owned shipyards. We didn't used to have as many problems when they were. But as they have been taken over by capable and efficient, relatively efficient conglomerates, it is a whole new ball game. These people are looking for how they can make every dollar. And it bothers me——

Chairman PROXMIRE. Like Lockheed.

Mr. RULE. All of them. Lockheed took over Puget Sound bridge drydock. And they have this big claim in. They have had nine Navy contracts, and they lost money on every one. And they put the claim in. And as I think I mentioned previously, the claim that they put in was exactly the difference between the bid on everyone of these nine contracts and how much it was going to cost them to complete the contract, which was approximately $180 million.

EQUITABLE ADJUSTMENTS

Chairman PROXMIRE. I understand the Navy is currently facing requests for large adjustments on certain shipbuilding contracts. Although these adjustments are essentially the same as claims, they are being handled as procurements and are not reported in lists of outstanding claims. Do you know of any specific cases where this has happened?

Mr. RULE. Yes, Senator. But there is a difference—and this is hard to get—between a claim and equitable adjustment under the contract clause. In other words, there is a change clause in the contract. And if a lot of these things that develop in the claims were handled as they could be handled under that changes article, and equitable adjustment would be negotiated under that clause of the contract, the contract price would be increased or decreased, and the delivery schedule of the ship would be slipped.

Now, these are things that can be done under the contract. If they are done under that contract they still have to come into my shop for review.

Chairman PROXMIRE. So this wouldn't be a way of evading the claims procedure and the legality of the various requirements under claims?

Mr. RULE. No, sir.

Chairman PROXMIRE. It would be improper and inefficient?

Mr. RULE. As a matter of fact, we have two of those, one involving National Steel and the other involving Electric Boat. And these, when handled that way, get handled primarily by the supervisor of shipbuilding right on the spot. And he is the one that should know most about the claims. This is one of the hassles I have right now, because when they are not handled that way, they are handled here in Washington as claims by a special group set up to handle claims and when I asked them in writing, what does the supervisor of shipbuilding out in the field think of that claim, they won't get me that information. And it is my opinion that that is pretty fundamental.

LOCKHEED BAILOUT

Chairman PROXMIRE. I want to come back to this claims issue in a minute.

But first I would like to ask you to respond to the question of the proposed Government bailout of the Lockheed Corp. You are a very high ranking procurement official, and you have had great experience, and have demonstrated competence that I just pointed out has been recognized. I wonder whether you could give us your views as a procurement official on the proposed Lockheed bailout.

Mr. RULE. I think it is most unwise. I think from a procurement point of view it is most unwise. And I can tell you that there are other companies standing in line right now, and if we do this for Lockheed, we will have set a precedent that I don't think we will ever live down.

And I think if these people—of course, the L–1011 is not a defense procurement and, it is not a piece of military hardware that we want, and I think it is one that the country could very well get along without. We don't need that plane. But to the extent that they are doing military hardware for us, I say that if they are overextended, if their management has been so lousy that they are in the position they are today, let them go into bankruptcy. We will get our Poseidon missile, we will get the hardware out of there if they are in bankruptcy just the same as the railroads are running and they are in bankruptcy. And I don't see why in the world we would take that action, except for the fact that they are from California.

Chairman PROXMIRE. You say it is unwise. I think it is too. I think you have given some substantial reasons for it.

But from the standpoint of procurement, what would be the adverse effects, if any—you implied, or I thought you implied, that this might have a direct adverse effect on your procurement operations.

Mr. RULE. Normally some of our procurement is sole source, and obviously we are not going to get competition for the Poseidon missile. But to the extent that a contractor gets his contracts, his defense contracts competitively, and is able to outbid his competitors, and then for the Government to step in and bail him out when he gets in trouble, I just don't think is right, and it does a great violence, in my opinion, to our whole competitive procurement system.

Chairman PROXMIRE. My time is up.

Mr. Brown.

RELATION OF CLAIMS TO RENEGOTIATION BOARD

Representative BROWN. Mr. Rule, how does your operation relate to that of the Renegotiation Board?

Can you put it in a procedural light for me or a sequential light?

Mr. RULE. That is a very interesting question.

I was very interested to sit here and listen to those gentlemen from the Board.

Mr. Brown, I wear two hats. I happen to be the chairman of this group that is listed here, the chairman of the Contract Claims Control and Surveillance Group. That is a special group set up to review these claims over $5 million.

My other hat, I am head of the Contract Control Division and Clearance Division in the Naval Material Headquarters. The function of that group is to view every contract over a certain amount before the contract can be awarded. We pass on the business aspects of every contract before it is awarded.

Representative BROWN. So you sit on both sides of the contract, is that right?

Mr. RULE. I am not with you.

Representative BROWN. You sit on both sides of the contract, in other words, you review the contract before it is awarded, and then you review the claim on the contract?

Mr. RULE. Yes, if it is a claim. We have to review the claim, sir.

I must point out that if this group, this Claims Contract Group wasn't set up at all—but it is, and it has some high-powered people on it that don't work for me normally—if that group wasn't set up, these claims, because of being over $5 million, would come to me in a review capacity anyhow. It is an adjustment. It really is an adjustment under the contract, you see. And having approved the awarding of the contract in the first place, any subsequent adjustment to that contract by way of modification or add on to it, or a claim under it, has to come back for review also before it can be consummated.

Representative BROWN. Assume a claim is allowed. Then the contractor, I gather, goes to Renegotiation Board as matter of course, does it not?

Mr. RULE. Well, all of that contractor's renegotiable business for that year, including an adjustment, will go.

Representative BROWN. If there is a contract, it is renegotiable business, isn't it?

Mr. RULE. Yes; if it is over the million clause; yes.

Representative BROWN. So, most of the contracts, sizable contracts over which you have control, would go to the Renegotiation Board?

Mr. RULE. The answer is, yes; they would go.

Representative BROWN. Does the Renegotiation Board ever mark down any of these contracts.

Mr. RULE. The contract itself?

Representative BROWN. Any of those companies with which you have contracted.

Mr. RULE. I am sure they have.

Representative BROWN. Because they don't have individual contract reviews, as you have testified; they do have an annual review based on the company's profit from military work?

Mr. RULE. They will look at that contract, all of his contracts, all of his renegotiable business, and they will see it—I don't think they look at a claim per se; they will just look in the broad general way in which they described this morning, they will look at all his business.

Representative BROWN. Are you set up in a statutory sense in the same way they are?

Mr. RULE. No, sir.

Representative BROWN. Do you have some of the guidelines to the way the Renegotiation Board looks at a contract?

Mr. RULE. This function of reviewing contracts before they are awarded is peculiar to the Navy. It is a function that was set up by Secretary Forrestal when he first came down here to be Navy Secre-

tary. After he was here a short while he realized two shortcomings in our process. First, he set up the Office of General Counsel, and had civilian lawyers set up as a group. Prior to that time there was just the Navy Judge Advocate General's office, and they were all military.

Mr. Forrestal wanted a civilian lawyer group to advise him on contractual and business matters. So he had Struve Hensel down from New York, who was the first general counsel.

In addition, he set up this function that I now head. It was then called the Contract Clearance Branch outside of any other then bureaus which are now called systems commands. It was set up in the Chief of Naval Material's office to give this objective review of the business aspects of these contracts before they are awarded. So it does not have statutory origin, but it does go back to Mr. Forrestal's days.

Representative BROWN. Did you come into the picture at that time?

Mr. RULE. No; I was in uniform in the Navy then.

Representative BROWN. Not an admiral, I guess.

Mr. RULE. No; I never could make it. But I got to be a captain.

Representative BROWN. In the buying of carryover claims by consolidation, by the conglomerate purchase of companies, does this function the same way that a company might buy up another company with some kind of a carryover tax loss? Is that what we are talking about here?

Mr. RULE. I can't answer that. But it certainly sounded like it this morning, the way I heard it described.

Representative BROWN. You mentioned though, that several of the private shipbuilding companies had been acquired by conglomerates. Would the company with a claim under the responsibility that you have exercised be more likely to be purchased than another company?

Is this a matter of dealing with dollars that we are talking about here?

Mr. RULE. In the light of what you are asking, I don't think so. All of these companies that have claims are going concerns.

Representative BROWN. I understand that.

Mr. RULE. They are not on the brink of bankruptcy or anything like that.

Representative BROWN. Unless the claim has been hanging around for a long time, then I suppose they might be.

STATUTE OF LIMITATIONS PROPOSED

Mr. RULE. I want to make one point, Mr. Brown. Because one of my recommendations, when I get to that point, is that I would like somehow to have a statute of limitations set on when these claims under shipbuilding contracts can be filed, because we see them now coming in on very old contracts: back in 1964 and 1965. I would like to see a reasonable statute of limitations set, for example, and I don't know whether this is reasonable, but if we said, if you are going to have a claim under this contract, you have to file it within 1 year after the last ship was delivered. I don't think that would be unreasonable.

Representative BROWN. I notice, for instance, in the list of renegotiations pending before the U.S. Tax Court as of May 1, 1971, that there are some cases, for instance, that go clear back to 1953, which is sort of the other side of that question, isn't it? In other words, you

wouldn't want anybody to make a claim that is too old. But it occurs to me that if justice is supposed to be swift and sure, it is apparently swift and sure in a very slow way in some of these areas. You mentioned to Senator Proxmire in your opening remarks about the amount of these renegotiation claims—I shouldn't call them renegotiation claims. What is the title of the claims?

Mr. RULE. Shipbuilding claims.

Representative BROWN. Shipbuilding claims. That $750 million is all in shipbuilding claims.

Mr. RULE. $790 million. That is the face value of the claims.

Representative BROWN. Those take time, I gather.

Mr. RULE. Yes, sir; they do take time. And I think they should take time. We ought not to drag our feet. But it does take time to reconstruct and dig out all the facts and find out what happened and review them.

Representative BROWN. For you or for the company?

Mr. RULE. For the company.

Representative BROWN. Does it take any more or less time for the company to dig out these facts?

Mr. RULE. Well, most of those companies today are hiring lawyer firms that are knowledgeable and pretty astute in formulating and writing up these claims. They are also hiring the best accounting firms in this country. And they put together just massive volumes of data. And they do a professional job. It reads well. And it takes time to get into that and weed it out, sort it out, and digest it. And I wouldn't be surprised at all if we come back here and talk about Government waste, inefficiency, 10 years from now. Some of these same cases may be before the Board or in some court.

Representative BROWN. What you are suggesting, I guess, in a way is that it seems to be a game, the Government on one side and the contractor on the other side, the contractor hiring a good lawyer and a good accountant to prepare a claim and then the Government taking the time to handle that claim in one form or another. Is that the way it works?

Mr. RULE. Yes; that is the way it works. And it is a pretty deadly program, too.

Now, these two cases that I said were settled that were gotten up by the supervisor of shipbuilding, they did not hire a law firm and they did not hire an outside accounting firm. The supervisor and the company put the claim together, because they after all knew the most about it. And I thought that is the proper way to do it. We have a claim pending now where they tell us right in the claim that the cost of getting up the claim is $1.5 million. It is an interesting question whether that amount or any amount for preparation for the claim should be allowed.

Representative BROWN. I suppose on the other area that Erie Forge & Steel Co., for instance, which is a claim going back to April 30, 1953, which is about 18 years from May 1, 1971, and what is involved here is a Board determination of $400,000—I wonder how much has been spent in legal fees, and so forth, defending the Erie Forge & Steel Co. against the Board claim of $400,000. And I wonder conversely what has been spent by a company putting together a claim, by the Federal Government trying to disprove that claim in this process

where it costs the company $1.5 million to work up a claim on a Navy contract.

Mr. RULE. I don't know whether you are a lawyer or not.

Representative BROWN. No, sir. I came clean to this business.

Mr. RULE. Did you really?

Well, then, maybe I will tell you something you don't know.

Representative BROWN. I wasn't a Navy captain, either, sir.

Mr. RULE. Well, there are a lot of lawyers that if they get hold of one of these things from 1953, they won't let go of it. They get paid on a time-spent basis.

Representative BROWN. Let's go back to the buying of the claims, then. Are we seeing here a dealing in these claims by companies? And to what extent is the Government implicated, if it is, by the very process that we are working here today?

Mr. RULE. Well, as Admiral Rickover has said—I hope you don't mind me quoting him, since you quote him so much yourself, so I will follow in your footsteps—as Admiral Rickover has said, and quite properly, if somebody sets out to find something wrong in a Government drawing or a Government specification, with a view toward filing a claim, there just isn't a contract, I guess, that that couldn't take place in.

Representative BROWN. Would you say the same thing of the Renegotiation Board with reference to a profit figure here? I am just asking a question. We seem to have two sides of the same issue here.

Mr. RULE. I hear you, but I don't get the significance.

Representative BROWN. My question is, could the Renegotiation Board, in looking at a contract that they think the company has made more money on than they should have, essentially do the same thing? In other words, could a Government accountant or Government lawyer go in and find the same problem in a Renegotiation Board case?

You are talking about a company finding cause for a claim in a Federal contract, in a Government contract.

Mr. RULE. That is right.

Representative BROWN. I am talking about the Government finding cause for a claim against the company in an after-the-fact profit situation. I am just asking , who is playing which sides in this game, and who comes out in which way?

Mr. RULE. I understand what you are talking about, Mr. Brown, but I don't know how to answer it. Because it seems to me, from listening to Mr. Hartwig and his associates, that they have pretty broad, general powers. They have some criteria, and then they have got an awful lot of room to move around within those criteria. It may be like the Navy Contract Adjustment Board, of which I am a member. This is the Board that administers what used to be the Wars Powers Act to grant unusual relief. We purposely don't have any set rules of how we operate. We want the flexibility of complete judgmental effort. I suppose in these contracts you can find almost anything you are looking for if you have an object in mind. I am sure that if they wanted to really get down to the nitty-gritty, sure, they could find things. But I don't think they do it, and I am not sure they should.

Representative BROWN. My time is up.

ROLE OF WASHINGTON CLAIMS LAWYERS

Chairman PROXMIRE. As you say, I would like to quote Admiral Rickover. Let me quote him once more to you and refresh your recollection. Admiral Rickover testified before this committee as follows:

> Part of the increase in claims activity over the past few years may be due to Washington claims lawyers. These law firms probably get a fee based on how much they can get from the Government. One prominent Washington attorney, who served most of the 1950's as General Counsel to one of the military departments, today handles claims against the Government for several large defense contractors. Another leader in the claims business was formerly the Chairman of the Armed Services Board of Contract Appeals. After occupying key jobs in the Defense Department, these men are well prepared to prosecute claims against the Government—working across the table from their former colleagues and employees.

Would you comment on the Admiral's statement?

Mr. RULE. It is an accurate statement.

Chairman PROXMIRE. Do you think, Mr. Rule, that we should prohibit that by law? We do have laws limiting the activity of procurement officials, military officials, in working for the defense contractor with whom they dealt when they were procurement officials.

Mr. RULE. Well, there still is a prohibition against a lawyer or anyone else partaking in a claim against the Government if it is a matter that the lawyer himself had anything to do with when he was with the Government. I remember when I opened my law office I was happy one day when a man walked in and asked me if I would represent him in a matter against the Government on a shipbuilding contract.

And I said, "May I see the contract?"

And my name was on it. I had signed it.

So I had to thank him and send him somewhere else.

You just can't do that. But there is no other prohibition.

Chairman PROXMIRE. Do you think there should be?

Is there anything we can do about it? For instance, a 2-year prohibition on any activity in this kind of a capacity after having served in the Government in a capacity such as these men did?

Mr. RULE. I don't really think so. It is a debatable point. But people who are looking for lawyers are going to look for the best lawyers they can find to handle their particular case. And I think it is perfectly natural that if a man thinks he has a claim and he wants to get a lawyer, for him to inquire around as to who is the best lawyer or who are the best lawyers handling Government claims.

Chairman PROXMIRE. I have no objection to that. What I am talking about, though, is that those who have the best contact or the best associations, who formerly were in the department and therefore have a personal relationship that might enable that claim to be resolved not on its merit. In other words, what I am getting at is, I would gather from Admiral Rickover's statement that you have a situation where these claims might be resolved on the basis of personal relationships, personal friendships, and an unhealthy, unwholesome and unethical kind of a situation that undoubtedly is legal, but maybe we ought to get at it with law.

Mr. RULE. I think the chances, Senator, of a claim being settled on the basis of somebody being very buddy-buddy with Trowbridge vom Bauer I think are very remote. I think the chances are much greater in the area of former Navy officers, admirals and generals, going to work for companies, whose classmates are still in the Government and in high places. That is a far greater area that bothers me more than vom Bauer. I don't think they are going to get that. I would be surprised if they did.

RESTRUCTURING CONTRACTS

Chairman PROXMIRE. We have long been concerned, Mr. Rule, about the tendency of the Department of Defense to inflate contractor prices by poorly justified contract change orders and claims. More recently, we have heard a great deal about restructuring of contracts. In some instances, the old contract is simply torn up and a new one written so as to make things more comfortable for the contractor. Could you comment on this practice, particularly as it affects the motivation of contractors. If they know they will be bailed out if they get in serious trouble, why should they extend themselves to meet the contract terms? The C–5A and the Cheyenne helicopter are two outstanding examples of restructuring. How can we ever hope to enforce tough contracts in the future after we do this?

Mr. RULE. Well, I don't think we do that in the Navy. I really don't.

I sat in a meeting with an admiral once who was just about to do that. He made a statement, the company had come in and was crying about losing money, and he said, "I am going to reform the contract"

And I said in front of the whole group, "Over my dead body, you will reform that contract."

Chairman PROXMIRE. That is exactly the kind of response that is the most helpful because it indicates that if the Navy doesn't do it, why in the world should the Air Force have to do it.

Mr. RULE. This admiral would have done it just like that, he would have done it that afternoon. So I say, there are problems in-house but I really did say, "Over my dead body you will reform that contract."

You asked me about this $94 million that had come in.

Chairman PROXMIRE. Right.

Mr. RULE. I do know that in there there is a proposal, a claim, for three submarines down there that came into me some months ago on the theory of reforming the contract. It was a fixed price incentive contract with the incentive in it, and they wanted to reform the entire contract to bail this man out. We sent it back and rejected it. And now it is coming in as a claim. Those ought to come in as a claim distinguished from reforming the contract.

Chairman PROXMIRE. Would you be opposed to restructuring the F–14? That is the gravy train that Grumman is complaining about and they would undoubtedly like to have restructured. Would you oppose that?

Mr. RULE. I would oppose restructuring any contract. Of course, there is such a thing now as being able to change a clause or change something for consideration, if there is adequate consideration, which I would have to see and judge whether it was adequate or not. You can

do a lot of things if you have consideration. But to restructure something for no consideration, absolutely not.

Chairman PROXMIRE. How would you distinguish—Congressman Brown suggested very properly—between the two, between restructuring and restructuring for a consideration?

Representative BROWN. Restructuring and just putting in a claim for a change.

Chairman PROXMIRE. Or negotiating for a change. You would agree on a change. Changes, of course, are essential. You make them all the time, and often they are abused in some areas, as you know, but the fundamental principle is right. But I take it that restructuring the entire contract because the contractor is not doing well, you think as a matter of principle is wrong, and you say that the Navy as a principle does not do it.

Mr. RULE. That is right, sir. I might point out that there are a lot of things we can do to adjust a contract. If we have been late with Government-furnished material, or if we have withheld Government-furnished information, and it has caused the contractor loss, we can adjust under the changes article and have an equitable adjustment for our having done that. And that might extend the delivery date of the ship. But what has led to these claims is, we haven't done that, we haven't taken advantage of the contract clauses, which we should have.

SHOULD-COST APPROACH

Chairman PROXMIRE. As you know, we have a long-standing interest in the should-cost approach to contract pricing. However, in the light of the trend toward "restructuring" and other forms of nonenforcement of contracts, does should-cost make sense? If the DOD is not determined to enforce the prices they negotiate, why spend resources on should-cost, or for that matter, on any other kind of contract pricing and factfinding?

Mr. RULE. I don't know——

Chairman PROXMIRE. You have answered a part of that by saying that you shouldn't just restructure. Of course, if you follow your principles, should-cost may make sense. If you are going to work out a should-cost contract, and then insist on it, knowing the fact, I take it you wouldn't have the problem we raise here. If you don't, on the other hand, should-cost can be frustrating.

Mr. RULE. If you have made a should-cost, you ought to stick with it. You mentioned the F–14. I know that the Navy has stressed what is going wrong up there. I am not privy to what they have found. But I will say this, that Grumman obtained that contract in a competitive climate. And they are big boys, and they knew what they were doing. And this is one of the areas that I think falls right in line back of Lockheed. If we start bailing Lockheed out, Grumman is going to be standing right in the wings, and I think it is time we held some of these people to some of these contracts. And if they lose money, it is just too bad.

Chairman PROXMIRE. In an earlier appearance, you gave this subcommittee an excellent insight into the TF–30 jet engine should-cost project. Can you bring us up to date on this project? Have the commitments to improvement been kept? Have we really saved any money on it?

Mr. RULE. A tough question to answer, Senator. Because after we conducted that should-cost and after we reset those prices so much lower, then came along a series of cutbacks into the whole airframe program, cancellations of engines, stretchout of engines 2 years in the future, and the whole thing got pretty crossed up. We had a team recently up at Pratt & Whitney to see how they are doing.

In addition to that, Mr. Gwinn, the chairman of the board of United Aircraft, made a talk not long ago before IAC on their side of the Pratt & Whitney should-cost. And he said that they have become more efficient. And from our local representatives up there, and this group that went up, it is our opinion that they are more efficient. But it is hard now, in view of the jumping around of the engine requirements, to say just exactly where the dollar savings figure is today.

SUMMARY OF TF–30 CONTRACT PRICES AND UNIT ENGINE PRICES

Chairman PROXMIRE. Would you give us a summary of TF–30 contract prices and unit engine prices over the period affected by the various should-cost studies? We would like to have the figures for each major proposal by the contractor and we would also like to have the findings of each of the should-cost studies, results of negotiations, and currently projected prices. If you would give us that for the record, we would appreciate it. My time is up. I have just one more question, and I will yield to Mr. Brown.

(The following information was subsequently supplied for the record:)

DEPARTMENT OF THE NAVY,
HEADQUARTERS NAVAL MATERIAL COMMAND,
Washington, D.C., December 23, 1971.

Mr. RICHARD F. KAUFMAN,
Joint Economic Committee,
New Senate Office Building, Washington, D.C.

DICK: The attached is the information that you requested with respect to the TF30 series of engines which the Special Negotiating Team (Should Cost) negotiated with Pratt and Whitney, which information you reminded me was requested by Senator Proxmire.

GORDON W. RULE,
Director, Procurement Control and Clearance Division.

Attachment.

The Letter Contract which the "Should Cost" Team was to definitize was for the procurement of 2,053 TF30 Series engines, with Deliveries over four calendar years (1967–70 inclusive).

	TF30 model	Letter contract ceiling	Negotiated target prices	Negotiated ceiling prices
Year:				
1967	P–1	$755,747	$680,552.52	$755,747
1967	P–3	805,000	726,910.24	805,000
1968	P–3	780,000	[1] 710,096.00	[1] 710,096
1969	P–3	845,000	638,400.00	712,500
1970	P–3	845,000	638,250.00	721,500
1968	P–12 (Navy)	740,000	[1] 732,386.00	[1] 732,386
1963	do	800,000	680,952.00	759,991
1970	do	800,000	680,790.00	769,588
1968	P–12 (Air Force)	770,000	[1] 731,388.00	[1] 731,388
1969	do	830,000	682,907.00	762,172

[1] 1968 prices were negotiated as firm fixed price by the Team; all other prices are fixed price incentive.

Note: The prices negotiated by the Team for the TF30 series engines to be delivered in 1969; 70 were later revised upwards by reason of the volume adjustment clause of the contract. These volume adjustment pricings were required because of cancellations and stretchouts in deliveries of the TF30 engines.

Representative BROWN. Will you go ahead, sir.

Chairman PROXMIRE. We have strongly endorsed the should-cost approach in the past, but we are somewhat apprehensive about some recent developments. One of the should-cost projects we are attempting to follow is the current series of studies on the Mark 48 torpedo program. I was surprised to learn that the first two phases of the Mark 48 should-cost study cost about $1,200,000 in consultant fees alone, and that a third phase is now planned. We don't know the price of the third and subsequent phases. Can you shed any light on why this should-cost study should be so expensive?

Mr. RULE. This sounds like a lot of money, I know, and I have been gagging at it myself. But again, I would like to assure you that from what I know about the Mark 48 torpedo program, the studies were worth it, and the results are going to be beneficial to the Government.

Chairman PROXMIRE. Can you give us the names of the consultants involved? We would like to know the names of the consultants, and whether they previously worked on the Mark 48 program, and how long they will be working on the program, and how much they have been paid.

Mr. RULE. Dick, will you remind me of those? I am not taking notes. Should I?

Chairman PROXMIRE. That is all right. You will get a copy of the transcript.

Mr. RULE. The company's name is Kearney Co. from Chicago, an industrial engineering company.

Chairman PROXMIRE. I was just wondering if it is possible that consultants could become so closely identified with a program that their objectivity suffers. For example, if a consultant had collected millions of dollars in fees and had prospects of more on a program, would it be reasonable to expect him to make unflattering recommendations? Could we expect him to recommend cancellation of the project if this should be indicated?

Mr. RULE. A good question. In the Mark 48 it was an interesting thing, because there are two companies competing for the Mark 48 in there, there is severe competition. And the Kearney Co. is should-costing both of them. They are competing for the production cost to make the Mark 48 torpedo. But the Kearney Co. is should-costing both of those competitors. And I have recommended that we include a clause in the successful contract that for the duration of that contract, they can't retain the company for anything. I don't know whether that will sell or not.

Chairman PROXMIRE. Do you think it is likely to be accepted?

Mr. RULE. I don't know.

Ernie, is that a good clause or not?

Mr. FITZGERALD. Yes.

Chairman PROXMIRE. And give us any other recommendations you may have on how we might hold down costs of consultants' services, and also assure objectivity.

Mr. RULE. Right, sir.

I have a couple of recommendations on claims that I haven't gotten to yet. Should I put those in now?

Chairman PROXMIRE. Go right ahead.

Mr. RULE. The first one I did mention, a statute of limitations on when, so that there couldn't be any claims filed after everybody has gone, or many years later. I would like to see that. There is something I don't think you can do anything about, but I would like to see the commander of the system stay out of the negotiation.

I think Admiral Rickover made a recommendation that GAO review these claims. I would like to see that. That raises the question, he didn't say whether he meant before they were settled or after they were settled. I personally would just love to get the GAO in with their know-how, because we need all the help we can get. I would just love to get the GAO to sit in with us before they are settled, so that if we are doing something wrong, they can tell us.

Now, you get into two schools of thought. Some people say, no, let them carry out their historic, traditional function of looking at things after the fact. I say that with this many dollars involved, if they can help us come up with the right answer, I would like them to sit right there at the table with us.

Chairman PROXMIRE. I think it is a very constructive idea. I will write the Comptroller General today and get his reaction to this.

(The letter to the Comptroller General and his response were subsequently supplied for the record:)

JUNE 24, 1971.

Hon. ELMER STAATS,
Comptroller General of the United States,
General Accounting Office,
Washington, D.C.

DEAR ELMER: In our recent hearings on the Acquisition of Weapons Systems, Gordon Rule recommended that the GAO be brought into the evaluation of shipbuilder claims before they are finally acted upon by the Navy. Mr. Rule testified, "I would just love to get the GAO to sit in with us before they are settled, so that if we are doing something wrong, they can tell us."

As you know, the amount and the processing of shipbuilding claims have become major problems. The GAO has done an excellent job so far in reviewing the procedures employed by the Navy. However, the reviews are after the fact, after the claims have been settled and paid out.

I find Mr. Rule's suggestion to be a most interesting one because it would give the GAO an opportunity to exercise its authority before final action is taken.

Of course, I realize there are other considerations and, for that reason, I would like for you to respond to the idea before I take a position on it.

By the way, I appreciate your letter of June 14 in which you commented on two aspects of Assistant Secretary Shillito's testimony before this Committee. I intend to place your letter in the record of the hearings.

Sincerely,

WILLIAM PROXMIRE,
Chairman, Subcommittee on
Priorities and Economy in Government.

COMPTROLLER GENERAL OF THE UNITED STATES,
Washington, D. C. September 8, 1971.

Hon. WILLIAM PROXMIRE,
Chairman, Subcommitee on Priorities and Economy in Government,
Joint Economic Committee, Congress of the United States.

DEAR MR. CHAIRMAN: Your letter of June 24, 1971, requested our views on the suggestion of Mr. Gordon Rule during the Hearings on Acquisition of Weapons Systems that he would like to have our Office participate in the Navy's evaluation of shipbuilder claims before settlement by the Navy.

We have carefully considered the advisability of our participation and we have concluded that it would be inappropriate for our Office to become involved in the administrative evaluation of the merits of the claims. If on the one hand Mr. Rule's suggestion contemplates that our role be limited to that of an observer

we see no useful purpose to be served by such a role. On the other hand, we are concerned that our direct involvement at this stage of the settlement process could be subject to legal question.

The courts have recognized that contracting officers have authority to administratively settle claims and have accorded such decisions a considerable degree of finality. Our Office has itself recognized that the contracting agencies have primary responsibility in this area. Moreover, the courts have indicated that where, as is the case here, primary responsibility rests with the contracting officer, he has a duty to reach an independent judgment on the merits. E.g., *Schlesinger* v. *United States*, 390 F. 2d 702 (Ct. Cl. 1968).

We will, of course, continue to review the manner in which the Navy discharges its responsibility in the settlement process.

Sincerely yours,

R. F. KELLER,
Acting Comptroller General of the United States.

Mr. RULE. We have got some neat problems in the settlement of claims. Are we going to pay interest on claims?

We have got the cost of preparing the claims.

We have got the question of, should we pay a profit on claims? The GAO has raised this in one of their reports that I read.

And then the treatment of legal fees. Things like that.

I would think that it is just constructive to sit down with these people and get their views before they go off the deep end, if we are about to do it, so that we come out of the thing with a pretty good product.

Chairman PROXMIRE. That makes sense.

Mr. RULE. I have two others.

Chairman PROXMIRE. Good.

INDIVIDUAL RESPONSIBILITY

Mr. RULE. I still think, Senator, that there should be found some way to put some discipline which there isn't today, into the producer procurement side of the house, and into this claims area. I think if there is a big claim, and it is the fault of the Government, somebody ought to study this, and somebody ought to get disciplined.

Take the DE-1052 class, where people have this dynamic analysis problem that costs many, many millions of dollars. I think somebody ought to look at that and see who was responsible for it.

Chairman PROXMIRE. What kind of discipline would be effective?

Mr. RULE. Under the users' side of the Navy—we are the producers' side—we produce the things that the users use; on the users' side, there is plenty of discipline. If a man runs a boat aground, there is a board of inquiry to see who is responsible. But we can make the biggest goof over here, hundreds of millions of dollars, and nobody ever looks at it to see who is responsible. Now, maybe it is difficult to find out who is responsible. But I would sure like to see the effort made, if for no other reason than to compile some lessons learned, what we are doing wrong. But we don't discipline anybody. It applies to me. If I approve a deal and the business aspects are later found to be sour, I ought to be disciplined or fired, one or the other, it doesn't make any difference. But I think that we ought to do this in the Navy on the producers' side of the house. Now, my last recommendation is, there are a lot of people talking about procurement. And I have got to mention Admiral Rickover again, and you. There are a lot of people, I just wish, instead of doing so much talking back and forth, letter writing, that all these people that are really genuinely interested in saving money could go down, as do a lot of groups, to Airlie for a week and sit around the table and talk about it face-to-face, not keep writing all these letters back and forth and criticizing here—and I engage into this too—I

would like to see us get a group together that is genuinely interested and go down there for a week. This is done regularly by groups who want to get away and come up with some answers. So I make that as a recommendation.

Chairman PROXMIRE. August might be a good time. Congress isn't in session. Maybe you can arrange something like that.

Mr. Brown.

Representative BROWN. I think your suggestion is very interesting. But I am not sure that Airlie has got accommodations for the press to cover such a program. Or is that what you are trying to get away from?

Mr. RULE. No. I was trying to get away from talking and letter writing.

PROCUREMENT STUDY COMMISSION

Representative BROWN. What do you think about the Procurement Study Commission? Do you think that is an effective provision for solving this problem?

Mr. RULE. No; I do not.

Representative BROWN. Why not?

Mr. RULE. Because I think they are going about it the wrong way.

Representative BROWN. What is your feeling about this?

Mr. RULE. Don't be shaking your head, or they will think we have talked about this.

Well, sir, I really don't think that they have started on the tasks and are going about their tasks in the proper way. They are trying—I think they have bitten off too much. I think they have set up too many groups and are going into too many details or by-products of basic problems. And the staffing they are trying to get—and they have gotten indeed a great many people to work on these groups free, and a great many from the aerospace industry, high officials. I think if this effort was worth doing—and certainly when I urged Senator Proxmire to support it, I thought——

Chairman PROXMIRE. Your recommendation was a decisive factor in my decision; yes, indeed.

Mr. RULE. I think I did say that the key to it was how they staffed it, who they put on the Commission and how they staffed it. I don't think you should be going around with your hat in your hand begging companies and even the Government departments, to loan people to them; they ought to, if it is a worthwhile effort, tell Congress how much they think it is going to cost, and what they expect to achieve, with some sort of a blueprint.

Representative BROWN. The blueprint to a great extent was the objective, wasn't it?

The objective was outlined in the legislation, wasn't it?

Mr. RULE. Yes; the objective was. But the staff of the Commission and the methods they were going to use and just exactly how they were going about it was left to them. But I think they should have told the Congress that they needed this money for these people, and here is what they will do in 2 years. But they did not approach it that way. And I am disturbed about it, I really am. I expected great things.

Of course, it is too early. Maybe we will get some results, but I am not optimistic.

Representative BROWN. Have you communicated your criticisms to the Commission?

Mr. RULE. No, sir; not to the Commission.

Representative BROWN. I think it might be desirable. I think both the Senator and I would perhaps recommend that. If they are off the track at this point, it might be helpful in getting them back on.

Mr. RULE. I told Mr. McGuire sitting in the club one night with two other members that I thought he was going to fall on his face. And for some reason or other, he didn't seem to appreciate that too much.

PROPOSED GAO ROLE IN CLAIMS SETTLEMENT

Representative BROWN. Let me go back and ask about the early participating of the GAO in the writing of contracts. If GAO participates in the writing of the contract and the assessment of the contract early in the game, and then the contract must be evaluated to find out what is wrong with it, who does that? Does GAO sit in judgment on their own early participation?

Mr. RULE. Mr. Brown, I did not suggest that GAO sit in and have anything to do with the award of the contract. I was confining that suggestion to the settlement of claims, a totally different area than making contracts. No, sir; I would not recommend that they get in on the making of contracts.

We have got specialists that are geting paid enough money so that they ought to know how to make a contract. But we don't have specialists, I will be frank with you, in settling claims. This is an area where we have some very knowledgeable people, but they work part-time on these things, and it is in that area that I need help. I think the Navy needs help.

Representative BROWN. Would you need the GAO for their independence in this situation and operating in this situation, or for their ability, or what? As I understand your position, you write the contract and participate in the compilation of the contract. And then do you also participate in the selection of the best bidder or the wording of the contract?

ROLE OF CONTRACT CLAIMS CONTROL AND SURVEILLANCE GROUP

Mr. RULE. That is all under the heading, Mr. Brown, of the business aspects. We have to determine—is this contract being awarded a prudent business arrangement?

Representative BROWN. Is that your participation in the operation?

Mr. RULE. Yes, sir.

Representative BROWN. And then you assess the contract claim after it is over, and there is a claim on the contract too?

Mr. RULE. No, sir; if there is a claim that comes in, and it is over $5 million, that claim cannot be consummated and paid until we approve that claim settlement.

Representative BROWN. But you are involved in that end of it too; is that right?

Mr. RULE. Yes. But this is years later. You see, it takes 4 or 5 years for these claims to surface.

Representative BROWN. And whether or not the company gets its claim, it faces the Renegotiation Board also?

Mr. RULE. That is right, sir.

Representative BROWN. As you pointed out in your comments, the interest on the claims, the cost appropriation of the claims, your legal fees, and all of that are taken as a risk by the company that puts in a claim?

Mr. RULE. The present thinking, they expect to get that as part of the claim. These are questions that, as I say, have not been decided within the Navy yet.

Representative BROWN. Since you are writing the contract and awarding the bid and then judging the claim on the contract, then you do business with the Government, it seems that they are both the judge and the jury frequently in such arrangements. What factors go into your judgment on these claims, in view of the fact that you have written a contract and don't think contracts ought to be written? First, if you allow their claim, what would you allow that claim on?

Mr. RULE. Most claims are made up, Mr. Brown, of excess labor hours spent by the contractor as a result of what he says the Government either did to him or omitted to do. It can be an omission or a commission.

Representative BROWN. When you say, did do, what do you mean? Changing the specifications?

Mr. RULE. It may have been a constructive thing, an unwritten change. It may have been——

Representative BROWN. Those changes are not negotiated as they go in the contract, is that right, or the contract does not provide for those changes, is that right?

Mr. RULE. Under the changes article, they could have been, they could have been adjusted as changes. But in the absence of not having done that, you end up with a claim, you say, that is a distinction between handling them under the contract and not handling them.

Representative BROWN. I don't know whether it is fair to put the Federal Government or the various agencies and the Defense Department in this sort of a position of a housewife building her own house, but as you get into this, there is an awful lot of putting the window here, the porthole, something else, that compares maybe to the girl walking across the property after the foundation has been put in and wanting to move the front porch over to the side of the house, or something, I would assume. Now, is that what you are talking about in the specification changes, that these are the things where the claims come in?

Mr. RULE. No, sir. For example, in the construction of a submarine, it is recognized, and it is part of the Navy's normal procedure, to estimate that 16 percent of the contract price—it will increase 16 percent for these changes you are talking about.

Representative BROWN. Where does that 16 percent come from?

Mr. RULE. It is budgeted for.

Representative BROWN. It is based on this type of experience?

Mr. RULE. Yes, sir. Sixteen percent is, as history has shown, needed in addition to the actual shipbuilder's cost of construction, 16 percent more should be budgeted for changes.

Representative BROWN. How long has that been true?

Mr. RULE. I don't know the number of years, but it is in black and white.

Representative BROWN. It is in the book somewhere?

Mr. RULE. It is in the book somewhere.

Representative BROWN. Does that apply to nuclear submarines, or was that true before nuclear submarines got in?

Mr. RULE. Nuclear submarines, I believe, appeared, but that is the figure that goes into the end cost today.

Representative BROWN. Is there something in the book for airplanes and destroyers?

Mr. RULE. There is for ships. Whether there is for airplanes, I don't know.

Representative BROWN. What about Federal law changes? Should we change the minimum wage law? Now, obviously nobody in the contracting business with the Federal Government is paying any minimum wage. But when the minimum wage changes, it certainly impacts on all of the labor contracts, and so forth and so on. Is that sort of thing allowed for?

Mr. RULE. Speaking again specifically with respect to ships, shipbuilding contracts generally have escalation clauses in them. We escalate the price for labor and material.

Chairman PROXMIRE. Based on——

Mr. RULE. Based on a Department of Labor index.

Chairman PROXMIRE. The cost-of-living change is anticipated, isn't it?

Mr. RULE. And an index in the Department of Labor which develops the actual increase, and we pay that outside the contract price, no profit on it.

Representative BROWN. But suppose I came to you—this is your contract that you have written now, and I came to you because your job is to assess whether my claim is fair, and I said, you know, the Government passed a minimum wage law which raised all the wages around the area, so I had to raise my wages in the middle of this contract. How long does it take to build a submarine? Some years. Is that the kind of thing you would allow in a claim or that you would have to prove in a claim?

Mr. RULE. That would never be in a claim. That would be covered by this escalation.

Representative BROWN. The escalation, I understand, is a cost of living change, is that right?

Mr. RULE. No; it is the increase in labor and the increase in materials over the life of that contract. We know they are going to increase, both labor rates——

Representative BROWN. And the Bureau of Labor Statistics gives you a percentage of how much they are going to increase. But I am talking about a change in a Federal law that changes the cost factor. In other words, if you raise the minimum wage you just sort of jump up the price for everybody. If you don't have a change in the minimum wage, you are going to have an escalating cost of labor anyway, because of inflation being what it is. But when you suddenly make a change in the minimum wage law, that changes everybody's face some, is that right?

Mr. RULE. Here is one way we would have to pay that in a claim——

Representative BROWN. And BLS doesn't know this ahead of time, and the contractor doesn't know it ahead of time, and you don't know it ahead of time, and Congress just comes in and passes the law?

Mr. RULE. That is right.

If we hade done something to this contractor, either by commission or omission——

Representative BROWN. You are talking about the Navy?

Mr. RULE. Yes, sir.

Representative BROWN. I am talking about the Congress or somebody else.

Mr. RULE. I have enough trouble thinking about the Navy, Mr. Brown.

But if we did something to this shipbuilder which interfered with the work he was going to do in an orderly manner in 1971 and 1972, if we made him change that work at a later period, that was a higher priced period by reason of a change in the law, we would have to pay him under that claim for the hours we found he was entitled to by that new labor rate.

Representative BROWN. This isn't the Navy doing it, this is the Federal Government. This is a change in a fundamental law. Or take another example.

Let's say that suddenly a raw material is not available as it was because of some policy of the Government, or just the way that these things develop. What does that do to his contract?

Mr. RULE. It depends a great deal on what type contract he has. If it is a cost-type contract, obviously we would pick it up.

Representative BROWN. Let's assume that it isn't.

Mr. RULE. If it is fixed-price contract——

Representative BROWN. Then he would put in a claim for it.

Mr. RULE. No; you can't put in a claim for it if it is a fixed-price contract. If it is, this man has just guessed wrong.

Representative BROWN. Let's say he has guessed wrong as a result of something that has changed because of a change in Federal policies. Now, it is difficult for me——

Mr. RULE. I will need a lawyer to answer that.

Representative BROWN. Aren't you a lawyer, sir?

Mr. RULE. Yes, sir.

Representative BROWN. I am not.

Mr. RULE. But I am not practicing.

Representative BROWN. So I think the competition is even. You say could you give us an answer? I am thinking of the Federal policy with reference to imports. We were talking about perhaps tightening up or relaxing oil imports, and changing the price of oil. Oil isn't a component of the construction of a ship. But let's take some similar product.

Let's say steel. Let's say that suddenly we are going to slap the Japanese, and we don't have that competition in steel, and the price suddenly shoots up.

Mr. RULE. OK. Some outfit in this country has a contract with some Japanese company for steel. And it is a firm contract to supply x number of tons at x number of dollars a ton. And then the Government comes along and puts a higher tab on the importation of that steel. Is that the case you are talking about?

Representative BROWN. Yes.

Mr. RULE. I think he is stuck under the contract if it is a firm fixed-price contract.

Representative BROWN. Even though the Federal Government may be partly responsible?

Mr. RULE. If the contract provided for such contingency or such happening—it is not an act of God that relieves you from the terms of your contract.

Representative BROWN. But an act of the Government.

Mr. RULE. I dare say that most astute people today have clauses in the contract that probably look forward to such an event and protect themselves against it.

Representative BROWN. That answers my question, I guess, pretty much in that line. You make those determinations.

Let me just ask one other area question. What about the numbers of products, once a product is developed, that are involved in this contract? Is it ordinarily clear in the contract how many of the widgets that I build for the Federal Government I am going to be able to amortize my costs on, or is that left for sort of a by-guess, by-golly approach on the part of the contractor and the Navy?

Mr. RULE. I think when he bids on something, a new product, that he has to amortize, he knows the number that he is going to amortize it over. And he will tell us. And then, of course, it gets sticky if we cancel some off the contract.

Representative BROWN. Then I have to put in a claim?

Mr. RULE. No.

Representative BROWN. Is that written into the contract usually, a cancellation?

Mr. RULE. You can put in a cancellation claim when the Government terminates or cancels part of the contract.

Representative BROWN. But you don't rewrite the contract at that point?

Mr. RULE. No, sir.

Representative BROWN. You just say, put in a claim?

Mr. RULE. He has under the terms of the contract a termination article or a cancellation article that allows him to put in his claim for cancellation.

Representative BROWN. And then you make the determination on whether that claim is acceptable?

Mr. RULE. That is right, sir.

Representative BROWN. And what recourse does a company have if he says, you didn't allow us that claim, and we don't think that is fair, what does the company then do?

Mr. RULE. He asks the Government to make a contracting officer's decision denying him what he thinks he ought to get, from which he appeals to the Armed Services Board of Contract Appeals.

Representative BROWN. And then what?

Mr. RULE. To the Court of Claims.

Representative BROWN. Are there information decisions or discussions on what the contractor may expect in the way of future orders or further orders, or is it all written right down there on a piece of paper, so that he knows that it will be a thousand widgets, is that it?

Mr. RULE. If I understand your question, Mr. Brown, as to future requirements of the Government in any particular area, most contractors know as well if not better than we do, certainly——

Representative BROWN. I don't understand how they can know better.

Mr. RULE. You would be amazed at the intelligence system that these people have.

Representative BROWN. So you mean that in spite of the fact that the contract says a thousand widgets, he may assume that there is really going to be a need for 2,000, based upon what he has learned in other branches of the armed services?

Mr. RULE. There is such a thing in all services as a 5-year defense plan, what they think they are going to buy, airframes, ships, what have you. And they know what are in those things. They know that if he gets a contract today for 100, that this 5-year plan might have a thousand in it for future years.

Representative BROWN. So he might accept a contract, make his bid on a different basis, is that what you are talking about?

Mr. RULE. No, sir. You are only asking me if he knows future requirements, and that is all I answered.

Representative BROWN. What is your feeling on that? You have been in the business a long time. Is that a part of the pattern ever?

Mr. RULE. My feeling on what, sir?

Representative BROWN. On whether or not the contractor might anticipate that future order and act on it in terms of some informal information that he might have.

Mr. RULE. Well, if he is a sole-source producer—if he is Lockheed, for example, making the Poseidon missile, he knows that no one else is going to make the Poseidon missile. And he has a pretty good idea, I guess he has to know, as to how many Poseidon missiles we are going to buy this year, the next and the next. I don't think that he can do anything about that contractualwise. If it is competitive, if people are bidding on something, and we know the future requirements, they know that to get any of those future requirements, they have got to bid on them, and that is a totally different picture.

Representative BROWN. Well, into that picture, what is the situation?

Mr. RULE. What do you mean?

Representative BROWN. Are you likely to get in on a real tight contract on that basis?

Mr. RULE. Yes; if you believe as I do that if it is genuine competition, the forces of the marketplace will give you a reasonable price. One of the things you have got to guard against there is that you get too low a price, and that somebody buys in, hoping then to get some of the future work.

Representative BROWN. Then if there is a change in that future work, he is stuck?

Mr. RULE. He may be.

Representative BROWN. Thank you.

Chairman PROXMIRE. Mr. Rule, thank you very, very much for an excellent job. You have certainly given us some extremely useful testimony. We are grateful to you.

NEED FOR MORE CANDOR

Mr. RULE. Thank you. And I would like to go back to those two paragraphs you read from my remarks when I got that award a couple of months ago, on the point of candor. I just wish we could find a way to get more candor. I wish we could, instead of looking like we engage in operation coverup, I wish we could engage in operation candor. And I wish that instead of putting out so many publications on ships and aircraft, we could just put out one on operation candor. Because I think it is a situation that has gotten worse.

Chairman PROXMIRE. You have certainly helped this morning. And I think your testimony is an example of the usefulness of candor.

The subcommittee will stand in recess until tomorrow morning at 10 o'clock, when we will meet in this room to hear Assistant Secretary of Defense Barry Shillito; Robert B. Chapman III, AAI Corporation; and J. M. Lyle, president, National Security Industrial Association.

The subcommittee stands in recess.

(Whereupon at 12:50 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Tuesday, May 25, 1971.)

THE ACQUISITION OF WEAPONS SYSTEMS

TUESDAY, MAY 25, 1971

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON PRIORITIES AND
ECONOMY IN GOVERNMENT OF THE
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:10 a.m., in room S-407, the Capitol, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire; and Representatives Conable and Brown.

Also present: Lucy A. Falcone and Jerry J. Jasinowski, research economists; Richard F. Kaufman and Ross F. Hamachek, economists; George D. Krumbhaar, Jr., minority counsel; Walter B. Laessig and Leslie J. Barr, economists for the minority; and A. Ernest Fitzgerald, consultant.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The subcommittee will come to order.

After listening to the testimony in the current hearings on "The Acquisition of Weapons Systems," and studying the facts, I am more convinced than ever of the need for a very deep seated reform of the procurement system.

From beginning to end—from the award of contracts and the negotiation of prices to the adjudication of claims and the renegotiation of profits—defense contracting is riddled with inefficiency and mismanagement.

The renegotiation process has become a bandaid operation. The Renegotiation Board is a hobbled and miniature version of what it once was. It is unable to do the job that is needed.

The Board has less than a third of the employees that it had during the Korean war. It has substantially less funds. Its scope and jurisdiction have been restricted over the years by statutory limitations and loopholes.

It was shown yesterday that nine board employees, seven of them professionals, are responsible for reviewing 5,000 filings of defense contractors per year and of passing judgment on the segregation of sales and the allocation of costs of those companies. That is an impossible job. Anyone who believes that renegotiation is an effective way of recapturing excess profits is fooling himself.

The taxpayer is not getting a dollar's value for a defense dollar spent. The enormous amount of waste that goes on has been amply documented. But the problem goes further than that.

Defense contracting is a disaster area. It is ironic that those who are responsible for bringing the procurement system and a large sector of the industrial community to the brink of fiscal chaos have done so in the name of national security.

Moreover, the loss of confidence they have engendered in the average citizen by their seeming indifference to the public interest, by the favoritism they show to the giant aerospace firms, and by their insatiable appetite for larger and larger defense budgets, threatens the very fabric of our political and economic system.

The list of modern weapon programs is a rogues' gallery of financial and technical felons: the B–70 bomber, the Skybolt missile, the nuclear-powered airplane, the C–5A, the F–11, the Cheyenne Helicopter, the main battle tank, the DE 1052 destroyer, the Drone helicopter, the deep submersible rescue vehicle, the gama goat, to name a few. These programs represent billions of dollars of unnecessary cost overruns, significant and sometimes catastrophic technical failures, and extensive delivery delays.

There has been little improvement in the past few years and there is little hope for change at the present time. Even candor from Pentagon officials, as Gordon Rule reminded us yesterday, is lacking.

The Pentagon, with its harebrained schemes to bail out sick contractors and its Panglossian attitude that all is well in the best of all possible worlds, is fiddling around with the taxpayers' money while taxpayers burn with resentment.

Yesterday's disclosure that the Navy has agreed to pay two shipbuilders over $135 million in claims against the Government without bothering to determine whether the Government is legally liable is another example of this attitude.

It is no wonder that the public and many members of Congress are losing patience with the Department of Defense.

Our first witness this morning is Barry J. Shillito, Assistant Secretary of Defense for Installations and Logistics. Mr. Shillito is an able and competent official and the top procurement expert in the Defense Department. Perhaps he can explain why so many military programs have gone sour.

F–14

One of the matters I intend to explore with Mr. Shillito in some depth is the Defense Department's application of its new weapons acquisition policies to one specific program—the Grumman F–14 fighter.

The F–14 is the latest in a long line of weapons systems to falter on the production line. Recent reports indicate that cost problems at Grumman and a 6–9 month testing delay due to the crash of an F–14 prototype last December will ultimately be responsible for a $700 million increase in the cost of the F–14 program.

But this is probably only the tip of the iceberg. There have now come to my attention two additional indications of F–14 cost overruns. In the long run, these two factors may produce an overrun, if the F–14 program is allowed to continue, every bit as large as the $2 billion overrun on the C–5A.

One problem is the fact that, for all practical purposes, the Navy has yet to sign a contract with Grumman for 253 of the 722 aircraft it presently plans to buy.

According to my information, the F–14 contract was first entered into between the Navy and Grumman on February 3, 1969. At the time, it called for a baseline purchase of 469 production and test aircraft in eight lots running through fiscal year 1976.

Yet Navy planning now calls for the purchase of 722 aircraft. In the past 2 years a decision has apparently been made to increase the projected buy of 253 aircraft.

At no time, it appears, has any action been taken to place these additional aircraft under contract with Grumman. The net result is that the Government has no price protection on these planes and will be able to buy them only if it pays whatever price Grumman chooses to charge.

The second problem stems from the fact that the Navy is apparently stretching out its purchase of the 469 aircraft originally contemplated under the Grumman contract.

Lots IV–VII of that contract, covering fiscal years 1972–75, call for the baseline purchase of 96 aircraft a year, with minimum options of 48 aircraft and maximum options of 144.

Instead of purchasing more than the baseline figure and bringing at least some of the additional 253 aircraft under the contract's protection, the Navy is actually doing just the opposite.

The 1972 budget contains funds for only 48 aircraft, and according to a recent article in Aerospace Daily, the same reduced buy is apparently contemplated in each of the next 3 years.

If this plan is followed, one result will be to slip the purchase of another 192 aircraft until fiscal years after 1976, when there will again be no price protection for the Government, because the contract with Grumman will have expired.

Another result will be to raise dramatically the unit cost of each aircraft bought over the next 4 years.

The Navy has long maintained that the unit cost of the F–14 will be $11.5 million. But this is predicated on the purchase of a full 96 aircraft a year over the next 4 years.

At a rate of only 48 aircraft a year, the price will be much higher. As indicated by the $806 million in F–14 funds requested in the fiscal year 1972 budget to cover procurement of 48 aircraft, it would rise to over $16 million each.

The cost implications for the next 4 years alone are staggering. By buying a total of 192 aircraft over the next 4 years at a price of $16 million each, rather than over the next 2 years at $11.5 million each, it will cost us an additional $1 billion over the price originally contemplated for those planes.

Mr. Shillito speaks in his prepared statement of the new management policies for weapons acquisition which have been instituted in the Pentagon over the past 2 years. These policies, he says, have been designed to produce efficiency by decentralizing responsibility while at the same time retaining essential overall controls at the OSD level.

That a decentralization of responsibility has occurred I am sure, but on the subject of overall controls I have my doubts. If such control does in fact exist, why was it not exercised to prevent either the stretched-out buy or the lack of contract protection to which I have just referred?

Mr. Shillito, I apologize for my tardiness, and for having a longer opening statement than usual at the beginning.

STATEMENT OF HON. BARRY J. SHILLITO, ASSISTANT SECRETARY OF DEFENSE FOR INSTALLATIONS AND LOGISTICS, ACCOMPANIED BY DON R. BRAZIER, PRINCIPAL DEPUTY ASSISTANT SECRETARY-COMPTROLLER; J. M. MALLOY, DEPUTY ASSISTANT SECRETARY FOR PROCUREMENT; VICE ADM. ELI T. REICH, U.S. NAVY, DEPUTY ASSISTANT SECRETARY FOR PRODUCTION ENGINEERING AND MATERIEL ACQUISITION; AND VICE ADM. VINCENT P. dePOIX, U.S. NAVY, DEPUTY DIRECTOR FOR ADMINISTRATION, EVALUATION, AND MANAGEMENT, D.D.R. & E.

Chairman PROXMIRE. You have a 45-page prepared statement, Mr. Shillito.

Mr. SHILLITO. Yes, Mr. Chairman, I do.

Chairman PROXMIRE. I take it you can summarize that. And the entire prepared statement will be placed in full in the record at the end of your oral statement. We would appreciate it if you would confine your oral statement to 20 minutes or so, so that Congressman Brown and I can question you in detail.

Mr. SHILLITO. I will attempt to do that, Mr. Chairman.

By the way, I can hardly remember a more stimulating introduction.

I would have to say, too, as I mentioned 2 years ago before this committee, that when I go home late each night, and sometimes even on Sundays, my wife keeps wondering why I keep wrapped up in this job. When you say we have had comparatively few improvements, I, too, wonder why I am wrapped up in this job. I don't think we have had minor improvements. I think we have brought about significant improvements. I would like to talk to you about a few of them.

First, I appreciate very much your allowing me to postpone my appearance before this committee due to having to make a trip to Southeast Asia which you know about.

I should introduce first the gentlemen that are with me. On my left is Mr. Don Brazier, who is the Principal Deputy Assistant Secretary-Comptroller. Next to Mr. Brazier is Mr. Malloy, who is the Deputy Assistant Secretary for Procurement.

On my right is Vice Admiral dePoix, who is Deputy Director for Administration, Evaluation, and Management under Mr. Foster in D.D.R. & E.

On his far right is Vice Admiral Reich, who is Deputy Assistant Secretary for Production Engineering and Material Acquisition.

With the help of these gentlemen we should be able to answer most of the questions that you might care to raise.

I will attempt to limit my comments to the 20 minutes that you have suggested.

We want to make it very clear that we do have an awful lot of problems. We are probably more aware of these problems than anyone else is. In fact, our self-criticisms in many ways, Mr. Chairman, are much more severe internally than those you hit us with externally.

It is time for us to touch on a number of points that you raise, as cited in your letter asking that we be with you today, and as were raised by Mr. Kaufman in his discussion with me.

These matters are timely in view of the concern that has been expressed by a number of people, including the concern expressed by

Admiral Moorer in his recent posture statement in which he compared our activities in the Department of Defense to the Soviet and others. It is most timely that we look at our operation in toto.

I spell out quite clearly in my prepared statement the reordering of priorities that has taken place within the Department of Defense, particularly over the past 2 years. It should be recognized that we are looking at an environment in the Department of Defense in which our budget represents the lowest percentage of gross national product since 1951, and the lowest percentage of our Federal budget since 1950. Of course the cost and price figures make it very clear that the real defense spending as we move into 1972 is quite comparable to that of 1964. The spending in other areas of our total Government is significantly different. Other areas have grown significantly more than has been the case of defense. The numbers, I think, speak for themselves.

COST OVERRUNS

We are faced with an economic problem. You have touched on it. It has been called a lot of things. It has been called cost growth, it has been called overrun, and it has been called inflation. I cite a few things here that are typical of what we hear about each day and frequently note in the newspapers relative to our economic problems. In addition we also hear of these problems from our wives after their daily visits to the store. I mention the cost growth of the John F. Kennedy Center, which we are all quite familiar with, a growth from $31 million to $68 million; the World Trade Center in New York; and a post office in New Jersey.

This last week we had a number of people from Australia visiting us. They are building an opera house in Sydney that has gone from $8 million to something over $100 million to complete.

The only point that I leave with you is that we are faced with a very severe situation in various segments of our economy. These comparatively standard things are indeed much more simple than the very complex weapons systems that we are attempting to buy in the Department of Defense.

We have internally within the Department of Defense the same kind of problems that we are talking about in some of these other fairly simple areas. The prices of food and clothing that we buy, for example, have increased significantly.

Mr. Chairman, I would like to emphasize one fundamental point with regard to the economic impact of what we are doing. As we move into 1972 we are talking about operating with 133,000 less people than we had in 1964. We are going to be operating in an environment that will involve almost $18 billion more for pay and related costs for these people. As I recall, Mr. Chairman, you have voted on each occasion for the increases that are tied to the pay and related costs that go to these people—this $18 billion.

We recognize that we have cost growth problems in the major weapons systems. We have attempted to define them. I think we have defined them fairly well into proper categories. We have stratified them, if you will.

Mr. Packard has made quite a point of this point. We touched on the need to identify the areas of cost growth the last time I came before this committee. This categorization has helped us do this.

We have established a number of new policies in the weapon systems acquisition area. You are aware of a number of these. I touch on these

in my prepared statement. The Defense System Acquisition Review Council was established. This is a very active organization that reviews all major programs on at least three different occasions in their life cycle and prior to production. My prepared statement shows the relationship of the DSARC to the development concept paper. We are also moving in the direction of area concept papers to relate the priorities which we feel to be very important in these major weapon systems.

You touched on the matter of decentralization versus controls in your introductory statement. I would mention here, Mr. Chairman, that 200-plus major weapon systems under the management of 200 project and program managers are just simply too many for people at the top of the Department of Defense to know all the details. These are major and very complex programs. While we may be able to make some comments that would be helpful to you on the F–14, for instance, I would urge that if you want to get into the F–14 in great detail that we consider having the program manager come over here and give you a detailed discussion on the F–14.

We have made clear our development policies. We have outlined our policy on making practical trade-offs between the stated operating requirements and the engineering design and with the other factors that are tied into tradeoffs. The tradeoff spectrum will range throughout the design, the development, and into production. I would say this is being done in a most effective way. As best we can we are pushing for the fly-before-you-buy concept.

Changes are being made in the contractual environment. We are moving away from innovation and variation in our contractural environment towards simplification. The contractural complexities are being minimized in every way. We are moving towards an environment that will involve more use of cost-plus-incentive-fee type contracts in development and in the embryo stages of production. We will then move into fixed-price type contracts later in production.

DEFENSE PROFITS

Mr. Chairman, a lot has been said about defense industry profits. I will only take a couple of moments to talk about defense industry profits.

Frankly, I can only conclude that the results of the GAO study reemphasize my opinion that I gave this committee 2 years ago—that average profits earned on defense business are neither excessive nor unreasonable. My prepared statement goes into detail in support of this opinion. I will be glad to cover this subject as thoroughly as you might care to.

This opinion applies to profits or equity capital investment, or total capital investment, or on sales.

The statistics that I spell out in my prepared statement, I think, support this position, when one compares the average profits in all categories across the 4-year span of the GAO study. The GAO supplied two study techniques, if you will. One study was across the total myriad of companies in a broad and, dollarwise, large sample, while the other related to only 146 contracts.

The 146 contracts were only a piece of the total but have received a lot of attention. Indeed, this limited sample has a distribution curve significantly different from that of the 74 companies that made up the

larger sample. As my prepared statement notes, the 146 contracts are just 3 percent of the total dollars of contracts awarded during this time frame. I think, Mr. Staats made it quite clear that the GAO does not consider the 146 contracts as representative of the total defense industry profit environment.

Of course, as you must appreciate and we recognize, there are some cases where relatively high profits are earned, while other contracts will involve substantial losses. But on an average, there is no evidence to support the inference that there is a trend toward excessive profits in the defense industry. In fact, our concern has been that the trend is in the opposite direction.

We have in my prepared statement a table derived from statistics published by the Renegotiation Board. I think this is a pretty clear depiction of what has happened over the past 15 years as far as renegotiable profits are concerned. I should emphasize that these figures are profits before taxes.

I would conclude that those who express the opinion that high average profits are being made by the defense industry are making assumptions that are not supported by facts. I find no evidence of this. We must be concerned and are concerned with the possibility of recurring excess profits by individual companies, or excess profits on noncompetitive, contracts. However, I believe that both the Department of Defense and this committee, in the interest of national security, should be much more concerned that perhaps there are insufficient average profits being realized, and that this in turn will affect the future viability of our defense industry.

I realize that this committee thoroughly appreciates the importance of a healthy defense industry in the interest of national security. I am also appreciative of the importance of the sound economic policies in the eyes of this committee. I am reminded of the words of Bernard Baruch when he said:

> If our general economic policies and national defense are sound we need not worry. On the other hand, if we fail to preserve national security and credit nothing any of us owns can have a lasting value.

Frankly, gentlemen, I am much more concerned that we may adversely affect our national security by allowing the health of this industry to deteriorate because of the "profits are bad" syndrome than I am about average realized profits of defense contractors going up significantly.

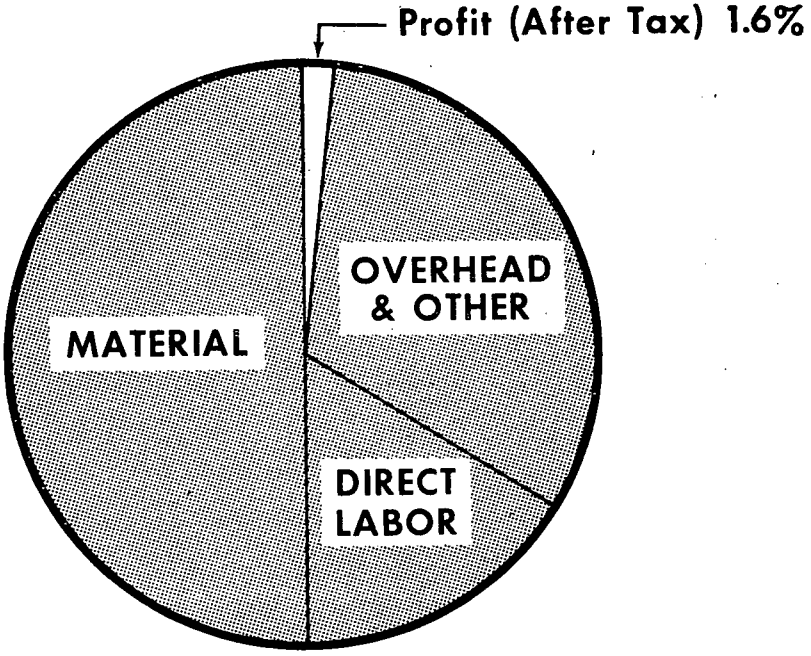
We have taken a lot of action with regard to profits in relation to capital employed. We can go into this in some detail in the questioning if you so elect. We feel as you do that we must do something about moving more in this direction. We feel that it can be done.

While profits are terribly important, we are giving too much attention to this particular subject. Considered as a whole, looking at the Renegotiation Board data and looking at profits on an after-tax basis, average profit comes out to about 1.6 percent of sales. This is less than 1 percent of our defense budget. I submit, gentlemen, that it is somewhat ridiculous the degree of attention that many people have been giving to developing these additional techniques for controlling this area.

I would just like to call your attention to one particular chart that I happen to have here, if I may. (Showing chart.)

(The chart referred to above is as follows:)

THE CONTRACT PRICE DOLLAR



Mr. SHILLITO. As far as the defense budget is concerned, or as far as the total dollars are concerned this is what we are talking about. All these controls, all of these concerns relate to 1.6 percent average after tax profit. This is where we have been spending an awful lot of our time. Frankly, gentlemen, a lot more in the way of satisfactory results can be realized if we concentrate most of our attention in these other areas—possibly this area in particular (referring to "overhead and other" on the chart above). Frankly, undue attention has been given to this particular subject, in spite of its importance.

GOVERNMENT OWNED EQUIPMENT IN THE HANDS OF CONTRACTORS

Moving to the subject of industrial plant equipment, we have reduced the number of machines in the possession of contractors by 25 percent in the last 2 years.[1] This represents a 20-percent reduction in acquisition value. We have had trouble getting rid of some of our industrial plant equipment. A lot of this has been due to lack of profits, I might add. We are moving in the direction of developing necessary plans to dispose of Government equipment in contractors' plants. As of December 31, 1970, 111 phaseout plans have been approved, and 700 more are in process of review.

[1] See letter from Elmer Staats, Comptroller General of the United States, dated June 14, 1971, on p. 1216.

PROGRESS PAYMENTS

As to progress payments a lot of attention has been given to this subject, and more will be given in the future. We feel that we have turned the corner on progress payments.

The private capital environment should be playing a greater role than has been the case historically for the capital required by this industry. It will have to be attractive for this to happen.

Progress payments outstanding on December 31, 1970, totaled $9.4 billion as compared to outstanding progress payments of $9.8 billion on June 30, 1970. Our progress payments are just about double what they were in 1964. This has disturbed us. We would expect to see this change.

TRUTH-IN-NEGOTIATIONS

You touched on the Truth in Negotiations Act. Contractors are required to submit cost or pricing data and certify that it is current, accurate and complete. We have had some exceptions, and some waivers have been authorized. Something like 85 waivers have been given.

The key to understanding this particular law is that it applies to sole source noncompetitive contracts. The law is so written that cost on pricing data must be furnished only when we are in a noncompetitive situation. We have been criticized on the one hand for not being hard enough in specifying the actions to be taken to implement the law. On the other hand we have been criticized for going way beyond the original intent of the law.

The recent GAO report, that is referred to in my prepared statement, recognizes the problems that we are faced with in this law. I think their sampling has brought into focus the problems that will lead to additional sound implementations of the law.

The waivers, as I say, have been comparatively few. While we have had 100,000 contractual actions, waivers to date have been about 85.

As has been touched on by this committee, we have had problems connected with the implementation of this law. A few of these problems were tied into some of the discussions that you had with Admiral Rickover on steel that is being procured by Navy shipbuilders. We support the Navy's efforts in attempting to obtain necessary cost or pricing data. We intend to continue to improve the effectiveness of our implementation of Public Law 87–653.

SHOULD-COST APPROACH

As to should-cost, we feel that we are moving in the right direction in this industrial engineering approach to a cost estimating. This is not a new topic. We have applied the team approach most successfully. This technique will move us in the direction of improved pricing, particularly into follow-on procurements under cost-incentive-type contracts and as transition to fixed-price-type contracts for production.

We have performed a functional analysis in diverse areas. This highly concentrated intensive effort is having a pay off. We are exploring in detail various techniques regarding the conduct of these in-depth reviews. You are familiar with most of them. We have

developed a should-cost coordinating committee as a forum for the interchange of our experience in each of the services. We want the departments to be free to innovate as they move ahead in their application of should-cost. We plan at a future date to formally synthesize our total experience. We are encouraged by the results to date.

I look at my watch, Mr. Chairman, and it is 20 minutes. I will stop at this point.

Chairman PROXMIRE. Thank you, Mr. Shillito. You did an excellent job of summarizing a very complicated prepared statement. As I said, the entire statement will be put in full in the record.

(The prepared statement of Mr. Shillito follows:)

PREPARED STATEMENT OF BARRY J. SHILLITO

Mr. Chairman: I appreciate the opportunity to appear before the Joint Economic Committee once again. I have been advised by your staff that the Committee is interested in discussing the acquisition of major weapons systems and in addition has requested the Department of Defense to discuss profit, industrial plant equipment, and contract financing. My statement will include information as to how we have been restructuring the weapons systems acquisition process and will speak specifically to the other items.

In reviewing the testimony of other witnesses, I have noted other areas of interest to the Committee which I will discuss briefly. These include the Truth-In-Negotiations Act (PL 87-653), cost growth on major weapons, and should cost.

It is particularly timely that we discuss these important economic issues in the light of our over-all defense posture in today's environment. This posture was quite clearly enumerated by Admiral Moorer in his recent posture statement when he stated: "Our comfortable lead has now all but vanished, and within the next five or six years we could actually find ourselves in a position of over-all strategic inferiority, certainly as far as numbers of offensive delivery vehicles and megatons. and air defense systems are concerned."

Before proceeding to discuss the management of the weapons systems acquisition process and the other specific areas which I have referred to above, I think it is appropriate to place the weapons systems acquisition process in the proper context as it relates to the resources available to the DoD.

REORDERING OF PRIORITIES

There is no question but that a substantial "reordering of priorities" is presently taking place. The shift in our priorities, from defense and to civilian pursuits, has been significant. The size and price of this change is not generally appreciated. For example, in current dollars, the increase from FY 1964—the pre-Southeast Asia period—to the FY 1972 request shows the following growth comparison:

	Billions
Defense spending	$+25.2
Other Federal spending	+90.3
State & local spending	+89.9

Netting out duplicates, since 1964 Defense spending has increased by $25 billion while other Federal, State and Local spending has increased by $156 billion.

In this regard, it is useful to view FY 1972 as the year when DoD returns its effective budget and manpower levels to those which prevailed prior to the Vietnam War—requiring less than seven percent of the Gross National Product (the lowest % of GNP since 1951) and a military force structure of 2.5 million men.

The constant price figures, based upon FY 1964, adjusted for pay and price increases are much more significant. Defense spending rose by $24.1 billion from FY 1964 to FY 1968, and fell by $23.9 billion from FY 1968 to FY 1972, so that real defense spending in FY 1972 is just slightly above the FY 1964 level. (Other federal spending has grown by $68.3 billion and state and local spending by $58.6 billion. This means that net public spending (in constant prices) has grown by over $103 billion from the prewar level—practically all of it for non-defense programs.)

Expressed another way, defense spending in FY 1972 will amount to 6.8% of the Gross National Product (GNP), compared to 9.5% at the Southeast Asia 1968 peak and 13.3% at the Korea peak. (This 6.8% is significantly lower than the prewar figure, 8.3% in 1964.)

As for federal spending, the defense budget for FY 1972 is 32.1% of the total, compared to 42.5% at the Southeast Asia 1968 peak, and 62.1% at the peak of the Korean War. The 1972 percentage is nearly ten points below the 41.8% for prewar 1964.

The same pattern pertains in comparing defense spending with total public spending (Federal, state and local with grants-in-aid and other offsets netted out). Defense spending will account for 21.3% of all public spending in FY 1972, significantly below the levels in FY 1968, FY 1964, and FY 1953.

PRICE INCREASES IN U.S. ECONOMY

At the same time that the Federal Government budget is experiencing this "reordering of priorities", the entire national economy, involving every individual and every business in the U.S., has been experiencing a phenomenon which some people call "cost growth", which other people may characterize as "cost overruns", and which other people may characterize as "inflation". I think a fair assessment of the matter is that increased costs of goods and services very often involve a portion of all three. So, while we say that Defense spending will be less in 1972 as a percentage of GNP compared to previous years, or less as a portion of Federal spending, it must also be remembered that even were we to have the same numbers of dollars as in previous years, these dollars would not go as far under current economic conditions.

A few examples may serve to illustrate this point. The John F. Kennedy Center for the Performing Arts is a good example of the severe impact rising costs can have. In 1962 the initial cost estimate for the Center was $31 million. The most recent estimate is $68 million, representing an increase of 113% in eight years. The World Trade Center in New York City since 1962 has increased in cost from an original estimate of $350 million to a current estimate to complete of $650 million, an increase of 85%. There was an article in the *Washington Star* recently concerning a post office to be constructed in Secaucus, New Jersey. Congressional testimony in the spring of 1970 indicated a projected cost of about $72 million. The article indicates that the current estimate is about $120 million, or an increase of 66% in one year.

Perhaps one of the most dramatic examples of cost increase involves the conversion of the Queen Mary in Long Beach, California, to a tourist attraction. The original estimate to convert the ship in 1967 was $8.7 million. Costs incurred so far are about $60 million, or an increase of 581%, with additional cost yet to be incurred.

Our experience in buying commercial type items provides similar illustrations. In the Defense Supply Agency where there is extensive competitive procurement, we have experienced substantial cost increases completely beyond our control in the past six or seven years. For example, since 1964 the cost of simple items such as cotton shirts and trousers have increased 25% to 45%, and boneless beef has increased 40%.

Military Departments have also experienced substantial cost increases. For example, the university semester hourly fee paid by the Army has increased from $18 an hour in 1964 to $50 an hour, an increase of 178%.

In summary, Mr. Chairman, I believe it is evident that the Department of Defense is subject to the same upward pressure of wages and prices as the rest of the economy. The economic impact becomes most distressing; however, when you realize that in 1972, based on our submitted budget request, we will be operating this Department with 133,000 less personnel than was the case in 1964, only at a cost of $17.8 billion more in pay and related costs.

COST GROWTH ON MAJOR WEAPONS

This leads me to the subject of cost growth on major weapons which you asked that I discuss today. I think that everyone would agree that the Department of Defense, as well as other agencies and activities, has a cost growth problem. In recognition of this we have taken a very important first step in coming to grips with the problem. We did this last year when Secretary Packard *defined cost growth* and set forth nine categories of cost growth which are to be used in managing the problem. Now, when we talk about cost growth, we can get down to specifics and have an understanding of the causes of cost growth.

This understanding is vital in managing the problem. The most comprehensive analysis of cost growth is the recent GAO report of March 18, 1971 on the "Acquisition of Major Weapons Systems". GAO states that it is important to recognize that not all cost growth can reasonably be prevented and that some cost growth, even though preventable, may be desirable. As an example of cost growth which cannot be prevented. GAO cites the effect of unusual periods of inflation. Also, GAO notes that changes in technology may make it possible to incorporate modifications that result in overall increases in the effectiveness of a system. Such changes may also result in an increase in cost.

The nine categories of cost growth are as follows:

1. Engineering changes.
2. Quantity changes.
3. Support changes.
4. Schedule changes.
5. Unpredictable changes, such as acts of God or strikes.
6. Economic changes, such as inflation.
7. Estimating changes, such as a change in the base year.
8. Contract performance incentives, such as award fees.
9. Contract cost overruns or underruns.

To place the problem in perspective, the GAO report contains a breakdown of $24 billion in cost growth on 52 weapon systems for which Selected Acquisition Reporting System (SAR) data are available. Engineering changes account for 17% of the total cost growth. Economic changes account for another 17%. Quantity changes and support changes—where we are buying additional items—account for almost 16%. Schedule changes account for 11%. I might add here than many schedule changes are caused by factors beyond our control such as the appropriation processes. Estimating modifications account for 26% of all cost growth.

GAO recommended that DOD give increased attention to the problem of identifying cost growth. The recent report notes that DOD has made a good start in this direction with the establishment of the nine categories of cost growth. The importance of this system of classifying cost growth is that it permits us to focus attention on areas where improvements can be made. For example, the Joint Logistic Commanders (JLC) are now looking into the development of procedures for attaining a common data base and common definitions for use in cost estimating by the three Services. Additionally, the JLC are studying improved implementation of the Cost Schedule Control System criteria to improve the data available for exercising management control during the development and production of defense systems.

FEATURES OF THE NEW POLICY IN ACQUISITION OF DEFENSE SYSTEMS

When I last appeared before this Committee in June of 1969, Mr. Packard and Mr. Laird were in the process of coming to some decisions as to what aspects of DoD management needed improvement and the general direction in which they felt our efforts should go. We discussed with you in detail the environment in which major defense systems are acquired. including the various steps from the initiation of a new defense system through production and fielding of a major defense system.

At that time we were just beginning to accumulate experience on the use of such management tools as the Development Concept Paper (DCP) and the Defense Systems Acquisition Review Council (DSARC).

We also mentioned other approaches which we were exploring to improve the efficiency and effectiveness of the acquisition process. These included improved program management, modifying the approach to the systems acquisition process, and improved initial cost estimates.

In the development and acquisition of new defense systems, the past two years have seen a number of substantial changes. As you know, the Deputy Secretary of Defense has directed a substantial effort toward resolving these problems. He has essentially reoriented the defense system acquisition process.

Defense Systems Acquisition Review Council (DSARC)

In past years OSD offices became too deeply involved in selective specific programs, and in making decisions that more logically could be made by the Services. We believe this was wrong. The programs, under control of more than 200 project managers, are simply too big and too numerous for this kind of OSD activity. OSD has the responsibility for establishing policy, making the key decisions for transition from one phase to another and evaluating performance.

The Services have the responsibility for managing the programs. A Defense Systems Acquisition Review Council (DSARC) was established by Secretary Laird to assist him in making these critical decisions. The mission of the Council is to review major and important weapon system acquisition programs at appropriate milestone points in their life cycle and make recommendations as to the status and readiness of the program to proceed to the next phase of effort.

The DSARC is comprised of the Director of Defense Research and Engineering and the Assistant Secretaries of Defense for (Installations and Logistics), (Comptroller), and (Systems Analysis). Usually the first review is when the sponsoring Service desires to initiate a major new defense system, the second prior to approval for full-scale development, and the third prior to release for production. Additional reviews can be called, as I will explain later, when thresholds specified in the Development Concept Paper (DCP) are broken.

Development Concept Paper (DCP)

Used in conjunction with the DSARC considerations is a document which I have already mentioned, called the DCP. The DCP is a summary top management document, limited to twenty pages, which assesses the important factors in each decision, including risks, full military and economic consequences and alternatives with pros and cons of each. Furthermore, it provides explicit decision-review thresholds for key factors such as cost, schedule and performance. The DCP is also a record of the decision and its rationale. An updated DCP is provided for the DSARC review and then is forwarded to Secretary Packard, with recommendations of the DSARC, for final decision. It then becomes an arrangement between the Secretary of Defense and the sponsoring Service, prescribing the limits or thresholds for delegating the authority for managing the program. As long as the program proceeds within these thresholds, the next top-level review will be held at the next transition milestone. If, however, a cost, schedule or performance threshold is threatened to be breached, the program is subject to a special DSARC review, where a recommendation will be made concerning a program adjustment.

Service Responsibility

The Services are given the responsibility for program execution management. They are given the appropriate delegation of authority. We have taken the necessary steps to precisely define the responsibilities between OSD and the Military Departments. Additionally, we are taking steps to define more explicitly the responsibilities for review and for action within the Military Departments themselves. Lack of proper designation of responsibility has in the past, in large part, caused the past layering of staff reviews and staff action in carrying out the acquisition process.

Briefly stated, we have adopted a concept of program management that is based on participatory decision making, accomplished through decentralization and delegation of authority under specific guidance. The concept attempts to place more emphasis on people and less emphasis on elaborate procedures. Directives, instructions and procedures have been modified and eliminated in many instances to reflect this change in direction.

Our prime objective is to enable the Services to improve their management of programs. To accomplish this, our policies add new stress on the quality and importance of people. It is our belief that if we are to improve the acquisition process, we must put and keep better people in the key management jobs related to this process. The simple guidelines provided by Mr. Packard were, "put more capable people into program management, give them the responsibility and the authority and keep them there long enough to get the job done right." We have a long way to go for program improvement to become satisfactory, but we are moving in the right direction.

Development Policy

We also must bring into the acquisition process certain restraints regarding operational objectives. We don't have the money to buy all of the desired operational capabilities which are often specified in the requirements. There is always a risk that the desired operating capability for a new system cannot be met within reasonable time and cost constraints. Technical risk will be minimized by risk analyses at all stages and by early component testing, or where feasible, complete system prototyping. Another important way to reduce risk, and cost, is by tradeoff—e.g., by giving up an on-the-deck supersonic dash capability and thereby reducing development risk, complexity and cost. As Mr. Packard has

stated, the cost of developing and acquiring new systems is more dependent upon making practical tradeoffs between the stated operating requirements and engineering design than upon any other factor. This must be the key consideration at every step in development, from early conception until the new weapon goes to the military forces. Tieing ourselves to production dates before technology is in hand will be avoided and current technology should be used where possible. That is, development problems must, in general, be resolved before initiating production.

We are requiring the program schedule to be structured to allow time for accomplishing the development job without unnecessary overlapping on concurrency of effort within the development process or between development and production. Enough slack time is to be allowed to deal with the unanticipated problems. If development milestones are not met, releases will slip.

It is desirable to have completed development testing before initiating production. In most progams, it is not practical to actually complete the development, produce a test quality, do the testing, and then start up the production again. Frequently, some limited expenditure on production may have to overlap development to demonstrate engineering accomplishment and necessary production engineering. It is also frequently desirable to have the system that is being tested fabricated with production tooling and processes to insure that it is representative of the production article. The acquisition process should be structured, however, to establish milestones which demonstrate the actual achievement of development objectives at appropriate points in the development program. By this we mean proof by test of hardware that the program is moving ahead. Progressive commitments or resources are to be based upon successful accomplishment of these milestones rather than calendar dates.

With regard to the testing that is required to prove out a system before going into production, I can't overemphasize the importance of this point. We just can't substitute hopes, anaylses or predictions that everything will work as planned for hard facts based on test results. Mr. Packard has been a leading proponent of this. This is more than talk. He is doing something about this. He has recently authorized the creation in Dr. Foster's organization of a Deputy Director for Test and Evaluation. This position will be filled by a man with a "can-do" reputation. He will review the test concepts and plans for major defense systems and provide an assessment of test results prior to the production decision.

The Development Contract

Since our policy is to use risk assessment, demonstrated milestones and continued trade-off activity to determine necessary program adjustments, the type of contract used for development of a major weapon system must be tailored to the risk involved and provide a vehicle for accomplishing this policy. We have eliminated the practice of attempting precise production cost estimates for a complex new defense system before it is developed. A cost estimate in advance of development is often only an educated guess. Since important trade-offs are made as development progresses, the production cost estimates are continuously modified based on the trade-off analysis. Our belief, therefore, is that these development contracts should almost always be cost incentive type contracts. They provide the trade-off flexibility essential to sound development. Obviously, if we use these types of contracts we must do a good job of managing them to keep costs under control. Contractors who accept such contracts must be willing to accept more closer management involvement by the Services. Government disengagement is not compatible with cost reimbursement type contracts. I know of no other workable approach to this problem.

When risks have been reduced to the extent that realistic pricing can take place, we will move toward fixed-price type contracts. In most cases, fixed-price type contracts for production should be negotiated when the development has progressed to the point that the production design is adequately documented and can be realistically specified and estimated.

One cause of lack of program cost control has been the use of letter contracts and the authorization of ill-defined changes. To deal with this problem our policy is that Letter Contracts will be minimized and changes will not be authorized until they have been contractually priced or until contractual ceilings have been established. Both of these topics are a matter of constant attention to DSARC and Management Review meetings. As a result of the attention given at all levels open letter contracts have been reduced from $4.4 billion to $1.2 billion

since January 1969 and undefinitized change orders have been reduced from $1.7 billion to $1.2 billion during this same time period.

The Selected Acquisition Report (SAR) is also used to maintain surveillance of these programs. The SAR is a quarterly management report that summarizes cost, schedule and control information for the program. If the report indicates that DCP cost, schedule or performance thresholds are threatened the program is subject to a special DSARC review.

We believe that these new techniques in the management of weapons system acquisition represent a major step forward in solving the problems which have plagued this area.

DEFENSIVE INDUSTRY PROFITS

Turning now to the subject of profits, I would like to discuss the recent studies that have been made on this subject. These studies further emphasize my opinion when last testifying before this Committee; that average profits earned on defense business are neither excessive nor unreasonable. Measured by any meaningful standard Defense profits have shown a continuing decline during the past 11 years.

The recently released report by the General Accounting Office (GAO) entitled Defense Industry Profit Study discloses that pre tax defense profits calculated as percentage of sales have dropped from 4.7% in 1966 to 3.4% in 1969—a 27% decline during that four-year period. In all the four years covered by the GAO study the rate of profit to sales earned on commercial business was about twice the profit earned on government business. As you are aware, the GAO computed profit as percentage of sales, as a percent of total capital invested and as a percent of equity capital.

I believe it might be worthwhile to review the definitions of these measures of profitability, and to discuss both the applications and the limitations of each base as a meaningful measurement. Profit expressed as a percentage of sales is perhaps the better known measurement used in many circles because it is easy to calculate, simple to understand and permits comparison of many industries on a common base readily available to the public. Also in some industries there is very little capital employed. The percentages are derived by dividing net profit either before and/or after taxes by the annual sales volume. Another base used for measuring profitability is equity capital invested (ECI) which includes the dollars assigned to capital shares, retained earnings, and other capital reserves. This base reflects for the most part capital supplied by stockholders as well as earnings retained in the company for future growth.

The rate of return on ECI is calculated by dividing profits before and after taxes by equity capital. It is an important rate of return to the owners of the business. since in effect it represents the return on the owners capital. It should be noted, however, that this ratio does not reflect the total capital used by a company in its business operations.

The third generally accepted measurement base that I will discuss is the one I believe to be most meaningful—that is, the total capital invested (TCI) used in the business. Another way of defining TCI is to say that this base consists of the total capital provided by the creditors as well as the owners of the business. This definition of course excludes government owned or leased items which are not reflected in the corporation's financial statement. The rate of return on TCI reflects profit therefore to the capital available to produce that profit, regardless of the *source* which provided it. As long as the Government does not allow the cost of interest in its reimbursement of costs, we should not be concerned with whether contractors secure capital from debt sources (loans) or from the equity market (stock). Interest, as you know, is not an allowable item of cost on government contracts and must be paid out of profits; therefore, in my opinion, total capital is the more meaningful measurement base to use in evaluating profits and overall profitability trends.

GAO Study

Measuring profit as a percent of total capital invested, the GAO study reveals that DoD contractors have realized a weighted average pre tax rate of 11.2% over the four years included in their study. For the same period commercial business of these defense firms returned an average of 14% pre tax. For each of the four years covered by the report the statistics show that commercial profit exceeded profits realized on defense contracts as a percentage of total capital invested. This trend is depicted in the following tabulation:

PROFIT AS A PERCENT OF TCI (PRETAX)

	1966	1967	1968	1969	Weighted average
DOD	11.3	12.1	11.9	9.5	11.2
Other Defense agencies	15.8	14.7	15.5	14.0	15.0
Commercial	16.2	12.2	15.6	12.4	14.0

A similar trend was noted in figures reported by the GAO when profit was measured as a percent of equity capital invested. You will note that in only one of the four years did profit as a percent of ECI for defense business exceed the profit realized by these companies on their commercial programs.

PROFIT AS A PERCENT OF ECI (PRETAX)

	1966	1967	1968	1969	Weighted average
DOD	21.4	22.9	22.6	17.4	21.1
Other Defense agencies	28.7	27.1	28.9	24.8	27.5
Commercial	26.4	19.6	25.8	20.4	22.9

For the four years studied the weighted average pre tax profit earned on ECI for defense contracts was 21.1% as compared to 22.9% earned by these companies on commercial business. The weighted average FTC/SEC comparative number reflecting comparable durable goods categories for American industry is 24.1% for these same years.

Since all figures used in these tabulations are expressed on a pre-tax basis the profit earned by Defense contractors would be reduced by approximately one-half if these numbers had been expressed on an after tax basis.

The conclusions reached in the GAO report and their objective analysis of defense profit statistics reinforce the earlier studies performed by the Logistics Management Institute in which that firm studied defense profit trends for the 11 year period 1958 to 1968. The two studies are quite similar with comparable results and recommendations. Both studies measured the annual profits of a large sample of defense contractors and provide comparisons with commercial profits. From either of the studies it is more than apparent that excessive profits are not being realized in the defense industry. In our opinion, the GAO data reflects conclusively that average defense profits, based on sales or on total capital invested, are lower than non-defense profits in American industry.

The GAO study presented results based on two separate study techniques. I have commented on the larger sample in which companies submitted annual data to GAO in response to their questionnaire. This data was audited, verified and reviewed to the extent deemed necessary by GAO's field audit activities. We are in complete agreement with the sampling techniques and with the conclusions reached by the GAO regarding this phase of their study. The second phase, however, was narrow. It included only 146 contracts performed over an indeterminable number of years. The GAO report cites only very generalized criteria as to how these contracts were selected. In fact, it is our understanding that 48 of the 146 contracts were issued in the early 60s (1965 and earlier). We have been advised also that 10 to 12 of the 146 contracts are not DoD contracts. Even if all contracts had been awarded and completed during the four-year study period, this sample represents less than 3% of the total dollars of contracts awarded during that time frame. Many of our contracts go to types of industry requiring comparatively little capital. Some of these contracts are probably with such industry groups. The GAO has clearly stated that its limited sample is not representative; and they have cautioned against such generalized conclusions as have been reached by the communications media. It is unfortunate that parts of the press seized upon this data and wrote headlines which tend to becloud the more significant findings and conclusions reached by GAO.

As you can well appreciate, profits may be calculated in any of several ways. Unfortunately there is no standard for realistically comparing profit earned on a defense contract with that earned on commercial work. While we consider profit on an individual contract an important segment of procurement, using

such figures on a contract-by-contract basis as a measure of profitability for the entire defense industry is both artificial and misleading. A corporation's profit performance is measured for a period of time, usually a fiscal year, and not by its return on an individual contract. You recognize as well as I that in some cases relatively high profits will be earned on some contracts while on others substantial losses may occur. But on an overall basis there is no evidence to support the inference that there is a trend towards excessive profits in the defense industry. In fact, our concern should be that the trend is in the opposite direction.

Renegotiation Board

Congress has established the Renegotiation Board to protect the public against any abnormally high profits by individual companies. The Department of Defense has consistently supported legislation to continue the Board. It, too, annually reports on total government negotiable sales and profits.

It might be worthwhile to look at the factual data which has been published by the Board during the past 15 years (fiscal years 1956 through 1970).

BEFORE TAX NET PROFIT AVERAGES ON SALES, RB YEARS 1956 THROUGH 1970

[Dollar amounts in billions]

RB year ending June 30	Renegotiation sales reported	Net renegotiation profits reported	Before tax percent on sales	RB year ending June 30	Renegotiation sales reported	Net renegotiation profits reported	Before tax percent on sales
1956	$28.2	$1.8	6.5	1964	39.3	1.1	2.9
1957	27.7	1.6	5.8	1965	34.8	1.0	3.0
1958	26.6	1.3	4.9	1966	31.8	1.0	3.0
1959	26.3	1.1	4.2	1967	33.1	1.2	3.5
1960	28.5	1.1	4.0	1968	38.8	1.7	4.4
1961	25.1	.9	3.6	1969	48.5	2.2	4.5
1962	29.3	.9	3.1	1970	48.0	1.5	3.2
1963	31.2	.9	2.9				

I emphasize that these profits reported are before tax.

As you know, the Renegotiation Act of 1951 requires that the Renegotiation Board review the total profits derived by a contractor during its fiscal year from all its renegotiable business, including subcontracts, in order to determine whether or not the profit earned during that year was excessive. Excess profits are then recouped. The volume of sales reported has increased significantly during the past ten years and the number of filings with the Renegotiation Board have increased accordingly. Yet despite the fact that renegotiable sales have increased approximately $20 billion, the average profit as a percentage of sales before taxes for 1970 is less than half that reported in 1956. I do not contend that these figures should be used as exclusive increments for evaluating profit on a year by year basis but I do contend that the data reflects a trend which supports the conclusions that average defense industry profits earned on government business are neither excessive nor unreasonable.

Conclusion as to Defense Profits

From the above evidence and from all other data that I have been able to examine I can only conclude that those who express the opinion that high profits are being made by the Defense industry are making assumptions not supported by facts. I find no evidence to support the inference that on the average the Defense Industry is a profiteering industry. We must be concerned and are concerned with the possibilities of recurring excess profits by individual companies or excess profits on noncompetitive individual contracts. At the same time I believe that both the Department of Defense and this Committee, in the interest of national security, should be much more concerned that perhaps there are insufficient average profits being realized and that this will in turn affect the future viability of our defense industry mobilization base.

I realize that this Committee fully appreciates the importance of a healthy defense industry in the interests of national security. I'm also appreciative of the importance of sound economic policies in the eyes of this Committee. I'm reminded of the words of Bernard Baruch when he said "If our general economic policies and national defense are sound we need not worry. On the other hand, if we fail to preserve national security and credit nothing any of us owns can have

a lasting value." Frankly Gentlemen, I'm much much more concerned that we may adversely effect our national security by allowing the health of this industry to deteriorate because of the "profits are bad" syndrome, than I am about average realized profits of defense contractors going up significantly.

Proposed Revision of DoD Profit Policy

As you are probably aware, the Department of Defense has been vitally interested in improving its policy for establishing prenegotiation profit objectives. During the last several years a considerable amount of effort has been expended in searching for the most administratively feasible method of allocating capital to government contracts. At this time we have evaluated a number of alternatives and are now in the process of gathering capital data on approximately 300 contracts. With this information a number of alternatives can be tested, the dollar impact assessed, and we can ultimately introduce as a part of our profit philosophy a revised policy which will give adequate recognition to capital employed on government contracts.

A special subcommittee has been created within our Armed Services Procurement Regulation Committee which is well underway at this time with its testing plans. Both contractors and contracting officers are being briefed on the concept at four prime locations, and we anticipate that further presentations will be scheduled. While some progress has been made toward the objective of recognizing capital employed we do not anticipate that any significant changes will be made to the profit policy before the end of this calendar year. If an administratively sound approach can be developed it will be implemented.

We must constantly practice sound business policies in the Department of Defense. The undue concentration of our efforts on this small segment of the total price tends to shift our attention from other important avenues for reducing the total price paid by government for products it purchases. Considered as a whole based on Renegotiation Board data, average after-tax profits (estimated 50% for taxes) are about 1.6% of sales. This is less than 1% of the DoD budget. Gentlemen, I submit that it is ridiculous to give the abnormal degree of attention that many people have been giving, to developing additional techniques for controlling this area, when we really can so much more beneficially devote our time to those other areas of total cost which will allow us to secure the maximum return from our defense dollar.

REDUCTION IN INDUSTRIAL PLANT EQUIPMENT

We are aggressively continuing our efforts to selectively reduce Government-owned industrial facilities in the possession of contractors. In the area of industrial plant equipment—severable machine tools, etc.—we have reduced the number of machines in the possession of contractors by 25% in the last two years.[1] This represents a 20% reduction in acquisition value.

The number of Government-owned industrial plants has also been significantly reduced. In 1954, the Department of Defense owned 288 plants, currently we own 189. Approximately 100 plants have thus been disposed of during this time period and we currently have several in the process of disposal. The recent overall economic downturn and resultant decreased demand for production capability has slowed our disposal actions. It has been especially difficult to consummate sales of very expensive large installations.

The disposal of equipment in the possession of contractors was slowed during the Southeast Asia buildup. In fact, it was necessary to increase the amount of equipment in some contractors' plants. A number of contractors were reluctant to displace stable, profitable commercial business in order to produce military products. It was, therefore, necessary to provide Government-owned production equipment to these contractors in order to obtain the military items that were urgently needed in Southeast Asia. With the requirements for support of Southeast Asia now phasing down, we are increasing our efforts to reduce Government ownership of industrial facilities in contractors' plants.

We are handicapped in our disposal efforts, however, by the lack of authority to negotiate a sale of equipment in-place to the using contractor. In many cases equipment is excess to Government ownership but it is not excess to Government production requirements. Thus, equipment has had to be held in-place under con-

[1] See letter from Elmer Staats, Comptroller General of the United States, dated June 14, 1971, on p. 1216.

tinued Government ownership to assure an adequate production capability to meet defense requirements. This situation, of course, perpetuates the problem of surveillance and management control and interferes with the contractor's freedom in use of his overall production operation. Approximately 550 contractors are involved in this type of situation, including some 200 small business concerns. Legislation is pending in Congress which would authorize such sales.

We have developed several programs and policies that will result in further significant reductions in our inventory.

a. Under the Department of Defense Industrial Facilities Phase-out program all contractors are presently being screened to determine those that can be phased-out without causing an adverse effect on current and projected defense requirements. As of 31 December 1970, 111 phase-out plans had been submitted and approved; approximately 700 more are in process of review. We intend to vigorously pursue this program of reducing Government ownership of equipment in contractors' plants. Mr. Packard reaffirmed this policy in a memorandum to each of the Services and the Defense Supply Agency on February 13, 1971.

b. Policies concerning the furnishing of additional facilities to contractors have been restricted to those instances where additional equipment is necessary to meet an authorized preparedness requirement or when it is determined that essential DoD requirements cannot be met by any other practical means.

c. Contractor use of Government-owned facilities for commercial work is permitted on a restricted basis. To discourage such use for any extended period of time, the rental rates were increased in 1968 to a point where they generally exceeded commercial rates for like equipment. Under these rates, rentals amount to 96% of the cost of a new machine in the first three years. Many contractors have complained that these rates are too high and they cannot remain competitive when paying such rent. Contractors have further stated they could lease like equipment from commercial sources at lower rates and have the option to purchase the property at a later date with a portion of the rental paid applying toward the purchase price. Some have taken this course of action. It has been nearly three years since the current rental formula was developed. We are therefore currently examining these rates, in cooperation with the Office of Emergency Preparedness, to assure that rental charges are equitable in today's environment. We believe it is of utmost importance that contractors are not given a competitive advantage by this usage. We further desire that our rates be sufficiently high to discourage commercial use for extended periods.

d. The surveillance of utilization of Government facilities is being more closely monitored by on-site contract administration personnel to assure that property is used for the purpose intended. When the purpose for which the equipment was furnished is completed, action is taken to promptly remove the equipment from the contractor's plant or take such other action as may be determined to be in the national interest.

e. The Department of Defense actively supported legislation that was proposed in the 90th and 91st Congress that would authorize the negotiated sale of Government equipment to the using contractor. Passage of such legislation is needed in order to reduce Government-owned facilities in contractor plants while at the same time maintaining the capability to meet current and future defense requirements.

I am sure you recognize that the management of our inventory of Government-owned facilities is a very complex task. There are no quick easy solutions to all of our facilities problems; however, I feel the actions we have taken in the past and the ones we have in process, will result in a reduction of our holdings to only those that are essential to current and future preparedness requirements. This will take time to accomplish. The average age of our Government-owned industrial plant equipment is 16 years. With strict control on furnishing additional equipment, our inventory in the hands of contractors will decline as this old equipment is phased out.

I recognize the importance and magnitude of this problem and I assure you we will continue to give it a high priority in attention and effort.

PROGRESS PAYMENTS

I would like now to turn to the subject of progress payments. "Progress Payments" is a technical term. Often people group other types of payments into this category, such as advance payments, partial payments, or even, on occasion, government guaranteed loans. Advance payments are almost exclusively restricted

to revolving type funds with contractors operating Government-owned facilities or with research educational institutions and are established at the time of the award of the contract.

The funds available in the account at any one time are a nominal amount. Partial payments are actual payments for items delivered under fixed-price type contracts. Progress payments on the other hand are payments to contractors based on cost incurred in the performance of Government contracts. Contracts providing for progress payments contain specific clauses governing the extent to which those payments will be made, and there is considerable policy guidance relative to determining the need for progress payments and the administration of contracts in which progress payments are granted.

Generally, in contracts on which progress payments are made, there is a substantial lead-time between contract award and initial delivery. The long cycle from award in some major contracts to first delivery necessitates considerable financial commitment by contractors for tooling, pre-production expense, purchase of long lead-time materials from subcontractors and other related expenses. On 31 December 1970 outstanding progress totaled $9.4 billion as compared to outstanding progress payments of $9.8 billion on 30 June 1970. (These figures include progress payments for ship construction.)

Outstanding progress payments are about double what they were in 1964. Mr. Packard has been concerned with the problem created by DoD financing of its long term contracts. He has directed a study to see whether it may be feasible to transfer a significant portion of this function to the private sector.

PUBLIC LAW 87–653—THE TRUTH IN NEGOTIATIONS ACT

I would now like to comment on Defense implementation and enforcement of PL–87–653, the Truth-In-Negotiations Act. As you know, this law was passed to put the government contract negotiatior on an equal factual footing with his industry counterpart for the negotiation of sole source or non-competitive contracts. This is where the law gets its name.

To achieve this goal, contractors are required to submit cost or pricing data and certify that it is current, accurate and complete. The statute further provides that the contract price shall be adjusted to exclude any significant sums by which it may be determined by the head of the agency that such price was increased because the contractor or subcontractor furnished data which were inaccurate, incomplete or non-current.

The key to understanding the law is that it applies to sole source or non-competitive contracts. Our whole pricing system is structured around the idea that free and open competition is the best guarantee that a given price is fair and reasonable. Where price competition is present, there is no need to analyze individual cost elements. The people who drafted PL 87–653 obviously had this in mind. The law is written so that cost or pricing data must be furnished only where we are in a non-competitive situation. Also, the drafters of the law recognized that established catalog and market prices of commercial items sold in substantial quantities to the general public are just as competitive as prices which are established by formal advertising or by competitive negotiation. Contracts for such items, as well as those in which the prices are set by law or regulation, are exempted under the law.

DoD Implementation of the Law

The law does not define terms that it uses. This has necessitated the drafting and promulgation of detailed procedures in the Armed Services Procurement Regulation to implement the law. The result has been a continuous refinement of our procurement regulations as problems come to our attention. For example, regulations have been promulgated to deal with such questions as:

What is cost or pricing data?
What is adequate competition?
When is cost or pricing data submitted?
What date shall the certificates be dated?
Are setoffs permissable?

We recently published guidance on the requirements for submission of contractor cost or pricing data. We currently are developing a form to more clearly define the "catalog price" of an item sold in substantial quantities to the general public. We have been criticized on the one hand for not going far enough in

specifying actions to be taken to implement the law and we have been criticized on the other hand for going way beyond the original intent of the law. On balance, we believe that we have effectively implemented and complied with the law. The Armed Services Procurement Regulation is the most detailed of all the government procurement regulations on PL 87–653. Our negotiators and buyers have received extensive training in the requirements of the law and we have a significant audit effort to review contracts on an after-the-fact basis.

GAO Report, December 29, 1970

I think it is significant to review the most recent GAO report on this subject dated December 29, 1970, in which GAO reviewed 35 noncompetitive contracts valued at $135 million. Potential overpricing totalling $1.5 million was found in 18 of these procurements. I use the word potential because there may be significant amounts of underpricing. This occurs frequently and the courts have determined that contractors are entitled to set-off such amounts against any overpricing. In any event, the $1.5 million is about 1% of the total contract dollar value. It should also be noted that in the 18 procurements where GAO found overpricing, about ½ of them, or ¼ of all the contracts reviewed, involved one type of item—hand grenade fuses. Action has been initiated to recoup that which is due us on these contracts.

Waivers to the Law

The law recognizes that there may be situations where for one reason or another a contractor may simply refuse to furnish cost or pricing data and it is still in the government's best interests, after full review and approval at the Secretarial level of the Miliary Department, to go ahead and contract with that firm. Defense has granted less than 100 waivers (about 85) since 1962 whereas there have been well over 100,000 contractual actions where contractors have furnished cost and pricing data and the necessary certification. This low number of waivers is a direct reflection of the efforts of DoD, and the Military Departments, to obtain compliance with the law by contractors.

To be sure, there are problems connected with the implementation of the law. The Navy, for example, has had problems with respect to the purchase of specialty steel and forgings for its shipbuilding program. The Navy is not satisfied that there is adequate price competition present in the purchase of HY80 and HY100 steel by its prime contractors. It has taken action to have the Federal Trade Commission look into this matter again and it has also asked the GAO to audit these contracts. In the forgings area, the Assistant Secretary of the Navy was successful in obtaining cost and pricing data from one contractor and was not successful in another case. We support the Navy's efforts in attempting to obtain cost or pricing data. The application of this law, or any other law for that matter, to a specific fact situation involves the use of judgment. Situations inevitably arise where reasonable men will differ. We recognize that such problems exist and we attempt to deal with them in the only practical way, which is on a case by case basis.

Pricing is one of the most complex aspects of procurement. It cuts across all industry, commodity and geographical lines. I believe it is reasonable to expect that other problem areas in contract pricing in relation to the requirements of PL 87–653 will be identified from time to time and that our procurement regulations will have to be further refined. This is a continuing process. We welcome the constructive criticism of the Congress, the General Accounting Office, and other interested parties as well as our own auditors and procurement managers. We hope that we can continue to improve upon the effectiveness of our implementation of PL 87–653.

SHOULD COST

I would like to touch now on a rather important point with respect to cost estimating. This is the subject of should cost. Possibly, this term is a misnomer, since the technique really is nothing more than the application of a sound industrial engineering approach to cost estimating. It is not new. The objective is to establish a fair and reasonable price. The philosophy is that historical costs should not necessarily be accepted as the base point for starting negotiations for production items which are non-competitive or where the contractor's business is largely non-competitive. This is particularly true where there is a history of rising costs for those items. Rather, the Government should look at the way he conducts his business, including his non-Government business, to eliminate non-productive and

inefficient practices and procedures which may have resulted possibly because competition is not present. In other words, the price that we pay ought to represent what that item should cost, assuming reasonable economy and efficiency.

Should Cost Techniques

How you obtain a fair and reasonable price and get a contractor to operate his plant in a manner that reflects reasonable economy and efficiency is the difficult aspect. This is the "how" part of the equation, or the technique. There are any number of ways of doing this. For some time now, DoD has sought to improve the economy and efficiency of our major contractors by maintaining a presence in the contractor's plant. Where we cannot be present on a full time basis, we go into his plant and review selected aspects of how he conducts his business. We review such things as his purchasing system, his make-or-buy decisions, his overhead costs, and so forth.

We recently have developed another way to accomplish our objective of good pricing. This is to organize a team of experts in procurement, industrial engineering, design engineering, accounting, legal, and so forth, and send that team into the contractor's plant for an extended period of time to engage in an in-depth review of the contractor's operations and relate them to a specific price proposal for items which we are about to buy. The team looks at such areas as his industrial engineering standards, plant layout, production methods, purchasing system, accounting system and overhead structure. They document their findings and quantify the effect that recommended changes would have on the price for these items. This is a price which those items should cost assuming reasonable economy and efficiency. Moreover, they make use of the Government's bargaining power to get the contractor to agree to a management improvement plan to achieve economy and efficiency on a long term and continuing basis.

I think that it's significant to note at this point that we have performed functional analysis in these areas in the past. The thing that is different about the integrated team approach is that it is a highly concentrated and intensive effort and there is a greater emphasis placed on such aspects as industrial engineering. Also, the scope of inquiry is broader. The team may look at the contractor's entire business, or at least all the business which is in that plant, as opposed to perhaps only a product line. This highly organized and concentrated effort is the chief ingredient in placing our negotiators in a stronger bargaining position. Hence, it is a tool that can enable us to do a better job of pricing.

We are exploring in detail various techniques regarding the conduct of these in-depth, in-plant reviews of contractor operations. You are familiar with the review conducted by the Navy at Pratt & Whitney. The Army built upon that experience in conducting reviews at Raytheon and Bell Helicopter. The Army experimented with the technique further at the Holston Army Ammunition Plant and at Hazeltine. It is conducting other reviews right now and has more on the drawing boards. The Navy is using an outside contractor with a recognized expertise in industrial engineering to look at the Mark 48 Torpedo program. The Air Force is using the technique with General Electric and Boeing.

Other Aspects of Implementing Should Cost

We believe that there is a definite place for the use of integrated teams performing such in-depth and in-plant reviews. We established a Should Cost Coordinating Committee as a forum for the interchange of our experience in utilizing this technique across departmental lines.

We do not intend at this time to publish uniform DoD guidance on how to organize and conduct such reviews. These must be custom tailored to the product we are buying, to the procuring activities' organizational structure and to the contractor himself. The Departments are free to innovate. We plan, at some future date, to formally synthesize our total experience and publish broad policy guidance on the use of this technique. However, I expect that the mechanics of how such studies will be conducted will remain largely in departmental regulations. We are encouraged by the results achieved by the use of this technique to date. I am confident that its use will expand as our experience widens.

I appreciate the concern of this Committee and other members of Congress, as well as every citizen in this country, that the acquisition of Defense supplies and equipment is carried out as efficiently as possible so as to minimize waste and obtain the most for each dollar spent. The policies and procedures I have discussed in this statement are structured to do just that.

Mr. Chairman, I have tried to provide the Committee with information in the areas in which the Committee has expressed some interest. I will be glad to answer any questions you and the other members may have.

Chairman PROXMIRE. In your statement you outline the main features of the administration's new program management policies for the acquisition of weapon systems.

You state that the main concept is decentralization and participatory management on the part of the services, but that the services nonetheless remain subject to central guidance, provided by the Defense Systems Acquisition Review Council (DSARC) and Development Concept Papers (DCP's).

You indicate that the DSARC has scheduled meetings at three major milestones in a program's life, and that in conjunction with each of these meetings a DCP paper is fully coordinated and approved, setting forth program thresholds with respect to such matters as cost, schedule, quality, and technical performance. Finally, you indicate that special meetings of the DSARC are held, and the DCP's updated, whenever any of the three thresholds threaten to be breached.

Let me ask you about the application of these procedures to the F–14 program during the past 2 years.

The Navy decision to increase the projected F–14 buy from 469 to 722 aircraft strikes me as a significant change in the original quality threshold for the F–14 program.

When was this decision first made by the Navy?

Mr. SHILLITO. The decision to proceed on the F–14 program?

Chairman PROXMIRE. The decision to increase the projected F–14 buy from 469 to 722.

Mr. SHILLITO. That was a part of the F–14 program decision, as I recall, Mr. Chairman, several years back.

Again, depending on the extent of the details that you want to get into on the F–14, I would urge that you have the program manager visit you on the F–14.

Chairman PROXMIRE. I appreciate that. Of course, you may not be able to answer these directly, you may have to go to the records. But if these are going to have any meaning we will have to put some flesh on the bare bones and see what they really spell out.

Was this decision preceded by a DSARC meeting and the coordination of a DCP approving and reflecting the reasons for the increased buy?

Mr. SHILLITO. The last DSARC meeting that we had, Mr. Chairman, was last fall. At that time the entire program was gone over in some detail. The quantities were covered in some detail also. And I believe the meeting date was last October.

Chairman PROXMIRE. That was the last meeting. I just wonder whether there was a meeting that preceded your decision to expand the projected buys from 469 to 722.

Mr. SHILLITO. As to the 722, I think this actually goes back several years.

Admiral dePoix, do you recall that?

Admiral DEPOIX. No, I don't remember the circumstances. But the DSARC last October approved the 1971 buy.

Mr. SHILLITO. That is right.

Chairman PROXMIRE. Were reasons stated for the increase?

Mr. SHILLITO. Mr. Chairman, there was comparatively little in the way of awareness as to that which you have called an increase. In

all seriousness the entire situation as to the present F–14 problem has not been thoroughly reviewed yet by DSARC. We have a meeting coming up this week on the program.

Chairman PROXMIRE. I am talking about the quantity increase from 469 to 722, not the cost increase.

Mr. SHILLITO. I can recall that the 722 number including all year requirements goes back into a prior time frame.

Do you want to add to this, Admiral dePoix?

Admiral DEPOIX. No. The last DSARC adjusted the 1971 buy, and there would be further adjustments by the DSARC.

Mr. SHILLITO. That is right. You see, we don't have a commitment yet that takes us through the 722, as I am sure you appreciate. There are options but I am not sure just exactly what the numbers are that take us through the various options. We don't have a commitment yet to go through the complete program.

Chairman PROXMIRE. You say you haven't got a commitment? You mean you haven't decided to go to 722?

Mr. SHILLITO. That is right.

Chairman PROXMIRE. And that means you haven't decided to protect your contract with Grumman?

Mr. SHILLITO. We have a contract with Grumman.

Do the options take us through the 722, do you know, Admiral Reich?

Admiral REICH. No, I can't help on that one.

Chairman PROXMIRE. That was what I indicated in my opening statement. You are in a difficult position and, if you want to go ahead you might be victimized.

Mr. SHILLITO. Mr. Brazier says that we have options to take us through the 469. But beyond the 469, of course, it becomes a different contractual arrangement or a new ball game, if you will.

Is that correct, Don?

Mr. BRAZIER. Yes, if we decide to proceed with a higher number.

Chairman PROXMIRE. Whatever the number is.

The decision to stretch out the F–14 buy so that 192 aircraft will be purchased over the next 4 years rather than the next 2 years will have two effects: First, it will raise the cost of these 192 planes approximately $1 billion; and secondly, it will leave the Navy with approximately 400 planes still to be bought when the F–14 contract expires.

Isn't a stretch out of this kind every bit as much a cause of unjustifiable cost growth as a simple cost overrun on a contract?

Mr. SHILLITO. I can't reconcile these numbers.

Can you, Mr. Brazier?

Mr. BRAZIER. No.

Mr. SHILLITO. I am going to have to give you the information for the record, Mr. Chairman.[1]

Chairman PROXMIRE. Let me put it in a different way, then.

Wouldn't it be more responsible for defense managers faced with short term budget problems, to determine which of their programs were of high priority and which of low priority, and then to cancel low priority programs and fund high priority programs at an economically efficient rate, rather than stretching out all programs and actually raising the long term cost of the taxpayers?

[1] See response on p. 1165.

Mr. SHILLITO. Mr. Chairman, indeed it is sound but we continuously assess the priority of our programs. There is just no question about that. I know you have made this point several times. As I recall, this last month you made it in a speech—and we agree with it. At the same time our priorities get to be pretty dynamic.

It gets additionally awkward when you are looking at a major weapons system which may take as much as 7 years from development to operational inventory. You find yourself continuously making these trade offs and, sometimes you find it necessary to stop work on a major weapon system that has gone along quite a ways. The priority assessment is something that we must do, and we do do. But it is a dynamic thing. It is not a static thing.

Chairman PROXMIRE. I am just wondering whether or not in these stretch outs you fully evaluate the additional cost by a billion dollars.

Mr. SHILLITO. Sometimes the stretch outs can be economically sound.

Chairman PROXMIRE. I am sure it can be. But just on the basis of the apparent cost here I wonder.

IMPACT OF STRETCHOUT ON F–14 COSTS

Let me ask you this. Since the decision to increase and stretch out the F–14 buy was made some time ago, and it has obvious cost implications, why has the DSARC permitted the Navy to go on telling the Congress, until as little as 2 months ago, that F–14 unit costs would be $11.5 million a copy, a figure which has meaning only with respect to the 469 aircraft covered by the Grumman contract and only if purchased according to the baseline schedule envisioned herein.

It would seem that a corollary to the great service responsibility inherent in the new system of participatory management should be willingness to discipline service managers when they fail to exercise their responsibilities properly. Has anyone been disciplined either for misleading Congress about F–14 costs or for any other activities in conjunction with the F–14 program?

Mr. SHILLITO. As recently as late last fall I can recall quite vividly the president of Grumman making it a point to tell me that they were having virtually nothing in the way of cost problems with regard to the F–14. This was a very casual statement on his part. But the concern expressed with regard to the F–14, the schedule slippage and the accident with the first aircraft have lead to a number of actions. The first, of course, was kicking off a study by the Navy. The GAO, as you know, has also initiated review of the F–14 program.

At the Secretary of Defense's level we have still not gone over the Navy study of the entire F–14 program. We are going to do that at a DSARC meeting this week.

Mr. Chairman, we are just a little bit off cycle as far as answering some of the questions that you have raised. Again, I would urge that should you want to go into detail with regard to the F–14, we have Captain Ames, the program manager, come over here and go into such detail as he can with you.

Chairman PROXMIRE. I would just like to ask one more question before I yield to Mr. Brown.

I have a copy of a letter to the Navy by Mr. William Zarkowsky,

president of Grumman, which seems to take exactly the opposite position.

Mr. SHILLITO. I realize that.

Chairman PROXMIRE. This letter was dated March 31 this year and released to the press some time ago at a Pentagon press conference.

In the letter Mr. Zarkowsky indicates that due to abnormal inflation and decline of Grumman's business base, their company will be unable to meet its contractual commitments for the delivery of the 48 lot IV aircraft funded in the 1972 budget without a restructuring of the present contract. Presumably if such restructuring occurred, the cost of these 48 aircraft would rise even higher than $16 million each.

Mr. Zarkowsky notes that these problems were first called to the attention of the Navy in September 1969, and again in July 1970.

When were these problems at Grumman first brought to the attention of the DSARC by the Navy?

Mr. SHILLITO. I would repeat, Mr. Chairman, that late last fall the president of the company told me personally that they were—and again this was in something of an offhand way—that they were having no problems economically on the F–14. I happened to be talking to him about a number of other things when this came up.

The Zarkowsky letter does give this inference, indeed. The September 1969 letter suggests this inference. In the July 1970 letter there is now also suggested this inference.

Just because a contractor says that they are having severe economic problems in complying with the schedule and meeting the cost of the schedule, doesn't mean that we should roll over and say, gentlemen, we are going to do something about making you well. We just don't feel that way. We have not gotten into this sufficiently or satisfactorily, at least on the OSD level, to convince ourselves as to what the course of the action should be.

Chairman PROXMIRE. Can you tell me, as a member of the DSARC, will you oppose or support a bailout of Grumman by restructuring of the F–14 contract when this issue is formally presented to the DSARC?

Mr. SHILLITO. Mr. Chairman, we are going to review the F–14 program totally when it is presented. We are going to come up with the best possible decision after that review.

Chairman PROXMIRE. I am sure you will try to do that. But I hope some time you get answers before this committee on some of these things.

I will be back.

Congressman Brown.

Representative BROWN. I think it would be really desirable. Mr. Shillito, if we are not going to have a program manager for the F–14 up before the committee, to get a thorough review of what went into the decisionmaking process for the change in quantity order if, in fact, that is what it was.

Mr. SHILLITO. For the record, Mr. Congressman—I might suggest that we give you as complete a story as we can. There may be some minor security problems right now, but we will give you as complete a story as we possibly can for the record with regard to the status of the F–14.

(The following information was subsequently supplied for the record:)

F–14 PROGRAM

The explanation requested for the change in procurement quantity involves an increase from a total quantity of 469 F–14 aircraft, including RDT&E aircraft to a total of 722 aircraft.

In 1968 the force requirement for the Navy and Marine Corps was 469 F–14 aircraft. These requirements originated in the spring of 1968 in answer to the needs expressed by the Chief of Naval Operations to replace one F–4 squadron per air wing on an initial rate of 4 to 5 per year. A change in force structure requirement occurred in the fall of 1969 with a plan to replace all F–4 aircraft squadrons with F–14 aircraft squadrons. Considering the number of aircraft carriers operating, a dual training site requirement, and the Marine Corps requirement, the total requirement rose to 722 aircraft.

With recent changes in the national Defense posture and a reorientation of procurement priorities with restricted funds, the F–14 procurement plan may again be restructured.

The F–14 Program is currently undergoing intensive review. Since past events and current activities are inextricably interwoven into the decisions affecting the future of this program, it is premature at this time to provide any further run-down on the program.

Representative BROWN. I think that would be very helpful, because otherwise the charges stand and the answers are not a part of the record.

AVONDALE AND LOCKHEED SHIPBUILDING CLAIMS

And in that connection, I would like to ask you, if you would, to pursue for a moment one of the things that came up yesterday. And that is the settlement of two Navy contract claims without apparent satisfaction of the legal obligation of the Navy to meet those claims. This was presented in our hearing yesterday by Mr. Gordon Rule. Do you know the situation to which I refer?

Mr. SHILLITO. Yes; I do, Mr. Congressman.

I would like to make just a couple of points with regard to these claims, the one dealing with Avondale and the other with Lockheed.

First, one of the more outstanding people in our overall operations is Rear Admiral Sonenshein who heads up the Naval Ship Systems Command. He is a dedicated, hard-working individual. That is a very tough job; in fact, buying ships has been historically a very, very tough job. As head of a procurement activity, he can act and he can negotiate on these type claims.

We have had very severe claim problems. In fact, this administration has been very upset by this claim situation. As I think it came out in the discussion yesterday, we have had about a billion dollars in claims. It is important consequently that these claims be resolved. They need resolution. They have to be brought to a head. They have to be negotiated, and they have to be finalized.

Frankly, the settling of these claims in a timely manner bothers me more than the inference that maybe these claims were settled somewhat precipitously. As you know, all of these claims have been in process from a year and a half to 2 years. Admiral Sonenshein and the Chief of Naval Material have had teams of people working on these claims along with Mr. Rule's people. There has not always been a consensus relative to how they should be settled.

Representative BROWN. The suggestion yesterday, as I recall, was that the two claims were settled without the formalization of a written report establishing legal responsibility under the contract for the claim that was made by the company.

Mr. SHILLITO. Yes. There are several points that tie into this. Admiral Sonenshein has been trying to get these claims finalized. He did come to some tentative agreements which became the command's position with regard to these claims. The claims still have not been submitted to the Chief of Naval Material. Due to the dollar magnitude they have to go to the Assistant Secretary of the Navy, I. & L. They still have not gone to him. So these claims have not been finalized and they have not been signed off. If the tentative agreements are incorrect, they will be modified.

Representative BROWN. What you are saying is that these claims have not been paid?

Mr. SHILLITO. Progress payments have been made against them but, basically, that is right.

Representative BROWN. There has been a recommendation by Admiral Sonenshein with reference to the payment of the claims and with reference to his opinion about the legal obligation to pay the claims?

Mr. SHILLITO. That is right. Again, this was not a precipitous action. In fact, one of the things that bothers me more, if I were to look at our total problems within Defense, is that it takes too much time to get the job done. The inference in reading today's papers is that somewhere, somehow, somebody settled a couple of claims off the top of his head. This just isn't right. A year and a half to 2 years is too long to settle these things. It takes us too long to place an order. We have a lot of these kinds of problems that administratively we are just not on top of.

Representative BROWN. I notice in the list of claims for the U.S. Court of Claims—I think I am right in the identification of the court—before the Renegotiation Board—are some that go back to 1952, which were left over from the Korean war, as are the rest of us. It seems to me that the claims of the Renegotiation Board on the one hand—and there was some comment yesterday that the claims have not moved, that is, the total number of claims have not moved—I assume that there has been some increase in the number of claims. That means that there must have been some settlements. Or have there been no settlements over the last 2 years?

Mr. SHILLITO. There have been some claim settlements. The Todd claim was settled. I can give you a complete recap on all claims that were pending 2 years ago, the additional claims that have been submitted, the claims that have been settled, and the amount that they have been settled for, versus the amount that was submitted by the contractor.

Representative BROWN. I think that would be very helpful to have for the record, or at least provide it for the members of the committee.

Mr. SHILLITO. Yes, sir.

(The following information was subsequently supplied for the record:)

BREAKDOWN OF SHIPBUILDING CLAIMS

SHIPBUILDING CLAIMS ($5,000,000 AND OVER)

[Dollars in millions]

Company	Ships	Date claim submitted	Amount of claim	Amount of settlement	Remarks
Avondale Shipyards, Inc	DE 1052 class	January 1969	$49.3	$25.6	(1)
Do	DE 1078 class	September 1969	98.2	47.9	(1)
EDO Corp	Variable depth sonar	December 1968	16.7		(2)
Electric Boat Division, General Dynamics Corp.	Escalation: Various SSN/SSBN	November 1968	29.7	19.0	
Do	SSN 671	August 1969	8.1	6.7	
Lockheed Ship Building and Construction Co.	DEG 1, 2, 3	December 1968	11.5	4.2	
Do	AO 106, 109	November 1968	7.9	1.9	
Do	DE 1048, 1050	January 1969	12.9	3.7	
Do	LPD 9–15	do	102.0	48.4	(1)
Do	AGEH–1	do	6.5	4.0	
Do	AE 22, 24	November 1968	7.5	4.1	
Do	DE 1052 class	January 1969	50.7	13.6	(1)
Newport News Shipbuilding & Dry Dock Co.	CVA 67	June 1969	46.6	21.4	(1)
Do	Various SSN/SSBN	March 1969	40.5	20.6	(1)
Do	LCC–20	August 1970	11.0	(2)	
Tacoma Boat Building Co	PG 84–90	December 1968	6.0	3.4	
Bethlehem Steel	AE 28, 29	February 1971	48.3	(2)	
Litton Systems, Inc., Ingalls Division	Various SSN	May 1971	94.5	(2)	
General Dynamics Corp., Quincy Division	AE 26, 27	June 1970	22.7	(2)	
Do	SSN 638/649	January 1968	25.5	(2)	(3)
Defoe Shipbuilding Co	T–AGS 31, 33, 34; T–AGOR 14, 15.	August 1970	8.5	(2)	
Todd Shipyard Corp	DE 1052 class	November 1968	114.3	96.5	

[1] Tentative settlement—Subject to the approval of the contract claim control and surveillance group and the Assistant Secretary of the Navy.
[2] Open.
[3] In dispute, pending before ASBCA.

RESEARCH AND DEVELOPMENT GAP

Representative BROWN. Mr. Shillito, the question that we seem to be into here, is the question of whether we should have more quantity as in the F–14 or fewer items ordered with the initial contract, any time when we are cutting back our commitment to Defense in terms of the percentage of our GNP on the percentage of our national budget, that we have a greater quantity of a few items rather than the development of a broader choice of weapons and weapons systems. Has there been any overall commitment to a policy in that area? What is the rationale for that?

Mr. SHILLITO. We are very much concerned with our R. & D. budget and ensuring continued advancement in those areas that have potentially the greatest technical payoff. Frequently, this brings about the necessity for looking at a number of diverse approaches and a number of diverse items. As we move along through research and then through the development cycle, it becomes economically essential that we decrease the number of items. We just cannot afford to kick them all off, as I am sure you can appreciate. This is receiving an awful lot of attention.

I would like to ask Admiral dePoix to comment on this subject, because it is the type of thing that our D.D.R. & E. people have been spending an awful lot of time on themselves.

Representative BROWN. I would appreciate his comment. I would

like to know whether it relates to this from Admiral Moorer on the first page about our countable lead having now all but vanished, and within the next 5 to 6 years we will actually find ourselves in the position of overall strategic inferiority. Is that pace the reason for this overall decision?

Mr. SHILLITO. Overall strategic inferiority regarding the number of Defense missiles, megatons, our Defense systems. This I spell out from Admiral Moorer's posture statement.

For example, we are concerned about the number of engineers that we have graduating in this country. As I recall, we are now faced with a situation where the Soviets are graduating about 4 to 1 as many engineers as we are. We are talking about a situation where a significant percentage of their total engineering graduates are going to strategic type areas, or going into their strategic defense areas. This concerns us. We consequently find that we must be thinking about our technical talent—the diverse type of talents that we should be concerned with. Of course, a lot of this relates to our budget and an awful lot of it relates particularly to our R. & D. budget. We urge the passage of this budget at a level at least as high as has been submitted.

Admiral DEPOIX. I think everything you said is part of the picture, sir. We are trying to cut down the number of different kinds of weapons systems that we actually produce. We are not trying to cut down on the diversity of the research and the exploratory development that we conduct, because we feel that we need the maximum number of reasonable options that we can provide to the President and the Congress for the meeting of different kinds of threats that may either be facing us now or that may emerge.

So we actually have two things that are in confrontation here. We have to decide to produce the minimum number of different kinds of weapon systems. We have examples that I can mention here right now—the Agile air-to-air missile, which the Navy and the Air Force are jointly developing or planning to jointly produce and use as the follow-on to things such as the Falcon, which has been used by the Air Force for a number of years and the Sidewinder, which has been developed and produced by the Navy.

However, counter to this desire and drive to produce a minimum number of different kinds of things, so that one can be used by not only one service throughout but by two or three services, is the fact that we have a whole variety of threats which are facing us. The ability to face a group of threats frequently cannot be met by having only one weapons system. You have to have complete flexibility to meet the threats which are facing you.

Witness the fact, for example, that we have visual air-to-air missiles, all-weather air-to-air guided missiles, and other different kinds. The reason is that if we only have one kind, there is a very good chance that that one kind will be countered. If you have only one system and it is countered, then militarily you are in a pretty bad situation.

This, as you will recognize, is one of the reasons for the Triad in strategic warfare—the submarine ballistic missile, the land-based missile, and the airplane or bomber.

So we have these drives that are proceeding in opposite directions.

The major point I think to bring out here is that it is our policy in the Department of Defense to keep our research and development open,

particularly in the area of research and advanced technology which includes research, exploratory development, and nonsystems oriented advanced development, but not to produce more than we actually need to meet the threat as we see it.

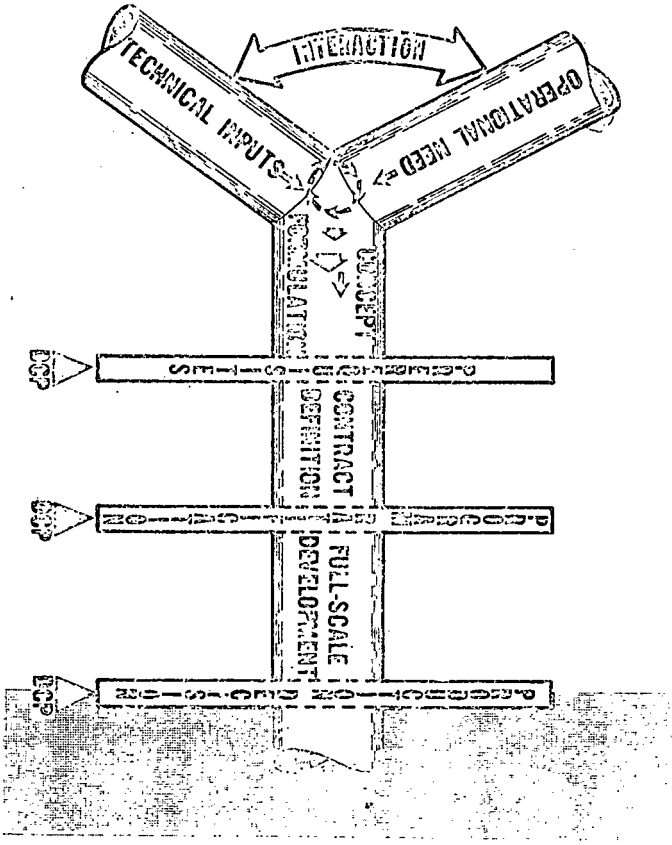
Does that help with the question?

Representative BROWN. I think it does. My time is up. Thank you.

Mr. SHILLITO. If I can make a point, Mr. Chairman, this ties into Admiral dePoix's comments. (Showing chart.) This is exactly the same depiction that we used 2 years ago.

(The chart referred to above is as follows:)

COPY OF WEAPON SYSTEMS ACQUISITION CHART



Mr. SHILLITO. I might say, Mr. Chairman, we are talking about the diverse options back in this time frame that warrant the kind of considerations that we are most concerned with. To look at the entire spectrum, these options become less and less available as you move across the contract definition into full-scale development. When we get to the point where 90 to 95 percent of the total dollars are to be spent on the production of a major weapons system, we necessarily get to comparatively fewer systems.

The difference between this chart and that presented a few years ago are these DSARC meetings that we have indicated on here.

Representative BROWN. Are those decisionmaking points? Is that what you are saying?

Mr. SHILLITO. Those are review points as to the major weapons systems. These then lead to recommendations to the Deputy Secretary of Defense, generally, and then the decision relative to proceeding to the next benchmark.

SHIPBUILDING CLAIMS—NAVY REVIEW PROCEDURES

Chairman PROXMIRE. Congressman Conable.

Representative CONABLE. Thank you, Mr. Chairman.

I would like to follow up on the testimony of Mr. Gordon Rule at this time.

I would like to ask you, Mr. Shillito, is the Navy's Contract Claims Control and Surveillance Group part of the process of arriving at contract settlements? Does it have the responsibility of checking the procedures that have been followed by an official like Admiral Sonenshein?

Mr. SHILLITO. That is generally correct, Mr. Conable.

Representative CONABLE. Who controls the Contract Claims Control and Surveillance Group? Isn't that the Navy also?

Mr. SHILLITO. This is under the Chief of Naval Material, that is correct, sir. The group is headed up by Mr. Rule.

Representative CONABLE. So Mr. Rule's function, then, is to be part of the process?

Mr. SHILLITO. That is exactly right.

Representative CONABLE. And he is apparently objecting to having to do some work in reviewing somebody's decision earlier in the process, is that true?

Mr. SHILLITO. I didn't say that, Mr. Conable.

Representative CONABLE. I said that.

Mr. SHILLITO. Mr. Rule's operation is an important, but comparatively small piece of the total Chief of Naval Material's operation. His function is normally a service-type function to the line-type people. It is his responsibility to insure that we are doing the right kind of job, among other things, in this particular area.

Representative CONABLE. And that there has been technical compliance, among other things. with the requirements of law?

Mr. SHILLITO. Yes, sir.

Representative CONABLE. What else happens before a claim like this Lockheed claim that is reported so extensively in the morning papers is paid?

Mr. SHILLITO. Well, a number of things happen. But the situation in this particular instance, as I recall, was that teams were formed by the Naval Ship Systems Command. This has been typical of all of these. These teams include engineering people, attorneys. procurement people, and production people. They go into great detail with regard to all facets of the claims that have been submitted by the contractor. On these particular ships—and I think we are talking about the 1052 class ships here, as I recall there were deficiencies in a number of the specifications, particularly with regard to shock and vibration specifications.

Representative BROWN. You mean in writing the original contracts?

Mr. SHILLITO. Yes, sir.

Representative BROWN. I was under the impression that Mr. Rule had a hand in the original contract. Is that right?

Mr. SHILLITO. I am not sure of that, Mr. Brown.

Representative BROWN. He is the one who has reviewed the contract before it is left, is he not?

Mr. SHILLITO. He is. But I am not sure as to what his role was in the original contract. The original contracts go back to 1964 or 1965, that time frame.

The claims are reviewed by these teams. Of course, Admiral Sonenshein is in the position where he has to weigh the recommendations of the entire team, and then has to move ahead on the recommendations.

These particular claims—and I checked this, this morning—have not been signed off yet.

Representative CONABLE. What happens after Mr. Rule's group is through reviewing them and insuring the technical compliance with the requirements of the law?

Mr. SHILLITO. In this case, they are in the dollar range that requires them to go to the Chief of Naval Material, Admiral Arnold, then, they go to the Assistant Secretary of the Navy, Mr. Sanders, for approval at that level.

Representative CONABLE. Do these gentlemen perform any further investigation?

Mr. SHILLITO. If they are satisfied with all the facts that have been presented to them, they do not. If they are not satisfied, they may require additional investigation. One of the things that bothers me very much about this whole claim situation is the time.

Representative CONABLE. May I ask you, sir—you said that Admiral Sonenshein had been working on this matter for a year or a year and a half; is that correct?

Mr. SHILLITO. These claims have been under review for a year and a half to two years. You get an awful lot of dust on some of these things with that kind of a time frame.

Representative CONABLE. Do these claims represent overruns, or do they represent matters in controversy? There have been substantial progress payments made and these sums are considered to be in relation to closing up all of the matters in dispute in the contract, is that right?

Mr. SHILLITO. That is correct, Mr. Conable. They tie more to controversy—frequently specification deficiencies. Frequently there is a physical inability on the part of a contractor to comply with a possible deficient Department of Defense specification. This, then, has necessitated some type action.

Representative CONABLE. Is this type of delay becoming inherent in contracting with the Government?

Mr. SHILLITO. I am of the strong opinion that as we move more into this so-called fly-before-you-buy approach—and I don't like to play up that approach—with more cost-incentive type contracts in the development area, we will end up with less uncertainties, and misunderstandings as to exactly what we want in the production phase.

There is little doubt but what that will be the case. Moving into a major weapons system before development is really completed on a

fixed-price basis under specifications that are pretty well frozen causes these types of problems.

Do you want to elaborate on this?

Admiral DEPOIX. No, I think that covers it completely.

Mr. SHILLITO. Admiral Reich.

AVONDALE AND LOCKHEED SHIPBUILDING CLAIMS

Admiral REICH. Yes, I will add to that.

In this particular project there are 46 ships. These ships are being built by Todd, Avondale, and Lockheed. There is considerable work in progress even now. Only about half of these ships have been delivered. Unfortunately, there are deficient Government specifications which have been called out. It is only at this latter day that there has been recognition of this fact. Obviously, the contractor is well aware of this. Rather than a completed program, this is very much an ongoing program.

Representative CONABLE. This is a problem for the Defense Department handling this kind of complexity in procurement, and it is also a problem for the contractor, is it not?

Mr. SHILLITO. Indeed it is, sir.

Representative CONABLE. Do you find increasing resistance to contractor dealings with the Government where this kind of contract is involved?

Mr. SHILLITO. This has had a lot to do with our reassessment of the total contracting environment. Of course, in a few instances we have been faced with situations where the magnitude of the problem is many times the individual contractors' equity. This presents almost impossible situations. But indeed it is a problem as far as the contractors are concerned, too.

GOVERNMENT-OWNED PROPERTY IN THE HANDS OF CONTRACTORS

Representative CONABLE. Mr. Shillito, you mentioned in your statement that the Government is trying to reduce the number of industrial plants which it owns. How are you disposing of them? I would be interested in how you go about getting rid of a portion of the $10 to $13 billion worth of Government plants and equipment that the Government is supposed to own at this point that is in the hands of contractors for the most part.

Mr. SHILLITO. Frankly, Mr. Conable, we are not disposing of them fast enough. We do develop extensive plans relative to the disposal of such equipment. On occasion we have been faced with problems regarding our ability to dispose of such equipment as rapidly as we might like to. We have been constrained, as Chairman Proxmire is aware, in our ability to negotiate with a contractor who has the facilities that we are concerned with. This is something that we very much want to do something about, as does the chairman. We are moving in the direction of disposing of these facilities. I would like to have been able to tell you that we are doing this at a satisfactory rate, but I cannot, Mr. Conable.

Representative CONABLE. You state that there is legislation pending before Congress relating to the disposal of Government equipment. It is the pending legislation concerned with the lowering of Defense De-

partment procedural requirements? What does the legislation do generally?

Mr. SHILLITO. The legislation really does a couple of things. Among other things, it would allow us to negotiate the sale of such equipment to the companies or contractors in whose hands the equipment resides. This happens to be a thing that is most important.

Representative CONABLE. In many cases, it is now leased to them for commercial purposes for short periods of time at any rate, is it not?

Mr. SHILLITO. They may be using it for some commercial work when it does not interfere with Government work at that plant. Some of this equipment, even though it may not be categorized as special equipment, has a much greater value to the company which uses it than it does to anybody else.

By the way, our negotiated sales numbers, looking at the acquisition value versus the sales value, are such that we are realizing a greater yield on sales to companies using the equipment than we are to companies acquiring the equipment through advertised sale. Admiral Reich, you may want to comment on this.

Admiral REICH. Yes, sir.

In terms of the number of plants—you spoke of plants where we have both industrial plant equipment and a certain amount of real estate—in 1961, we had 261. However, in 1971, we have 189.

The actual sale of plants is carried out by the General Services Administration. The Defense Department surpluses them, and then the General Services Administration conducts the sale, whether it be negotiated or advertised. Where real property is involved, there is provision for negotiated sales.

Representative CONABLE. And you are not trying to change it?

Admiral REICH. No.

Representative CONABLE. Mr. Chairman, my time is up.

AVONDALE AND LOCKHEED SHIPBUILDING CLAIMS

Chairman PROXMIRE. Could I ask you, Mr. Shillito, have you ever discussed the shipbuilding claims by Lockheed and Avondale, which are the subject of yesterday's testimony, with Admiral Sonenshein?

Mr. SHILLITO. Yes, sir; for about 5 minutes this morning.

Chairman PROXMIRE. Was that the only time you discussed it with him?

Mr. SHILLITO. Well, I wouldn't want to be tied down to that. I would have to say that the whole subject of claims has been a topic that many people discuss many times, Mr. Chairman.

Chairman PROXMIRE. What I am getting at is whether or not you advised Admiral Sonenshein to expedite the settlement of those claims.

Mr. SHILLITO. I have advised Admiral Sonenshein, Mr. Sanders, and everybody that I can talk to, to expedite the settlement of all claims, Mr. Chairman.

Chairman PROXMIRE. Did you suggest that they be negotiated before obtaining a complete legal and technical analysis of the claims?

Mr. SHILLITO. No.

Chairman PROXMIRE. By requiring the claims legally and technically to comply, isn't that exactly what Mr. Rule is doing, isn't that his function and responsibility?

Mr. SHILLITO. This is indeed a portion of his responsibility; that is correct, sir.

Chairman PROXMIRE. It seems to me that Mr. Rule has served this country well.

Mr. SHILLITO. I wouldn't disagree.

Chairman PROXMIRE. So how can you suggest that he is responsible for holding up claims in any way, shape or form, when he should be commended?

Mr. SHILLITO. Did I say he was holding them up?

Chairman PROXMIRE. No, but the implication that I got from the questions and answers this morning was that he wasn't doing his job.

Mr. SHILLITO. This implication must have been similar to what I saw in the paper this morning relative to this being a precipitous action.

Chairman PROXMIRE. It may not have been precipitous, but it is not Mr. Rule's responsibility, that is not his legal and technical responsibility, that is the responsibility of Admiral Sonenshein, is it not?

Mr. SHILLITO. That is exactly right.

Chairman PROXMIRE. Mr. Rule has indicated there doesn't seem to be any.

Mr. SHILLITO. Admiral Sonenshein will have all of this before it goes to the Chief of Naval Material, and before it goes to the Assistant Secretary of the Navy, I. & L.

Chairman PROXMIRE. You say, these claims have been pending for years, and Admiral Sonenshein still hasn't gotten the legal and technical analysis.

Mr. SHILLITO. Frankly, I did not ask exactly where he stands with regard to his legal and technical analysis, Mr. Chairman, when I talked to him. That will have to be a part of the package that goes forward, I can assure you of that.

Chairman PROXMIRE. Do you know of anybody in the Defense Department who has advised Admiral Sonenshein to go ahead and proceed without getting technical or legal analysis?

Mr. SHILLITO. I don't think anyone has ever advised him to proceed without getting legal and technical analysis, and I don't think you will find that he has.

Chairman PROXMIRE. Many other important questions raised in our correspondence with you and other high-ranking officials of the Department of Defense remain unanswered. Responses from Mr. Packard have been particularly inadequate. I don't want to take the subcommittee's time to pursue each unanswered question in detail. However, I don't intend to drop my insistence on full disclosure on unclassified Defense business matters in general and the Lockheed situation. I think that the behavior of the Department of Defense in protecting Lockheed at the taxpayers' expense has been nothing less than outrageous.

SHILLITO OPPOSED ASPECTS OF EARLY DRAFT OF GAO PROFITS STUDY

You strenuously opposed certain aspects of the early draft of the GAO profit study, Mr. Shillito. You particularly objected to the audits of the 146 contracts and the finding of the high profits, and you were also unhappy with the table in the early draft comparing the GAO questionnaire results with the LMI results. You recommended deleting

that table, and you recommended downgrading the importance of the audits. Both of your recommendations were followed; first, can you tell us when you were with LMI, and when the LMI profit study was conducted?

Mr. SHILLITO. I was with LMI from its inception, Mr. Chairman.

Chairman PROXMIRE. When was that?

Mr. SHILLITO. That was in 1962—and until the first part of 1968, about April of 1968. The profit study was started in August 1964, and ran for several years. The last report, published in 1970, covered profit statistics for the 11-year period 1958–1969.

Chairman PROXMIRE. You were the head of the LMI study?

Mr. SHILLITO. That is right.

Chairman PROXMIRE. Do you believe an appearance of a conflict of interests is suggested in the fact that you have worked so vigorously as a public official to preserve the reputation of the Think Tank with which you were formerly associated?

Mr. SHILLITO. No, sir. I made it very clear in my statement that we are completely satisfied with the GAO profit study. You might construe it that way, Mr. Chairman. But, frankly, I am only interested in the facts. That was the idea behind the LMI study.

Chairman PROXMIRE. How do you explain the fact that you have worked for the deletion from the GAO report of the table comparing the LMI results with your assertion that the GAO findings are consistent with the LMI findings? If they were so consistent, why didn't you want to leave the LMI table in the report? Isn't it true that the findings are not consistent, that GAO showed substantially higher profits than LMI?

Mr. SHILLITO. Yes, sir. Of course, there are several very fundamental reasons for this. It is a matter of comparing apples and oranges. The two reasons that come to mind most readily are, first, the GAO used a significantly different definition of total capital investment. I think Mr. Staats may have touched on that in his discussions with you. The second significant difference was the fact that the GAO weighted their results to include interest rates. The combination of these two things when compared to the LMI data with regard to total capital, which is just equity capital plus long-term debt, gives a disparity in these numbers. You just can't compare them.

By the way, the contractor relationship of the 74 in the GAO report versus those in the LMI report is such that it has not been possible to effect a reconciliation between the two. It just did not make sense to attempt to develop a comparison in a way that would infer that these were reconcilable.

At the same time the recommendations that the GAO came out with were not too much different than those that LMI came out with.

Chairman PROXMIRE. The LMI recommends—this is what Mr. Staats seems to put most emphasis on—and this is using and analyzing defense profits and relating defense profits to procurement policy—that much more emphasis should be put on return on capital investment.

Mr. SHILLITO. Yes, sir.

Chairman PROXMIRE. And did they recommend that?

Mr. SHILLITO. Yes. Mr. Malloy, you may want to correct me on this, but I think it was in 1967.

Mr. MALLOY. Yes.

TRUTH-IN-NEGOTIATIONS IN STEEL CASES

Chairman PROXMIRE. I wrote you a year ago expressing my concern over the lack of compliance with the Truth-in-Negotiations Act. In your letter of response dated April 21, 1970, you assured me that in general contractors were complying with the law and that it was being enforced. A few weeks ago Admiral Rickover appeared before the subcommittee with documented evidence showing that four major steel companies have all refused to comply with the Truth-in-Negotiations Act. This problem involves millions of dollars of steel contracts, and it has been going on for years. The Comptroller General, in the same hearings, said that he had reported on this problem with the steel suppliers in 1965, and that the problem had still not been resolved. This evidence seems to contradict your statement that defense contracts generally have complied with the Truth-in-Negotiations Act. Apparently, when you wrote the letter you either were not aware of the serious problem or you decided not to report it to me. What is the correct explanation?

Mr. SHILLITO. I report everything to you, Mr. Chairman, that you ask me for.

Chairman PROXMIRE. Well, I asked for it.

Mr. SHILLITO. As my statement indicates, we have had about 85 waivers to the Truth-in-Negotiations Act out of about 100,000 contractor actions. We do have some problems with some contracts. Admiral Rickover cited a few of these the other day. I, frankly, have not gone into these in great detail, Mr. Chairman, for which I apologize but I will be going into them in greater detail to find out exactly what the problems are. If problems do exist, the Department will do something about them.

Chairman PROXMIRE. You are referring to the testimony by Admiral Rickover of several forging suppliers that regularly refused to comply with the law on Navy contracts and widespread noncompliance in the steel, computer, and nickel industries?

Mr. SHILLITO. Yes, sir.

I noticed in one instance that he mentioned 1,200 purchases on the part of one shipbuilder, suggesting that individual large purchases were broken down into these elements sufficiently small to allow them to get around the Truth-in-Negotiations Act.

Chairman PROXMIRE. Of course, what I am referring to are the specific questions and answers. And let me read them because they are very short:

Are there any types of steel of which the Department of Commerce does not have adequate competition?

Your answer:

The Defense Industrial Supply Center in Philadelphia is the principal purchaser of steel products for the DOD. Adequate competition is considered to be present in all its steel purchases.

Of course, steel suppliers, forging suppliers, computer manufacturers, and other material suppliers now provide cost in pricing data in cases where this is required by the Truth-in-Negotiations Act. Generally speaking, Defense contractors, subcontractors and so forth, have done so.

So that the answers seem to be clearly contradicted by testimony documented by Admiral Rickover.

Mr. SHILLITO. Generally speaking, they do comply. Again, you are talking about 85 waivers out of 100,000 actions where cost or pricing data was required.

Chairman PROXMIRE. You don't really mean the 100,000 have all complied, you mean you just haven't had a chance to check into it.

Mr. SHILLITO. The figure of 100,000 is the number of noncompetitive negotiated procurements over $100,000 which require the submission of certified cost or pricing data.

Mr. MALLOY. We haven't been faced with the need to grant waivers except for a miniscule number of our procurements over $100,000. There could be some in that total that didn't come to our attention. We wouldn't know for sure.

Mr. SHILLITO. However, where there is a waiver granted, it does come to our attention.

Mr. MALLOY. I might say a word on this procurement of steel, Mr. Chairman.

The Secretary's reply to you dealt with the specific question presented, which was the procurements that we may make of a particular type of steel. We really make very few procurements of this type of steel ourselves. The problem presented by Admiral Rickover did not deal with the procurements we make. It dealt with the procurements that are made by Navy contractors. There has been a running controversy over the past several years as to whether the bids that are put in by the three suppliers are, in fact, competitive or not. The steel suppliers have not provided cost or pricing data. The Navy has that problem. They are dealing with it as best they can.

Chairman PROXMIRE. We covered the subcontracts in our letter, and you told us that there was competition with the subcontracts, too.

A couple of other things. You also told me in your letter that you are setting up a special task group to study the problem of compliance with the act. What has the task group found and what changes have been made as a result of their study?

Can you give us copies of any reports written by the task group?

Mr. SHILLITO. Yes, that which is available.

Mr. Malloy, can you address that?

(The following information was subsequently supplied for the record:)

SPECIAL TASK GROUP—PL 87-653

A special task group to study the problem of alleged contractor resistance to supplying cost or pricing data in specific instances was established in April 1970. The first meeting of the task group was held on May 5, 1970. Two other meetings were held shortly thereafter. An analysis of the problem area, as determined by the task group, is attached. One specific problem area involving aircraft wing pneumatic de-icers was discussed by the task group during these meetings. As a result of the relative lack of specific refusals by contractors to furnish additional certified cost or pricing data, further task group meetings were not called. Instead, subsequent specific problem areas were handled by the Service involved, often after consultation with the office of the Assistant Secretary of Defense (Installations and Logistics). Policy changes were initiated and staffed through the normal Armed Services Procurement Regulations (ASPR) Committee channels. During this time, the ASPR Committee dealt with problems involved in (1) the subcontract area where subcontractors refuse to furnish cost or pricing data to a prime contractor who also may be a competitor, (2) a clarification of that part of the law which exempts established catalog or market prices of commercial items sold in substantial quantities to the general public, and (3) a clarification of the applicability of the statute to final pricing actions under redeterminable contracts.

ANALYSIS OF PROBLEM

RE: OBTAINING COST OR PRICING DATA AS REQUIRED BY PUBLIC LAW 87–653

Conditions	Potential problem	Extent	Solutions
C. & P. data clearly required	Adamant refusal by contractor on special military item.	Very few cases—less than 10 since 1962.	1. Eliminate special item. 2. Develop new source. 3. Waive requirement.
Exemption possible:			
Competition sought:			
*Obtained	No problem		
*Sole response	Threat of competition determined does not exist.	25 to 50 cases per year (forgings, bearings, aircraft tires, elect. tubes).	1. Determine if other exemption applicable. 2. Obtain cost or pricing data. 3. Waive requirement.
Catalog or market price—sold in substantial quantity to general public:			
*Clearly exempt:			
Price OK	No problem		
Price not OK	Determining proper price—not Public Law 87–653 problem.		Negotiate better price.
*Not clearly exempt	Obtaining data to support claim of exemption and data to support "based on price."	Typical of computer elect. tube and auto parts.	1. Get data to support exemption. 2. Get data to support "based on price." 3. Get cost of pricing data. 4. Waive requirement.

Mr. MALLOY. Yes. Mr. Chairman, we are finding that there are two or three areas that we need to give more attention to in the implementation of Public Law 87–653. We are having difficulty in defining exactly what evidence should be presented to justify an exemption under the law with respect to catalog or market price procurements.

We are also having some difficulty with respect to certain subcontractors who do not want to provide cost pricing data to a prime contractor where the prime contractor may be a competitor of the subcontractor. We are providing that the subcontractor may, under those circumstances, supply its cost pricing data directly to the Government. This raises a number of complex questions. We have already indicated that there are trouble spots in the steel and the forging areas. I believe that these are the principal areas where we are having difficulty now.

Mr. SHILLITO. We have to realize that the Defense business of some of these companies is such an insignificant piece of their total business, they could care less whether they do business with us. It becomes pretty tough sometimes to obtain cost or pricing data under these circumstances.

DOD REFUSES TO PROVIDE CASH FLOW STATEMENT ON LOCKHEED

Chairman PROXMIRE. I would like to ask you if you would give us what we have been pleading for, for a long, long time, and now it seems to me that Congress has an absolute right to demand it, and I will do everything I can as a Senator to get it, including using my full authority such as I have as a Senator on the floor of the Senate to delay the legislation for the so-called Lockheed bailout unless we can get a cash flow statement on Lockheed. Now, we have a right to get that. And no banker would make a $100,000 loan without a cash flow statement. We are asked to guarantee a $250 million loan. And we have also been told that this is proprietary information. I think you have a point with respect to Defense matters. But now this is for a

commercial purpose, for a commercial product, for the L–1011. Under these circumstances, it seems to me that we have a right to get a full cash statement as Members of Congress before we go ahead and proceed with this.

You are in a position, Mr. Shillito, to help us with this and I hope you will.

Mr. SHILLITO. Well, as you know, Secretary Connally has taken over the responsibility for the entire Lockheed matter. This is something that I am most pleased with. At any rate, I would assume that this type question would be directed to the Secretary of the Treasury.

Chairman PROXMIRE. The Secretary of the Treasury may say, well, the military has been studying Lockheed for years, they know about it, Mr. Shillito is probably the outstanding authority on Lockheed in many respects, along with the Air Force experts, and they must have this material, I am surprised that you cannot get it from them.

Mr. SHILLITO. Mr. Chairman, we do have this material.

Chairman PROXMIRE. Why not give it to us?

Mr. SHILLITO. We do have an awful lot of the cash flow records with regard to Lockheed. You know we have it.

Chairman PROXMIRE. Can you give it to us?

Mr. SHILLITO. No, we can't give it to you, because it is proprietary data. It has all kinds of proprietary implications. We have told you this. It is a situation where we have sat down with the entire staff of the diverse committees on this, and we have gone over it in great detail with them. We have made it very clear as to what the situation is. You want things that you can release, sir. You have made that very clear to us.

Chairman PROXMIRE. Yes, indeed. There is no reason why you should classify it. It would seem to me that the taxpayers have an absolute right to this, if they are going to be asked to put up the $250 million guarantee.

Mr. SHILLITO. The staffs of the four committees that have been concerned with this whole Lockheed subject have gone into this in great detail. We don't lack for much information on the Lockheed financial situation.

(The following information was subsequently supplied for the record:)

LOCKHEED

As things stand now, Secretary Connally has been designated by the President to be the Administration's focal point regarding the $250 million guaranteed loan. The Treasury Department is preparing the justification for that legislation and working with Lockheed to obtain concurrence to release the company's confidential and proprietary data.

Chairman PROXMIRE. Mr. Brown.

Representative BROWN. In point of fact, when you say it is proprietary information, what you are saying is that its privacy is protected under the Freedom of Information Act, isn't that correct?

Mr. SHILLITO. That is right, Mr. Brown. An awful lot of the data is fairly sensitive as far as this company is concerned. There have been questions as to our legal right to take action in regard to the disclosure of this data. We have gone into this in great detail with our counsel.

Of course, though this company is in pretty dire circumstances now,

it still has a competitive position to attempt to fight for or vie for. We have to recognize this. That is about the situation.

Representative BROWN. As I recall the Freedom of Information Act, the things that are exempted are national security, defense secrets, in effect, and also the question of competitive status, in other words, competitive data that would disadvantageously affect the company.

Mr. SHILLITO. That is correct, sir.

DOD SPENDING

Representative BROWN. I would like to pursue, if I may, a little bit, the question of whether we are spending more or less, the same, or what, on our defense posture. Your statement said that in real dollars we had increased our spending between 1964 and 1968, the peak period of the Vietnam war, by $24 billion essentially, and that we have decreased it $24 billion from 1968 to 1972 based on the proposed 1973 budget.

Mr. SHILLITO. Yes, sir.

Representative BROWN. And during the same period of time, Federal spending, that is, 1964 to 1972, which was the period you are talking about——

Mr. SHILLITO. Yes, sir.

Representative BROWN (continuing). At the same time, we have escalated the defense spending and reduced defense spending by the same real dollars, we have escalated the Federal spending in the nondefense areas by $68.3 billion during that 8-year period from 1964 to 1972; is that correct?

Mr. SHILLITO. That is correct, sir.

Representative BROWN. And escalated other governmental spending aside from the Federal spending by $58.6 billion in the same 8-year period for a total of $103 billion.

Mr. SHILLITO. Yes, sir.

Representative BROWN. Obviously we are spending a great deal more money on the Government for nondefense purposes in this country, but essentially spending the same amount of real dollars. This is a 10 percent decrease in the percentage of Federal spending for defense purposes, is that correct?

Mr. SHILLITO. Well, actually what this adds up to is—and I think this is pretty well summarized by my statement—we are looking at a situation in constant dollars for 1972 that is quite comparable to 1964.

Representative BROWN. But in terms of what we are spending out of our Federal budget for defense, we are spending essentially 10 percent less, which I assume is some measure of the reordering of priorities—a term that is making the headlines all the time.

Mr. SHILLITO. That is correct, sir; yes.

Representative BROWN. In spending the same constant dollars, are we spending the same amount on defense that we were getting in 1964? In other words, are we in a technological sense keeping up to the posture that we would like to keep up to based on where we were in 1964? I'll assume that the answer to that, we must take into account the relative position of adversaries or potential adversaries. Do you understand the question?

Mr. SHILLITO. Yes, sir. In order to go into detail with regard to the relative position of our adversaries, Mr. Brown, I believe that you

would be well advised to have someone like Admiral Moorer come before you and testify.

Representative BROWN. The Admiral only has four stars and we have got six here at the table. Can we get some help from them?

Mr. SHILLITO. We will get some help in a moment.

May I make one comment. We look again at this 133,000 less people as we move into 1972 versus 1964, and we look at the almost $18 billion or more in pay and related costs than was indicated in 1964. You have to conclude that less of our total defense dollars are going into hardware than was the case in 1964. This, of course, is a disturbing type mix, when you look at the relationship of this country versus the Soviet.

Representative BROWN. Of course I would say in the Admiral's terms that this depends on whether or not you are buying yeomen or perhaps scientists in the laboratory.

Mr. SHILLITO. Yes, sir.

Representative BROWN. And that really is the thrust of my question.

Mr. SHILLITO. Would you care to comment on the Congressman's question, Admiral dePoix?

RESEARCH AND DEVELOPMENT GAPS

Admiral DEPOIX. I can really speak with authority only to the research, development, test, and the evaluation part of it, not to the production or the procurement part of the picture. In R.D.T. & E, our buying power has actually gone down significantly since 1964.

Representative BROWN. I am talking about real dollars. We are spending the same real dollars apparently in the total defense budget that we were spending in 1964. Mr. Shillito just said that we are spending significantly more in the personnel costs, less personnel, more money. My question is, How does that relate to the R.D.T. & E.? We are buying for every dollar less R.D.T. & E., but we are spending constant dollars in our R.D.T. & E—or has our R.D.T. & E. expenditure in constant dollars decreased?

Admiral DEPOIX. The R.D.T. & E. expenditure in constant dollars has decreased. The escalation in R.D.T. & E. is higher as a matter of percentage than it is in production. In addition to this, however, the threat has gone up considerably. I am sure you are aware of the recent discussions with respect to the technological drive on the part of the Soviets and the fact that it has been estimated by Mr. Foster, with support from the intelligence community, that the Soviets are spending about $3 billion a year more than we are at the present time in R.D.T. & E. We don't exactly know in what ways they are spending this. But this is measured by looking at both their output and their input. On the other hand, our spending capability, our resources in actual dollars have gone down over the last several years in R.D.T. & E., primarily because of inflation and, of course, to some extent because of the actual reduction in the budget. Our R.D.T. & E. in the fiscal 1970, for example, was down to about $7 billion, whereas it had been higher prior to that time. So we have a combination of the reduction in actual buying power due to inflation, as well as due to reductions in the budget over the last few years, in contrast to the steady increase on the part of the Soviets of 10 to

11 percent per year in their R.D.T. & E. programs over the corresponding period.

Mr. SHILLITO. I wonder if we could ask Mr. Brazier to make a comment on the comparative position with regard to the United States over this same frame.

Mr. Brazier.

Mr. BRAZIER. Yes.

Accepting, I think, that most of the military people will agree that the threat we face today is certainly not less than it was in 1964. Just looking at our general purpose force status as we project it in 1972, we are indeed going to have less as compared to the forces that we had in 1964. We are going to have three less Army Divisions. We are going to have eight less attack and ASW carriers in the force. We are going to have nine less carrier airwings, and we are going to have 14 less Air Force Tactical Squadrons. We are going to have 23 less aircraft squadrons, and we are going to have 274 less commissioned ships in the fleet. In only one significant area of our force and equipping are we actually higher in 1972 than we were in 1964. This is in helicopters, where we are going to have about 6,000 more than we did in 1964, involving a general reorientation of tactics in the military forces since those days. In fixed wing aircraft we are going to have 5,000 less than we had in the force at the end of 1964, the last peacetime year.

Now, looking at the categories in our budget, Admiral dePoix is correct, that in research and development on the constant dollars basis, we spent $9.3 billion in 1964, and we are planning to spend $7.5 billion in 1972. In our procurement area we spent $19.8 billion.

Representative BROWN. Are those constant dollars, sir?

Mr. BRAZIER. They are all constant dollars.

Representative BROWN. So we are actually spending less on our R.D.T. & E. in constant dollars in 1972 than in 1964?

Mr. BRAZIER. That is right, sir.

In procurement, we spent $19.8 billion in 1964, and we are planning to spend $17.9 billion in 1972, in constant dollars or $16.7 billion excluding free world force support.

The only area where we are spending more in constant dollars in 1972 than in 1964 is in operation and maintenance and military personnel. And this is largely related to the cost of the war in Southeast Asia, where the costs are higher now than they were in 1964. We do have a higher operation and maintenance cost in those areas because of the activities in Southeast Asia. Military costs on a cost and dollar basis are about the same.

Representative BROWN. My time has expired. But could you give me any comparison to a previous time frame, such as the period at the end of the Korean war, 1954, 1956, along in there to work in with the 1964–72 figure? That is an 8-year period. Perhaps we need 1956, if you could provide that.

Mr. BRAZIER. I can't in that detail, sir.

Chairman PROXMIRE. Will you provide that for the record?

Mr. SHILLITO. Yes, let's see if we can't do that.

Mr. BRAZIER. I do have the 1956 costs of defense. And these are constant dollar numbers. Defense expenditures in 1956 in total were $68.7 billion, which was after the Korean war reduction.

Mr. SHILLITO. Let us give you a rundown on that for the record.

(The following information was subsequently supplied for the record:)

The table which follows shows outlays in current and constant prices for FY 1956, 1964 and 1972.

OUTLAYS BY APPROPRIATION CATEGORY

[In billions of dollars; fiscal years]

	In current prices			In constant (fiscal year 1972) prices		
	1956	1964	1972	1956	1964	1972
Military personnel	11.1	13.0	21.6	21.8	21.4	21.6
Military retired pay	.5	1.2	3.8	3.8	3.8	3.8
Volunteer force			1.4	1.4	1.4	1.4
Operation and maintenance	8.4	11.9	19.9	15.3	17.2	19.9
Family housing		.6	.7		.8	.7
Civil defense	.1	.1	.1	.1	.1	.1
Total operations	20.0	26.8	47.5	42.3	44.7	47.5
Procurement	12.2	15.4	16.7	17.8	19.8	16.7
R.D.T. & E	2.1	7.0	7.5	3.5	9.3	7.5
Military construction	2.1	1.0	1.5	3.1	1.3	1.5
Total research and investment	16.4	23.4	25.7	24.4	30.4	25.7
Military assistance	2.6	1.2	[1] 3.3	3.7	1.6	[1] 3.3
Revolving funds, concepts adjustments, etc	−1.2	−.6	−.5	−1.8	−.8	−.5
Total	37.7	50.8	76.0	68.7	75.8	76.0

[1] Includes military assistance, service funded (MASF).

OVERALL OUTLAY TRENDS

FY 1956, FY 1964 and FY 1972 present data on Defense outlays at 8-year intervals, as requested, All references in this discussion will be to outlays in constant prices, as shown in the three right-hand columns.

FY 1956 represents the lowest level of Defense spending since before the Korean War. The Korean peak was $90.7 billion in FY 1953 and the post-Korea low was $68.7 billion in FY 1956, as shown. For the six years from FY 1956 to FY 1961, inclusive, Defense outlays varied little. They ranged from a low of $68.7 billion in FY 1956 to a high of $70.4 billion in FY 1959, averaging $69.6 billion.

For the next three years—FY 1962–64, inclusive—Defense spending was $75.2 billion, $76.1 billion, and $75.8 billion, respectively, an average of $75.7 billion.

The Southeast Asia spending peak was $99.9 billion in FY 1968.

Total FY 1972 spending of $76 billion, then, is (a) about 9% above the FY 1956–61 level; (b) about equal to the FY 1962–64 level; and (c) about 24% below the FY 1968 peak.

Incremental war outlays for FY 1972 are $7.8 billion, and baseline force outlays are $68.2 billion. Baseline force costs for FY 1972 are (a) 2% below the FY 1956–61 period and (b) 10% below the FY 1962–64 period.

In short, baseline costs in this budget are the lowest since before the Korean War, and significantly below the immediate (FY 1962–64) prewar period.

TRENDS BY CATEGORY

The table also shows data by appropriation category. Once again, the discussion which follows is in terms of outlays in constant FY 1972 prices—the three right-hand columns.

Operating costs increase from $42.3 billion in FY 1956 to $44.7 billion in FY 1964 and $47.5 billion in FY 1972. Deleting incremental war costs, the FY 1972 figure would be $43.1 billion. Aside from the war, then, operating costs for FY 1972 are 2% above the FY 1956 level, and 4% below the FY 1964 level.

Research and investment outlays grow from $24.4 billion in FY 1956 to $30.4 billion in FY 1964 and drop to $25.7 billion in FY 1972. Excluding incremental

war costs, the FY 1972 figure would be $24.6 billion. Aside from the war, research and investment costs for FY 1972 are about equal to the FY 1956 level and are about 19% below the FY 1964 level.

There are some shifts in appropriation coverage over these years that should be noted. Certain types of costs that were financed in procurement appropriations in FY 1956 are financed in RDT&E or operation and maintenance appropriations in later years. Other costs that were financed in O&M in 1956 are financed in RDT&E in later years. These are the major shifts.

The most important effect of these shifts involves the RDT&E comparisons from FY 1956 to FY 1964. On a comparable basis, RDT&E spending would have been higher than $3.5 billion in FY 1956—the real increase from FY 1956 to FY 1964 is less than the table indicates, and the procurement increase is correspondingly greater.

The military assistance program for FY 1972 is just over $1 billion. The table also includes under this heading over $2.2 billion for support of Free World Forces (Military Assistance, Service-Funded) normally reflected in the regular appropriation accounts.

In summary, referring to baseline (non-war) outlays for FY 1972:

Operating costs are about 2% above the FY 1956 level and 4% below the FY 1964 level.

Research and investment outlays are about equal to the FY 1956 level and are 19% below the FY 1964 level.

Procurement is about 21% below the FY 1964 level and about 7% below the 1956 level.

RDT&E is about 19% below the FY 1964 level, but significantly above the FY 1956 level (in the range of 50%).

Military construction is about 11% above the FY 1964 level but less than half of the 1956 level.

Military assistance is down about 36% from FY 1964, and down 72% from FY 1956.

Representative BROWN. If we could get a relationship in constant dollars—I am particularly interested in total Defense spending in relationship between R.D.T. & E. procurement. And the other generalized expenditures, because one of the points at issue in this hearing has been whether or not we are, in fact, maintaining the same amount of spending posture, whether we are increasing it, or whether we are decreasing it, and I would like to get that figure nailed down once and for all.

Mr. BRAZIER. Very well, sir.

Chairman PROXMIRE. Mr. Conable.

PROFITS AS A RETURN ON INVESTMENT

Representative CONABLE. Mr. Shillito, I want to come back to the suggestion that the contractor's investment be given a great weight in setting profits on Defense contracts. First of all, is there a realistic way of allocating capital investment on a contract-by-contract basis, or do you have to do this somewhat arbitrarily?

Mr. SHILLITO. Mr. Conable, we have given a lot of consideration to this subject. I am sure you would find a number of people that would disagree with my belief on this.

Mr. Malloy mentioned that we recommended that this be applied as far back as 1967. We are of the opinion, based on fairly extensive tests that we have been conducting over the last year, working with about 200–300 major contracts, that this can be done.

The GAO has made a recommendation that this be looked at across the executive branch, and that OMB be responsible for this review. We have had several meetings with OMB. We have gone into some detail with regard to the extent of the tests that we have been run-

ning in Defense. These are pretty comprehensive tests, I might add. In fact, the data involves 200–300 contracts. It is very voluminous.

NASA is also conducting tests. We are synthesizing the DOD–NASA tests. We know it is going to be a complex matter, and I just don't want to say to you categorically that we believe that this is something that can be handled easily. But we are optimistic as to our ability to do this. Theoretically, it is a sound, logical thing to do, there is no question about that. But, practically, it is tough. A lot of people—Mr. Robert Anthony and others—have been pushing this for some time, as you well know. We agree with this theoretically. We think that practically we are getting to the point where we are just about in a position to go further than the tests that we have been running so far. We are optimistic, sir.

GOVERNMENT-OWNED PROPERTY IN THE HANDS OF CONTRACTORS

Representative CONABLE. Do you feel that the practical effect of this will be to discourage the contractor's use of Government-owned property?

Mr. SHILLITO. We would like to hope that this would lead us in the direction of the greater use of the private capital market. That it would, among other things, move us away from the greater use of Government-owned property.

Representative CONABLE. Will it be your policy to discourage the use of Government-owned property or would you try to have capital become a neutral factor by giving the cost of raising capital its proper weight?

Mr. SHILLITO. Our goal right now is to discourage the use of Government-owned equipment.

By the way, we are not talking about this for a GOCO—Government-owned-Government-operated—facility of which, as you know, we have several. We are talking about this in the contractor owned area, where the contractor may have some Government facilities. These are the ones that present the greatest concern. I am afraid that we are always going to have some industrial type operations that, due to mobilization needs, would logically always be heavily Government-owned, in fact, maybe totally Government-owned.

Representative CONABLE. In other words, it would be your policy, if you were to do this, to try to encourage the use of private capital rather than the Government capital?

Mr. SHILLITO. Yes, sir.

Representative CONABLE. In other words, rather than have it be a neutral factor in the equation, you would want it to be a negative factor?

Mr. SHILLITO. Yes, sir.

Representative CONABLE. And that would be your purpose?

Mr. SHILLITO. Yes, sir.

Representative CONABLE. Now, let me ask you this. Does the Government still reserve the right to cancel Government contracts for its convenience whenever it wants to? We have seen an example of that here recently. Doesn't it in any of its contracts reserve the right to cancel?

Mr. SHILLITO. It does, sir.

Representative CONABLE. If you were a company manager, would you recommend to your board of directors investment of millions of dollars in fixed capital assets to perform a Government contract when the Government reserves the right to cancel?

Mr. SHILLITO. By the way, there is always consideration of these cancellation costs, as you can appreciate. Termination for the Government's convenience takes these type things into consideration.

Representative CONABLE. That is not the kind of business companies want to get into, is it?

Mr. SHILLITO. No, it is not. Consequently and quite logically there has evolved a rapid depreciation kind of arrangement with regard to these facilities. This creates a little less in the way of a problem. Some of the equipment that you are talking about has a multiuse, both commercial and Defense. It becomes particularly awkward when it does not have a multiple use. These type situations frequently have led to the Government's being required to supply some of these items.

Admiral Reich, you may want to comment on this. It is your field of expertise.

Admiral REICH. Yes, sir.

Of course, there is no question that we certainly support the idea of a contractor furnishing his own equipment in the main as a broad policy. As the Secretary just pointed out, there are exceptions when you get into such items as munitions—and here I am speaking in terms of the end product, the 8-inch shell, the 5-inch shell—where you have load, assembly, and packaging operations involving high hazards which require extensive facilities in terms of real property, personal property, and processing equipment. I don't think we will ever field an Army, Navy, or Air Force without an intensive munitions complex. I think the burden of that complex will have to be borne by the Government.

Representative BROWN. Will you yield on that point?

Representative CONABLE. Yes.

Representative BROWN. If you are going to change the pattern of having the contractor own all of his own equipment, and he must buy this to fill his plant quickly when he gets a Government contract, specialized equipment, which I think is fairly common in some of these contract industries, Defense contract industries, what kind of writeoff operations will be permitted? Will he be able to write that equipment off over the life of the individual contract with the Government? Will it be over the contract plus anticipation of follow-on orders on the Defense item, or will they then be stuck with a specialized piece of equipment which must be adjusted in his tax patterns? Or how do you handle that problem when the Government does not supply the equipment? And beyond that, how do you get the machine tool industry to tool up fast enough to produce specialized equipment to meet the individual contract in the Government order?

Can you answer those two?

Admiral REICH. Mr. Brown, I can't answer those questions. But those questions really delineate the great paradox we have here. How can you get business people to invest in these kinds of equipment if the contracts are not of sufficient duration to permit depreciation of this equipment. There is no straightforward answer to those questions. However, I would like to supply further information in this regard for the record.

(The following information was subsequently supplied for the record:)

POLICY REGARDING PROVISIONING, USE AND DEPRECIATION OF INDUSTRIAL FACILITIES

As stated in the Armed Services Procurement Regulations it is the policy of the Department of Defense that contractors will furnish all facilities required for the performance of Government contracts. Facilities will not be provided to contractors for expansion, replacement, modernization or other purpose except as follows:

(i) for use in a Government owned contractor operated plant operated on a cost plus fixed fee basis;

(ii) for mobilization production of items being procured in accordance with an approved mobilization plan (ASOD) package; or

(iii) when—

(A) the Secretary of the Department or his designee, in the case of new facilities, or an authorized official of the Department in the case of existing Government owned facilities, determines that: (1) the Defense contract cannot be fulfilled by any other practical means, or (2) it is in the public interest; and

(B) the contractor, represented by an executive corporate official, or his equivalent in non-corporate entities, either expresses in writing his unwillingness or financial inability or acquire the necessary facilities with his resources, or explains in writing that time will not permit him to make the necessary arrangements to obtain timely delivery of such facilities to meet defense requirements even though he is willing and financially able to acquire the facilities. In this latter case, existing Government-owned facilities (not new purchases) may be provided until the contractor purchased facilities are delivered and installed.

New facilities shall not be furnished unless existing Government-owned facilities are either inadequate or cannot be economically furnished.

In any case, competitive solicitations shall not include an offer by the Government to provide new facilities, nor shall solicitations offer to furnish existing Government facilities that must be moved into plants of contractors unless adequate price competition cannot be otherwise obtained.

New facilities shall not be provided by the Government where an economical, practical and appropriate alternative exists. Examples include:

(i) procuring from sources not requiring Government-owned facilities;

(ii) requiring the contractors to make full utilization of subcontractors possessing adequate and available capacity;

(iii) having the contractor rent facilities from commercial sources and

(iv) using existing Government-owned facilities.

New construction or improvements having general utility shall not be provided with appropriations for research or development unless authorized by law.

Facilities shall not be provided by the Government to contractors under this Section solely for non-government use.

DEPRECIATION OF INDUSTRIAL FACILITIES

When a contractor provides the required industrial facilities with private funds normally general purpose industrial facilities are depreciated following prescribed Internal Revenues schedules and are allowable contract costs for the time period such facilities are utilized on a government contract.

The cost of special tooling and special test equipment used in the performance of one or more government contracts is an allowable contract cost and shall be allocated to the specific government contract or contracts for which acquired. Where items are disqualified as special tooling or special test equipment because with less than *substantial* modification or alteration they can be made suitable for general purpose use, the cost of adapting the items for use under a government contract and the cost of returning them to their prior configuration will be an allowable contract cost.

CONTRACT TERMINATION PROVISIONS

Government contract terminations generally give rise to the incurrence of costs, or the need for special treatment of costs, which would not have arisen had the contract not been terminated.

Normally common items that are reasonably usable on the contractors other work shall not be an allowable termination cost unless the contractor can submit evidence that he could not retain such items at cost without sustaining a

loss. The undepreciated portion of general purpose facilities are normally not an allowable termination cost.

When government contractors are terminated the loss of useful value of special tooling, special machinery and equipment is generally allowable provided such special tooling, machinery or equipment is not reasonably capable of use in the other work of the contractor.

Under present policies contractors, as prudent businessmen, are understandably reluctant to provide industrial facilities for government contracts especially when the product is of such a specialized nature that the production facilities cannot be readily converted to commercial applications. Contractors are also hesitant to make large capital investments for even general purpose facilities if such expenditures would result in excess production capacity should the contract be terminated or not be of sufficient duration to allow depreciation of a major portion of the facilities.

Conditions such as these were the major reasons it has been necessary for the government to provide industrial facilities in the past.

If the Department of Defense is to be successful in its drive to have contractors furnish all facilities required for the performance of Government contracts additional incentives to encourage such investments and procedures to protect contractors from unwarranted losses due to termination or contract cut-backs may be necessary.

Mr. SHILLITO. If I can make two points, Mr. Brown, Mr. Chairman, and Mr. Conable. One, we have a very extensive study going on under Admiral Reich right now dealing with this entire subject of the mobilization base. It ties very closely into that which we are talking about—this subject of Government furnished equipment.

Depending on who you talk to, you can come up with a different number as to what this adds up to. Admiral Reich and his people have put together, I think, a pretty complete depiction as to just what this does add up to.

There is the one thing I would like to suggest, that we give you a recap as best we can as to what this total adds up to in a stratified fashion.

I have heard this committee use different numbers Mr. Chairman. I think it might be a good idea if we attempt to bring this together in total for your use, everything in hand, IPE, other plant equipment, material, special tools and test equipment, the whole subject.

Representative BROWN. Break it out, don't put it all together, don't lump the land with the tools.

Mr. SHILLITO. I think you should have that. We will give it to you.

(The following information was subsequently supplied for the record:)

Summary of Department of Defense property in the custody of defense contractors as of 30 June 1970

Total number of contractors, 1612.

[Dollar amounts shown represent acquisition cost]

Land	$213, 864, 602
Utility distribution systems	469, 346, 399
Buildings	2, 429, 808, 049
Industrial plant equipment	2, 468, 553, 228
Other plant equipment	2, 346, 385, 822
Government furnished material	3, 956, 530, 237
Subtotal	11, 884, 488, 337
Special tooling and special test equipment	2, 729, 043, 635
Total	14, 613, 531, 972

See attached for definition of terms.

DEFINITION OF TERMS

Industrial Plant Equipment (IPE)

Equipment or machinery costing $1,000 or more used for the purpose of cutting, abrading, grinding, shaping, forming, joining, testing, measuring, heating, treating or otherwise altering the physical, electrical or chemical properties of material, components, or end items entailed in manufacturing, maintenance, supply, processing, assembly or research and development operations.

The average age of DoD-owned IPE is 16 years.

Other Plant Equipment

Is any other equipment necessary for operation of a manufacturing, maintenance, supply, processing, assembly or research and development activity, which is not IPE. It includes IPE type items which cost less than $1,000 and such equipment as blueprint machines, office machinery, furniture, vehicles and cafeteria equipment.

Government Furnished Material

The materials furnished by the government become a part of the finished article that is delivered to the Department of Defense.

Special Tooling

The term "special tooling" means all jigs, dies, fixtures, molds, patterns, taps, gauges, other equipment and manufacturing aids, and replacements thereof, which are of such a specialized nature that, without substantial modification or alteration, their use is limited to the development or production of particular supplies or parts thereof, or the performance of particular services.

Special Test Equipment

The term "special test equipment" means electrical, electronic, hyrdaulic, pneumatic, mechanical or other items or assemblies of equipment, which are of such a specialized nature that, without modification or alteration, the use of such items (if they are to be used separately) or assemblies is limited to testing in the development or production of particular supplies or parts thereof, or in the performance of particular services. Due to its specialized nature special tooling and special test equipment has virtually no re-utilization or redistribution potential to another contractor.

PROPORTION OF GOVERNMENT-OWNED PROPERTY USED FOR COMMERCIAL WORK

Representative CONABLE. Mr. Shillito, can you give us any answer about the percentage of use of Government-owned production equipment which is applied by prime contractors to non-Government work, commercial work. It has been suggested that this may constitute a substantial subsidy to defense contractors. I know that generally speaking in your statement you refer to the fact that this is not done for extended periods of time, but just to fill gaps and to be sure the equipment is used and not allowed to lie dormant. But I wonder if it is possible for you to give us any estimate of the extent of this practice? It has been a matter of some discussion here at the committee.

Mr. SHILLITO. I will have to give you this for the record, if I might, sir. As you know, we have a requirement that contractors must have approval to use Government-owned equipment for commercial work when such use is in excess of 25 percent. We have about nine or 10 companies that we have given authorization to use in excess of 25 percent. So you are talking about all other contractors being under the 25 percent.

I don't have a mean average number as to what percentage we would be talking about.

Maybe you do, Admiral Reich?

Admiral REICH. No, I can't give it, other than those nine.

Representative CONABLE. But it is possible to give us some sort of an estimate?

Admiral REICH. Yes.

Representative CONABLE. I would appreciate that being put in the record.

Mr. SHILLITO. Our rental rates should allow us to develop some sort of estimate for you, sir.

(The following information was subsequently supplied for the record:)

THE EXTENT OF USAGE OF DEPARTMENT OF DEFENSE OWNED FACILITIES FOR COMMERCIAL WORK AS OF 1 JUNE 1971

Through the use of facilities contracts or use agreements, nine contractors have been granted permission by the Office of Secretary of Defense and the Office of Emergency Preparedness to use selected government equipment *in excess of 25%* for commercial work.[1]

A representative sample of the 1612 contractors that possess government property was taken to determine the extent of incidental commercial use *less than 25%*. All the large prime contractors were surveyed in addition to 155 smaller contractors. This representative sample revealed that 26% of those surveyed were using government owned facilities for incidental commercial use. Commercial use was not being permitted in the remaining contractor plants. Of the 26% that were permitted to use government property for commercial purposes, it was determined the government property was being used on an average of 9% for commercial work and 91% for government work.

Chairman PROXMIRE. I would like to announce that in view of the dispute we have had over claims, and the fact that we have you, Mr. Shillito, and Admiral Rickover, and we have had Gordon Rule, and others, that we are going to invite Admiral Sonenshein to come up and tell us his story.

Mr. SHILLITO. I think that is terrific.

Chairman PROXMIRE. And we will be able to get a much clearer picture of the situation.

INFLATION

I am somewhat concerned about the way you fellows assure us about what the costs of Defense spending are in constant dollars. We have some of the finest economists, I think, in the country on our staff, and they are completely baffled, they don't know what you mean.

We questioned the GAO, and they have some of the ablest experts in the country in this field and they say they are bewildered when you talk about your constant dollars, as to how you arrive at this. We know there has been an increase in pay, and you can crank that in. But it seems to me that every time I have discussed this with a Defense Department official, they greatly exaggerate the inflationary factor in your procurement and in your expenditures, although, as I say, you can't compute it without pay. What figures do you use to determine the degree of inflation?

[1] The number of contractors with permission to use Government equipment in excess of 25 percent for commercial work increased from 9 to 12 in the period June 1, 1971-Nov. 4, 1971. A list of the 12 contractors and the amount of rentals paid during fiscal year 1971 may be found on p. 1204.

Mr. SHILLITO. I am going to turn this over to Mr. Brazier for him to answer.

I would make one suggestion, Mr. Chairman. This is something that we can reconcile. There is little question in my mind that we can develop an agreement and an understanding as to what it is we are talking about with regard to our use of constant dollars. There may be some problems with regard to base points, and we can highlight these. But I would suggest that if we have a problem with regard to the Defense dollars, we think it would be advisable for the senior counsel on your staff, Mr. Kaufman, and others to get together with our people and work this out. This is something that cannot be argued.

Chairman PROXMIRE. Do you have an index that measures military price inflation?

Mr. SHILLITO. Yes.

Mr. BRAZIER. As you indicated, Mr. Chairman, on pay, it is pretty straightforward. We can document the pay raises for military and civilian personnel, and we can document the pay raises for our wage board people—it is arithmetic. There can't be, I think, any great dispute as to whether these are accurate or inaccurate, unless we have made a mistake in our arithmetic.

In the purchase area, it is indeed somewhat more cloudy. But we are using what we call a noncompensation component of the deflator for government purposes of goods and services that is prepared by the Office of Business Economics in the Department of Commerce. We had a great deal of discussion with them as to whether there is a better way of measuring inflation in the purchases of goods and services area. We have not found a better way. They have no better index. We have had discussions with the General Accounting Office.

Chairman PROXMIRE. You are relying on the GNP deflator?

Mr. BRAZIER. We are relying on the wholesale price index deflator that is used by the Office of Business Economics in the Department of Commerce for our goods and purchases.

Chairman PROXMIRE. The wholesale price index has been relatively limited. I have before me the economic indicators. And that shows a rise of about 3 percent a year, right up until 1971, which compares very favorably of course with the consumer price, because services are knocked out. And I think that would be a fair basis for our computation for Defense spending and consumer prices.

Mr. BRAZIER. We have eliminated from the wholesale price index the services cost and pay of personnel. We have done this in conjunction with the Department of Commerce, so that we have an index that they feel and we feel is more indicative of being relatable to material purchases and services.

Chairman PROXMIRE. Will you give us a memorandum on that?

Mr. BRAZIER. Yes, sir; we will be glad to do that.

(The following information was subsequently supplied for the record:)

This table illustrates the method used to reflect the cost of the Fiscal Year 1964 program in constant Fiscal Year 1972 prices:

[Outlays in billions of dollars]

	Actual outlays, fiscal year 1964	Pay and price increases, fiscal year 1964–72 (percent)	Outlays for fiscal year 1964 program in fiscal year 1972 prices
Military basic pay and related	$8.4	85.0	$15.6
Other Military personnel expense	4.6	27.7	5.8
Civilian payroll	7.3	61.2	11.8
Purchases	29.3	27.7	37.4
Military retired pay	1.2	----------	3.8
Volunteer force	----------	----------	1.4
Total	50.8	----------	75.8

The first line covers military basic pay and the items which vary directly with basic pay—social security tax (FICA), re-enlistment bonus, terminal leave, severance pay, and some minor items. Basic pay rates increase by 85% from FY 1964 to FY 1972, as shown in the accompanying table. Therefore the FY 1964 active and reserve military manpower—with no changes in numbers, grades, longevity steps, separation rates, or other factors—would cost $15.6 billion in FY 1972 versus $8.4 billion in FY 1964.

Other military personnel expense includes all costs financed in the active and reserve military personnel appropriations, other than basic pay and related items. This includes special pay, incentive pay, allowances, permanent change of station travel, subsistence for enlisted personnel, and certain minor items. Insofar as price behavior is concerned, this area might be broken down as follows: (a) Some of the special pays, incentive pays, and allowances are flat amounts fixed by law—from FY 1964 to FY 1972, some such items were added, and others were increased, by statute; (b) some of these items are covered by rates determined administratively, under a statutory formula and (c) other items, such as food purchases and transportation charges, are subject to inflation in the normal way. It would be a very laborious job to deflate each of these items for every year. However, we have compared FY 1964 with FY 1971 and FY 1972 in these terms, and have determined that the purchases deflator (discussed below) provides a reasonable approximation for this area. Therefore, the purchases deflator is used for all years.

Civilian pay rates are up 61.2% from FY 1964 to FY 1972. Classified pay rates have risen 56.5%, as shown in the accompanying table, and wage board rates are up 68.2%. This line covers the entire civilian payroll of the Department, wherever it is financed and for all programs.

Purchases cover goods and services procured from industry. This represents all spending except for the pay items specifically enumerated. The deflator used here is the non-compensation component of the deflator for Federal purchases of goods and services, supplied by the Office of Business Economics, with a Defense estimate for FY 1971 and FY 1972, as shown in the accompanying table. This OBE series is based upon weightings for various segments of the wholesale price index. We have made a number of checks, based on prices of individual items and services and on other data, and these indicate that the OBE data are reasonable—if anything, they are on the low side. However, our efforts in this area indicate that it would be an overwhelming (if not impossible) task to derive overall price indicators on the basis of specific experience for a sufficiently large group of purchases. The OBE data are by far the best we have. We have discussed the approach we are using with OBE, OMB and GAO; we described this approach to the Joint Economic Committee in 1969. We would cooperate with any of these groups in developing a better approach. The approach we are following, however, seems reasonable and is certainly the best we can do at the present time.

Military retired pay outlays were $1.2 billion in FY 1964, and are estimated at $3.8 billion in FY 1972. The FY 1972 estimate is shown for the purposes of stating the FY 1964 program at FY 1972 prices. There are three reasons for this treatment.

First, in stating Defense purchases in the national income and product accounts, retired pay is simply deducted (except for a relatively minor amount). Year-to-year changes in Defense purchases, in current or constant prices, exclude any changes due to retired pay. The treatment used here has the same effect. However, a retired pay amount is shown so that a recognizable budgetary total ($50.8 billion in the case of FY 1964) will appear.

Second, and related, retired pay does not involve any increase for current Defense programs. The $3.8 billion FY 1972 costs is in recognition of service

performed prior to FY 1972; the $1.2 billion in FY 1964 costs is in recognition of service performed prior to FY 1964. These figures ($1.2 billion and $3.8 billion) are not a proper comparison of FY 1964 and FY 1972 Defense program amounts. The correct figure would be the current value of military retirement earned in the two years—that is, the current value of the retirement liability accruing by reason of service performed in FY 1964 and in FY 1972. That figure, even if it could be computed in an unambiguous manner, would tend to vary largely because of changes in pay rate and CPI assumptions—which, when deflated, would produce the same year-to-year results as the method presently employed.

Third, it is necessary to recognize that retired pay has increased since FY 1964 to a great extent because of pay increases and CPI increases. The average population has almost exactly doubled (it's up 101%), so that population increases account at most for $1.2 billion of the increase from FY 1964 to FY 1972. Higher pay and CPI increases account for $1.4 billion.

Outlays for the Volunteer Force are estimated at $1.4 billion for FY 1972. This amount is largely for pay increases, but is shown separately to highlight this particular program. If the Volunteer pay scales and other items had been in effect in FY 1964, as they are assumed to be in the FY 1972 budget, FY 1964 costs would have been about $1.4 billion greater. There are, of course, qualitative aspects with respect to the Volunteer program involving the quality of people entering the force and the extent of retention. However, such considerations are not unique to the Volunteer program. They are a factor in any pay raise or compensation change. Moreover, qualitative analysis of the Volunteer program for purposes of making year-to-year constant dollar comparisons would become highly speculative in that such analysis would involve assumptions as to different mixes of draft inputs and enlistments (draft-induced and voluntary) from year to year. For these and other reasons, the Volunteer program is treated for this purpose in the same way as any other pay raise.

The net effect, then, is as shown in the table. To support the 1964 manpower levels and the 1964 volume of purchases—without adding a man to the civilian payroll or to the military rolls, active or reserve; with no promotions; and with no increases in purchases—outlays in FY 1972 would be $75.8 billion, compared to $50.8 billion in FY 1964. Since the additional $25 billion does not buy an additional manpower or any additional weapons, it is equivalent to inflation. Inflation has added $25 billion, or roughly 50%, to Defense costs from FY 1964 to FY 1972.

DEPARTMENT OF DEFENSE—PAY INCREASES SINCE 1945

Effective date	Amount of raise (percent)		Pay index (fiscal year 1964 average=100)		
	Military basic pay	Classified civilian salaries	Fiscal years	Military basic pay	Classified civilian salaries
July 1, 1945		15.9	1946	18.0	50.2
July 1, 1946	23.7	14.2	1947	59.4	57.4
July 1, 1948		11.0	1948	59.4	57.4
Oct. 1, 1949	22.9		1949	59.4	63.7
Oct. 28, 1949		4.1	1950	69.6	65.4
July 1, 1951		10.0	1951	73.0	66.3
May 1, 1952	4.0		1952	73.5	72.9
Mar. 1, 1955		7.5	1953	75.9	72.9
Apr. 1, 1955	10.0		1954	75.9	72.9
Jan. 1, 1958		10.0	1955	77.8	74.7
June 1, 1958	8.3		1956	83.5	78.4
July 1, 1960		7.7	1957	83.5	78.4
Oct. 14, 1962		5.5	1958	84.1	82.3
Oct. 1, 1963	14.2		1959	90.4	86.3
Jan. 5, 1964		4.1	1960	40.4	86.3
July 1, 1964		4.2	1961	90.4	92.9
Sept. 1, 1964	2.3		1962	90.4	92.9
Sept. 1, 1965	10.4		1963	90.4	96.5
Oct. 1, 1965		3.6	1964	100.0	100.0
July 1, 1966	3.2	2.9	1965	105.6	106.3
Oct. 1, 1967	5.6	4.5	1966	116.6	109.2
July 1, 1968	6.9	4.9	1967	120.3	113.3
July 1, 1969	12.6	9.1	1968	125.3	117.1
Jan. 1, 1970	8.1	6.0	1969	135.8	124.2
Jan. 1, 1971	7.9	6.0	1970	159.1	139.6
			[1] 1971	171.9	147.9
			[1] 1972	185.0	156.5

[1] Reflects Jan. 1, 1971 pay raise and assumes slightly smaller pay raise Jan. 1, 1972.

Note: Military basic pay and civilian salaries are not comparable. They can be brought closer to comparability by treating a 4-percent increase in basic pay as equivalent to a 3-percent salary increase.

NONCOMPENSATION COMPONENT OF THE DEFLATOR FOR FEDERAL PURCHASES OF GOODS AND SERVICES

[Fiscal year 1964=100]

Year:		Year—Continued	
1949	78.2	1961	99.3
1950	76.2	1962	98.9
1951	83.3	1963	99.4
1952	83.1	1964	100.0
1953	82.3	1965	102.3
1954	80.6	1966	104.2
1955	84.6	1967	106.8
1956	88.8	1968	109.6
1957	94.9	1969	113.7
1958	96.2	1970	118.7
1959	98.1	1971	123.4
1960	97.6	1972	127.7

Source: 1949–70, Department of Commerce. Fiscal years 1971 and 1972, estimated (4-percent increase for fiscal year 1972 and 3.5-percent increase for fiscal year 1972).

Chairman PROXMIRE. We have asked the GAO to compile a military price index and in 2 years they have been unable to come up with one.

Mr. SHILLITO. I suggest that if we have a problem here, that it is something that we can reconcile. When we look at such things as the numbers of jobs generated per billion defense dollars, this is something a large number of people have worked on to develop. Again, depending on some of the base points we might use, we might find ourselves looking at it a bit differently.

RESEARCH AND DEVELOPMENT GAP

Chairman PROXMIRE. Admiral, you say that the Soviet Union is spending $3 billion more in constant dollars on research and development, whereas we are spending less. Again, scientists only in the last 2 weeks have disputed that very vehemently, and have indicated that they just don't believe it. It is hard for this Senator to believe all of the charges about how the Soviet Union is 10 feet tall in the military area. Their economy is only one-half as productive as ours. They are very, very handicapped in all kinds of ways. We have had testimony from the top Kremlinologists in the country before this committee a couple of years ago, on this very issue, we had people from Rand and we invited people suggested by Barry Goldwater, as well as those from Harvard, representing, I suppose, two of the opposite poles. And they seem to concur that the Soviet Union's military budget was substantially smaller than ours. And yet we are always told just before appropriations time that somehow they are able to expend a great deal more in this area than we are, and it is increasing greatly. Can you document that in any way? Can you really establish the fact that they are spending so much more in research and development than before? A $3 billion increase would be an immense increase, because—what is the research budget around $7 or $8 billion?

Admiral DEPOIX. Yes.

Chairman PROXMIRE. Then you are talking about a 40-percent increase. On what do you base that?

Admiral DEPOIX. It is based on a fairly careful, and I must say a highly classified study, of a combination of things, Senator. It is based on a study of the Soviet Union budget as we know it, or as we can find

out about it, and it is somewhat difficult to do that. It is based at least as much on what we actually see the Soviets doing. Sometimes this is hard to document, because we are not completely sure in all cases when they bring a new weapon forward until that weapon is into production or close to production. I didn't make, or mean to make, the flat statement that the Soviets are spending $3 billion more than we are per year in our R.D.T. & E. There are indications that their spending rate at the present time is close to that. These indications are derived from the study I mentioned, the study that Mr. Foster and others have made. Of course, he is not talking about this only now. To my personal knowledge, he has been talking about this rather steadily for the last year or so. It is hard to nail this down to within a few percent. We feel, however, that there are rather definite indications. They can be seen in many ways. For example, in the building rates. Some of these are certainly unclassified; several of them have been mentioned in Admiral Moorer's recent posture statement. The building rate on their submarines—the number of different submarines both attack submarines, air-breathing missile and ballistic missile submarines, which they have come forward with in the last few years, the different classes of new ships. such as the Moskva, the Kresta, and the Kynda. All of these indicate an exceedingly healthy investment in the military budget. I think it is quite true that the civil sector in the Soviet Union is not moving ahead by any means as fast as the United States is in refrigerators, automobiles, and so forth. But our opinion is, that in Defense matters they are indeed quite advanced.

Chairman PROXMIRE. You say that you can't give us assurance that they are spending $3 billion more, but you feel that they are increasing their spending, and that we are not, and they seem to be developing, in your view, an advantage in the resources committed to R. & D. is that right?

Admiral DEPOIX. That is correct, sir.

Chairman PROXMIRE. Another problem that bothers us is that we don't seem to have a hard clear picture even of our own expenditures in research and development, as to whether they are comprehensive enough. For example, I wonder if your estimate includes the approximately $800 million per year independent research and development, I.R. & D., expenditures for ostensibly defense purchases, including costs funded by contractors under existing cost-sharing formulas, whether it includes the salaries of military personnel assigned to R. & D. work, whether it includes the cost of constructing, equipping and manning our R. & D. laboratories and test facilities, such as the Eastern Test Range funded this year for the first time in the O. & M. rather than the R.D.T. & E. budget. If you include all of these, it seems to me that we get a different picture of how much we are putting into research and development.

Admiral DEPOIX. It is hard to say that 100 percent of all the things that you have mentioned are in our R. & D. estimate.

Chairman PROXMIRE. We know the cost of equipping and so forth, the Eastern Test Range, is included in the other budget.

Admiral DEPOIX. That is true. And the reason it should be there is one that is sort of indicative of the whole matter of the passage of things in and out of the R.D.T. & E. budget. The R.D.T. & E. budget stands to defray the cost of some things which are not strictly

R.D.T. & E. For example, there may be an R.D.T. & E. station such as China Lake, one of our outstanding ordnance laboratories. There may be some operations there which are hosted by China Lake out of their total budget which are not strictly R.D.T. & E. On the other hand, the R.D.T. & E. people may be hosted at some time on a base which is budgeted under some other budget category. These things balance out reasonably well. We have been in the process of purifying the R.D.T. & E. budget to my knowledge for the last 6 or 7 years. Fuel for the R.D.T. & E. airplanes, for example, used to come out of O. & M. It now comes out of R.D.T. & E. The operation and maintenance of ships which are used only for R.D.T. & E. has as in the past few years been shifted into R.D.T. & E. The change in the eastern test range which you mentioned a while ago, didn't reflect a big shift away from R.D.T. & E. but rather the fact that within the last year or so the operations at the eastern range have tended to become O. & M. operations as contrasted to R.D.T. & E. operations.

So I think that our R.D.T. & E. budget is quite representative of our expenditures in R.D.T. & E. However, the Soviet Union, as you know as well or better than I, is a closed society and it is very difficult to find out exactly what the Soviets have in the way of a budget or what they are spending their budget for.

Chairman PROXMIRE. They are not speding then, what we ap- I.R. & D.?

Admiral DEPOIX. It isn't really $800 million, to the best of my knowledge; it is less than half of that.

Chairman PROXMIRE. Less than half of that?

Admiral DEPOIX. Yes, sir.

Chairman PROXMIRE. They are not spending then, what we appropriated. We had a big fight on the floor on that. I have been trying to limit that, to cut it down, to define it. It wasn't even a line item for years. Up until a number of years ago, the chairman of the Armed Services Committee didn't even know it existed. We had a terrible time getting that defined and so forth. And I do think it is better than $400 million.

Mr. SHILLITO. Actually, Mr. Chairman, it is in the neighborhood of $400 million for I.R. & D. Of course, the amount would be in addition to bid and proposal expenses, which you would also consider. Bid and proposal expenses would probably run around another $300 million. So you are probably talking close to $700 million.

Admiral DEPOIX. But that is not R.D.T. & E. There are really several figures involved here. One is what the companies are spending. They spend a fair amount more than the Government actually gives them for independent research and development.

Chairman PROXMIRE. Sure. But then after all we are comparing our society with their society. And if the companies are spending that, that is part of the national resources going into research and development, as compared with the Soviet Union. They don't have a private sector. Whatever they spend, of course, is reflected in their overall budget, because that reflects the total expenditures. So that that would seem to me to be a comparative figure.

Admiral DEPOIX. In my book, Senator, it is difficult to equate the two. There has been a great deal of testimony and discussion on the subject of independent research and development. It is not similar

to the line item R.D.T. & E.; if it were, it should and could be a line item. It is spent largely for the contractors to make sure that they are capable of keeping up technologically with the state of the art, so that they can successfully compete in the market for R.D.T. & E. work. The primary purpose of it is not to pick a certain program and to put money in it to bring that particular program ahead.

X–27 FIGHTER PLANE

Chairman PROXMIRE. My time is about up. And I have got to run for a rollcall. But I am going to ask one other question, if Congressman Brown would permit me before I run.

We have been concerned about the possible concealed bailout of Lockheed by giving them a noncompetitive defense contract and so forth. Is the Department of Defense proposing to award Lockheed a sole source, noncompetitive contract for early development of the new fighter plane?

Is this new plane called X–27? If not, what is it called?

Mr. SHILLITO. I can't answer that question, Mr. Chairman. I just don't have any basis for answering that question.

Chairman PROXMIRE. Do you know how much money could be involved in the initial award, Admiral dePoix?

Admiral DEPOIX. I can't answer the question exactly, either, Senator. But I can say that it is one of Mr. Packard's very strong policies, generally, that we keep the technology alive. This includes fighters as well as everything else.

Chairman PROXMIRE. Keep the technology alive or keep Lockheed alive.

Mr. SHILLITO. This is a small project as related to the total Lockheed problem, Mr. Chairman. We can't even find this in the total numbers as related to the total Lockheed problem.

Chairman PROXMIRE. If you say it is small, Mr. Shillito, you must know approximately how much it is.

You are only talking about tens of millions of dollars?

Mr. SHILLITO. Comparatively, Mr. Chairman.

Chairman PROXMIRE. As I say, I do have to run. And I am going to ask Mr. Brown to take over. I will be back. We have another witness and if Mr. Brown finishes and calls the next witness before I come back, I want to thank you very much, Mr. Shillito. You are obviously a highly competent man as are the other gentlemen with you. And you have been most responsive.

Mr. SHILLITO. Thank you very much, Mr. Chairman.

By the way, I should mention, Mr. Chairman, we do have a number of programs that are constantly being considered—new ideas, new concepts—as regards fighter craft. Of course, each and every one of these gets rather thorough scrutiny.

COST OVERRUNS

Representative BROWN (presiding). Mr. Shillito, I would like to go to your prepared statement where you say: "The nine categories of cost growth are as follows:" And I will ask you for a definition of some of them, which I must admit I am not sure I understand. And I would like you to identify them as we go down the line as to whether

or not they are controllable or uncontrollable as far as DOD is concerned. Now, we make a little fetish on the Federal budget, or the Federal budget for other expenditures, of identifying which are controllable and which are noncontrollable expenditures. And I wonder if you could go down that list and give me some clear picture of what engineering changes are. They account for 17 percent. And tell me whether or not they are controllable as far as the Department of Defense is concerned, and so on with the rest of them.

Mr. SHILLITO. I should mention, Mr. Chairman, that a number of these would fall into both the controllable and uncontrollable category. Most of them are controllable.

We do have very explicit definitions as regards each of these nine categories.

For example, engineering changes are considered as an alteration in the physical or functional characteristics of a system or item delivered, to be delivered, or under development. It means that we have decided to change that particular item. We then go through the normal engineering change process in order to make that change.

Next, a quantity change is self-explanatory. This particular category of change is, indeed, controllable.

Engineering changes, by the way, generally are controllable. Sometimes some of these are unforeseen, and they might be considered somewhat uncontrollable.

Representative BROWN. I am assuming that as to the quantity changes that what in effect you are winding up with is more for the money; in other words, you are buying more of a particular item. Isn't that what quantity changes mean?

Mr. SHILLITO. Yes; however, we may end up with buying less. We may find, as we move into 1973, that due to budgetary constraints, we are just not going to have the dollars that we thought we were going to have as we move into 1973 for a program that was started in 1968 or 1969 or 1970. Thus we end up with having to make a quantity change. Frequently we will end up with more dollars expended per item because of that.

Representative BROWN. I am sure that would be true if you reduce the number of items. But is it true also if you increase the number of items?

Mr. SHILLITO. It is not true as far as the unit cost is concerned; generally the unit cost would go down.

Support change, of course, is a change in the support item requirements. This could be everything from tools and test equipment to spare parts. We procure, as you know, significant numbers of these items along with the acquisition of a major item. Frankly, Mr. Brown, we really don't know exactly what we are going to require in the way of support for a major weapons system in detail until we actually get the item in the inventory. These type changes are called support changes.

Representative BROWN. You didn't identify a percentage for that. I assume it is part of the 14 percent that you didn't identify and, therefore, a relatively small percentage.

Mr. SHILLITO. Support changes account for slightly less than 6 percent.

Schedule changes, again, are self-explanatory. They are changes in our delivery schedule and, generally, this is a controllable type thing.

With respect to the support changes, even though we control the process, we may be required to initiate such changes to insure that the end item performs as required.

We define unpredictable changes next. This covers such things as work stoppages, acts of God, State law changes—the gamut of things.

Representative BROWN. Federal law changes?

Mr. SHILLITO. Yes, sir.

Economic changes are next. Here we are talking about some of the things that we touched on in my prepared statement. These are changes due to the operation of factors in our economy. This includes specific contract changes that relate to economic escalation, the economic impact in toto on the quantity or quantities of items that we are procuring.

Representative BROWN. I would assume that No. 6, economic changes and No. 5, unpredictable changes are not within the control of the Defense Department; is that correct?

Mr. SHILLITO. That is correct as far as No. 5 is concerned. Of course, as far as No. 6 is concerned, we frequently provide for escalation in our contracts. To the extent that we can do this, the effect of economic changes can be provided for, and, therefore, such changes are within our control.

We talked about estimating changes, a most difficult area in many ways. This is about 26 percent of the overall cost group discussed in my prepared statement. This is a change in program or project cost due to refinements of the base estimate. To a significant degree, that category reflects our ability to estimate the cost of a particular program over a 7-year spectrum that we are concerned with here. Unfortunately, it generally goes up.

Representative BROWN. I can understand that in the case of a very new item; that is, a researched item that has all of a sudden been developed for the first time. But certainly the estimated changes don't have anywhere close to this 26-percent change, the one you were talking about, the purchase of standard shelf items, does it?

Mr. SHILLITO. That is correct, sir. But, unfortunately, the standard shelf items are an insignificant piece of the total that we buy.

Representative BROWN. Let's get our base straight here because you were talking about cotton shirts and a couple of other things in your prepared statement also.

Mr. SHILLITO. We don't have a problem of estimating changes on these type items.

Representative BROWN. There were also cotton shirts. And they also have an escalation, a cost overrun factor, so to speak; is that right?

Mr. SHILLITO. Yes, they do.

We may have escalation clauses in the procurement of these kinds of items, but you are talking about awards made today that will involve the delivery of items in a few months. Economic changes in the short term do not have the same impact they have over the spectrum of many years. We are concerned here with the procurement of major systems as depicted on the chart over the long term.

Of course, some of our estimating changes involve mathematical errors and errors in estimating. As I commented 2 years ago before this committee that we have a severe overoptimism problem in-house with regard to what it is going to cost to get a job done. Frequently,

we get overoptimistic estimates from contractors. Sometimes this is reflected in our estimates.

Contract performance incentives, the next item, covers such things as award fees. This is a net change in the contractual amount that is due to the contractor's actual performance being different than what was predicted in the contract. These are the incentive changes that we have to recognize as the contract evolves.

Contract overruns or underruns are net changes over or under that contemplated by a contract target price in, say, a fixed price incentive contract. This is normally not attributable to any other causes of cost growth that I have identified earlier.

I would like to suggest, Mr. Brown, that we give you a complete recap of the detailed definitions of each of these for the record. As best we can, we will attempt also to break out that other 13 percent that is not identified in my prepared statement.

(The following information was subsequently supplied for the record:)

THE DEPUTY SECRETARY OF DEFENSE,
Washington, D.C., August 5, 1970.

Memorandum for Secretaries of the Military Departments: Director of Defense Research and Engineering; Assistant Secretary of Defense (Comptroller); Assistant Secretary of Defense (Installations & Logistics); Assistant Secretary of Defense (Public Affairs); Assistant Secretary of Defense (Systems Analysis); Assistant to the Secretary (Legislative Affairs); Director, Defense Supply Agency; and Director, Defense Contract Audit Agency.

Subject: Cost growth definitions.

As indicated in my memorandum of November 26, 1969, the views of each addressee were obtained relative to the tentative definition of "cost growth" which was distributed at that time. These views have been carefully considered and changes made to improve the clarity or the categorization of the reasons for "cost growth."

Distributed with this memorandum is the definition of "cost growth." This will apply to the net increased cost to the Government of items or services procured or to be procured. There are nine listed categories of reasons for cost growth which provide the visibility required.

This definition for "cost growth" or "cost decrease" will be used when necessary to explain programs, budgets or contracts. For internal management purposes, any of the categories may be grouped or further stratified to serve management needs. However, any grouping of categories thus used must be capable of being identified by the nine individual categories if this is later required for reconciliation purposes.

It is expected that this "cost growth" definition will be used wherever appropriate in management reporting, testimony, official correspondence or speeches, to explain instances of cost growth.

DAVID PACKARD.

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"COST GROWTH"

Cost growth is the net change of an estimated or actual amount from a base figure previously established. The base must be relatable to a program, project or contract and be clearly identified including source, approval authority, specific items included, specific assumptions made, date and amount. The events causing "Cost Growth" must then be identified by one or more of the following categories and the appropriate amount of each shown as "estimated" or "actual." These categories do not necessarily determine whether the cost growth could have been avoided by the Government or contractor or both. They provide the essential visibility and information required to determine the cause of the cost growth.

CATEGORIES

1. *Engineering Change.*—An alteration in the physical or functional characteristics of a system or item delivered, to be delivered, or under development, after establishment of such characteristics.

2. *Quantity Change.*—A change in quantity to be procured, the cost of which is computed using the original cost-quantity estimating relationships, thereby excluding that portion of the current price attributable to changes in any other category.

3. *Support Change.*—A change in support item requirements (e.g., spare parts, training, ancillary equipment, warranty provisions, Government furnished property/equipment, testing, etc.).

4. *Schedule Change.*—A change in a delivery schedule, completion date or intermediate milestone of development or production.

5. *Unpredictable Change.*—A change caused by Acts of God, work stoppage, Federal or State Law changes or other similar unforeseeable events. Unforeseeable events include extraordinary contractual actions under the authority of PL 85–804 except that formalization of informal commitments should be reflected under the other categories, as appropriate and not included under this category.

6. *Economic Change.*—A change due to the operation of one or more factors of the economy. This includes specific *contract changes* related to economic escalation and the economic impact portion of contract quantity changes computed using the original contract cost-quantity relationship. This also includes changing real dollar amounts in *program estimates* to reflect (1) revised economic impact or (2) definitized contract amounts.

7. *Estimating Change.*—A change in program or project cost due to refinements of the base estimate. These include mathematical or other errors in estimating, changing the base year of the constant dollars, revised estimating relationships, changing from constant dollars to real dollars, etc.

8. *Contract Performance Incentives.*—A net change in contractual amount due to the contractor's actual performance being different than was predicted by performance (including delivery) incentive targets; as differentiated from cost incentive targets; established in an FPI of CPIF contract. This category also includes any changes in amounts paid or to be paid a contractor due to (1) award fee for performance accomplishments under a cost plus award fee contract or (2) the sharing provisions of a value engineering incentive clause included in any type of contract.

9. *Contract Cost Overrun (Underruns).*—A net change in contractual amount over (under) that contemplated by a contract target price (FPI contract), estimated cost plus fee (any type cost reimbursement contract) or redeterminable price (FPR contract), due to the contractor's actual contract costs being over (under) target or anticipated contract costs, *but not attributable to any other cause of cost growth previously defined.* Offsetting profit or fee adjustments attributable to cost incentive provisions, if any, shall be considered in determining the net contract cost overrun (underrun).

BREAKDOWN OF COST GROWTH ELEMENTS

The percentage figures used in statement are those percentages applied to a GAO analysis of cost growth in 52 weapon systems for which Selected Acquisition Reporting (SAR) cost data was available. This breakdown, as reported by the GAO on page 61 of their report entitled "Acquisition of Major Weapon Systems" (B–163058 dated March 18, 1971), is as follows. It should be noted that the categories used by GAO are not identical in all respects to the nine categories used by DoD. The major categories however, are the same.

[Amount in millions]

	Amount	Percent
(1) Net quantity changes	$2,382.5	9.9
(2) Engineering changes	4,072.5	17.0
(3) Support changes	1,366.0	5.7
(4) Schedule changes	2,615.5	10.9
(5) Economic changes	4,014.4	16.7
(6) Estimating changes	6,179.2	25.8
(7) Sundry	1,084.7	4.5
(8) Unidentified	2,264.9	9.4
Total	23,979.7	99.9

Representative BROWN. Let me move on to this concern that you express about the GAO study involving only 3 percent of the contracts and not being typical. I have a list of 4,828 cases in 1969 and 4,853 cases in 1970, that came before the Renegotiation Board. These are not individual contracts, they are company positions, I assume, based on the way the Renegotiation Board operates. But in this statistical breakdown, between 17 and 18 percent of their study represented studies in which current losses were involved, or in which carryover losses, carry forward losses were involved. Now, there were losses involved in the GAO contract study.

Mr. SHILLITO. Yes, sir, there were.

Representative BROWN. What percentage?

Mr. SHILLITO. I don't have the number at my fingertips, but we can give you that number. Mr. Malloy says that he doesn't think we have that number.

Representative BROWN. Can we identify it and see if it rates typically with the consideration there given.

Mr. SHILLITO. In some of their range data on the 146 contracts they did indicate some losses. I think that is fairly well spelled out in the record. We will check with the GAO on that and supply it for the record.

(The following information was subsequently supplied for the record:)

LOSSES IN THE GAO PROFIT STUDY

In Mr. Staats' testimony on 29 April 1971 before the Committee, additional back-up material was provided by the General Accounting Office (GAO). This material, amplifying the facts and data associated with the group of 146 contracts, described in part the circumstances and range of losses associated with this segment of the GAO Profit Study. Of the 146 contracts 17 were losses ranging as high as a minus (78%) on Total Capital Investment (TCI). GAO has advised that the losses averaged a minus (20.7%) on TCI.

As to the primary segment of the GAO Profit Study relating to the large sample of 74 defense contractors, the schedules attached to the Study report display the losses observed by GAO. Schedule 3 of the report shows the following losses measured as a return on TCI by year:

Losses on TCI

Year:	*Percent loss*
1966	—27
1967	—06
1968	—22
1969	—12

In the most recently published report by the Renegotiation Board, renegotiable losses totalling $461 million were reported against a sales volume of $9,256 million, with the largest losses occurring on fixed-price contracts. In that category, losses of $358 million were incurred against renegotiable sales of $5,368 million Trend data on the number of loss filings reported to the Renegotiation Board for the last 3 years are as follows:

Renegotiation Board year ending—	Total number of nonagency filings	Nonagency filings reporting losses	Loss filings as percent of total filings
1968	4,027	676	16.8
1969	4,452	788	17.7
1970	4,400	1,029	23.4

Mr. SHILLITO. By the way, for 1970, the Renegotiation Board losses as a percentage of nonagency filings were 23.4 percent. I think this is an interesting number, too.

Representative BROWN. This would be 23.4 percent of the companies covered by the Renegotiation Board or contracts covered, which?

Mr. SHILLITO. This is related to the number of total nonagency filings; this is, companies. You are talking about 4,400 companies which filed in 1970, with 1,029 of these companies incurring losses.

Representative BROWN. I am hard-pressed, Mr. Shillito, to answer one question in my mind. I was not going to ask you this, but how did you resist in your examples in your testimony, of cost overruns and other projects the temptation to mention the Rayburn Building which was built during the time of relative price stability in which we had some rather extensive cost overruns? I just find that beyond belief.

Mr. SHILLITO. I am just extremely tactful, Mr. Brown.

Representative BROWN. Mr. Chairman, now that you have returned to the fray, I have to be excused because they are playing my song, too, in bells. So I will yield back to you.

X-27 FIGHTER AIRCRAFT

Chairman PROXMIRE (presiding). Mr. Shillito, this thought occurred to me as I was going down to the floor. You said that X-27 wasn't the kind of thing that would bail out Lockheed, talking about tens of millions of dollars, but it seems to me like tens of millions here and there, might add up to a little money.

Mr. SHILLITO. I don't have any idea at all about the so-called X-27. The only thing I can assure you is that, knowing the magnitude of the Lockheed problem, you won't correct the Lockheed with a fighter plane development contract.

Chairman PROXMIRE. I am sure not with that alone. It is just an example of one way in which you could get at it, and one way that could be shockingly wasteful.

Mr. SHILLITO. I can assure you that regardless of what happens with respect to the X-27 it would indeed in no way relate to the kind of pending major decisions as regards Lockheed. In any event, as far as I am aware, there is no contract being considered for award to Lockheed for the development of a new fighter plane.

Chairman PROXMIRE. Thank you, very, very much.

Mr. SHILLITO. Thank you, Mr. Chairman. It is nice being with you again.

Chairman PROXMIRE. It is nice having you up.

(The following information was subsequently supplied for the record:)

Rental collection listing

Cessna, Wichita, Kans	$47,244.37
Cleveland Pneumatic Tool,[1] Cleveland, Ohio	804,590.37
Fairchild-Hiller,[1] Republic Division, Long Island, N.Y	630,087.00
General Electric,[1] Albuquerque, N.M	199,947.05
McDonnell-Douglas, St. Louis, Mo	575,447.00
Menasco Manufacturing, Fort Worth, Tex	108,904.36
National Water Lift,[1] Kalamazoo, Mich	29,364.92
Rohr Corp.,[1] Chula Vista, Calif	515,513.17
Aeronca,[1] Middletown, Ohio	175,464.73
Heintz Division, Kelsey Hayes, Philadelphia, Pa	151,604.26
Utica Division, Kelsey Hayes,[1] Utica, N.Y	325,813.00
Menasco, Burbank, Calif	209,850.00
	3,773,830.23

[1] Rental includes 1st quarter fiscal year 1972.

Chairman PROXMIRE. Our next witness is Joseph M. Lyle, president, National Security Industrial Association. And I will ask Mr. Robert B. Chapman III, president, AAI Corp., Cockeysville, Md., to come up with Admiral Lyle.

Admiral Lyle is a friend of our committee. During his active career he was awarded the Legion of Merit and the Distinguished Service Medal. In July 1967, he joined the National Security Industrial Association as vice president for operations. On September 28, 1967, he was appointed president of the National Security Industrial Association.

He is a past national president of the Armed Forces Management Association.

Mr. Chapman has been with AAI Corp. since its founding in 1950. He has been assistant general manager and member of the board of directors since 1952 and executive vice president from 1959 until 1967, when he was elected to the office of president and chief executive officer. He is vitally engaged in the work of the National Security Industrial Association, as a member of the executive committee and immediate past chairman of the board of trustees.

I am very happy to have you with us. And I apologize for keeping you so long. We are looking forward to your testimony.

STATEMENT OF JOSEPH M. LYLE, PRESIDENT, NATIONAL SECURITY INDUSTRIAL ASSOCIATION, ACCOMPANIED BY ROBERT B. CHAPMAN III, PRESIDENT, AAI CORP., COCKEYSVILLE, MD.

Mr. LYLE. I am Joseph M. Lyle, president of the National Security Industrial Association, which is a nonprofit association of approximately 300 American industrial and research companies of various types and sizes from large to small, representing all segments of the defense industry in every part of the United States.

Our essential purpose and function is to serve as a two-way communications medium between Government, primarily defense and NASA, and the industry which supports it.

I am accompanied by Mr. Robert B. Chapman III, a member of the NSIA Board of Trustees, of which he is immediate past chairman, and president of the AAI Corp. of Cockeysville, Md.

Mr. Chapman will present the association's statement on the GAO defense industry profit study.

Mr. CHAPMAN. I appreciate this opportunity to appear on behalf of the National Security Industrial Association to present its views on the report by the Comptroller General entitled "Defense Industry Profit Study" dated March 17, 1971.

A brief word about my industry identification and experience. I am president of the AAI Corp. and immediate past chairman of the board of trustees of the National Security Industrial Association. I have 30 years experience with defense industry, 10 years with the Glenn L. Martin Co. and 20 years with AAI Corp., which I helped to found. I have worked 17 years under NSIA aegis in the Government/industry interface relating to procurement legislation, policies, and regulations.

The AAI Corp. is a medium-sized defense contractor employing about 1,000 people, with annual sales of about $25 million. We work primarily as a prime contractor, developing and producing training and simulation systems, automatic test equipment, materials handling systems, fluid power systems, and weapons and munitions.

We believe that the General Accounting Office has done a competent and thorough job in making the profit study, and we do not question the validity of their data in regard to defense profits reported in the normal annualized form.

Broadly speaking, we do not argue with GAO's conclusions on page 54 of its report that in determining profit objectives for negotiated Government contracts where effective price competition is lacking consideration should be given to contractor capital requirements as well as to such other factors as risk, complexity of the work, and other management and performance factors. However, we are wary of moving too far from reliance on costs and specifically we disagree with the language in the preceding paragraph on page 54 which states ". . . it is essential that capital investment be substituted for estimated costs as a basis for negotiating profit rates." With respect to GAO's finding that it is feasible to develop invested capital data by contract, we question that this can be done with any acceptable degree of precision, either before or after contract performance.

First let me speak to the feasibility and desirability of negotiating profits for individual defense contracts on the basis of return on investment rather than on a basis of return on costs.

It will be extremely difficult, if not impossible, to develop reliable capital investment data which can be used to negotiate the profit ratio of individual contracts. One major obstacle will be that investments made in one fiscal period will benefit contracts in later periods, sometimes years apart. Another obstacle will be in reaching agreement as to what investments should be made and allocated to a particular contract. Some of the most useful company investments have appeared to be of questionable value in their early stages. In the light of the foregoing, it is probable that when investment is allocated among the individual contracts, a portion of the investment will be left which the Government negotiators will say is not properly allocable to any con-

tract and for which the contractor will not therefore be able to get any return.

Our economic system depends on balancing out profits from all contracts so as to produce an overall satisfactory net return. It is not at all based, whether defense or commercial business, on obtaining the same return on investment from every contract.

Apart from the inherent imprecision of the allocation process previously noted, it is not surprising that the GAO study of 146 contracts showed wide variation in return on investment. We believe this finding is of little significance. An examination of the individual contracts of any contractor, whether defense or commercial, would show such a widespread variation between the return on investment for individual contracts because of normal differences in the work requirements. Further, the basic method of defense contracting leads to such large variations between return on investment of individual contracts. For any major sysem or subsystem there will be many contracts, some of which require a very high investment and some of which require almost no investment at all.

The concept of basing profits on return on investment developed for the public utilities is applied on a overall basis to the entire operation of a particular utility company during an annual period. If it is desired to introduce the concept of return on investment into the determination of defense profits, it should be done after the fact on an overall annual basis for a whole company or profit center rather than before the fact on an individual contract basis.

It is absolutely essential that any change that would introduce contractor investment as a major criterion for determining profit objectives should carry with it a change in Government procurement policy that would make interest costs an allowable cost. The disallowance of interest as a cost is one of the elements of the present pricing formula. Any approach to pricing which puts a major or whole emphasis on return on investment should consider interest as a cost to avoid confusing or conflicting incentives.

In considering defense profits, however established, it must be kept in mind that Government contractors assume a far greater risk in the feast-to-famine economy of defense contracts than do most commercial contractors. The termination of a single contract representing the major portion of the contractor's volume, the stretchout or partial termination of such a contract, the failure to win in the win-all or lose-all competition of a major new program award—these are risks which the commercial company whose volume typically bears a closer relationship to the much more stable general economy does not have to assume. Since the most elemental function of profit is to reward the entrepreneur for the assumption of risk, the defense contractor should show his stockholders a higher return on defense contracts than on a commercial business. The fact that the reverse is true is a forecast of trouble for the retention of a broad industrial base for the production of the sophisticated weapons required for our Nation's security.

Finally, it is important to recognize that the defense industry profit study made by the GAO clearly demonstrates, as did the previous studies by the Logistics Management Institute, that contractor profits on defense work are not excessive and in fact are lower than for comparable commercial work.

We feel, based on recent changes in defense procurement regulations promulgated since the period covered by the study, that similar data for the current period would show even lower defense profits and a wider disparity between defense and commercial profits. These changes, impacting on the allowability of rental payments for property and for automatic data processing equipment, as well as introducing greater limitations on independent research and development, tend to lead to a further erosion of profits.

We are concerned that continued pressure on the level of defense profits will still further adversely affect an industry which is aready in a very unhealthy condition due to the large reductions in force which have been implemented in the last 2 years as a result of cutbacks in defense funding.

In brief summary, while agreeing with the concept of considering contractor capital investment as one factor among others, including costs, risks, complexity, et cetera, in determining going-in profits for negotiated contracts, we seriously doubt the feasibility of and are opposed to negotiating profits primarily or solely on the basis of return on investment. We feel that return on investment can be determined accurately only after the fact on an overall company or profit center annual basis. We further point out that the GAO's report of defense industry's profits solidly supports the conclusion that industry profits on defense business are not excessive, but indeed are lower than for commercial business.

Thank you.

Chairman PROXMIRE. Mr. Chapman, you say in your statement: "since the most elemental function of profit is to reward the entrepreneur for the assumption of risk, the defense contractor should show his stockholders a higher return on defense contracts than on a commercial business." Do you as a defense contractor also have commercial business?

Mr. CHAPMAN. Yes, sir; we do.

Chairman PROXMIRE. Are you publicly held?

Mr. CHAPMAN. We are a publicly held corporation, sir.

Chairman PROXMIRE. Can you show your stockholders your return on your defense contracts and on your commercial business?

Mr. CHAPMAN. We have not yet reached a point where we have disclosed returns on the individual elements of the business.

Chairman PROXMIRE. Do you know what they are?

Mr. CHAPMAN. Yes, sir.

Chairman PROXMIRE. You know yourself?

Mr. CHAPMAN. Yes, sir.

Chairman PROXMIRE. Don't you think any good businessman would know that before he would either sell in the commercial market or take a defense contract?

Mr. CHAPMAN. Yes, sir.

Chairman PROXMIRE. If you know, then you have answered the question that you raise in your statement: "It will be extremely difficult, if not impossible, to develop reliable capital investment data which can be used to negotiate the profit ratio of individual contracts."

Mr. CHAPMAN. I misunderstood you.

Chairman PROXMIRE. But any competent businessman would know that, or he won't stay in business very long, he knows when he gets a

defense contract at least roughly what kind of a return he can get on equity capital. That is his job as a good businessman, and that is his responsibility to his stockholders, to be sure that when he goes into this business he is going to get a return. So that if you have been able to operate efficiently—and I am sure you have and you have a good reputation as a businessman, you have been successful—you have been able to do it based on an understanding of the kind of return you are going to get when you get into a defense contract. You certainly don't go into them to lose money.

Mr. CHAPMAN. The overall aim is not based on individual contracts. It is in some cases desirable to take an individual contract which in itself will lose money.

Chairman PROXMIRE. Of course.

Mr. CHAPMAN. You have to balance all the contracts, and your end goal is to balance from a line of business, to get a balance from a line of business which may return in 25 programs a profit for a period of time. The particular line may be unprofitable for a year or 2 and then be profitable, and it has to make up for the losses in previous years. On an individual contract basis there is no real equity return measurement—you attempt to take every individual contract on a profit-on-cost basis using the pricing formula. You don't try to find out what the relation of that is to the equity. And it is a very arguable thing. Almost no one can agree on how to spread the investment over the individual contracts.

Chairman PROXMIRE. You approve the GAO study, but you challenge their computation of return on equity capital from defense work?

Mr. CHAPMAN. Not on a normal annualized basis.

Chairman PROXMIRE. If you are able to do it, why can't this be done by the Defense Department in its procurement policy? That is all we are asking for.

Mr. CHAPMAN. We did not agree with the GAO's allocation of invested capital to the 146 contracts. I have studied carefully what they have said, and they indicate that there was considerable disagreement between them and the contractors, that they developed it, and the contractors were allowed to see it, and there was some disagreement, but they don't tell how they did it. I have tried to do this in many instances for many reasons—justifying IRD, justifying investment—I have tried to do it internally, and I have tried to do it with Government agencies. We always try to do it in setting up our bid rates for the year; that is, what we are trying to allocate is overhead costs, which include some of these investments, and in establishing rates to be applied to a completed contract. It takes a long, long time to do it. And doing it on an individual contract basis will bog the procedure down very badly.

Chairman PROXMIRE. The GAO study was based in the first place on a questionnaire, and then they spot audited the returns, and then they went into the more detailed audits, on 146 contracts. On the questionnaire they asked the contractors to give their profits, as I understand it, on their defense contracts and on their commercial business. And then the GAO calculated the returns of the defense contractors. And they calculated it in various categories. And they came up with conclusions. And I don't know of anybody in the industry who has

challenged the accuracy of these conclusions. They were able to compute what the return was on equity capital, on total capital, etc. They were able to do it. If they were able to do it without question, why, then, shouldn't this system, which they say should be adopted and, which, according to the previous witness the LMI recommended, and which the Defense Department recommended, why shouldn't this be a sensible policy? Your only objection is that it is extremely difficult if not impossible to apply, you say. They have done it, and you haven't challenged the accuracy of their being able to do it with respect to individual contracts.

Mr. CHAPMAN. We have to differentiate between two parts of the study. One part of the study was on the questionnaire. It was normal annualized data. They did break it down between commercial and defense contracts, but not by the individual contracts—rather on the basis of all contracts for a given company in a particular period. When someone says that this has been done, you have to visualize what that means in any one year—moreover, you have to know, is the contractor on a completed contract basis, or is he on a percentage of completion basis? It makes a major difference in his profit as reported. In any one year a contractor can be reporting on contracts which have started in previous years and are finishing up this year, on contracts which start this year and finish up this year, and on contracts which start this year and don't finish until the future. So that the data that they have developed, which I say is accurate, is on total defense business for a particular year. But it bears no resemblance to a program or a contract which has stretched over 7 years.

Chairman PROXMIRE. You have done a skillful job of differentiating. But it seems to me that you are still hung up on this problem.

Is there not a similar problem with respect to the allocation of estimated costs which you approve? You say you should compute your profit on the basis of costs, i.e., the profit related to the costs. Now, to allocate those costs it seems to me is a similar problem. Isn't the majority of the in-house contract costs allocated rather than directly identified with the instant contract?

Mr. CHAPMAN. I think in general the in-house costs are split approximately 50 percent—50 percent directly identified, and 50 percent must be allocated.

Chairman PROXMIRE. And that allocation is a matter of judgment?

Mr. CHAPMAN. It is a very difficult judgment, and presently, under the DOD pricing formula, it is done at least twice a year. At the beginning of each year a contractor must make projections—and sometimes correct them quarterly; I do it quarterly with the Government auditors who are in my plant—of what business he expects to have for the year. I make projections of what direct costs I expect to have, and I make projections of what nondirect costs must be allocated. And this is a matter that continuously goes on between me and five resident Government auditors on an overall annual basis and not on an individual contract basis. We establish a set of rates to bid by, a set of rates to bill by, and then finally sometimes 2, 3, 7 years later we negotiate the rates for complete contract billing. And this is only negotiating my total indirect costs over my total direct costs for 1-year periods, and not broken down by little pieces. If I have to break it

down by contracts I would have to break it down into many separate negotiations.

Chairman PROXMIRE. Then you are not arguing about computing profit with relation to cost as being better than with relationship to capital. What you are saying is that you can't differentiate individual contracts either way.

Mr. CHAPMAN. I am saying that I have participated in discussions where a board of directors or a set of outside auditors, who are the most expert people you can find, have tried to decide after the fact how to allocate certain investments. You can see the results of these discussions all the time. You can see an annual report adjusted because an allocation made 3 years ago turned out to have been an error, and there is a change, retroactive, 3 years past. This is a very tough thing to do. And all I'm arguing is, let's not try to do it on a contract-by-contract basis.

Chairman PROXMIRE. Then it seems to me that you don't have any basis at all for negotiation with the Defense Department. You can't negotiate in the relationship of your profit to your costs, so I don't know how the Defense Department would be in a position to negotiate with you.

Mr. CHAPMAN. We do negotiate with relation to costs. We establish a profit relationship with reference to predicted cost.

Chairman PROXMIRE. On a contract basis?

Mr. CHAPMAN. On a contract basis. But the allocable parts of it are applied by formula which is previously agreed to on an overall basis.

Chairman PROXMIRE. Why can't you do the same thing with respect to capital?

Mr. CHAPMAN. Because capital actually—and here again I am not quite sure what the GAO is calling capital—clearly they are calling capital that part——

Chairman PROXMIRE. Very simply, the total assets—your total investment or your equity capital. You know what that equity is, and you know what your total investment is.

Mr. CHAPMAN. My equity is easy to divide overall. But when I want to divide it individually by contracts, some elements of my equity will apply more to one contract than to another. And this is a very difficult thing to do, which people have tried to do after the fact, and have not done very successfully. I am arguing that we shouldn't try to do it before the fact.

For instance, just take my example of the time period. I make an investment, which in the commercial world would be called a capital investment, and in the military world we call IRD, of $100,000 this year. If we were negotiating no contract in that year, I would have to set up some kind of a pool to reserve this against. The first contract I got, I would then say that the contract resulted from that investment. Actually I may obtain contracts from an investment made in 1959 as late as 1972. I have programs which were started back in 1951 which I am still contracting for. And the investment that I made back in 1951 has spread over all these years, including tools, facilities, and so on. And so it is extremely difficult to take an investment and try to tie it down to an individual contract.

Chairman PROXMIRE. But when you are relating your profits to your cost you have the same kind of a problem, because one of your costs you say is your indirect cost?

Mr. CHAPMAN. That is correct, Senator Proxmire.

Chairman PROXMIRE. The cost of depreciating capital, getting a fair return on the amount that is invested altogether, you have to compute that and determine whether to go ahead with it?

Mr. CHAPMAN. You compute it once on an overall basis——

Chairman PROXMIRE. You compute it with respect to the contract too?

Mr. CHAPMAN. But only allocate it to the contract on the basis of taking the total direct costs of the contract during that year in relation to the other direct costs, and you take its part of the depreciation and apply it. We haven't yet in our pricing formula reached a point where we try to take depreciation of manufacturing equipment and allocate it only to manufacturing contracts using specific equipment.

Chairman PROXMIRE. This seems to me to be primarily an accounting problem. And the expert accountant advising the Government is the General Accounting Office. They have a great reputation. And they have consulted in great detail with the people in the Defense Department, and with large and small contractors. And their best judgment is that this is the fairest and best way from the standpoint of both the taxpayer, the Government, and the contractor to handle this situation and to get fairer treatment for both the taxpayer and the contractor.

Let me ask you this. Mr. Chapman, would you agree to supply the Government with information about your defense profits if you were asked to do so? Would you oppose such a request? Do you think contractors ought to report the profits they make on Government work in the performance of negotiated contracts?

Mr. CHAPMAN. Actually, it is not too difficult in my company, since we are 95 percent defense, to figure our defense profits. Essentially, since I have been a defense contractor for 21 years I have really been supplying that kind of data.

Chairman PROXMIRE. Can you tell us what profits you made on your defense business in each of the 5—past 5 years, figured as a return on sales and as a return on investment?

Mr. CHAPMAN. Not offhand. I can tell you what my total return on investment is for the whole company for the last 5 years.

Chairman PROXMIRE. That is pretty close, because 95 percent of your business is defense, unless you had a mighty profitable or unprofitable commercial business.

Mr. CHAPMAN. In the last years—I can give you 1966 through 1970.

Chairman PROXMIRE. All right, sir. What was it?

Mr. CHAPMAN. Return on stockholders' equity, 3.92; 13.58; 4.76; 1.49; 7.45.

The average return for the whole 21 years of our existence is 9.28.

Chairman PROXMIRE. And your return on sales?

Mr. CHAPMAN. The return on sales I didn't put down, because I consider that pricing.

Chairman PROXMIRE. The reason I asked that is because I just wondered whether this was possible to do. Do you think it would be

reasonable to ask or require all defense contractors to provide that kind of information?

Mr. CHAPMAN. We are reaching this point. This is one of the big arguments nationally in the American Institute of Certified Public Accountants with the SEC—this question of requiring executives to disclose their profits by elements of their business.

Chairman PROXMIRE. On what side of the argument do you come down?

Mr. CHAPMAN. I am concerned that if managers disclose the elements of their business in great detail, they will then have their company managed by a committee of the public, or the stockholders. And frankly, any time you cut through a company and look at its product lines, you can find individual product lines that are not very profitable now, but which the manager as an entrepreneur feels will be profitable in the future. And if these were attacked, some of the great things we have done in this country would never have been done.

Chairman PROXMIRE. Doesn't seem to be any problem for you. You have been very frank. You have told us what your profits are as a percentage of your investment, and it would be very easy to compute it, since you are publicly held. And I think that that means that you sell your stock, so the SEC would require that you divulge that kind of information. And you also divulge what your equity is, and what your total assets are, and what your sales are. So it is easy to compute. Why shouldn't your competitors be in the same position? And publicly held corporations are in the same position where they have such a high proportion of their sales in defense. Where they do not, of course, they have an advantage over you. They don't have to disclose what their profits are with respect to defense. It seems to me that this particular area—because the taxpayer has to pay for it—is something that should be publicly disclosed, since you have publicly disclosed it anyway, what your overall profits are.

Mr. CHAPMAN. Of course, my feeling in coming down here today was that the GAO study and the LMI study had disclosed this mix without disclosing any individual companies they were talking about.

Chairman PROXMIRE. That is it. What we want to get at is, why should we not know which individual companies?

Mr. CHAPMAN. Fundamentally, I guess for the reason I have given you, that the managers feel that the more information that they give out about the details of their operation, the more people that they have to justify what they are doing to.

Chairman PROXMIRE. What is wrong with that?

Mr. CHAPMAN. Business management is extremely difficult, and management by committee is impossible. A company benefits from strong, capable people leading it, and it is because of them that it has been successful.

Chairman PROXMIRE. I think that is absolutely right. I agree with that. But I don't see how that means that the profit in defense shouldn't be disclosed when your overall profits are disclosed. If busybodies are going to poke their noses into it, they are not going to get anywhere unless there is very high profit. It seems to me, on the other hand, that if you are not making any money out of defense, we ought to know about it, because that means that you haven't been treated fairly overall in procurement. The more information the public and

the Congress has about this, is would seem to me, the stronger the basis and the fairer basis we have for our procurement policies.

Mr. CHAPMAN. Well, listening to the earlier testimony, I came up with the thought that perhaps deals with this subject. Looking at that set of figures that I read to you—and you are right, they are public, anybody can get our annual report and calculate return on equity. I said our 21-year average was 9.28 percent—but did you realize what the spread has been? From minus 3,000 percent to plus 264 percent return on investment.

Chairman PROXMIRE. Oh, are you talking about your company?

Mr. CHAPMAN. My company.

Chairman PROXMIRE. 3,000 percent of course means that you had a very bad year.

Mr. CHAPMAN. No, it doesn't. That is the point. That is the truth I am trying to demonstrate. The distribution of a study like that, without knowing in detail what those figures mean, can result in some awfully wrong conclusions. For instance, there is no statement made here about the difference between the completed contract basis and percentage of completion basis, which, as you know, is one of the things in which the IRS is publicly considering making a major change. When I was on a completed contract basis, I would work sometimes 3 years in a company doing 4 or 5 million of sales a year on a $3 million contract, and on a completed contract basis, not report one dollar of profit until the fourth year, when I might have only had $20,000 of sales from that contract. The net result is that you see these figures of 264 percent return on investment in that particular year for my company.

Chairman PROXMIRE. It is important to know it by contract.

Mr. CHAPMAN. I would be glad to work with any member of your staff on some details of this business of trying to allocate investment by contract. I tell you, I have been involved in it, I have tried to do it with friends, and I have tried to do it with foes, and it is just as tough to do with friends as it is with foes. No one wants to admit that he has the responsibility for a part of an allocation. For instance, have you ever been involved in seven divisions with a corporate headquarters, allocating to the seven divisions in the commercial world the cost of the corporate headquarters, and trying to get the seven general managers, all of whom may be on the board, to agree with the allocation—on a one-time-a-year basis, now—not on an individual contract basis? Believe me, I can talk for 8 hours on how to allocate specific cost items on an individual contract basis.

Chairman PROXMIRE. You have been very frank in telling us the return on your overall business. What is your salary?

Mr. CHAPMAN. My salary is disclosed in the annual proxy statement. Senator, I would be glad to tell you that too, since you can get it by reading it. I will tell you what was disclosed in the 1970 report, which is the one that has just gone out. It is $54,000 a year.

Chairman PROXMIRE. You are paid more than we are. You are probably worth more.

I wonder if both of you gentlemen could give me your views on the proposed Lockheed bailout. Do you approve of restructuring Lockheed's contracts, changing them from fixed price to cost plus, so as to provide for payment of the cost over-runs?

Mr. Lyle.

Mr. LYLE. Mr. Chairman, the association has no position on this. As perhaps you know, we are not a monolithic organization.

It is our practice to determine association positions on a consultative basis, and we have not addressed this question.

My personal answer to your question is that I am not expert in all the ramifications, but I do think a very important factor that needs to be taken into account in the resolution of this matter is the importance of Lockheed to the economic health and the national security of the country. And I think that if these are deemed to be of overriding national importance, and that if special measures are not taken, we will lose the company, then to my mind that would be a basis for saying, yes, you should bail them out in your terms.

Chairman PROXMIRE. What do you think we should do? Do you think we would in fact lose Lockheed? We have had testimony from Admiral Rickover, Mr. Connally admitted that in the event Lockheed should go into bankruptcy, there might be a delay on defense contracts, but that 80 percent of their business would probably continue.

Mr. LYLE. I really can't comment on that.

Chairman PROXMIRE. Then you don't have a judgment on whether we should provide this guarantee loan or not?

Mr. LYLE. Not in the final assessment.

Chairman PROXMIRE. How do you feel about restructuring their contracts in view of their plight to convert them to cost-plus?

Mr. LYLE. I have no opinion on that.

Mr. CHAPMAN. May I respond to that?

Chairman PROXMIRE. Mr. Chapman.

Mr. CHAPMAN. Again as an individual.

Somewhere around 12 years ago, I helped the ASPR Committee write part 4, section 3, which resulted in the abominable mess of contracting we had in the late 1960's. I made a number of national speeches, and I wrote a paper and presented it to Members of Congress, and so on. In that I predicted exactly the situation that we are going in today, the situation of gigantic claims and restructuring of contracts. My personal assessment of the Lockheed situation is that under their C–5A total package procurement—and I happen to have studied this some years ago and made some prediction on it—they had a contract which had protections in it against contingencies. No one could foresee that in the long run, when the contingencies arose, we would choose not to honor the contract as a nation. So I personally feel that there is an obligation to go through the course of restructuring the contracts and considering this economic decision that Admiral Lyle suggests.

Now, it doesn't bother me if we make the economic decision to give Lockheed financial assistance. As a citizen who knows what is going on in the high technology industry, I am not sure we can take many more blows. High technology engineering is reeling. Hundreds of thousands of engineers and scientists are out of work, and the marketplace is not picking them up, and it is not going to pick them up. Moreover, the attack on consumerism at the same time is turning off many of the things that the society might have done. And neither the open nor the closed market has decided to do anything with the national environmental problems. So we are sitting on dead center. The

blow to Lockheed, and the major banks, and many subcontractors, I personally feel, would be a very serious thing to contemplate. I don't think bankruptcy proceedings would be a very safe way to tackle it.

Chairman PROXMIRE. Do you think the safe way would be to rely on the defense budget as a way of maintaining economic health?

Mr. CHAPMAN. Oh, no.

Chairman PROXMIRE. Then should we convert the Lockheed defense contracts from fixed price to cost-plus to assist them? And your answer to that was, No. 1, you predicted the mess they are in——

Mr. CHAPMAN. I think that their contracts were very poor contracts, very poorly written. I heard Dan Houghton make a speech years ago in which he stated that the only basis under which we (industry) could make these very difficult attempts to do incalculable things, the unknown things on fixed price, would be to have provisions for relief in the contracts. Thus they would not really be fixed price contracts. So he advocated that we not go to this form of contracting.

Chairman PROXMIRE. There was a target price and a ceiling price, and we are providing a substantial additional appropriation over the ceiling price with respect to the C–5A. I am talking about whether we should divert the defense contracts generally for Lockheed into cost-plus.

Mr. CHAPMAN. My personal feeling is that we have an excellent way to resolve this that works very well, and that is the Armed Services Board of Contract Appeals, one of the finest semijudicial organizations we have in the country.

Chairman PROXMIRE. You would rely on that?

Mr. CHAPMAN. I would personally rely on that. In my 21 years, I have had seven or eight claim situations, and have never gotten anything but fair judgment. The difficulty with Lockheed is that their problems are so great that they can't wait for their claims to be adjudicated. So it is back to an economic decision. Either Lockheed is important, and you want to help them, or Lockheed is not important, and then let them go under in the normal free enterprise system. But somebody else has to make that judgment. I can't.

Chairman PROXMIRE. What happens if we go ahead and provide this $250 million loan guarantee for Lockheed, and Lockheed makes it, and we in effect force the L–1011 on the market in competition with McDonnell-Douglas, doesn't this simply mean that there is less work for McDonnell-Douglas and for GE, which produces the engine, and more work, maybe, for Rolls-Royce in Britain? You are not increasing the demand at all, it is fairly finite. It seems to me it is very, very hard to see where you draw the line here. If you are going to do that, maybe we will have to bail out McDonnell-Douglas next, and then go to other aerospace people and help them too.

Mr. CHAPMAN. It is a very difficult decision to make, I agree. But we are paying the penalty for living in a mixed economy. And we are so deeply mixed now between our commercial business and our military business and are involved in regulations and controls, that it is very hard to separate these things. Again, I would have to say, if I were in the position of you gentlemen, and had to make the judgment, I would judge on what is good for the country and not an individual company. I would look at what is good for the country as a whole. If what is good for the country as a whole helps someone in a way you

would rather not do it, and hurts someone else in a way that you would rather not have done, that is too bad, but it must be accepted.

Chairman PROXMIRE. After all, Lockheed were big boys when they made that contract. And if they are going to take the profits when they do well, they also have to pay the penalty if they don't do well. Otherwise the free enterprise system loses a lot of its discipline and meaning.

Mr. CHAPMAN. I agree with that in theory. But from the standpoint of the country, you have to make sure that you can afford to pay that price. And you can, of course, with a company my size. So I wouldn't even argue twice about what the rule would be with a company my size. The rule would be the free enterprise system. But with a company the size of Lockheed, with the involvement that it has in the financial world, you had better think twice before you decide to apply the regular rules.

Chairman PROXMIRE. What happened to Penn Central when they went into bankruptcy? There were dire warnings. The administration was asking for a bailout of Penn Central. They didn't make it. Nothing has happened. Unemployment didn't increase. Services have been increased. And in fact, it has even been better run. And now they have even found some of the railroad cars that they lost.

Mr. CHAPMAN. I am not sure. It is hard to tell any difference in the service on that railroad, which I ride very often. That is a service operation, and not a large multidivision conglomerate contract operation. I am not sure you can go through with simplicity the bankruptcy proceedings that we went through with Penn Central. Again, that is something that someone with a lot more economic knowledge than I have would have to study.

Chairman PROXMIRE. Mr. Chapman and Admiral Lyle, thank you very, very much. You have been most helpful.

The subcommittee will stand adjourned.

(Whereupon, at 1:10 p.m., the subcommittee adjourned, subject to the call of the Chair.)

(The following information was subsequently supplied for the record:)

COMPTROLLER GENERAL OF THE UNITED STATES,
Washington, D.C., June 14, 1971.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee,
Congress of the United States.

DEAR MR. CHAIRMAN: In reading the statement that Mr. Barry Shillito made on May 25, 1971, before your Subcommittee on Economy in Government, I have noted a few areas upon which I would like to comment.

Mr. Shillito points out that, in the last two years, there has been a reduction of about 20 percent in the Government-owned industrial plant equipment in the possession of contractors. This may appear to be at variance with my testimony. I stated that the total value of Government-owned industrial facilities in possession of contractors had remained relatively constant during the past few years. The distinction to be made is simply that "industrial plant equipment" is only one category of industrial facilities in the possession of contractors. This consists of machine tools such as lathes and presses. Another category is "other plant equipment" that includes such things as furnaces, furniture, and fixtures. During the last two years, although industrial plant equipment has been reduced, other plant equipment has been increased a comparable amount so that the total of about $9.9 billion has remained constant. A major portion of the changes in

the figures between the different categories of equipment is attributable to redefinition of certain items.

Mr. Shillito's statement might also have left the impression that the rent collected for the commercial use of Government-owned facilities is adequate. We have not questioned the rental *rates* prescribed by regulations, however, we believe that improvements can be made in the records of utilization. Unless the utilization records are accurate, application of an appropriate rental rate will not yield an appropriate rental charge. As stated during my testimony, we are initiating further reviews in this area.

Sincerely yours,

ELMER B. STAATS,
Comptroller General of the United States.

COMPTROLLER GENERAL OF THE UNITED STATES,
Washington, D.C., July 16, 1971.

Hon. WILLIAM PROXMIRE,
Chairman, Subcommittee on Priorities and Economy in Government,
Joint Economic Committee, Congress of the United States.

DEAR MR. CHAIRMAN: This is in regard to your letter of June 24, 1971, requesting further comment on the practicality of shifting from a cost basis to a capital investment basis for negotiating profit rates on defense contracts.

The subject is, of course, controversial and there are some who say that return on investment can only be determined after the fact on an overall company or profit center basis. Our study of the subject, however, showed that generally return on investment data can be developed by contract. As stated in our report, the National Aeronautics and Space Administration has developed such a system and in tests has been able to employ the new technique under operational conditions. Further, in our study we developed cost, profit, and investment data for 146 contracts for a fairly wide assortment of items purchased by the defense agencies. While our study was for completed items, the basic procedures could be applied to develop similar data on a forecast basis.

Return on investment information has been developed and used by industry for many years. Such information is frequently considered by commercial firms in pricing product lines, in determining whether to purchase new facilities, and for other purposes. We understand that it is also used by some defense contractors in establishing target profits for negotiating contract prices with the Government.

Numerous articles have been written concerning return on investment and an interesting one appeared in the July-August 1967 issue of Management Services, published by the American Institute of Certified Public Accountants. The title of the article is "Controlling Return on Investment in Government Contracts" by Robert L. Lenington. The article describes how one major electronic products manufacturer forecasts investment requirements for each Government contract and compares actual results with those estimated. The contractor's purpose is to minimize investment and, thus, maximize return on capital. While the contractor's system only covers selected capital items, we believe that the system could be expanded to cover all elements of capital.

We also believe that it is extremely important to change the present system, essentially of determining profit as a percent of costs, in order to motivate contractors to reduce costs. Where the acquisition of more efficient facilities by contractors will result in savings to the Government in the form of lower contract costs, contratcors should be encouraged to make such investments. In this regard, the financial vice president of one of the largest defense contractors advised us that under current procedures, "there is no direct inducement from a financial standpoint to ever make a capital investment in support of a Government project!"

In negotiating profit rates, when appropriate, consideration would continue to be given to factors such as risk, complexity of the work, and other management and performance requirements. In our opinion, if consideration is also given to capital required for contract performance, the profit rates negotiated should be fairer to both contractors and the Government.

Sincerely,

ELMER B. STAATS,
Comptroller General of the United States.

COMPTROLLER GENERAL OF THE UNITED STATES,
Washington, D.C., August 6, 1971.

Hon. WILLIAM PROXMIRE,
Chairman, Subcommittee on Priorities and Economy in Government,
Joint Economic Committee, Congress of the United States.

DEAR MR. CHAIRMAN: On April 29, 1971, at the Hearings on Acquisition of Weapons Systems (*pages 110 and 178* of the transcript), you raised the question whether there was any basis to recover the payments made by the Navy under settlements of three claims described in the April 28, 1971, Comptroller General's report to the Congress: "Evaluation Of Information From Contractors In Support Of Claims And Other Pricing Changes On Ship Construction Contracts."

In our April 28, 1971 report, we described claims submitted by contractor A in the total amount of $114.3 million. Both of the claims represented additional costs incurred or expected to be incurred because of acts of the Government relating to defective specifications for dynamic analysis, shock resistance and noise reduction, and administrative failures of the Government such as failure to furnish design data in time. Both of the claims were submitted on essentially the same basis.

Each of the modifications (signed by the contracting officer) under the contract with contractor A described the consideration for the increase in the contract price in substantially the same terms as follows:

"2. This increase in contract price is provided in consideration for the following:

"A. Full and final settlement of the Contractor's claim for equitable adjustment as amended * * *, including the claim for price adjustment on account of changes in the cost of labor and material during the performance of this contract.

"B. Full and final settlement of the Contractor's claims submitted under the 'Changes' clause of the contract for the following changes: * * *"

The details concerning the claim for disruption and overtime in the prices proposed for two change orders submitted by contractor B, were set forth on pages 13 through 15 of our report of April 28, 1971. The $354,000 paid to contractor B under two change orders was included in a supplemental agreement between the contractor and the Navy (signed by the contracting officer) for a partial convenience termination of contractor B's contract. It was the understanding of the parties that the supplemental agreement would be final except for certain rights and liabilities which were reserved to the Government. The Government did not reserve any rights with respect to the finality of the settlement of the two change orders.

The third claim discussed in our April 28 report was submitted by contractor C for delay and disruption caused by the late delivery of Government-furnished material and by defects in the material. This claim was settled for about $760,000. The settlement agreement with contractor C (signed by the contracting officer) provided that payment of $760,008 would constitute full payment, settlement and discharge of any and all liabilities of the Government and contractor arising out of, under, or in any manner connected with the contract.

We have been advised that the contracts concerned in the first and second claims contain a Suspension of Work clause. Navy apparently is unable to locate the contracts involved in the third claim; therefore, we do not know whether the third claim was settled under the Suspension clause although it would be logical to assume that it was consistent with the other two contracts.

Contracting officer's final settlements are binding on the Government, at least in absence of a showing that the act of settlement constituted gross mistake, or that the settlement was secured by fraud on the part of the contractor. *Bell Aircraft Corporation* v. *United States*, 120 Ct. Cl. 398, 100 F. Supp. 661 (1951), affirmed 344 U.S. 860 (1952). In the *Bell Aircraft* case the contract provided that allowable items of cost would be determined by the contracting officer in accordance with certain regulations. The contracting officer made a determination under the provision that certain experimental, development and production tooling costs were allowable costs. The General Accounting Office excepted to the payment made pursuant to the contracting officer's determination and another contracting officer (the successor to the first contracting officer) recouped the excepted payments from money otherwise due the contractor. The court held that the contracting officer's determination made under the provision previously described, followed by the actual payment was conclusive and binding on the parties unless the contractor, being dissatisfied with the decision, made an objection to it which resulted in a dispute to be resolved by the disputes article of the contract.

The court cited the case of *James Stewart & Co.* v. *United States*, 71 Ct. Cl. 126, and concluded that in the absence of a showing that the approval by the first contracting officer constituted gross mistake, or that his approval was secured by fraud, the first contracting officers' decision was conclusive and binding on the Government. The court found for the plaintiff on the claim.

The rationale of *Bell Aircraft* would apply to the settlements of the claims discussed in our report since the contracts here contained the Standard Disputes clause giving finality to the contracting officer's resolution of dispuates subject to the contractor's right of appeal and would require the conclusion that Navy's settlements are binding on the Government absent fraud or gross mistake.

In further support for the conclusion that the contracting officers settlements of the three claims were binding see *Cannon Construction Company* v. *United States*, 162 Ct. Cl. 94, 314 F. 2d 173 (1963), which states than an executive department acting through its duly authorized agents has inherent authority to enter into binding agreements settling claims which, because of the absence of a contract clause permitting or requiring payment, was necessarily one for damages for breach of contract.

While the facts of the claims considered in the April 28 report are distinguishable from *Cannon* since the current claims apparently were settled under the Suspension clauses of the contracts, *Cannon* is useful as an indication of the court's position with respect to the contracting officer's settlement authority.

Our examination of the facts of the three claims discloses no basis for an exception to the general rule stated above on the ground of fraud or gross mistake; consequently, it is our view that there is no basis to recover the payments made under the settlements of the three claims discussed in our April 28 report.

Sincerely yours,

ELMER B. STAATS,
Comptroller General of the the United States.

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