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

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THE ACQUISITION OF WEAPONS SYSTEMS

MONDAY, DECEMBER 18, 1972

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 10:05 a.m., in room 4221, Dirksen Senate Office Building, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire and Representative Blackburn.

Also present: Ross F. Hamachek and Richard F. Kaufman, economists; Jerry J. Jasinowski, research economist; George D. Krumbhaar, Jr., minority counsel; Walter B. Laessig, minority counsel; Leslie J. Bander, minority economist; and Michael J. Runde, administrative assistant.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The subcommittee will come to order. We have a great deal of ground to cover this morning. We have not just one report, as usual, but instead of the usual we have something like four or five reports and, for that reason, I would expect the Comptroller General, Mr. Staats, to take a little longer than the usual 10 minutes. In fact, if he took 15 or 20 minutes I would understand because there are so many reports here to present. At the same time we want to go into these reports in some detail because they are enormously important and complicated and we simply cannot have one or two questions on each report and expect to have an understanding of it. So we will take longer than expected. For that reason, I think the witnesses scheduled for 11 o'clock may not be able to appear until this afternoon. At any rate, we are going to proceed as rapidly as we can but we certainly want to give these reports our full attention.

Today's testimony presents a microcosm of problems encountered in the acquisition of weapons systems. We will range from a discussion of how to identify inefficiency in a contractor's plant before a contract is formally negotiated, to the question of mismanagement and waste in the performance of major weapon programs.

Charges have been made of contractor abuses in the production of the C–5 cargo plane. We will receive a report from the Comptroller General about the charges, and we will give an opportunity to one of the men who made them and a spokesman for the company to comment on the report.

We will discuss briefly the cost overruns and schedule delays in ship programs occurring at the Nation's largest and newest shipyard and the matter of claims filed against the Government by shipbuilders.

We will probe, in some detail, into alleged unauthorized progress payments given to contractors by the Pentagon in amounts totaling several hundreds of millions of dollars.

And we will examine the status of the Emergency Loan Guaranty Act, known as the Lockheed loan program, designed to render Government assistance to a giant aerospace firm experiencing financial difficulties.

All of these subjects are of deep significance to the Government, the defense industry, and the taxpayers. Decisions about defense contracts influence the spending of billions of dollars of public funds.

These are highly emotional issues. The life of one of our witnesses and the safety of his family was threatened as a result of statements he made about the Lockheed Corp. Because of these threats, U.S. marshals were sent for his protection. I am not criticizing officials of that company when I point this out. It is a fact that some of the threats were reported to have been made by Lockheed workers.

I have received both oral and written threats directed against my own life by persons who disagree with my views about Government procurement and the aerospace industry. I have had to refer a couple of threats to the FBI.

All persons in public life are targets for threats from irate individuals and many are made. I bring this up only to demonstrate how charged with emotionalism and extreme feelings the subject of defense contracting is.

But the Congress must continue to investigate and inquire. That is what we are doing this week. It is my hope that by holding this hearing we will be able to place facts and informed opinions before the public and Congress. We have a right and a duty to know what is going on.

Our procedure this morning will be to first listen to a presentation and questions—I should say presentations and questions of the Comptroller General, Elmer B. Staats. Following the GAO's presentation, we will hear from Mr. Lawrence Kitchen, president of the Lockheed-Georgia Co. and from Mr. Henry Durham, a former employee of Lockheed-Georgia.

Mr. Staats, you have done an enormous amount of work for this hearing. GAO has prepared four special reports at the request of the subcommittee, including your statement on Litton's two new ship programs, and in addition you will be testifying about the emergency loan guaranty program, as I understand it, so there are four reports, there are four different issues on which you will comment.

I want to say that we are very grateful for your efforts. Without the General Accounting Office, Congress would be greatly handicapped in carrying out its responsibilities to review programs implemented by the exectuive branch. You do a remarkable and indispensable job. I want to welcome all of your experts who are here with you this morning but I especially want to single out, and I do not mean any derogation of the other fine and able men you have

with you, but Tom Morris, whom we are delighted to see here, he is a distinguished former Assistant Secretary of Defense, who did a splendid job for our Government for many, many years, known as perhaps the hardest working man, certainly one of the hardest working men, we have had in the executive branch for a long, long time.

Go ahead.

STATEMENT OF HON. ELMER B. STAATS, COMPTROLLER GENERAL OF THE UNITED STATES, ACCOMPANIED BY ROBERT F. KELLER, DEPUTY COMPTROLLER GENERAL, THOMAS D. MORRIS, ASSISTANT COMPTROLLER GENERAL, RICHARD W. GUTMANN, DIRECTOR OF PROCUREMENT AND SYSTEMS ACQUISITION DIVISION (PSAD), HASSELL B. BELL, DEPUTY DIRECTOR (PSAD), JAMES H. HAMMOND, DEPUTY DIRECTOR (PSAD), AND JEROME H. STOLAROW, MANAGER, REGIONAL OFFICE, LOS ANGELES, CALIF.

Mr. STAATS. Thank you very much, Mr. Chairman.

Mr. Keller, to my right here, in addition to Tom Morris, whom you have already identified. To my immediate left Mr. Richard Gutmann, who is the Director of Procurement and Systems Acquisition Division of the General Accounting Office, and to his left Mr. James Hammond, who is Deputy Director of that Division.

As you have indicated, I have several topics that I will be commenting on in summary form this morning. We have as the first item the results of our investigation of the charges brought by Mr. Durham with respect to the Lockheed Corp. Our report on that has been filed with the subcommittee.[1]

CHARGES BY HENRY DURHAM CONCERNING C–5

In the prepared statement I point out the findings of the GAO supporting several charges brought by Mr. Durham concerning the Marrietta plant. The aircraft assembly records, for example, did not accurately reflect the physical condition of the aircraft; parts had been removed from the aircraft without authorization; parts had been erroneously scrapped; there were inadequate controls over disbursement, handling, and usage of titanium fasteners.

We could not, however, determine the full extent of these conditions or their impact on the cost or schedule of the C–5 aircraft program.

We simply could not identify and quantify the full and total effect of these difficulties.

Now, on the other hand, we point out that our findings did not support charges involving Marietta. We did not find evidence. for example, to indicate that parts had been unnecessarily procured. This is based on a detailed review of a random sample of purchased parts.

We did not find evidence to indicate that Lockheed maintained the production schedule in order to collect payments related to the accomplishment of milestones. We did find, however, that the Air

[1] The full text of a GAO report on "Investigation of Charges Concerning Unsatisfactory Management Practices in the C–5 Aircraft Program at Lockheed-Georgia Company" together with a supplemental letter report dated June 25, 1973, may be found on pp. 2355–2409.

Force had withheld about $3.7 million from milestone payments on the 5 test aircraft because of shortages and variances from specifications when the aircraft were delivered to the flight-test organization.

We did not find evidence to indicate that there was subterfuge involved in the rollout ceremony of the first aircraft.

The Air Force issued a press release on February 21, 1968, that the C–5 aircraft rollout would be conducted on March 2, 1968. The release also indicated that the C–5 aircraft was scheduled to fly for the first time in June 1968 and it was not fully completed at that point.

This shows that the aircraft was not intended to be fully operational at the time of the rollout, a perfectly understandable difficulty on the part of someone who is not familiar with that point.

Now, at the Chattanooga, Tenn., plant of Lockheed, our findings support charges made by Mr. Durham in some respects. First, high strength nuts and bolts had been purchased for plant maintenance when, for some purposes, lower grade materials would have sufficed.

Second, substantial quantities of material and miscellaneous small parts had accumulated as a result of canceled orders and transfer of items from another plant, and, third, some items which were available at less cost from the Marietta storeroom had been purchased locally.

Our findings do not support the charges brought by Mr. Durham that there were inadequate inventory controls over tools, raw materials, and miscellaneous small parts. We found that consumable tools, such as drill bits, reamers, and cutters were provided to employees as they were needed without establishing a record of issue. With respect to raw materials and miscellaneous small parts, we found that these items were purchased and controlled on an individual job order basis in lieu of detailed inventory controls. We believe these practices were reasonable because it is generally impractical to provide a detailed inventory control system for small and inexpensive tools and parts. In addition, we found that these practices were consistent with others in the industry.

Now, we also point out, Mr. Chairman, that similar problems to some of those pointed out exist at other aircraft plants. We were not able to quantify whether Lockheed was worse or better in this respect than others. But we also found that the Air Force was familiar with some of these charges prior to the time that they were filed and there were some of which they were not aware.

But we point out that for the most part the Air Force did not direct the contractor to take specific corrective action because the Air Force, in administering the contract, followed a philosophy of "disengagement." This philosophy required minimal participation by the Air Force in the day-to-day management of the program as prescribed by the total package procurement concept under which the C–5 aircraft was originally purchased. This concept has now been abandoned by the Air Force and by the Department of Defense.

That is about, I believe, all that we need to say or can say within the time on this particular point in our testimony, I now move to the question of progress payment practices on the C–5. This problem arose, as you may recall, because the Defense Contract Audit Agency

had prepared a report in February of 1970 in which the report concluded that the contractor had understated the cost of delivered items by failing to include overruns and, as a result, over $400 million worth of progress payments then outstanding were due to this understatement of the cost of delivered items; and, thirdly, there was a question of whether the contractor would be able to finance his overruns and complete the contract, since the ceiling on progress payments was rapidly approaching.

C–5 PROGRESS PAYMENTS

In the prepared statement we point out that the standard progress payment clause provides for payment of a stipulated percentage of the contractor's incurred costs. In the case of the C–5 aircraft program, the progress payment rate was set at 90 percent of the costs incurred. The cumulative progress payments could not exceed 90 percent and subsequently this was increased to a hundred percent of the ceiling price established in the contract.[1]

When an item is delivered and invoiced, the progress payments received by the contractor during its production are deducted from the total amount due. This is known as liquidating the progress payments. The C–5 contract provided that the amount of unliquidated (i.e., outstanding) progress payments not exceed the lower of (1) 90 percent of the costs incurred for undelivered items, or (2) 90 percent (subsequently increased to 100 percent) of the contract price of the undelivered items. As of January 20, 1970, C–5 progress payments were not in violation of any of the above ceilings but we go on to point out that the regulations provided at that time three options which were available to the contractor in his discretion.

We have here, Mr. Chairman, some charts which will set this forth, I think, more clearly than anything I can say in the form of textual material. The principal chart is included in the prepared statements, and we have other charts here which will be presented and I would suggest, following the completion of my statement, if that is agreeable with you, otherwise we can go to those charts at the present time. But the principal point we make in the prepared statement is that at the time this matter came about, at the time of the DCAA report, the progress payments were still below the total ceiling price under the contract but they were proceeding at a rate which, if it had been continued, would have exceeded the ceiling price before very long.

One particular page of the prepared statement deals with actions between February 1970 and May 1971, when the contract was restructured, and explains that the increase in the ceiling price of some $557 million was due to three causes; and, secondly, the Air Force decision to allow progress payments to go up from 90 percent to a hundred percent of the ceiling price. Now, these two changes, taken together, all these changes taken together, added up to the $705 million which, you will recall, was the amount of additional progress payments mentioned at the time of our earlier hearings.

[1] The full text of the Comptroller General's report on C–5 contract progress payments, dated Dec. 11, 1972, may be found on pp. 2410–2415.

In the prepared statement we bring out the restructuring of the contract in May of 1971, to a cost reimbursement type contract.

METHOD USED FOR COMPUTING PROGRESS PAYMENTS INAPPROPRIATE

The method used by the company in asking for progress payments, in other words, was not illegal, it was in accordance with regulations that were issued by the Air Force. But we point out that it is our opinion that the method used for computing the progress payments was inappropriate under the circumstances. Now, progress payments are designed to help the contractor finance the cost of undelivered items, and we believe when an item is delivered and accepted the actual cost to produce the item should be deducted from the total costs incurred when computing the maximum permissible progress payments.

Now, as a result of the DCAA report——

Chairman PROXMIRE. Would you explain at that point, Mr. Staats, what you mean between the actual costs incurred per item and the, what do you say, total costs incurred? As I understand, the total costs incurred would not only include the cost of the item but the overhead costs; is that part of it?

Mr. STAATS. Overhead, I believe, is included.

Mr. GUTMANN. Yes, sir, that would include overhead.

Chairman PROXMIRE. It is puzzling, you see, to understand the difference. The purpose of the progress payments, as I understand it, is to provide Government capital instead of private capital at lower cost—it makes some sense to some people, it is disputable, but at least there is an argument for it, but in view of the fact that overhead costs do not involve the same kind of capital investment or capital borrowing, I should say, or do they? I should not think they would.

Mr. STAATS. Yes, indeed.

Chairman PROXMIRE. It seems in order for me to understand how they could be included in progress payments in order to save the contractor from having to go to the market to borrow the money to make the purchases.

Mr. STAATS. They were, of course, included at that time under the regulations.

Chairman PROXMIRE. What is the theory behind it? How do you justify it?

Mr. STAATS. Well, the whole theory of progress payments is that, as you have indicated is, the Government is in a sense providing the financing for the company on long lead time types of procurement, and the argument has been that the Government can borrow money more cheaply than the contractor and since it ends up as a cost of the item in any event, then it makes sense for the Government to furnish that money as the contract is being executed and payments are made against work completed.

Now, the option (A) under the regulations as set forth here is, to be sure, the preferred option by the Air Force, and option (C), which was the one selected by the contractor——

Chairman PROXMIRE. Option (A) is for the actual costs of the various items they have to procure in order to put the aircraft together——

Mr. STAATS. That is right.

Chairman PROXMIRE. Material costs, labor costs, and so forth?

Mr. STAATS. That is correct.

Chairman PROXMIRE. All their direct costs would be included in option (A)?

Mr. STAATS. That is right.

Chairman PROXMIRE. Option (B), however, would include what, in addition to those direct costs?

Mr. STAATS. Mr. Chairman, if I may, I believe this is a very complicated——

Chairman PROXMIRE. I do not want to disturb you now but, you see, the trouble is unless we understand this, it is hard to see how this $400 million might have been paid, what justification there is for it or what lack of justification there is for it. It is hard to evaluate.

Mr. STAATS. This is, if you care to go to the chart at this point, I believe——

Chairman PROXMIRE. Fine, any way you want to proceed. I just want you to make it clear.

Mr. STAATS. I would suggest Mr. Gutmann go through this as briefly as he can. It is almost essential to have a chart to understand exactly what transpired in this case.

Chairman PROXMIRE. Fine.

Mr. GUTMANN. First, Mr. Chairman, it is well to point out DCAA's findings that, as has been stated in Mr. Staats' statement, the contractor had understated the costs of delivered items by failing to include overruns.

Chairman PROXMIRE. Let me just interrupt at that point. It is hard for a layman to understand how the contractor can benefit by understating his costs if he is going to be reimbursed for part of his costs.

Mr. STAATS. I think it will come out.

Mr. GUTMANN. This will become clear. As a result, this had increased progress reports by $400 million more than would have been allowed if the actual costs had been used.

Chairman PROXMIRE. Explain that, will you?

Mr. GUTMANN. Well, the way the computation is made, the total costs incurred to date under the contract are a starting figure. Then you deduct from that either actual costs incurred or the contract price of the item. Where actual costs incurred are in excess of the contract price, you see, there is a lesser amount available for progress payments. This, I think, will become a lot clearer as we go along.

Chairman PROXMIRE. All right, very good.

Mr. GUTMANN. DCAA raised a question, quite understandably, as to whether or not the contractor would be able to finance overruns and make delivery.

Before moving on with the charts, it might be useful to talk a little bit about that concept here and draw an analogy between what takes place between a manufacturer and his banker and his buyer in a commercial situation. The manufacturer gets a contract for, say, a hundred items, whatever it may be, and he takes his contract to the banker and says, "I would like to have some financing of my work in process. I have to buy material, I have to pay labor, I have

to incur overhead costs." And the banker then says, "OK, I will loan you the money," but he puts certain restrictions on how much he will loan in relation to the undelivered items under the contract, and that is what was done in this case. In this case the banker and buyer are in one party, that is the Government. The Government acts as both banker and buyer, and this is an important analogy to think about as we go through this discussion.

Chairman PROXMIRE. I do not want to belabor this thing but I want to be sure I understand it. Let us take the simple example you have of a buyer going to his banker, buys a hundred items at a hundred dollars apiece, $10,000.

Mr. GUTMANN. OK.

Chairman PROXMIRE. And, therefore, he gets the $10,000 at the time he has to make payments for the hundred items, is that correct?

Mr. GUTMANN. Well, except that if the $10,000 is the selling price, the banker is not going to loan him the full amount. Probably only going to loan him up to 90 percent.

Chairman PROXMIRE. I am not talking selling price but cost. Then the banker would loan, on this hundred percent basis he would loan, him $10,000, is that right?

Mr. GUTMANN. Yes, if——

Chairman PROXMIRE. When would he get the $10,000 in cash?

Mr. GUTMANN. He would get that during the course of his work as he needed it.

Chairman PROXMIRE. As he incurs the obligation, right?

Mr. GUTMANN. As he incurs the costs, right.

Chairman PROXMIRE. Now, how would he get more by understating the cost, then? As I understand it, the staff tells me he would get more because he would be able to hold on to the amount that had not been delivered to him, is that correct?

Mr. GUTMANN. That is right. He gets more by understating the cost of the items that he had delivered to the buyer.

Let us go on with your example.

Chairman PROXMIRE. All right.

Mr. GUTMANN. Supposing the manufacturer had produced 15 of these items and he delivered them to his buyer, he gets $100 apiece of $1,500 for them, he has to repay a portion of that loan out of the $1,500 because the banker no longer has as collateral those items upon which he loaned the money. In other words, let us say he borrowed $10,000, he delivered some items and he got $1,500, and this is a gross oversimplification of it.

Chairman PROXMIRE. So he holds on to the money longer if he understates the amount. He does not have to repay to the banker or in this case the Government——

Mr. GUTMANN. Exactly.

Chairman PROXMIRE [continuing]. The amount.

Mr. GUTMANN. That is right.

Chairman PROXMIRE. So by understating the amount, the value rather, of what he has produced he is able to hold on to it for a longer period.

Mr. GUTMANN. Yes.

Chairman PROXMIRE. And in this case he was able to hold on to how much, $400 million?

Mr. GUTMANN. That is right, that is what DCAA calculated, $400 million as of January 1970.

Chairman PROXMIRE. And that is an enormous amount of money. Even the interest on that on a monthly basis is a whale of a lot, is it not?

Mr. GUTMANN. Yes, it is.

Chairman PROXMIRE. All right.

Mr. GUTMANN. Now this again, is a reproduction of a chart, of the statement in the prepared statement that Mr. Staats referred to, the three different ways in which you can compute the costs of items that have been delivered. We will take actual costs, DCAA used this method, you can take projected costs which are simply an estimate of actual or you can take the contract target cost, and Lockheed used this method so, you see, Lockheed deducted less from their total incurred costs for the purposes of getting progress payments than they would have if they had used actual costs.

Chairman PROXMIRE. I see.

Go ahead.

Mr. GUTMANN. Now, the actual figures that resulted from the manner in which Lockheed made their computation are these. First, at this point in time, January 20, 1970, $1,866 million had been incurred. DCAA said that the actual cost of delivered items was $1.106 billion.

Chairman PROXMIRE. $1,106 million?

Mr. GUTMANN. Yes, it is $1,106 million or $1.106 billion, that is correct.

Chairman PROXMIRE. Yes.

Mr. GUTMANN. Now, to compute the amount that is subject to progress payments, take total costs incurred of $1.866 billion, less the $1.106 billion, take 90 percent of the difference between these two figures or $684 million, add the $177 million of subcontract costs, and $861 million was subject to progress payments. Lockheed on the other hand, did it this way. They deducted from the total pool of costs incurred only $637 million as the contract target cost of the delivered items. That left the remainder, back to the analogy a minute, available to borrow from the banker.

Chairman PROXMIRE. I see.

Mr. GUTMANN. The difference here again, the same calculation, $1.866 billion minus $637 million; that 90 percent of that difference or $1,106 million plus $177 million results in $1,283 million. The difference between the $1,283 in method (C) and the $861 million in method (A) is the approximately $400 million that DCAA was talking about.

Chairman PROXMIRE. Now, DCAA, what does that stand for again, tell us?

Mr. GUTMANN. Defense Contract Audit Agency, I am sorry.

Chairman PROXMIRE. And they are under the Defense Department?

Mr. GUTMANN. Yes, that is correct.

Chairman PROXMIRE. How is it that Lockheed can make a choice here and get this enormous benefit? They can only do that with the sufferance and permission of the Air Force and the Defense Department?

Mr. GUTMANN. That is right. Each request for progress payments has to be approved by the administrative contracting officer, and it was.

Now, again, back to the analogy, look upon DCAA as the banker's auditor.

Chairman PROXMIRE. Let me, before you leave that, let me just say, as I understand it, what happened then was the Defense Department agreed with Lockheed they should have this method that would give them an additional $400 million over the DCAA's preferred method, is that right?

Mr. GUTMANN. Well, of course now, these payments at this time had already been made. DCAA is examining into this process after the payments are made.

Chairman PROXMIRE. Did they not know what they were doing when they were making the payments? Were they not fully aware they were making it on the basis of contract target costs?

Mr. GUTMANN. I am not sure DCAA——

Chairman PROXMIRE. Whether they were brought into it at that point.

Mr. GUTMANN. Whether DCAA audits it at the time.

Chairman PROXMIRE. The Air Force?

Mr. GUTMANN. The Air Force——

Chairman PROXMIRE. The Air Force then, they were well aware of what they were doing?

Mr. GUTMANN. Yes.

Chairman PROXMIRE. Why did they depart from method (A) and go to method (C), then?

Mr. GUTMANN. I am not sure they ever were on method (A). There are three methods that were permissible under the regulations at that time, it is important to point out that method (C) is no longer permitted.

Mr. STAATS. Lockheed decided to go for the third option at the very beginning of the contract. It was not a question of shifting over from (A) to (C). It was a question——

Chairman PROXMIRE. I want to make sure I understand that. Then, as far as they were concerned, Lockheed made that decision, it was a legitimate, proper decision to make, and it was proper for you, so far as you know, the Defense Department and Air Force to do it. There was nothing illegal to it except it cost the taxpayers money because Lockheed had this $400 million for a considerable period, for a considerable period they otherwise would not have——

Mr. STAATS. Our conclusion was that it was a poor decision, to begin with, to give them that option and I think that is what DCAA auditors are saying also, to give them that option, because in a situation where they had a cost overrun. If they had been perfectly on schedule in terms of cost it would not have made any difference, but if you had a situation where there was a cost overrun, as there was, then it ends up with the Government advancing money at a rate which if continued would have exceeded the ceiling price.

Chairman PROXMIRE. On this basis the Government had nothing to gain by going option (C) and everything to lose.

Mr. STAATS. That is correct.

Chairman PROXMIRE. And under those circumstances how could any government official justify that course? Does he not defeat the interests of the taxpayers in doing that?

Mr. GUTMANN. Well, at that time, Mr. Chairman, the contractor was experiencing severe cash shortages. His cash flow was not adequate to maintain his operations. This is probably one of the reasons that this method was permitted.

Furthermore, as Mr. Staats mentioned, the contract ceiling at this point was only $2.2 billion approximately and, DCAA was saying as the banker:

> Look, you are coming very close to the ceiling under this method. What is going to happen when we have to stop making progress payments and the contractor may then be unable to obtain private financing.

So that is the reason then that the Air Force raised the ceiling, as Mr. Staats said.

LOCKHEED PAID $400 MILLION "EXCESS" PROGRESS PAYMENTS

Chairman PROXMIRE. So it had two consequences. Number 1, it gave Lockheed $400 million they would not have had otherwise for a longer period and, No. 2, it meant that they were compelled later on to raise the ceiling price, the ceiling contract, they had to go above the initial agreement.

Mr. GUTMANN. Yes, sir.

Chairman PROXMIRE. Is that correct?

Mr. GUTMANN. Yes, sir. It was necessary to do that.

The decision was made by the Air Force that it was in the best interests of the Government because of their need for the airplane, and so on.

We know that the method was permitted, of course, at the time, but think it was inappropriate. It has since been discontinued.

Chairman PROXMIRE. Let us get on this inappropriate. You said it was inappropriate because it cost more money, and it is inappropriate in having the contract price elevated later. However, as Mr. Gutmann says, as I understand it, the justification for it was necessary because, to get a C–5–A if we wanted to have it delivered that had to be done, is that right?

Mr. STAATS. That, I think, offers a plausable explanation as to why the contractor chose method (C) but we say it was inappropriate from two standpoints: One is, it did not take into account the possibility that there would be a cost overrun—in other words, the costs would be in excess of those which would relate to the deliveries actually made.

Chairman PROXMIRE. It is incredible to me in view of the long, long record of overruns, not only by Lockheed but by many other contractors, that the Federal officials responsible could not make the assumption there could well be a cost overrun.

Mr. STAATS. It was inappropriate from a second point of view in that if they had continued, as Mr. Gutmann has pointed out here, much longer, then they would have been up to the ceiling price and would have had to terminate progress payments. That would have

put the contractor in a position where he would have had to have gone out into the private market to seek his financing and might not have been able to have done that and the contract would, therefore, have been in danger. That is why we say it was inappropriate, Mr. Chairman, for those two reasons.

Chairman PROXMIRE. What would be the options, what could be done instead of this? If you permit, if you bar from now on, I understand method (C) is not permitted so you cannot get this additional $400 million of working capital, what happens, then you get into the Grumman type situation where if the contractor feels that he cannot complete an order, he closes his doors or threatens to do so.

Mr. STAATS. Well, we would not want to speculate what would have to happen in a case like this. Each case undoubtedly has to be dealt with on its own but that would certainly be one possibility, one which I think we would have to foresee if you continued under that option (C) for the future, but the Defense Department now wisely has eliminated that third option among those available to the contractor.

Chairman PROXMIRE. Let me just see if I can wrap this thing up by saying the remaining statements here are especially interesting. You say the Air Force dealt with the progress payment limitation by increasing it from 90 to 100 percent of the contract ceiling price, increasing contract ceiling by $557 million, finally converting the contract to a cost-reimbursement basis.

Leaving out of account the final action this kind of increase of progress payments from 90 to 100 percent and increasing the contract ceiling in your experience, Mr. Staats, and you now have, I think, an excellent defense procurement capability in the GAO, is this common or uncommon, is this extraordinary?

Mr. STAATS. This has been, we are advised by the Defense Department that this option 3 had been used before but it was not the preferred method.

The thing which is difficult for us to understand is if it were not the preferred method then why did they leave it open to the contractor?

Chairman PROXMIRE. Then, when you combine it, you see, you go from 90 to a 100 percent of the contract ceiling price in addition to permitting option 3, that is something extra. I am asking you do you very often have this kind of combination of largesse to a contractor: No. 1, you have the soft option in which he has more money, hundreds of millions of dollars, in addition; No. 2, you give him a 100-percent progress payment; and, No. 3, you increase the ceiling price by half a billion dollars, and my question is is that not extraordinary for any contractor in your experience?

Mr. STAATS. I would say it was certainly not the usual situation and certainly not a desirable situation, Mr. Chairman.

Chairman PROXMIRE. I hope not. All right, proceed.

Mr. STAATS. I do not think you can escape the conclusion that in this case the fact that the progress payments were being made in the manner in which they were made had a great deal to do with the restructuring of the contract which took place in May of 1971. Be-

cause without these actions it is quite clear that the contractor would not have been able to finance the continuation of his work.

Chairman PROXMIRE. Very good. You may proceed.

SHOULD-COST STUDIES

Mr. STAATS. If you would like, Mr. Chairman, we will move on to the third matter covered in our prepared statement today. The subcommittee asked us in our hearing in April of 1971 to follow up on earlier studies that we had done with respect to studies called should-cost studies as a part of the negotiation process or negotiated procurements.

Chairman PROXMIRE. Let me just say on this, I think this is a very, very vital part of your presentation because we all criticize procurement, many of us in the Congress and the public and the press, but if we are short on constructive alternatives how we can improve it and this should-cost, it seems to me, to be one of the most promising. As I understand the should-cost, what it is is you have the experts go in and try to estimate what it should cost to produce a certain weapons system or what, considering all the labor costs, material costs, overhead costs, and so forth, on the most efficient basis available, is that correct and then on that basis they try to assess what the negotiating ought to be or what the bids ought to be and they are also in a position then to make an analysis of whether the bids are responsive or whether they are too low, buy-ins, whether they are too high and on that basis suggest to the defense contractor how they can do an efficient job, make profits and provide procurement at a reasonable cost, is that right?

Mr. STAATS. That is correct.

The term "should-cost" was developed, I believe, by Mr. Gordon Rule. In some ways it carries a misleading connotation in that it assumes something much more finite than actually can be developed, and I do not believe that he intended to convey that impression either.

But what it really represents is the result of a team of experts, of engineers, cost estimators, industrial management people with background in that area going in, working with the contractor, with his cooperation, in seeing if they can do what a management consulting organization would do if they went into that same plant by way of improving plant layout, improving supervisory methods, doing any one of maybe a hundred different types of things that would result in a lower cost on that procurement than it would be if you started without that kind of information.

Chairman PROXMIRE. Let us face it, one additional benefit of should-cost, it seems to me, is that it acts as a discipline to prevent allocation of costs which perhaps have no business being applied to a weapons system from being applied because you have the standard, you have the experts estimation, they could be wrong and I suppose they often are wrong, but at least you have some basis for measuring whether or not additional costs are applicable or not.

Mr. STAATS. I think we would prefer to call it a joint Government-contractor cost-reduction survey.

Chairman PROXMIRE. OK.

Mr. STAATS. Or cost-reduction effort. The team of industrial experts of this type frequently will come up with recommendations which management itself says, "We cannot possibly do that." They will try in many cases to do it but they cannot be certain at the outset that you are going to be able to achieve it any more than you can achieve the results of a team of management consultants, whether it be McKinsey & Co. or Booz, Allen or some other organization of that type.

GAO REVIEW OF ARMY SHOULD-COST STUDIES

Mr. Chairman, we have made reviews of nine of the studies made by the Department of the Army which have been called should-cost studies. Three of these have been in depth. We have in process and will report later on similar reviews being made of the Air Force and the Navy studies but we are reporting here today in our prepared statement with respect to our findings on these nine Army should-cost studies.[1]

As pointed out there, the nine studies involve contracts totaling about $300 million, where the should-cost studies identify potential reductions of $97.8 million.

Now, the potential price reduction represents a difference between the contractors' proposed price and the estimates developed by the should-cost teams.

Now, the actual price reductions realized by the Army in negotiations on these contracts total $46.7 million or 15.6 percent of the contractors' price proposals. Figures developed by the Army show that on prior procurements of the same or similar equipment from the nine contractors price reductions amounted to 8 percent of the contractors' proposals. We confirmed this for three of the nine studies.

So we have, I think, pretty clear evidence that these are resulting in very substantial savings to the Government.

IMPROVEMENTS SUGGESTED TO CONTRACTORS

Now, in addition, as we point out, in addition to these contract price reductions negotiated, six of the nine contractors agreed to apply their best efforts toward attaining a number of improvement goals in areas which the should-cost teams felt had potential for improvement and from which the Government stands to benefit from any subsequent contracts. The goals concerned such things as achieving higher labor efficiency levels and preparing and implementing estimating and accounting manuals.

So one of the important payoffs here is not limited to the contracts that are being negotiated but on any subsequent follow-on contracts for the same or similar items with those companies.

Now we suggest in the prepared statement there that they need to emphasize much more than they have contractor operation, manufacturing methods and things of this type which they, in our opinion, did not adequately emphasize.

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[1] The full text of a GAO report on "Assessment of Army Should-Cost Studies" may be found on pp. 2416–2441.

GAO VIEW OF SHOULD-COST APPROACH

Chairman PROXMIRE. Now, in the prepared statement you say, "Our view, however, is that open and frank discussions throughout the studies can help to develop stronger bargaining positions by enabling the teams to isolate areas of agreement and disagreement earlier;" and so forth. You show a sharp difference between your view and the DOD. As I understand it, the Defense Department's argument was that this should be used as a negotiating weapon and that it should be kept secret. There is a lot to that, I think. I am not sure it should be dismissed as easily as you imply. You may be right but I think there is a sharp difference. Will you explain the two, the difference between the two views? The Defense Department says they find out what the costs ought to be and then they are in a stronger position to negotiate a lower price than they are likely to get without a "should-cost" study. You say work with the contractors right along, and point out where they can be more efficient, and you can probably in cooperation work to a better price. I am not so sure the Defense Department is not right about that.

Mr. STAATS. Well, we recognize there may be room here for judgment but on balance we would believe that the Government would be in a stronger position at the negotiating table with respect to some of these kinds of proposals that we are talking about if it, in advance, had talked with the people at the various levels in the organization as to what they were thinking about, and get their rebuttal from it so that they could come to the table reinforced with their additional data that they might need. In other words, if you come to the negotiating table, if you are confronted with the arguments on the part of the contractor that something just is not feasible, and they do not have all the facts, it is pretty difficult to go back and get your facts at that point in time.

Chairman PROXMIRE. Yes, but does not the Defense Department's position, which I take it, has been quite successful, I mean, not as successful as perhaps it ought to be, it should have been able to cut almost $100 million out of that $300 million of price for the six products, nevertheless they were able to cut instead of a $100 million, $97 million, cut $47 million. I just have a fear that if they did this on the basis of so-called "cooperation" that there might be more of a softness on the part of the negotiating, that they might be talked out of it by the defense contractor, that they might be pushed into a position where they would not be able to get much of a gain at all.

Now, maybe I am wrong and you are right on it, but the Defense Department, in my view, has not been sufficiently tough on defense contractors and, it seems to me, they are being a little tougher than you are being here, is that wrong or right?

Mr. STAATS. We think it could be tougher.

Chairman PROXMIRE. You would be tougher if you negotiated with them and cooperated with them and gave them all the data in advance?

Mr. STAATS. If you knew—well, you would not have to necessarily give them all the data in advance but if you knew that something

was going to require substantial change, say, in manufacturing methods, if you could get the data from them as to what would be involved in that change and cost it out we think you could be much tougher at the negotiating table than if you hit the contractor with it as a surprise.

Chairman PROXMIRE. One more question in this respect. We have had some should-cost studies, this is not the only one, but we have had a number, have they been always successful, have they always followed the policy the Defense Department prefers or have they sometimes followed the policy you prefer here?

Mr. GUTMANN. They have always followed this policy.

Chairman PROXMIRE. Your policy?

Mr. GUTMANN. No, the Defense Department's policy.

Chairman PROXMIRE. Of keeping it secret and using it as a negotiating weapon?

Mr. GUTMANN. We really believe the cooperative effort between the should-cost study team and the contractor during the course of the study is very, very important, because it is difficult for a team, even of experts, to come into a large contractor's plant and, in a short period of time, become so familiar with it that they can develop every possible efficiency, identify every inefficiency, and then make an estimate——

Chairman PROXMIRE. Why do we not suggest here that they try them both?

Mr. STAATS. I think, Mr. Chairman, that might well be worth experimenting with to run studies in generally similar situations where both approaches were tried.

IMPROVEMENTS POSSIBLE IN GOVERNMENT POLICIES

I think our reason also relates to the next point in our testimony. We found there has been really little evidence that the teams had considered a need for or the desirability of changes in Government policies, procedures or practices to reduce the cost of contractor operations. For example, we found in other reviews that substantial savings could have been achieved by eliminating or modifying certain Government testing and packaging requirements. We have recommended that, in addition that, these matters be given attention in future studies, but in addition, we believe the Department of Defense should study the question of whether the should-cost concept should be expanded to include considerations of the impact on costs of schedule and performance requirements.

In some instances, Mr. Chairman, the Government may not make all that difference whether you hold to a precise schedule or not but it could well mean the contractor has to go into overtime.

Chairman PROXMIRE. I think this is very good. It is good to get a criticism not only of contractors but also the Government here. But could you give us any quantification of this? To what extent do you think that it might be able to save funds? I tend to assume too often that the contractor is at fault and the Government requirements are not at fault, and often the Government requirements, I am sure, are.

Mr. STAATS. This is the reason I would prefer to call this effort a joint cost reduction effort, because if the Government on its side can change specifications without doing great damage to the performance of the end item or can change a schedule in such a way as to minimize costs on the part of the contractor, those things should be identified as a part of what is now called the should-cost review and the Government on its side ought to be just as willing to make modifications within reason as they are going to expect the contractor to.

Chairman PROXMIRE. I see. At the present time, you should get a should-cost study to emphasize changes that the contractor might make to reduce costs and that the Government might make in order to reduce costs. Very good.

Mr. STAATS. We think it ought to be a two-way street, that is about all, I think, that we need to say other than the fact we are going to continue making these studies, and we will report on our analysis of the Air Force and the Navy studies at a later date.

EMERGENCY LOAN GUARANTEE ACT

If there are no more questions on that, Mr. Chairman, I will go ahead to our first report on the implementation of the Emergency Loan Guarantee Act, which was a loan guarantee to the Lockheed Corp., and we point out in the prepared statement that barring unforeseen circumstances available information indicates that Lockheed should be able to generate sufficient cash during the next several years to permit repayment of the Government-guaranteed portion of its loan. However, unless Lockheed is successful in obtaining a substantial number of additional orders for its L–1011 Tristar commercial airliner, losses on that program could impair the financial condition of the company. Firm orders and options amount to 117 and 67 aircraft, respectively, making a total of 184 as of today compared to Lockheed's estimated break even point at the present time of 275 aircraft.

We have done the best we can of surveying, Mr. Chairman, the potential market for this type of aircraft among all the aircraft manufacturers and the Air Transport Association and, as we point out here, the best estimate on the average indicates that less than 40 percent of the demand has been thus far satisfied in the form of either orders or options received by the two manufacturers of the trijet aircraft.

Airlines normally order 2 or 3 years in advance, but several important developments have occurred recently which we would like to point out here and I have pointed them out in the prepared statement. I will not take the time to read that other than to say that costs have increased. The break-even point has increased to a range of 265 to 275 aircraft. The cost increase here has been due in part, and we think quite clearly identified, to the Rolls Royce engine problem which caused very substantial delays in production at Lockheed.

We point out that it is now estimated that they will need some $220 million of the authorization of $250 million under the Emergency Loan Guarantee Act. They still estimate that the pay back

will be completed by the end of 1975 which is the period provided for in the loan guarantee, although 3 additional years are permissible under the legislation.

ACCESS TO RECORDS PROBLEM

I would like to call your attention to the fact that we still have not resolved the access to records problem with the Emergency Loan Guarantee Board. You will recall, Mr. Chairman, at the time of our earlier hearings we were having difficulty. The Senate Banking and Currency Committee and the House Banking and Currency Committee both went on record with the Treasury that these records should be provided, so as a result the Board made those records available to us after some 2 months' time had elapsed. But in their report to the Congress they point out on page 11 of their report that they have done this only because of the committees' request and that from a legal standpoint that we are not entitled to this information.

I bring this up here, Mr. Chairman, only for this reason. That if this attitude prevails there is no assurance of our being able to make a second report similar to the one we made this year, and it does seem to us like a waste of time of the committee and of the General Accounting Office and the Treasury to go through this kind of a debate when the statutes establishing the GAO are so clear that we think it is unmistakeable that this authority is with us.

Chairman PROXMIRE. Mr. Staats, I am glad you made a strong point on this. I think this is of the greatest importance, far more important than the instant procurement problem we have here, because if GAO is not given access to the records I do not know how you can carry out your work but, at the same time, you say the banking committees of the two houses have supported your position. What can we do to see that you get this kind of access, that you can do the job you are required to do by law?

Mr. STAATS. I suppose it would be possible to write the statute more clearly than it is written today. I do not quite know how you would write it more clearly than it is written today.

Chairman PROXMIRE. I understand you have the power to cut off their funds and they have to test it in court, is that right?

Mr. STAATS. No, we do not have the authority to cut off their funds. The funds are not appropriated funds. They are derived from the banks in the form of fees.

Chairman PROXMIRE. Because of the guarantee. You have the right to suspend the guarantee?

Mr. STAATS. No, sir; there is no legal recourse that we have available to us, Mr. Chairman.

We are frankly at a loss to understand why the Board has taken this position, and why I did feel since we are discussing this matter I should call it to your attention.

Chairman PROXMIRE. If you can give us a specific recommendation as to what we can at least fight for in the Congress it would help us.

Mr. STAATS. The only thing that could be done, I think, Mr. Chairman, other than getting them to withdraw their position, which I would prefer to see them do, would be to have the matter become one of new negislation. Those are the only two options that I know of.

Chairman PROXMIRE. Well, you recommend the specific kind of new legislation that you would like to see that would give you clear access. We have five laws, at least, as you pointed out in the past, that give you access. But you say that is not enough, now you want another one, a sixth?

Mr. STAATS. It would have to be—I do not know of any other options and if we are unsuccessful in getting them to cooperate with us then I would be prepared to recommend legislation.

Chairman PROXMIRE. Well, I hope so, because we talk so much about the weakness of the legislative branch in connection with the Executive, and here is an outstanding example of it. You are our investigative arm, and if you do not have the access to the records you cannot do your job, and they refuse to give you that access, although, as you say, the law is clear in five different respects, is that not correct? There are five laws that you cited to the Banking Committee?

Mr. STAATS. That is right.

Chairman PROXMIRE. And in spite of that they will not give you access to the records?

Mr. STAATS. They have given it, as they say in their report here they have given it, to us——

Chairman PROXMIRE. And you say you have no standing in law to bring a lawsuit, is that right, in this case?

Mr. STAATS. I would not want to be strictly categorical on this point. There has not been such a test of that type in the past.

Chairman PROXMIRE. Why should we not bring it? We have been waiting a long time for cooperation and we are not getting it.

Mr. STAATS. That is right.

I would like to suggest, Mr. Chairman, that the section in the report of the Emergency Loan Guarantee Board, together with appendix II to our December 6 report on the implementation of the Loan Guarantee Act, be put into the record at this point because they indicate that the Board still maintains the view that we have no legal right to these records.

Chairman PROXMIRE. Without objection, they will be printed in the record at this point.

[The documents referred to follow:]

[Excerpt from p. 11 of the Sept. 5, 1972, Report of the Emergency Loan Guarantee Board]

REQUESTS FOR INFORMATION

In September, 1971, the Comptroller General of the United States addressed a letter to the Board asserting the legal authority of GAO to review the Board's decisions and requested access to the Board's records for that purpose. After careful consideration, the Board in December 1971 declined this request. At about that time, the GAO, with the Board's permission, began auditing the Board's records relating to its receipts and expenditures.

The Comptroller General in February, 1972, renewed his request for access to Board records upon which decisions of the Board had been made. The Chairman of the Board responded to the effect that he saw no basis for changing the Board's position. This matter was mentioned by the Comptroller General during a hearing in April, 1972, before the Senate Committee on Banking, Housing, and Urban Affairs; and, during hearings before that Committee and the House Banking and Currency Committee in June, 1972, the Senate Committee expressed the view that the Board should cooperate

fully with the GAO and the House Committee indicated that the GAO should have access to Board records in order to evaluate the Board activities.

In accordance with the wishes of these Committees, the Board made available to the GAO the records requested by that Office but with the understanding that the legal differences between the GAO and the Board were unaffected.

[Excerpt from app. II to GAO Report on the Emergency Loan Guarantee Act dealing with the Board's position on access to records]

SUMMARY OF GUARANTEE BOARD POSITION FOR GAO REPORT

The crux of the controversy between the GAO and the Board is whether the GAO enjoys a statutory right of access to internal records of executive agencies relating to the decision-making process. Section 312 of the Budget and Accounting Act of 1921 grants the Comptroller General authority to investigate all matters *relating to the receipt, disbursement and application of public funds.* The underscored language indicates that something less than unlimited authority to investigate all executive matters was contemplated.

The Attorneys General who have considered the proper role of the GAO have consistently maintained that the GAO lacks authority to go behind determinations made by executive agencies and form independent judgments as to their validity. See, for example, 37 O.A.G. 95 (1933); 34 O.A.G. 311 (1924). This position of the Attorneys General is consistent with the Supreme Court's statement as to the limited changes effected by the 1921 Act: "The chief change effected by the Budget and Accounting Act was that it transferred powers lodged with officials of the Treasury Department to the Comptroller General and made his office independent of the Executive Branch of government. *Globe Indemnity Co. v. United States*, 291 U.S. 476, 480 (1934).

It is submitted that the GAO possesses no statutory authority to examine internal records of executive agencies relating to the decision-making process. To hold otherwise would make it difficult for responsible government officials to obtain complete and candid staff advice. Moreover, while the Board does not rely on the doctrine of executive privilege, if the GAO's claim to the right of unlimited review of executive records were adopted, it would necessarily raise serious constitutional questions involving separation of powers.

Mr. STAATS. Mr. Chairman——

Chairman PROXMIRE. For the record, if you would give us any recommendations you have, any notion you have, of why you are not bringing a lawsuit, the legal basis on which you could bring such a suit, and so forth, we would appreciate it for the record.

Mr. STAATS. Right.

[The following information was subsequently supplied for the record:]

With respect to the instant situation the question of a lawsuit against the Board is moot since the Board has furnished its records to us. We brought up the access matter only because it was the Board's position that it was legally required to make the records available. Our view is that the statutes clearly give us the legal right of access to the records of the Board. However, we do not have statutory authority to institute a suit against the Board in our own right. Assuming we could petition the Department of Justice to bring such a suit on our behalf, the Department of Justice could find itself in the anomalous position of representing us as plaintiff and the Board as defendant.

NAVY SHIPBUILDING CLAIMS

Mr. STAATS. Now, we turn to the status of the various Navy shipbuilding claims, this matter was likewise discussed at our earlier hearing.

You will note from the table in the prepared statement that the claims have decreased from $845 million to $620 million. However,

within that $620 million there are three claims that were, since our last hearing, totaling $162 million which have now gone before the Board of Appeals.

Chairman PROXMIRE. So there is no real reduction at all, it is before the Board of Contract Appeals, right, is that right as far as the claims are concerned, there are still $845 million or higher?

Mr. STAATS. It is pretty close to that. But actually, it may be larger, as I will point out here in a moment.

Chairman PROXMIRE. All right.

Mr. STAATS. As I say, these figures do not include claims which have been referred to the Armed Services Board of Contract Appeals or claims that have been rejected by the Navy.

The difference between the value of claims outstanding as of last March and current claims is attributable to the settlement of some claims but is due primarily to Litton's referral of three claims totaling $162 million to the Armed Services Board of Contract Appeals.

LHA PROGRAM

Now, I will not take the time unless you wish, Mr. Chairman, to detail the status of individual claims but will go on to discuss the LHA program claim which is not in these figures.

On March 30—that is not in the figures on that table in the prepared statement—on March 30, 1972, a $270 million——

Chairman PROXMIRE. To make me sure we know what you are talking about, LHA is a small landing ship for helicopters, that carries helicopters instead of planes, is that correct?

Mr. STAATS. Yes; that is correct. It is being made by the Litton Corp. at Pascagoula, Miss.

The Navy has rejected this claim. Litton also proposed price increases for costs related to the cancellation of four ships, escalation charges, and miscellaneous changes to the contract. Now, these negotiations are currently in process. We are not, of course, able to speculate on how they might come out. But we thought at your request we would give you a brief summary now of the status of the LHA program. I want to emphasize, however, that as far as the GAO is concerned, we are in the, currently in the, process of making a review of both this program and the destroyer program, the DD963 and therefore, we are not able to give you anything more than a factual status report. We expect to have our report completed by the end of February, and should you wish at that time we would be glad to come back, but we have been, as you know, Mr. Chairman, making reviews of individual weapons systems since 1969 and been reporting these to the Appropriations Committees and the Armed Services Committees for their use in Congressional hearings on authorizations and appropriations, and that is why we are making studies of these two systems.

Last year we made studies of over 70 different weapons systems. I do not think our number this year will need to be as large, but this, studies of these two systems, will be a part of a series of individual reviews that we are preparing for use of the two committees that I have mentioned.

DELIVERY DELAYS

Now, serious problems have been reported in the press, as reported in the press, have been encountered in getting the LHA program underway. LHA cost estimates are now more than contract prices and delivery of the ships is delayed 2 years or more, I believe about 33 months is the longest on the ships that are now scheduled. The contractor and the Department of the Navy disagree on who is primarily responsible.

Chairman PROXMIRE. Are these delays new estimates?

Mr. STAATS. Pardon.

Chairman PROXMIRE. Are these delays you have given, these are new estimates on the length of the delays?

Mr. STAATS. They show up later in the prepared statement, but the fifth ship delivery as pointed out there will be delayed 32½ months, I said 33, but to answer your question, yes, Mr. Chairman, I believe I can say that to the best of our knowledge, these are current estimates.

Chairman PROXMIRE. The first time I have seen an estimate that long, 32½ months, almost 3 years, now.

Mr. STAATS. Right.

Chairman PROXMIRE. Yes, go ahead.

Mr. STAATS. We have the schedule on each of the five ships, and I know of no reason why we could not supply that for the record, but the fifth ship delivery is the longest one, and that is 32½ months, which I am reporting here.

[The following information was subsequently supplied for the record:]

LHA DELIVERY DATES

	LHA				
	1	2	3	4	5
Current Navy estimate, November 1972.	Mar. 14, 1975	Sept. 12, 1975	Feb. 27, 1976	July 30, 1976	Dec. 17, 1976.
Slippage in months from original contract schedule, May 1969.	23½	26½	29	31	32½.

COST INCREASES

Mr. STAATS. Among the many factors affecting the price to be negotiated are increases due to the cancellation of four ships, costs associated with delays, disruptions and work stoppages due to matters beyond the contractor's control such as strikes, acts of God, and unilateral Navy program changes.

The Navy and the contractor have been negotiating price changes since March 31 of this year on the contractor's proposal to reset the LHA program prices, giving recognition to escalation estimate changes, delays and changes in the contract. Negotiations on these items are scheduled for completion by March 1, 1973. Both the Navy and the contractor project a cost increase on the LHA contract but the amount cannot be determined at this time. The original ceiling

price of the nine-ship contract was $1,199 million. We point out the extent of the delays in the prepared statement.

PROGRESS PAYMENTS

We point out in most fixed price ship construction contracts, progress payments are made on the basis of percentage of physical progress made in performance of the contract. That is a matter we have been talking about in connection with Lockheed. The fixed price LHA contract, however, provided for payments on the basis of physical progress starting 40 months after award. Payments for the first 40 months were on a "cost incurred" basis to cover anticipated high start-up and preliminary design effort. Litton's price proposal on the LHA was conditioned upon including these provisions in the contract.

The cost reimbursement method of payment was to have ceased on September 1, 1972. By that time a determination was to have been made of the status of physical progress as well as an accounting of the status of progress payments so far made. Because of a variety of delays, the Navy extended the date for progress payment conversion to February 28, 1973.

As we understand it, the Navy planned to have a basis for measuring progress early in the program but this has not been accomplished. On September 29, 1972, however, Litton submitted a plan for measuring physical progress which is being evaluated by the Navy. The progress measurement issue will either be negotiated by February 28, 1973, or determined unilaterally by the Navy in case of disagreement. A new contract price for five LHA ships and a schedule are to be determined by that date.

As of November 29, 1972, progress payments of $395 million have been billed. The contractor reports that as of that date he considers the program about 33 percent completed. Until the current repricing negotiations are completed and the system of measuring physical progress agreed upon, the validity of the claimed progress payments cannot be determined.

DD963 PROGRAM

Now, turning to the DD963 program: A development and production contract for the construction of 30 DD963 class destroyers was awarded to Litton Systems, Inc., on June 23, 1970. The DD963 destroyer contract is a multi-year, fixed-price incentive, successive target contract. The initial target price for the 30 ship program was $1,798.2 million with a ceiling price of $2,139.9 million. The contract provides that the ships will be funded in specified increments over 5 fiscal years.

Litton has projected slight changes in the contractually established delivery schedule. Fabrication of the first ship began in June 1972, and currently, the DD's are scheduled to be delivered slightly ahead of the contractually established dates.

The Navy position is that it is too early to know whether costs will increase or delivery schedules will slip but the Navy thinks they probably will.

Through fiscal year 1972, over $1.4 billion had been appropriated for 16 of the ships. Action by the Congress resulted in a reduction of $636 million in the fiscal year 1973 budget request of $610 million for the next seven DD963's. However, the contractor has agreed to extend the option date for funding these seven destroyers from January 15, 1973, to January 15, 1974, with no change in contract price or contract delivery dates provided funding was provided to continue long lead equipment subcontracts on their current schedules. The funds provided in the fiscal year 1973, budget, provide for these long lead subcontracts.

This matter will have to be decided in considering the fiscal year 1974 budget request.

Further, the last seven ships will have to be considered and full funding or long lead time money provided this coming year.

This concludes my statement, Mr. Chairman, and I will be glad to answer any questions.

Thank you.

[The prepared statement of Mr. Staats follows:]

PREPARED STATEMENT OF HON. ELMER B. STAATS

Mr. Chairman and Members of the Subcommittee; as requested in your letter of December 7, 1972, my statement today will cover five topics:

1. Our investigation into the charges made by Mr. Henry M. Durham concerning certain aspects of Lockheed's management of the C-5 aircraft program.
2. Progress payments practices on the C-5 aircraft program.
3. Our assessment of Army "Should-Cost" studies.
4. Our review of the implementation of the Emergency Loan Guarantee Act (Public Law 92–70).
5. The status of shipbuilding claims.

INVESTIGATION OF CHARGES BY HENRY M. DURHAM

This segment of our statement concerns our investigation at your request of October 12, 1971, of the charges made before your Subcommittee by Mr. Henry M. Durham, a former employee of Lockheed Aircraft Corporation, regarding Lockheed's management of the C–5 aircraft program.

The General Accounting Office has given particular attention to the following matters relating to Mr. Durham's charges:

1. The contractor's awareness of the problems cited by Mr. Durham and the timeliness and effectiveness of the action taken.
2. The comparison of Lockheed's experience on the C–5 aircraft with its past experience and with that of other major aircraft companies in producing new aircraft systems.
3. The awareness of and the actions taken by the Air Force in respect to these matters.

We also obtained Lockheed and Air Force comments on Mr. Durham's charges in letters dated May 26 and July 13, 1972, respectively.

Mr. Durham provided a set of 23 exhibits in support of his charges of unsatisfactory management practices in the assembly operations at the Marietta, Georgia, plant and in the fabrication plant at Chattanooga, Tennessee, The principal problems cited by Mr. Durham at these two plants, along with our findings, are summarized below and are presented in detail in the report previously furnished to your Subcommittee.

Lockheed-Georgia Co. Marietta, Ga.

Mr. Durham charged that there was mismanagement of assembly operations in producing the C-5 aircraft at the Marietta plant. He charged, in part, that (1) assembly records were inaccurate, (2) parts had been removed without authorization, had been scrapped by mistake, and had been unnecessarily procured, (3) inventory controls over titanium fasteners were inadequate, (4)

aircraft were moved along the production line in order to collect payments related to the accomplishment of milestones, although the aircraft were incomplete, and (5) the subterfuge to conceal such problems began with the rollout of aircraft 0001. Mr. Durham stated that, as a result, production costs had been increased significantly.

Our findings support the following charges made by Mr. Durham.

Aircraft assembly records did not accurately reflect the physical condition of the aircraft.

Parts had been removed from aircraft without authorization.

Parts had been erroneously scrapped.

There were inadequate controls over disbursement, handling, and usage of titanium fasteners.

We could not, however, determine the full extent of these conditions or their impact on the cost or schedule of the C-5 program.

Our findings do not support the following charges made by Mr. Durham.

We did not find evidence to indicate the parts had been unnecessarily procured. This is based on a detailed review of a random sample of purchased parts.

We did not find evidence to indicate that Lockheed maintained the production schedule in order to collect payments related to the accomplishment of milestones. We did find however, that the Air Force had withheld about $3.7 million from milestone payments on the five test aircraft because of shortages and variances from specifications when the aircraft were delivered to the flight-test organization.

We did not find evidence to indicate that there was subterfuge involved in the rollout ceremony of aircraft 0001. The Air Force issued a press release on February 21, 1968, that the C-5 aircraft rollout would be conducted on March 2, 1968. The release also indicated that the C-5 aircraft was scheduled to fly for the first time in June 1968. This shows that the aircraft was not intended to be fully operational at the time of rollout.

Lockheed-Georgia Co., Chattanooga, Tenn.

Mr. Durham charged, in part, that (1) there were inadequate controls over tools, raw materials, and miscellaneous small parts, (2) there was unnecessary procurement of material and high-strength nuts and bolts, and (3) there was mishandling of materials. He stated that these conditions and practices had increased the cost of operating the Chattanooga plant.

Our findings support the following charges made by Mr. Durham.

High strength nuts and bolts had been purchased for plant maintenance when, for some purposes, lower grade materials would have sufficed.

Substantial quantities of material and miscellaneous small parts had accumulated as a result of canceled orders and transfer of items from another plant.

Some items which were available at less cost from the Marietta storeroom had been purchased locally.

Our findings do not support the charges by Mr. Durham that there were inadequate inventory controls over tools, raw materials, and miscellaneous small parts. We found that consumable tools, such as drill bits, reamers, and cutters were provided to employees as they were needed without establishing a record of issue. With respect to raw materials and miscellaneous small parts, we found that these items were purchased and controlled on an individual job order basis in lieu of detailed inventory controls. We believe thesee practics were reasonable because it is generally impractical to provide a detailed inventory control system for small and inexpensive tools and parts. In addition, we found that these practices were consistent with others in the industry.

General

We visited several aerospace firms to determine whether problems similar to those experienced by Lockheed could normally be expected in producing a new aircraft. We were advised that conditions such as out-of-sequence work and missing parts exist on every new aircraft program. However, it was also pointed out that management emphasis is directed toward insuring that such conditions do not develop into major problems. We were unable to obtain specific detailed information that could be used for comparison.

We found that prior to the publication of Mr. Durham's charges the Air Force was aware of some of the conditions he cited. For example, the Air Force knew Lockheed was experiencing difficulties with titanium fasteners, feeder plant assemblies, quality control, and out-of-sequence work. However, the Air Force could not provide any documentation that would indicate they were aware of other conditions such as inaccurate assembly records, unauthorized removals, or any of the conditions at Chattanooga.

For the most part, however, the Air Force did not direct the contractor to take specific corrective action because the Air Force, in administering the contract, followed a philosophy of "disengagement." This philosophy required minimal participation by the Air Force in the day-to-day management of the program as prescribed by the total package procurement concept under which the C-5 aircraft was originally purchased.

We also found that prior to the publication of Mr. Durham's charges Lockheed's management was aware of these problems and was directing corrective action, as evidenced by (1) discussions at special meetings held to review the progress of the C–5 aircraft program and (2) numerous Lockheed internal audit reports which were widely disseminated to Lockheed officials.

PROGRESS PAYMENT PRACTICES ON THE C–5 AIRCRAFT PROGRAM

You requested our comments on a February 20, 1970, report of the Defense Contract Audit Agency on progress payment practices on the C–5 aircraft program. The Agency's report concluded that:

> The contractor had understated the cost of delivered items by failing to include overruns.
>
> As a result, over $400 million worth of progress payments then outstanding were due to this understatement of the cost of delivered items.
>
> There was a question as to whether the contractor would be able to finance his overruns and complete the contract, since the ceiling on progress payments was rapidly approaching.

Frequently a Government contract, as was the case in the C-5 aircraft program, requires a long period of performance or substantial expenditures before the contractor makes delivery and receives full payment. Using private capital in such cases may not be economical or feasible because the financial requirement may exceed the contractor's capability or impair its ability to perform. Thus, the Government has followed the practice of reimbursing the contractor for part of the costs incurred on work in process but not yet delivered. Payments to contractors on this basis are authorized by 10 U.S.C. 2307 and the Department of Defense procedures for such payments are included in the Armed Services Procurement Regulation.

The standard progress payment clause provides for payment of a stipulated percentage of the contractor's incurred costs. In the case of the C–5 aircraft program, the progress payment rate was set at 90 percent of the costs incurred. The cumulative progress payments could not exceed 90 percent (subsequently increased to 100 percent) of the ceiling price established in the contract.

When an item is delivered and invoiced, the progress payments received by the contractor during its production are deducted from the total amount due. This is known as liquidating the progress payments. The C–5 contract provided that the amount of unliquidated (i.e., outstanding) progress payments not exceed the lower of (1) 90 percent of the costs incurred for undelivered items, or (2) 90 percent (subsequently increased to 100 percent) of the contract price of the undelivered items. As of January 20, 1970, C–5 progress payments were not in violation of any of the above ceilings.

The regulations provided that the costs for undelivered items be determined by deducting the costs attributable to items delivered, invoiced, and accepted from the total costs incurred. The regulations also provided that the costs of delivered items be computed as follows:

"In order of preference, these costs are to be computed on the basis of one of the following:

> (A) The actual unit cost of items delivered, giving proper consideration to the deferment of the starting load costs;
>
> (B) Projected unit costs (based on experienced costs, plus estimated costs to complete the contract), where the contractor maintains cost data which will cleary establish the reliability of such estimates; and

(C) The total contract price of items delivered."

Lockheed followed method (c) in computing the costs of delivered items. Therefore, in arriving at the costs of undelivered items, Lockheed deducted from the total costs incurred an estimated or target cost based on the contract billing price of delivered items rather than actual or projected costs (methods a and b). Because the costs deducted for delivered items were less than the actual costs of such items, the amount subject to progress payments was increased.

This was the situation presented in the defense contract audit agency's February 1970 report, which stated that lockheed had been overpaid about $400 million. The chart on the following page illustrates how the defense contract audit agency computed the amount of overpayment.

The following is an explanation of how the $400 million overpayment was computed by the Defense Contract Audit Agency:

The center bar shows that total costs incurred by the contractor were $1,866 million.

The DCAA, based on data from the contractor's "Contract Status Analysis Report" concluded that the actual cost of delivered items was approximately $1,100 million (left bar). On this basis, $861 million was subject to progress payments as shown on the chart.[1]

However, the regulations then in effect permitted the contractor to state the value of delivered items, as shown in the right-hand bar, at the contract target costs, which was reported by Lockheed as $637 million in its Request for Progress Payments. Using this lower figure, the amount subject to progress payments was increased to $1,283 million.

By subtracting $861 million, the amount available under method (a); from $1,283 million, the amount available under method (c); we confirmed that Lockheed's method resulted in progress payments being $400 million greater under method (c) than under method (a).

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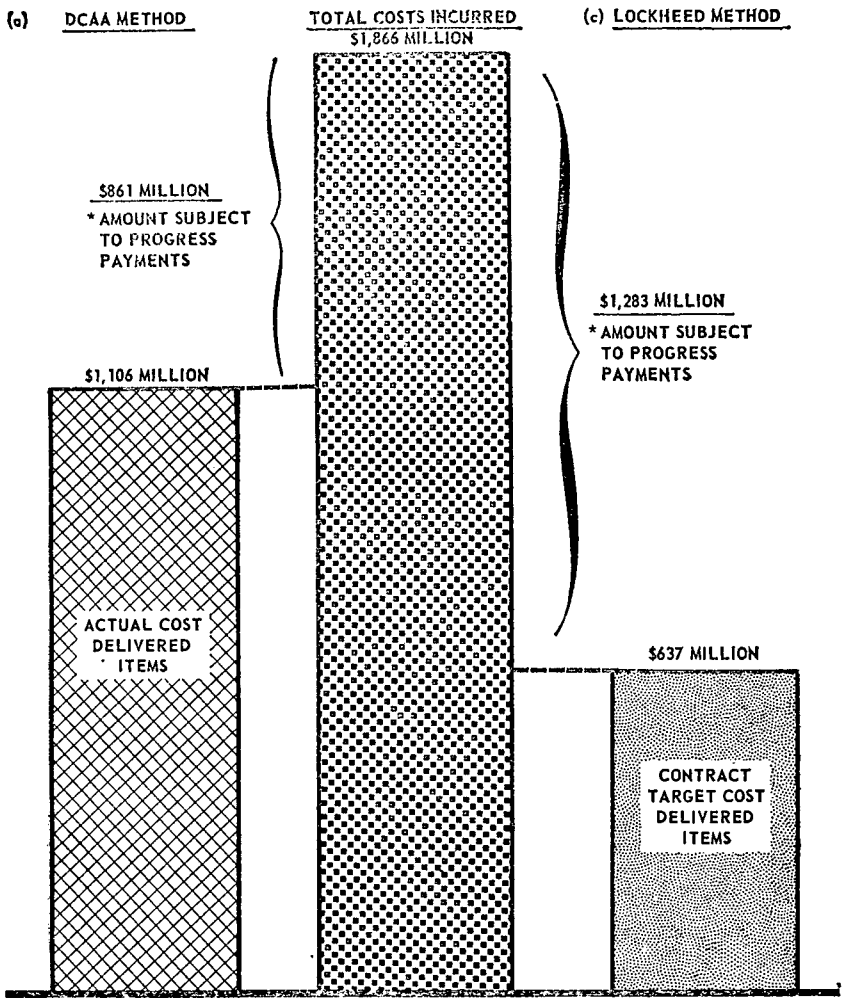
[1] The amount subject to progress payments is determined by taking the difference between costs incurred and the value of delivered items times 90% (1866 minus 1106 equals 760 times 90% equals 684) plus payments to subcontractors of $177 million (684 plus 177 equals 861).

C-5A PROGRESS PAYMENTS AS OF JANUARY 20, 1970
THERE WAS A $400 MILLION DIFFERENCE BETWEEN THE TWO METHODS OF COMPUTING VALUE OF UNDELIVERED ITEMS



*BASED ON 90% OF DIFFERENCE PLUS SUBCONTRACT PAYMENTS OF $177 MILLION

The regulations of the Department of Defense permitted this procedure, The Air Force's written comments to the General Accounting Office on this matter pointed out that:

> Both parties recognized that an upward adjustment in the contract ceiling was essential because of several factors, including inflation, repricing because of the number of aircraft being procured under "Run B," and repricing because of overceiling costs on "Run B."
>
> This method of computing progress payments had been in effect from the start of the contract. Because the contractor had filed an appeal with the armed services board of contract appeals indicating an intent to Litigate contractual differences the Air Force considered that progress payments should be continued using this method. The Air Force believed that to do otherwise might incur a breach-of-contract action.
>
> The Air Force concluded that, were progress payments suspended or past payments significantly recouped, C–5 aircraft production would come to a halt and the ultimate cost of completing the program would greatly increase.

Between February 1970 and May 1971, when the contract was restructured, the Air Force increased the ceiling price of the contract by about $557 million to recognize (1) fluctuations in the economy in excess of the rate included in the original contract price, $143 million, (2) provisional items and change orders for which firm prices had not been established, $114 million, and (3) interim repricing adjustments for "Run B," $300 million. These actions provided additional funds for progress payments since such payments are limited by the ceiling price for the contract.

The Air Force also changed the limit on the percentage of the contract price that would be available for progress payments. Originally, progress payments were limited to 90 percent of Lockheed's allowable incurred costs, up to a maximum of 90 percent of the contract ceiling price, in April 1970 the Air Force changed this maximum to 95 percent of the ceiling price, which provided an additional $73 million for progress payment. The contract was again changed in September 1970 to allow progress payments up to 100 percent of the ceiling price; this made available an additional $75 million. Therefore, by changing the limit from 90 percent to 100 percent, an additional $148 million was made available for progress to Lockheed. This $148 million and the 557 million increase in the ceiling price comprise the $705 million discussed in the staff study.

The contract was converted to a cost-reimbursement contract in May 1971, and the contractor stopped receiving progress payments and started receiving reimbursement on the basis of costs incurred. Negotiations to convert the contract considered all payments previously made to Lockheed.

The method lockheed used was allowable under the contract and was permitted under the regulations then in effect; however, as previously illustrated, this method permitted the contractor to receive progress payments for costs incurred on delivered items in excess of the unit prices for such items. By June 1968, six months after lockheed started using this method, Lockheed and the Air Force were projecting an overrun on the contract.

It is our opinion that the method used for computing the progress payments was inappropriate under the circumstances, Progress payments are to help contractors finance the cost of undelivered items and we believe that when an item is delivered and accepted the actual costs to produce the item should be deducted from total costs incurred when computing the maximum permissible progress payments.

As a result of the Defense Contract Audit Agency Report and of subsequent studies by the Defense Internal Audit staff, it was decided in November 1971 that the practice of using method (c) to compute the costs of delivered items should be discontinued. Defense Procurement Circular 94, dated November 22, 1971, announced plans to revise the progress payment request form, and the new form omitting method (c) became effective on April 1, 1972.

ASSESSMENT OF ARMY SHOULD-COST STUDIES

In testimony before this Subcommittee in April 1971, we reaffirmed our intention to follow up on the efforts of the military services in performing should cost studies of contractors' operations.

To date we have completed our assessment of nine Army studies which were made during 1970 and 1971. Since our reviews of the Navy and the Air Force should-cost studies have not yet been completed, my remarks today will be limited to the Army studies.

Our primary objective was to examine the manner in which the should-cost studies were conducted and to identify areas in which improvements could be made to increase their usefulness and the benefits derived from the studies. I would like to emphasize that we did *not* attempt to evaluate the overall conduct of contract negotiations.

The Army's objectives in making should-cost studies are to develop realistic Government estimates for use in negotiating contract prices, and to obtain the contractors' agreement to make improvements in those operations determined to be below acceptable levels. We stimate that the three studies which we reviewed in depth cost a total of about $463,200, including consultant fees of $47,885. The in-plant phases of these studies consumed periods of 5 to 8 weeks and the study teams varied in size from 15 to 27 members.

Although no two studies were the same in areas covered, depth of review, fiindings, or recommendations, on the we believe the studies strengthened the Army's bargaining position in contract negotiations. Some of the benefits which could have resulted from the studies were not realized, however, because insufficient attention was given to identifying ways to improve the contractor's efficiency and economy of operations.

The teams made in-depth analyses of the contractors' proposals and arrived at cost estimates which were much lower than those of the contractors. The nine Army should-cost studies evaluated contractors' proposals totaling $299.2 million and identified potential reduction of $97.8 million. The potential price reduction represents the difference between the contractor's proposed price and the estimates developed by the should-cost teams.

The price reductions realized by the Army in negotiations totaled $46.7 million, or 15.6 percent of the contractors' price proposals. Figures developed by the Army show that on prior procurements of the same or similar equipment from the nine contractors price reductions amounted to 8 percent of the contractor's proposals. We confirmed this for three of the nine studies.

We could not determine the precise amount of the cost reduction for each individual should-cost finding because final agreement was reached on a lump-sum basis rather than on individual elements of cost. In addition, the full extent of the savings to the Government cannot be determined until the final costs of performing the contracts are known because in seven instances fixed-price-incentive type contracts were awarded. Under this type of contract the contractor is paid on the basis of the costs incurred in performing the contract up to a ceiling price and the contractor's actual profit is determined by the extent to which the final costs are either higher or lower than the contract target costs.

In addition to the contract price reductions negotiated, six of the nine contractors agreed to apply their best efforts toward attaining a number of improvement goals in areas which the should-cost teams felt had potential for improvement and from which the Government stands to benefit from any subsequent contracts. The goals concerned such things as achieving higher labor efficiency levels and preparing and implementing estimating and accounting manuals.

The studies we reviewed had few suggestions for specific changes in the contractors' operations to improve efficiency or economy. The teams relied principally on in-depth analyses of the contractors' records and on the teams' judgments. We believe the best means to challenge the efficiency of a contractor's operations is to identify the specific practices which need improvement. We have recommended that the Army give increased emphasis to this in future studies.

The study teams did not discuss their specific findings with the contractors prior to negotiations for fear of jeopardizing their negotiating positions. Our view, however, is that open and frank discussions throughout the studies can help to develop stronger bargaining positions by enabling the teams to isolate areas of agreement and disagreement earlier; to undertake additional work when necessary; and to refine their positions when justified. Such discussions would also allow greater contractor participation in determining the actions needed to improve their efficiency and would lead to Quicker agreements during negotiations.

We found little evidence that the teams had considered the need for or the desirability of changes in Government policies, procedures or practices to reduce the costs of contractor operations. For example, we have found in other reviews that substantial savings could be achieved by eliminating or modifying certain Government testing and packaging requirements. We have recommended that these matters be given attention in future studies. In addition, we believe that the Department of Defense should study the question of whether the should-cost concept should be expanded to include consideration of the impact on costs of schedule and performance requirements.

At one location we found that the resident audit office had difficulty measuring the contractor's progress toward the improvement goals for certain categories of indirect expenses. The goals were expressed as percentage reductions or percentage levels to be attained. Because these rates could be affected by cost accounting changes or fluctuations in the costs, changes in the rate did not furnish meaningful information as to the contractor's progress in reducing costs. We have recommended that the teams define improvement goals in terms which will permit more meaningful progress evaluations.

We are convinced that should-cost techniques, properly applied, can be of great assistance to Government negotiators in arriving at fair and reasonable prices. We intend, therefore, to continue to follow up on the efforts of the military services in applying these techniques and to recommend improvements when we find the need for them. Our assessments of the studies performed by the Navy and the Air Force should be completed shortly, and copies of our reports will be provided to the Subcommittee.

IMPLEMENTATION OF THE EMERGENCY LOAN GUARANTEE ACT

The Emergency Loan Guarantee Act requires GAO to make an audit of any borrower under the act. Lockheed Aircraft Corporation has been the only borrower.

We have concluded that Lockheed and the lending banks have complied with the requirements of the Act. As required by the Act, the Government has been placed in a preferred position with respect to the collateral and, based on current book valuations and certain known market values of the pledged assets, the Government's interests appear to be adequately protected.

Barring unforeseen circumstances available information indicates that Lockheed should be able to generate sufficient cash during the next several years to permit repayment of the Government-guaranteed portion of its loan. However, unless Lockheed is successful in obtaining a subtantial number of additional orders for its L–1011 Tristar commercial airliner, losses on that program could impair the financial condition of the company. Firm orders and options amount to 117 and 67 aircraft, respectively, as of today, compared to Lockheed's estimated break-even point of 275.

In this connection our review of available forecasts of the world-wide demand for widebodied trijet aircraft of the L-1011/DC-10 type through 1980 indicates that less than 40 percent of the demand has been thus far satisfied in the form of either orders or options received by the two manufacturers of the trijet aircraft. In part this maybe attributable to apparent airlines policy of not placing orders or options more than 2 or 3 years in advance.

Several important developments have occurred recently such as:

1. The receipt of orders for 32 additional aircraft (13 firm and 19 options) from customers that are expected to have substantially larger needs for these planes in the last half of the decade of the 1970's.

2. The issuance by Lockheed of a new 5-year forecast that recognizes the following factors:

(*a*) L–1011 production costs increased during the first 6 months of 1972 and the production schedule of the planes was extended by 18 months. These two situations have contributed to increasing the break-even point, estimated by Lockheed, from 265 to 275 aircraft. Lockheed has attributed the increase in production costs primarily to out-of-station work and unscheduled overtime required to meet delivery commitments on the first 12 aircraft. We are seeking to determine whether there are indications that Lockheed is resolving these problems and bringing costs in line with its initial estimates.

(*b*) Lockheed will need to draw down a greater proportion of the total funds available under the $250 million guaranteed loan. Initially Lock-

heed estimated it would draw a maximum of $150 million. This has been increased to an amount between $195 million and $220 million. Currently, $130 million has been borrowed and Lockheed's forecast indicates that this is expected to reach $150 million by the end of the year.

(c) Lockheed originally planned to payback the guaranteed loan by the end of 1974. Lockheed currently estimates payback will be completed about 3 to 6 months later. However, the current estimate is still within Lockheed's obligation to fully repay the guaranteed loan by December 31, 1975.

In view of broad language in the legislation with respect to the nature and objectives of GAO's examination of the borrower, we coordinated our plans with the chairmen of the House and Senate Banking Committees and Congressman Dingell, the sponsor of the GAO audit provision.

We have interpreted the statute as requiring GAO to:

(a) Monitor the financial and other activities of the borrower to provide assurance that the borrower and lenders comply with the terms of the statute and the implementing agreements, and that the interests of the Government are adequately protected;

(b) Advise the Congress of any matters that may affect the ability of the borrower to repay the Government-guaranteed portion of its outstanding loans; and

(c) Inform the congress of any other information that may be relevant under the circumstances existing during the loan guarantee period.

In addition, since all of the authority to administer the loan is vested in the emergency loan Guarantee Board, we consider the review of the activities of the Board to be a vital part of our overall examination.

Although the Emergency Loan Guarantee Act does not require GAO to review the Board's activities, such a review is clearly authorized under the general authority granted to GAO by the Congress to review the records of the agencies of the Executive Branch of the Government. The Board, as you know, has taken the position that we do not have statutory authority to review its internal records relating to its decision-making process and continues to hold to this position. We believe that GAO has the responsibility for reviewing the activities of the Board and has the right to examine any records related to the decisions previously made by the Board. In compliance with the views expressed by the Senate Committee on Banking. Housing and Urban Affairs and the House Committee on Banking and Currency, The Board provided us with certain correspondence and financial analyses prepared by its fiscal agent which enabled us to examine the activities of the Board in connection with the Lockheed guarantee, Consistent with its earlier position, however, the Board stated in its Annual Report dated September 5, 1972, that the legal difficulties between the GAO and Board were unaffected by its release of records to us. Thus, the Board has not conceded that GAO has a legal right to records of the Board that GAO believes are necessary to carry out its statutory responsibilities—a position we think is without merit.

STATUS OF SHIPBUILDING CLAIMS

In hearings before this Subcommittee in March of this year we discussed, in some detail, contractors' claims for price increases and why these claims have been a recurrent element in Navy shipbuilding programs. A comparison between claims over $5 million then outstanding and the latest data reported by the Navy is shown below.

	Mar. 1, 1972	Nov. 1, 1972
Avondale Shipyards, Inc	$142.2	$142.2
Bethlehem Steel	53.6	49.1
Defoe Shipbuilding	5.4	
Dillingham Shipyard	14.2	15.9
General Dynamics	204.6	204.6
Ingalls Shipbuilding, Litton Systems, Inc	174.6	
Lockheed Shipbuilding	139.6	139.6
Newport News Shipbuilding	111.0	69.1
Total	845.2	620.5

These figures do not include claims that have been referred to the Armed Services Board of Contract Appeals or claims that have been rejected by the Navy.

The difference between the value of claims outstanding as of last March and current claims is attributable to the settlement of some claims but is due primarily to Litton's referral of 3 claims totaling $162 million to the Armed Services Board of Contract Appeals. A discussion of these three claims follows.

Ammunition Supply Ships—AE 32–35

Litton Systems, Inc., Ingalls Nuclear Shipbuilding Division, claims $36,780,419 for alleged extra work performed during construction of four ammunition supply ships AE 32–35. The Navy has advised the contractor that it had reviewed the record relating to this claim and had determined that the claim for additional payment should be granted in the amount of $962,057.

On August 14, 1972, the contractor submitted this claim to the ASBCA.

Nuclear Attack Submarine—SSN 680, 682, 683

Litton is claiming $30,575,000 due principally to late delivery of Government-furnished material. By letter dated July 31, 1972, the Navy advised the contractor that it was entitled to a compensation increase of $3,774,803. On August 14, 1972, the contractor submitted this claim to the ASBCA.

Various Contracts

Litton alleges that due to the impact of the Government actions, it incurred additional cost of $94,395,059. Government actions cited include massive changes on submarine contracts for SSN 621, 639, 648, and 652, priorities, and acceleration of submarine work. The claim was submitted in May 1971.

The contractor appealed to the ASBCA on July 11, 1972, without waiting for a contracting officer's decision.

LHA Program Claim

On March 30, 1972, a $270.7 million claim for an equitable adjustment was submitted by Litton Ship Systems on the LHA contract. The Navy has rejected this claim. Litton also proposed price increases for costs related to the cancellation of 4 ships, escalation charges, and miscellaneous other changes to the contract. Negotiations are continuing on these proposed price increases.

Current Status of the LHA Program

You also asked that we discuss our work on the Navy's LHA and DD963 ship acquisition programs. As you know, we have been making reviews of major acquisition programs for several years. Those reviews are made at the request of the Appropriations and Armed Services Committees and reports on our studies are given to those Committees, and to other interested congressional committees, early in each congressional session. Our current work on the LHA and DD963 programs was undertaken as a part of that effort. However, a great deal of work remains to be done before we complete our review and report to the Congress.

Serious problems have been encountered in getting the LHA program underway. LHA cost estimates are now more than contract prices and delivery of the ships is delayed two years or more. The contractor and the Department of the Navy disagree on who is primarily responsible for the problems and the resulting cost growth and delivery delays. Among the many factors affecting price to be negotiated are; increases due to the cancellation of 4 ships, costs associated with delays, disruptions and work stoppages due to matters beyond the contractor's control such as strikes, acts of God, and unilateral Navy program changes.

The Navy and the contractor have been negotiating price changes since March 31, 1972, on the contractor's Proposal to reset the LHA program prices, giving recognition to escalation estimate changes, delays and changes in the contract. Negotiations on these items are scheduled for completion by March 1, 1973. Both the Navy and the contractor project a cost increase on the LHA contract but the amount cannot be determined at this time. The original ceiling price of the nine ship contract was $1,199 million.

The contractor now estimates that the 1st ship will be delayed 23½ months and the 5th ship delivery will be delayed 32½ months.

Major subcontracts have all been awarded. These 131 subcontracts, totaling over $100 million, are fixed-price awards. No significant delivery problems were noted.

Litton's Data Systems Division received a $150 million work authorization from the Litton prime contractor for command and control equipment, certain functions and development of computer programs for 9 ships. The Data Systems Division, at the request of the shipyard, has slipped its schedules for LHA installation work to coincide with the shipyard's current schedule.

In most fixed-price ship construction contracts, progress payments are made on the basis of percentage of physical progress made in performance of the contract. The fixed-price LHA contract, however, provided for payments on the basis of physical progress starting 40 months after award. Payments for the first 40 months were on a "cost incurred" basis to cover anticipated high start-up and preliminary design effort. Litton's price proposal on the LHA was conditioned upon including these provisions in the contract.

The cost reimbursement method of payment was to have ceased on September 1, 1972. By that time a determination was to have been made of the status of physical progress as well as an accounting of the status of progress payments so far made. Because of a variety of delays, the Navy extended the date for progress payment conversion to February 28, 1973.

As we understand it, the Navy planned to have a basis for measuring progress early in the program but this has not been accoplished. On September 29, 1972, however, Litton submitted a plan for measuring physical progress measurement which is being evaluated by the Navy. The progress measurement issue will either be negotiated by February 28, 1973, or determined unilaterally by the Navy in case of disagreement. A new contract price for five LHA ships and a schedule are to be determined by that date.

As of November 29, 1972, progress payments of $395 million have been billed. The contractor reports that as of that date he considers the program about 33 percent completed. Until the current repricing negotiations are completed and the system of measuring physical progress agreed upon, the validity of the claimed progress payments cannot be determined.

Current Status of the DD963 Program

A development and production contract for the construction of 30 DD963 class destroyers was awarded to Litton Systems, Inc., on June 23, 1970. The DD963 destroyer contract is a multi-year, fixed-price incentive, successive target contract. The initial target price for the 30 ship program was $1,798.2 million with a ceiling price of $2,139.9 million. The contract provides that the ships will be funded in specified increments over five fiscal years.

Litton has projected slight changes in the contractually established delivery schedule. Fabrication of the first ship began in June 1972, and currently, the DDs are scheduled to be delivered slightly ahead of the contractually established dates.

The Navy position is that it is too early to know whether costs will increase or delivery schedules will slip but the Navy thinks they probably will.

Through fiscal year 1972, over $1.4 billion had been appropriated for 16 of the ships. Action by the Congress resulted in a reduction of $636 million in the fiscal year 1973 budget request of $160 million for the next seven DD963's. However, the contractor has agreed to extend the option date for funding these seven destroyers from January 15, 1973, to January 15, 1974, with no change in contract price or contract delivery dates provided funding was provided to continue long lead equipment subcontracts on their current schedules. The funds provided in the FY 73 budget provide for these long lead subcontracts.

This matter will have to be decided in considering the fiscal year 1974 budget. Further, the last seven ships will have to be considered and full funding or long lead time money provided.

This concludes our statement, Mr. Chairman, and we will be pleased to discuss any of these matters in further detail or answer any questions the Subcommittee may have on our statement.

Chairman PROXMIRE. Thank you, Mr. Staats. Let me first get into this last item you deal with because again, I think it is a very vital item.

LITTON AMMUNITION SHIP CLAIM

Let us take the statement dealing with Litton shipbuilding program. Litton filed a claim totaling $36.8 million, as I understand it, for alleged extra work performed on four ammunition supply ships. The Navy offered to settle the claim for less than a million dollars. That is a tremendous disparity. Litton has appealed the Navy's decision. Does the small amount of the offer suggest that the claim may have been grossly exaggerated or inflated?

Mr. STAATS. I do not really believe, Mr. Chairman, I would have any view on that particular point.

LITTON SUBMARINE CLAIM

Chairman PROXMIRE. Does it not seem striking? Let me go into the next one then. In addition, Litton claims $30.5 million for alleged late delivery of Government-furnished material in the construction of three nuclear submarines. Again, the Navy offered a relatively small amount, $3.8 million, in settlement. If the claims in these two cases are worth only what the Navy has offered, does it not indicate that something is wrong with the claims?

Mr. STAATS. I guess that would be proper to conclude the Navy did not think much of it.

Chairman PROXMIRE. It seems such a striking and sharp disparity.

Mr. STAATS. It certainly would seem correct.

LITTON "RIPPLE" CLAIM

Chairman PROXMIRE. Let me get into the third case. Litton claims $94.4 million for what you call massive changes on submarine contracts. This is the so-called "Ripple" claim, as I understand it. Can you explain the basis for that?

Mr. STAATS. Mr. Hassell Bell, deputy director of the Procurement and Systems Acquisition Division has been following this.

Chairman PROXMIRE. Mr. Gutmann, would you let Mr. Bell take your microphone so he could be heard?

Mr. GUTMANN. Surely.

Mr. BELL. If I understand the ripple effect claim, the basis of that says that over a period of some years of Government contracts, the various things that have happened on these series of contracts that cannot be specifically identified with one individual contract have collectively resulted in the contractor being unable to attain the level of efficiency that he had planned to attain and, therefore, this claim is based upon the amount of money that he says he would have earned had he been able to attain that level of efficiency.

Chairman PROXMIRE. Is that not an unusual and unprecedented claim?

Mr. BELL. Mr. Chairman, it is the first one I have seen like that, yes.

Chairman PROXMIRE. The contractor says he agreed to a contract price but then he is less efficient than he thought he was so he is going to have to have more to reward him, to compensate him for his inefficiency, is that right?

Mr. BELL. Well, he alleges his inefficiency is as a result of various things that occurred on the contract that were caused by matters that were beyond his control.

Chairman PROXMIRE. Such as?

Mr. BELL. Such as Government changes, such as labor troubles, such as storms and various other types of things. But as you ask now and I reply, it is the first claim of that type that I have seen.

Chairman PROXMIRE. And it is such a big one, a hundred million dollars almost, $94½ million.

You state, Mr. Staats, that Litton appealed to the Armed Services Board of Contract Appeals before the Navy made a decision on it. Is it not correct that the Navy thought so little of this claim that it was going to refuse to offer any amount in setlement on that $94 million claim?

Mr. STAATS. That is correct.

Chairman PROXMIRE. So that in taking these three claims we have discussed the $36.8 million claim on the ammunition ships, $30.5 million on the submarines, and $94 million on the ripple claim, it looks as if the Navy has taken a position on all of them they are not worth very much, at least the amount that should be allowed should be relatively very small.

LHA PROGRAM

Let us get into the landing helicopter assault program. The Navy's position on the landing helicopter assault program is a little harder to understand. First, will you tell us why the Navy wants the landing helicopter assault ship, what is its mission?

Mr. STAATS. It is for the support of the Marine Corps assault mission, Mr. Chairman. The original requirement on this was nine ships, as you know, and since that time the requirement has been reassessed to reduce that by four ships making a total of five ships that will be constructed under the contract.

Chairman PROXMIRE. What was the contract price for nine landing helicopter assault ships?

Mr. BELL. $1.199 billion.

Chairman PROXMIRE. About $1.2 billion?

Mr. BELL. That is right.

Chairman PROXMIRE. According to the prepared statement, Litton has been paid $395 million as of November 29, 1972, and reports that the program is about 33 percent complete. Assuming the estimate of physical completion is correct, does that indicate the cost of five ships will be $1.2 billion, and that Litton's cost per ship has risen from $133 million each to $237 million each? In other words, are we going to get five ships for what we were going to get nine ships and that they have an overrun here of about 80 percent? Can we project this on the basis of they are saying it is a third complete?

Mr. BELL. Well, if you go on the basis that that is a straight arithmetical average, Mr. Chairman, that is the kind of figure you would get. But both the contractor and the Navy felt when this contract was awarded and they activate a new shipyard there would be a considerable amount of rather fairly sizable unusually large startup costs which would have to be borne and would be borne whether they

built one ship or nine so I do not believe it would be really fair to draw a straight arithmetical average.

Chairman PROXMIRE. Well, you have got more than half of the amount that the cost of five ships could be already paid and they say they have only completed a third of the work so those really must be unusually high startup costs, and a red flag to us to be aware of the very strong possibility of overruns on these ships, would you not say?

Mr. BELL. I think that Mr. Staats said in his statement that both the Navy and the contractor predict an overrun. It is just the size of it that cannot be determined until the negotiations——

Chairman PROXMIRE. It is pretty mild language on it. But you think it looks pretty strongly as if there is going to be an overrun here?

LACK OF PROGRESS ON LHA

At our request you sent analysts to the Litton yard to look into this program. I understand that at least one estimate prepared by Litton earlier this year indicates that there has been far less progress than has been reported. This estimate shows slightly more than 13 percent completion on the hull of one ship—they were talking about 33 percent altogether—13 percent on the hull of one ship, 5 percent completion on the entire ship. Can you comment on these figures?

Mr. STAATS. I do not believe, Mr. Chairman, I can at this point. I would like to say though, in connection with your question that we are reviewing these two programs in great detail. We have had five men down there within the last 10 days who have spent about 4 days at the site. We will be making our report, as I have indicated, we now contemplate, at the end of February. I believe that it is too early for use at this point in time.[1]

Chairman PROXMIRE. I understand those figures come from an in-house Litton estimate. Mr. Bell cannot comment on those figures? Are you not familiar, Mr. Bell, with those figures?

Mr. STAATS. If these are their figures, I have no problem at all. I just did not want to speculate what our figures would be until we are further along with our review. But if these are their figures there is no problem, I am just not familiar with it.

Mr. BELL. The point is that the figures that you read relate to yard labor, the amount of labor that has been expended on those particular ships at the yard. There are additional amounts of money on subcontracts that also apply which make up the difference in the progress reported.

LOW EFFICIENCY IN LITTON SHIPYARD

Chairman PROXMIRE. I also understand that this same Litton estimate, in-house estimate, showed that the yard where the LHA is being built is operating at 40 percent efficiency. Is that not a rather low efficiency level?

Mr. BELL. Forty percent strikes us as low but I do not really know what a national average for shipyards really ought to be.

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[1] The GAO staff study entitled "General Purpose Amphibious Assault Ship (LHA) and the DD–963 Antisubmarine Warfare Destroyer Shipbuilding Programs" may be found on pp. 2442–2478.

Chairman PROXMIRE. I cannot believe it is anything like that. Where there is 90 percent efficiency there might be some reason for some concern, 75 percent, 50 percent would be appalling; 40 percent just seems to me, 40 percent efficiency even for a Senator to operate at is pretty low. [Laughter.]

Mr. BELL. Well, again, as Mr. Staats said in his statement, and I think it is commonly conceded, Litton has had difficulties, there have been some serious problems, in getting that shipyard started. One of those, of course, would be getting the labor force operating at some acceptable level of efficiency.

Chairman PROXMIRE. Incidentally, we are going to have a representative of the union that represents the workers here to talk to us about that tomorrow. We can question him on it. Why has it been so difficult for the Navy and Litton to agree on the amount of physical progress? I realize that it is difficult to estimate progress on something as complicated as a large ship program, but it is done all the time on other programs. Should not the Navy and Litton have worked out a method to determine physical progress early in the program?

Mr. BELL. Here, Mr. Chairman, the primary problem was getting a shipbuilding program going in a new yard and that was the same basis for the cost reimbursements period of 40 months.

The construction of ships on a module basis as opposed to laying the keel in construction of the ship was thought by both parties to be somewsat different. We are told that they did not anticipate having the kind of difficulties they have had and agreeing on that basis, yes.

DELIVERY DELAYS

Chairman PROXMIRE. Then, you talk about the delivery date, this is something, of course, time is money, and it is also a matter of preparedness for our armed forces, for our Navy. We are told the first ship is going to be 2 years late, 23½ months, the fifth ship 32½ months late, almost 3 years, which is an extraordinarily long delay. On the other hand, if there is no firm estimate on physical completion how is it possible to estimate delivery delays? Are not these just guesses, too, and likely to be low guesses?

Mr. BELL. I believe that is probably—I think that we said in the statement that we do not believe they have a basis.

Chairman PROXMIRE. So 2 and 3 years, which is extraordinarily late, it is likely to be more than that?

Mr. STAATS. These slippage schedules are the Navy's figures, not ours. We question——

Chairman PROXMIRE. They do not seem to have any physical basis for making the estimate either, is that right?

Mr. STAATS. I think the question is a good question, without some physical basis for measuring progress whether the Navy's estimates are really good.

Chairman PROXMIRE. So it seems likely the program will be delayed further.

NAVY GRANTS LITTON 6-MONTH EXTENSION

You mentioned the 6 months extension granted as of September 1. Can you explain what was extended and why the extension was granted?

Mr. BELL. We discussed this with the Navy, and the way it was explained to me in the Navy is that there were a number of things to be considered. The Navy wanted to find, they would concede that the hurricane had had some delays, they would concede that there had been a strike that contributed to the delay, there were also some Navy changes in the program, and it was explained to me the Navy attempted to arrive at what it thought would be its maximum involvement, the maximum things that the Navy would be responsible for. It felt the maximum amount would be 6 months, that was the reason for the extension of the 6 months period.

LITTON'S MODERN SHIPYARD

Chairman PROXMIRE. I recall that when the LHA contract was awarded to Litton one of the reasons given was its new modern yard and the modular construction technique. Do you think it may have been a mistake for the Navy to have invested so heavily in a new, untested yard employing new and untested techniques?

Mr. STAATS. We hope to have some judgment on that, Mr. Chairman, when we complete our report. I think, though, that all would agree that in the beginning a mistake was made in not having one manager for both yards. There was an fast yard and a west yard and for sometime they were under separate managements which caused serious problems of coordinating between the two. They are now under one management and this seems to be working much better.

Chairman PROXMIRE. But this would not be the sole or perhaps the principal explanation for this terrific time delay and for what appears to be a very strong likelihood of an increase in costs?

Mr. STAATS. We will attempt to assess this point but my impression is that it was not the sole but a very substantial element in some of the early difficulties which they ran into.

NAVY-MARITIME ADMINISTRATION AUDIT OF LITTON

Chairman PROXMIRE. Are you familiar with the joint audit of Litton conducted by the Navy and the U.S. Maritime Administration and the interim report filed on May 10, 1972?

This report finds evidence in inefficiency, poor workmanship and low productivity throughout the Litton shipyard; is that right?

Mr. BELL. Yes, we are familiar with that.

Chairman PROXMIRE. On the basis of your investigation do you confirm that?

Mr. BELL. I think that the Navy's production audit that was made in, I think it was in, May of 1971, would also have testified to the fact those were essentially correct statements, yes, sir.

FINANCIAL CAPABILITY OF LITTON TO COMPLETE PERFORMANCE

Chairman PROXMIRE. Now we have had trouble with Grumman, we have had trouble with Lockheed, it looks as if we are likely to have trouble with Litton with respect to their financial capability to complete performance. Complete performance on its Government contract. Your reply was was that you were unable to conduct an investigation when we asked you to check into it for us to see whether Litton had the financial capability to complete the performance on its contract. Why cannot GAO conduct that kind of an inquiry?

Mr. STAATS. On the financial capability, Mr. Chairman?

Chairman PROXMIRE. Yes, sir.

Mr. STAATS. Well, I do not—I would not say that we could not do it under any conceivable circumstance. It is a very, very difficult matter for an agency such as ours to make a judgment on what the financial resources might be available from the commercial market. Also, there are other parts of the total company business which we would have to go into. Some of them are commercial type ventures where we would not have access to information unless Congress gave us specific authority, as they did in the case of the Lockheed emergency loan guaranty.

Chairman PROXMIRE. You see, here is why it seems to me we are very foolish if we do not find out about this. We may be waiting for a weapons system we need, you say this is to support Marine landing and so forth, and it is something we might very well have to have on some kind of a schedule. It is already 3 years late and perhaps later than that. We have a company here that may not be able to perform. It has filed large claims which are very likely to be disallowed, the Navy has indicated it will not grant most of them. It has cash flow problems, it has had continued difficulties with the shipyard, it seems to me Congress would be foolish to ignore the possibility that Litton may try to halt production on one or more of its programs if the Navy does not agree to give it more money. In other words, another Grumman case. Can you recommend any steps that Congress might take to probe further into a giant Government contractor's financial capability in a situation such as this? We are developing now a series of contractors whose production is vital to our defense and who may not be able to perform. What can we do to protect ourselves in this case in the future without enormous cost to the taxpayers?

Mr. STAATS. Well, of course, the first and foremost responsibility here devolves on the contracting agency. It is their responsibility to make that judgment on the financial responsibility of the company. With a large contract of this type extending over several years, I would have to agree that it is a very difficult kind of a judgment to make. I do not know that there is any good answer to your question except in the way we go about, in the government, of procuring these major systems, Mr. Chairman, because the financial problem flows from design and production problems, and without those we probably would not have, perhaps except very rarely, the kind of financial problem which is faced by Grumman and faced by Litton.

Chairman PROXMIRE. Well, that may very well be, I think it is right that our design and production problems are expecting too much of our weapons systems and causing all kinds of difficulties, including great difficulties for the contractor, but it seems to me

Congress simply cannot sit back and wait——

Mr. STAATS. I agree.

Chairman PROXMIRE [continuing]. For one of those things to explode or just say "Well, it is another half billion or billion dollars for the taxpayer." We cannot go on like this. It seems to me we ought to have some kind of constructive way of finding out the situation so we can cope with this difficulty we have had in the past and are certainly going to have, I think, with greater emphasis in the future.

Mr. STAATS. What I am suggesting is you cannot divorce the financial problem from the problems that gave rise to the financial problems which go back basically to the need for improvements in the whole manner in which we acquire these systems, and that is what I am trying to emphasize.

We believe the Defense Department is taking some constructive steps; for example, Secretary Packard in his action issuing the procurement circular known as 5000.1, and I believe, that the Procurement Commission which will be making its report at the end of this month will have some very good recommendations to make.

Chairman PROXMIRE. All that is true but if the General Accounting Office, which is the accounting, auditing arm, the watchdog of Congress spending, cannot recommend procedures by which we can protect the taxpayer and also provide for the weapons we need, getting them on time at reasonable cost or begin to make progress in this direction, recognizing the financial problem involved here, the financial capability of the contractor, if you cannot give us recommendations I think we are in trouble.

Would you think about this for the record and see what you can file as an alternative?

Mr. STAATS. Yes; we can do that. But I do not want the point to go by that we have made to the Congress a whole series of recommendations on ways which we think the weapons systems procurement process can be improved. We think a great deal more use can be made of prototyping, of parallel development. We think we need a lot of changes in the cost estimating procedures to be sure that the cost estimates are realistic. We made an overall report on this to the Congress in March of last year, and we have made a series of reports going back to 1968 when I appeared before the Antitrust Subcommittee, Senator Hart's subcommittee, on the subject of prototyping. We do feel that we have good capability, and have actually developed some very good recommendations.

All I am suggesting here this morning is that the financial problems usually stem from design and production problems, and the way in which the contract was originally entered into. This matter of the single package procurement, we all agree, was a colossal failure.

[The following information was subsequently supplied for the record:]

Corporate financial difficulties can result from a variety of factors. One factor in the past has been the acceptance of multi-million dollar contracts on a firm fixed-price basis for systems on which there were significant development problems to be solved, where there was concurrency in development and production, where there had been no production experience, and where performance was to occur over a period of years. Forecasting of costs under such conditions is not likely to be very accurate especially where economic conditions are also not stable.

Another factor has been that the forces of competition motivate contractors to develop and submit overly optimistic proposals as to schedule, cost, and system performance, in order to obtain business. This is most likely to occur in the case of companies who have substaintially dedicated their performance to major systems work and who face market conditions very different from those in the commercial sector. In such cases, unless the U. S. Government buys the ship or the airplane, or the missile—there is no buyer. The very complex weapon systems being bought today require large organizations. When there is a reduction in Government orders, commercial work rarely is sufficient to provide the revenues necessary to replace the lost volume. Yet, an industrial base for mobilization must be maintained.

As we have stated, the Department of Defense is taking many actions to deal with these problems, such as by requiring operational prototypes where possible and by utilizing cost-type contract until reliable forecasts of production costs are available.

Three basic and difficult questions are apparent from the foregoing. First, what constitutes an adequate production base in the industries essential for national defense? Secondly, if the nation's present capacity is greater than our need, how is an appropriate reduction to be achieved? Third, what is the most effective and economical relationship between industry and the Government that can be established?

PRODUCTION BASE

The needed size of a production base should be determined by the Department of Defense. Timely completion of such a study is essential. It is realized that these matters involve complex judgments concerning international relations and the potentials that may exist for differing types of warfare in various parts of the world.

REDUCING INDUSTRIAL CAPACITY

Were there is an over-capacity in captive defense industries, what steps can be taken? First, efforts should be, and are being made, to divert our research and productive capacity to meet domestic needs. This, of course, has certain limitations. Other alternatives for consideration include the following:

Allowing the forces of competition to weed out the less efficient, or least essential, producers.

Retaining existing producers by spreading development and production work and paying some price premiums.

Selecting the most essential producers for weapons work, and subsidizing the conversion of others to serve commercial markets.

The choice of alternatives is one of national policy that must be made at the highest levels of Government, with full consideration of the overall impact of each option on the nation's security and economy.

INDUSTRY/GOVERNMENT RELATIONS

There are several levels of industry participation with the Government in supplying Defense needs.

In the case of the Government-owned, Government-operated plants, industry simply provides raw materials, parts, and in some cases subsystems. The gun factories and aircraft production facilities of the 1940's are examples.

Next in order of industry participation are the Government-owned, contractor-operated plants (GOCO's). Our present ammunition loading plants are illustrative of this arrangement. The Government designs the munitions, contracts for production of components with industry, and contracts for the operation and management of the loading plant, customarily on a cost-plus-fixed fee basis. Here there is considerable Government "engagement" with the contractor in the operation of the plant and in approving and auditing the costs. The fee or profit, is low in relation to other types of arrangements.

There are some large production facilities (buildings and equipment) owned in whole or in part by the Government and leased by contractors or assigned to them. In these cases, the prime contractor is responsible for design and production as fully as if he were operating in his own facilities. There is only nominal involvement by the Government in these cases, but the profit rate is negotiated to reflect the extent of contractor-furnished resources.

The situation where there is the greatest industry input to providing the needs of the Government is that where the contractor owns his own facilities. Accordingly, Government "engagement" should be the least, and the profit rate should be the highest.

In all of these arrangements, however, there must be some Government interaction with the contractor, and adequate *visibility* as to *problems and progress* on complex programs, especially those involving development work. Also, various functions of contract administration, such as quality assurance, must be performed. Auditing of costs will vary with the type of contract used and the degree of competition in its award.

In summary, it seems clear that there is no single answer to the question of industry/government relationships. The structure of that relationship must be designed on an individual case basis meeting the peculiarities of each situation. In any event, cost estimating, performance testing, trade-off analyses, cost/benefit studies, and the selection of the appropriate type of contract in the circumstances—all must be improved to avoid the problems of cost overruns which have occurred in recent years.

NEED TO PROTECT PUBLIC AGAINST FINANCIALLY INCAPABLE CONTRACTORS

Chairman PROXMIRE. What I am talking about is when the design of a complex, enormously expensive, weapons system is conceived, and when the contract is executed, that Congress should have some way of protecting itself against an incapable, financially incapable, contractor, being aware of that and being able to see that the taxpayer's interests are protected.

Mr. Morris, I wonder if you could comment on this general problem. You have had a whale of a lot of experience in the Defense Department and in procurement generally.

Mr. MORRIS. Sir, I think Mr. Staats has put the question in good perspective. We have come through an era of attempting to apply fixed-price contracting to concurrent production and development, and very long periods of performance with many unknowns and perhaps unrealistic requirements, both performance and schedule. We have seen in each case that we overextended, we were overoptimistic on both sides of the negotiation. And I think that is the big reason Mr. Packard pointed to when he said we should use flexible contracting during the development stage, we should prototype wherever possible before going into fixed-price production type situations. That is the kind of policy which it now seems to us is essential where many unknowns are involved, as there have been in these programs.

Chairman PROXMIRE. One final question I would like to ask with respect to Litton, and this refers to the new appointment to the Office of Management and Budget, the Director of the Office of Management and Budget, Mr. Ash.

The head of this company, Mr. Ash, will shortly be in charge of the Federal budget and has been designated to oversee the efficiency of the Government. What would it cost the United States next year if the Government operated at 40 percent efficiency? Maybe it would be an improvement.

Representative BLACKBURN. I think that would be the case. [Laughter.]

Mr. STAATS. I think, Mr. Chairman, that the Government is doing much better than 40 percent efficient. I am not one of the detractors of the people in the Government service. It has its many critics, and

undoubtedly there are some cases where that is warranted. But studies that we have made on productivity in the Government service, I think, stand up quite well with what has occurred in the private sector. But I really would not want to go beyond that point.

GAO DOES NOT HAVE INFORMATION TO FORECAST FINANCIAL CONDITIONS OF CONTRACTORS

Before I leave this question, though, of the analysis of the financial situation of these companies, I did want to be certain that you understood what I was concerned about. We do not feel that we have the information which would enable us to forecast the total financial condition of the company over a period of 3, 4, or 5 years, which is involved in major contracts of this type—not only because we do not have access to their records legally—but also because these companies will have other resources available to them. Many of them are doing work in the commercial sector, so that just taking that by itself we do not feel, I would not want to lead you to believe, that we could do a good job of forecasting the total outlook of that company in its totality over a period of 4 or 5 years.

What we do think we have a capability of doing is to look at the way agencies are buying major systems and suggesting improvements, as we have over the last 4 or 5 years, ways in which we think those systems can be procured more reliably and more economically.

GAO ACCESS TO CONTRACTORS' COMMERCIAL RECORDS

Chairman PROXMIRE. Well, let me consider that you suggest an alternative that goes a little further than you seem to be considering. Should the GAO be given access to commercial records, should it be given access to the full records of a substantial Government contractor so it is in the position of protecting the taxpayer in these circumstances. Is that a viable alternative?

Mr. STAATS. In specific situations, yes, but as a general proposition I would like to give some thought to that and supply you my feelings on it.

Chairman PROXMIRE. All right. Do that and give us what you would think would be reasonable limitations.

[The following information was subsequently supplied for the record:]

You have cited an example of the type of situation where a defense contractor will have to close its doors or go into bankruptcy unless the Government pays an additional $500 million over and above the contract terms. Under Public Law 85-804, the contracting activity has the sole authority to determine whether relief should be granted in the kind of situation such as you have suggested. The law could be amended to provide that no extraordinary contractual relief of some minimum amount such as $10 million or more will be granted until the Comptroller General has reported to the Congress on the contractor's complete financial condition. The amended legislation should give the Comptroller General access to all the contractor's records to permit an independent evaluation of the contractor's total resources available to meet its contractual commitments.

Mr. STAATS. In certain conditions we do think it is important that we have this, for example, when we are attempting to assess how

much overhead is properly allocable. Now, the Cost Accounting Standards Board of which I am the Chairman, is dealing in this area.

Chairman PROXMIRE. How about on this specific case of capability? We just do not want to be held up by their saying:

We are going to go bankrupt or close our doors if you do not give us the additional half billion dollars for the F–14 or landing helicopter assault ships. You are not going to get your weapons systems.

Mr. STAATS. I would be happy to give that matter some thought and some additional——

Chairman PROXMIRE. I have some other questions here but I am delighted to see Mr. Blackburn here. Mr. Blackburn is not a member of the subcommittee but a member of the full committee and I am very happy he has come. He, of course, has a deep interest in all of these matters and I will be happy to yield to Mr. Blackburn.

Representative BLACKBURN. Thank you, Mr. Chairman. Of course, I am on the Banking Committee, as you know, and we had jurisdiction over this matter of the establishment of cost accounting.

Chairman PROXMIRE. Also, of the full committee.

Representative BLACKBURN. And also of the defense industry, so we are very much interested in these matters.

I want to apologize for not being here earlier; I have been out of the country for the last week or so, actually out of Washington for the past 3 weeks, and I did not know anything about this hearing until this morning, so I will be——

Chairman PROXMIRE. I am happy to see Mr. Blackburn is sitting on the Democratic side of the table, even though he is a Republican.

Representative BLACKBURN. Trying to bring balanced judgment to these matters. [Laughter].

DIFFICULTIES OF FORECASTING

Mr. Staats, as I interpret your statment here, what you are saying is that in many instances due to the complexity of the technicalities involved, that is, in building a brand new concept in a defense system, it is impossible for the contractor or the Government to know just what is going to be involved before you finally come up with the finished product. Is that not what you are saying?

Mr. STAATS. Yes; I think the point Mr. Morris is making here is really the crucial point. It does not make good sense for the Government or the contractor to enter into a fixed-price contract on a weapons system where there are still so many unknowns and so much required by way of development of capabilities, electronic system, the landing system, any one of things which are new, are new to the state of the art. It only leads to difficulty. It would be much better, as we see it, to frankly recognize that you have to go through a prototyping type and development type of contract, perhaps parallel development in some cases where two contractors are competing for a design. Once these bugs are worked out, and the capability is tested, then you can go to your fixed-price contract and you can get more competition at that point in time, because contractors will be working against a known rather than against an unknown. This is the basic point I think that we are making here today.

CHANGES IN DOD PROCUREMENT PRACTICES

Representative BLACKBURN. And based on the experience of the C–5 contract and the present experience with the F–14, and perhaps to some extent the shipbuilding experience, the Defense Department has initiated some changes in its procurement practices, has it not?

Mr. STAATS. That is correct.

Representative BLACKBURN. And these changes are designed to avoid the very problems that we are discussing here today, which we have been discussing for some time in the past.

Mr. STAATS. We would like to see them go further. We think this directive that was issued by Mr. Packard was a good step in the right direction. There are further changes which are under discussion within the Pentagon today in the form of a new directive called 5000.2, which has not yet been decided upon, but there are elements of that which we think would go further in the right direction. But it is our purpose to see if we cannot look at these individual systems to see what has gone wrong and what has gone right. I think we can learn in some cases by what has gone right just as well as we can by what has gone wrong, to then recommend to the Congress policies and to recommend them at the time when Congress still has options open to it, either by way of authorization requirements or appropriation requirements, and that is the reason that we try to gear our schedule on these systems to the February-March period so it will be there and useful to the Congress as it has to take action.

Representative BLACKBURN. So, by having that information available to the Congress in, say, February or March we can take advantage of it before we adjourn for Christmas recesses and Joint Economic Committee hearings.

Well, thank you, Mr. Chairman, thank you, Mr. Staats.

ARMY SHOULD-COST STUDIES

Chairman PROXMIRE. I have a number of other questions. First, I would like to get into the Army should-cost studies briefly. Why were only about half of the potential reductions achieved in negotiations? As I understand of the nine systems here you found that that costs would have been about $300 million but the should-cost study indicated it ought to be closer to $200 million, about a $97 million suggested saving. Only about $47 million of that was paid. What is the reason for the difference?

Mr. STAATS. As I pointed out earlier, Mr. Chairman, we are dealing here with what is a list of possible reductions developed by knowledgeable people, experts in this area, who have gone in——

Chairman PROXMIRE. These are more than just possible reductions, are they not? Is this not a should-cost as to what the whole weapons system should cost under efficient circumstances?

Mr. STAATS. That is the reason I say the term "should-cost" is misleading because it represents their analysis as to areas where reductions could be made below the contractors estimate. It should cost from their point of view in the sense that they think those reductions are possible, but they may not be realizeable for reasons which may

be perfectly valid, and that is again why we say it would be better for the people who are making these should-cost studies to know what the contractor thinks about them as they go along so that they will not be developing estimates which are unrealistic, and which they would recognize as unrealistic had they had had a rebuttal on it before——

Chairman PROXMIRE. Well now, will these findings so far prevent that? Is it not possible that the costs may go right back up to what they were before, they may rise, the should-cost study may be a good academic exercise, I think it is very good but I am asking how this can be enforced, how it can be made effective. Do you not need further continuing should-cost reviews to determine whether inefficiencies are increasing during production?

Mr. STAATS. Oh, by all means, and this has been one of the things we have been urging against for many years—this policy of so-called disengagement.

We think that the Government should interface with the contractor all through the whole design and production of these major systems.

Chairman PROXMIRE. How can they move in if the inefficiencies are identified after the contract has been awarded? What can the Army do or anyone else do about them?

Mr. STAATS. Well, if there is an incentive type contract there is a built-in incentive on the part of the contractor himself to capitalize on any suggestions, recommendations that flow from the should-cost studies even though they may not initialy be a part of the contract price.

Chairman PROXMIRE. They can still move in and make the recommended, take the recommended action.

Mr. STAATS. That is right.

Chairman PROXMIRE. And reduce the costs.

ARMY PLANS ADDITIONAL STUDIES

Why are not these applied to bigger weapons systems? They are all relatively small. They are not insignificant, they add up to about $200 or $300 million but they are not some of the bigger Army programs.

Mr. GUTMANN. I believe, sir, that some of them are quite large, and the plans that the services have underway would include some that are even larger.

Chairman PROXMIRE. Well, that is good. I hope they do. When will GAO review the Navy's and Air Force's efforts to be ready for presentation before this committee?

Mr. GUTMANN. We have two reviews underway in the Navy, and two or three in the Air Force. We would expect to have a report sometime in early spring.

Chairman PROXMIRE. All right. That again, would be very welcome and very useful.

LOCKHEED LOAN GUARANTEE: BREAKEVEN POINT

Now, let us get into the area, that critical area, of the Lockheed loan guarantee.

Your testimony indicated a current break-even point on the Lockheed Tristar at 275 as estimated by Lockheed. During the hearings on the Emergency Loan Guarantee Act, as I recall during the hearings in the Senate and, I think, the same in the House, Lockheed had estimated a break-even point between 195 and 205. On the other hand, a Defense Department study indicated a break-even point of around 390. This higher figure, 390, was supported by aerospace executives from other companies and most recently, in a paper from Professor Reinhardt of Princeton. Now, this break-even point is very, very vital because, as you say, the loan guarantee may be paid back even though they do not reach the break-even point. However, the company is likely to be in serious trouble if they do not reach the break-even point and if they fall short of it, substantially short of it, we will have the same problem we have now, does the Federal Government step in and guarantee again, does it provide more funds under the defense contract? Does it go all out to save this very important contractor? What validity do you place on the Lockheed current estimate of 275?

Mr. STAATS. Mr. Chairman, if I may, I would like to ask Mr. Stolarow, who is the head of our regional office in Los Angeles, who has been working very extensively in this area, if he would care to comment.

Mr. STOLAROW. Mr. Chairman, the estimate of break-even points on aircraft systems such as this suffer from the same problems as we have been talking about in major weapons systems and that is predictions in advance of what the costs will be. Concerning our reliance on the current estimates, we have worked closely with Lockheed and with their public accounting firm in looking at how they arrive at their estimates and what kind of input they utilize. We think that within the bounds of reasonable estimating they are doing as good a job as can be expected, and that at the current time that the estimate is as good as——

Chairman PROXMIRE. Here is what troubles me about this estimate. As I understand it, there are two competitors here McDonnell-Douglas with their DC–10 and the L–1011. The DC–10 is a fine plane and so is the 1011. The estimates that Lockheed has, I may be wrong, are based upon the projection of a 10 percent growth of air traffic over the next few years and we have not had that. It seems to me it would be astonishing if we had that much of a growth. It is a very, very optimistic assumption, is it not?

Mr. STOLAROW. I believe it is not only Lockheed's estimate but various Government agencies that project a 10 to 13 percent growth in airline traffic for the future.

Chairman PROXMIRE. Is that not beyond our experience by quite a bit?

Mr. STOLAROW. No, sir, I do not believe so. I think it is beyond the experience of the last several years when we have had an economic recession.

Chairman PROXMIRE. All right, is it not about 5 percent on the basis of the last 10 or 12 years?

Mr. STOLAROW. I am not exactly sure about that figure.

Chairman PROXMIRE. My understanding is 10 percent is about

twice as great as we have had in the past and we might get, we all hope we will get, that kind of expansion.

Mr. STOLAROW. Some of that growth is in overseas traffic which has been growing at a faster rate than domestic traffic.

Chairman PROXMIRE. Of course, if we get a supersonic transport that will cut into the market, too, will it not?

POTENTIAL LOCKHEED LOSSES

How much money will Lockheed lose if they sell only the 117 planes under firm order?

Mr. STOLAROW. I think our estimate, sir, is about $60 million loss on the program if they sell the current 117 plus 67 options.

Chairman PROXMIRE. My question first, was how many if they sell only the firm orders, 117?

Mr. STOLAROW. I do not have that figure available.

Chairman PROXMIRE. It will be somewhat more, substantially more than the $60 million?

Mr. STOLAROW. Yes, sir.

Chairman PROXMIRE. $60 million if they sell all their firm orders and their options.

On the basis of your review is it reasonable to assume that there is a good possibility of Lockheed to once again be in financial trouble and seek financial assistance from the U.S. Government, further financial assistance?

Mr. STOLAROW. That is very difficult to say. As we know, a lot depends on the sales of the aircraft. The Lockheed people are fairly confident that the program will move ahead and the recent development, sales, for example, to the Japanese airline will generate substantially more sales in the future and the program will be successful but there is no way of telling.

Chairman PROXMIRE. There is no way of having assurance they will not be back asking for financial assistance?

Mr. STOLAROW. No, sir.

Mr. STAATS. There is one other factor, Mr. Chairman, that simply ought to be noted for the record: Lockheed does plan, as we understand it, to build a midrange aircraft in addition to this short-range airplane that they have. And they believe that the market for the total output will be increased substantially as a result of that. But that is a part of the picture in looking at the total market.

L–1011 COST INCREASES

Chairman PROXMIRE. By what amount has the cost of this program increased so far?

Mr. STOLAROW. Lockheed is currently estimating that on a 220 ship program, and that is what their projections are based on right now, that it may go as high as $70 million over initial estimates.

Chairman PROXMIRE. What is the reason for the cost increase?

Mr. STOLAROW. We have identified a number of reasons, what we think are a number of reasons, primarily the shutdown of the plant as a result of the Rolls Royce insolvency and of Lockheed's financial difficulties. We find that more than half of their production people were laid off at that time and actually left the area, they had to

recruit new people and in effect, there was a new start all over again. There have been some other problems also but this looks to be the major problem.

Chairman PROXMIRE. A year ago when Lockheed came before our Senate Banking Committee, they were sure that they would not have to borrow more than $150 million. In fact, there was some talk about limiting the guarantee to $150 million, and the argument was, "Well, $250 million will provide greater assurance and stability for the company, they will not use more than $150 million." Now they have increased their estimate to $220 million. Why is that?

Mr. STOLAROW. They attribute it, and I think correctly, to two factors. One, is an underestimate of the costs of the program, of the L–1011 program. There have been higher material costs, some higher labor costs, than were originally anticipated.

Chairman PROXMIRE. They should have known that more than a year ago, as recently as a year ago.

Mr. STOLAROW. No, I think during the hearings when they made those statements we were at a very low level of production, actually just working on some test and certification aircraft waiting for a resolution of their problem. Some of these things became evident when they started back into full production and the data——

Chairman PROXMIRE. In other words, the estimating was just poor.

Mr. STOLAROW. Partially. We have no way really of knowing at this time how good those initial cost estimates were.

Chairman PROXMIRE. Is it possible they will need the entire $250 million or more than the $250 million?

Mr. STOLAROW. It does not look like it at this point in time. They are delivering aircraft, they are generating cash inflow at this point in time.

Chairman PROXMIRE. Now, one of your conclusions, and the most significant one in my opinion, is that Lockheed may face financial difficulties if L–1011 sales are not increased. Why do you make this conclusion and what does it mean?

Mr. STOLAROW. Well, they have approximately a billion dollars invested in this program and unless they sell enough aircraft to recover a good portion of those costs the company can face financial problems.

Mr. STAATS. They have invested very heavily in inventory, Mr. Chairman, in order to keep their lines flowing and they have assumed that the market was going to be there. If the market does not develop then they are going to have very heavy inventory loss. I think that is what it comes down to.

Mr. STOLAROW. Yes, sir.

Chairman PROXMIRE. This whole question reverts to a previous question we asked Mr. Staats, in light of Lockheed's financial capabilities or incapabilities, do you not think it would be wise for the Federal Government to develop other suppliers than Lockheed for some of its weapons systems?

OVER-CAPACITY IN AEROSPACE INDUSTRY

Mr. STAATS. Well, I am not quite sure how I could answer your question, I am not sure whether our problem, I think, as a Nation, Mr. Chairman, is that, if anything, we have over-capacity in the

aerospace industry, and some of our problems on contracting and contract letting and cost estimating undoubtedly stem from the fact that contractors have been willing to err on the low side in their cost estimates in order to get the business.

Chairman PROXMIRE. What I am getting at is we are getting to be dependent on this one firm and because this financial guarantee, this very controversial act, passed the Senate by 1 vote, the House by 3 votes, sets an extremely dangerous precedent. We also have this extraordinary progress payment departure which you called inappropriate, and I think it is a mild term for it, we have a company which has had a consistent record of high overruns which cost the taxpayers a very great deal and, under these circumstances, should not a prudent buyer, if the government can become a prudent buyer, should it not be looking around for some other way of supplying its defense needs?

Mr. STAATS. I come back to——

Chairman PROXMIRE. Can we do it? I think you raise a good point. I do not mean by asking the question the way that we ought to look for some way of torpedoeing Lockheed, but, and you raise the point we already have overproduction in the area, it is very difficult to balance these two problems but, we do have a heavy dependence on a firm that does not seem to have the financial capability.

Mr. STAATS. I think it comes back again to the basic problem of being sure that when we make a decision to acquire a system that it is needed, that the cost estimates are realistic and that we know what we are buying before we enter into a contract.

LOCKHEED FINANCES

Chairman PROXMIRE. Let me be more specific on this. In your report you say that in August 1971, Lockheed's liabilities exceed its assets by $38.5 million. Does that mean that technically Lockheed was insolvent at that time? Its liabilities exceeded its assets by $38½ million?

Mr. STAATS. No, I do not believe so. Maybe my colleagues would want to answer. I would not reach that conclusion personally.

Chairman PROXMIRE. Well, let me ask you, does Lockheed liabilities still exceed its assets? You say they are not insolvent but when a firm's liabilities exceed its assets, that is the claims against its firm exceed the capability of the firm to meet its claims on liquidation, it is in great difficulty if not insolvent.

Mr. STAATS. Yes, not necessarily insolvent though, Mr. Chairman. It depends on many, many factors, work in process, new orders, financial lines of credit that are available to them but we can get—we do have some data, Mr. Chairman, I believe, that might bear on your questions. I am not sure we can give it to you right off.

Mr. GUTMANN. Mr. Chairman, in the report on the implementation of the Emergency Loan Guarantee Act——

Chairman PROXMIRE. Right.

Mr. GUTMANN [continuing]. This figure is excluding the L–1011 assets, Lockheed's current liabilities in August 1971, exceeded its current assets by $38.5 million.

Chairman PROXMIRE. The reason to exclude those assets is they are set aside as collateral, are they not, for the Emergency Loan Guarantee, is that right?

Mr. GUTMANN. No, that is not the reason. The entire assets of the company are collateral for the loan guarantee.

Chairman PROXMIRE. I see.

GOVERNMENT'S INTERESTS

Well, let me ask you this. You say in the report that the government's interests are adequately safeguarded. Now, what assurance is there that the collateral set aside to protect the government's interest is really worth $250 million? Has GAO done anything to determine the true value of this collateral?

Mr. GUTMANN. No, we have not. We state here the market evaluations are not readily available. It probably would be safe to say that certainly the total book value is not a fair reflection of market value. The opinion of the banks and of the Emergency Loan Guarantee Board, is that the collateral is adequate.

Chairman PROXMIRE. Of course, you do not have access to those records, that is one weakness and difficulty here.

Mr. GUTMANN. Well, we have had a lot of access to the Board's records. In fact, we have had everything that we feel that we need from the Board. We make the point of access only from the standpoint of a precedent that we would be setting if we accede to the Secretary's position.

Chairman PROXMIRE. But you have no independent knowledge of the value of that collateral?

Mr. GUTMANN. No.

Chairman PROXMIRE. You are taking Lockheed's word and the Board's word and that is it?

Mr. GUTMANN. Yes, sir.

FINANCIAL ANALYSIS OF U. E. REINHARDT

Chairman PROXMIRE. Last Friday, Mr. Staats, we gave your staff a copy of a financial analysis of the L–1011 prepared by Professor U. E. Reinhardt of Princeton University. Professor Reinhardt disagrees with the break-even estimate, with the market forecast and with the nature of Lockheed's investment. One of his major points is that none of the analyses so far have taken into account Lockheed's opportunity costs of its capital investment represented by the interests rate return it would have been able to earn if it did not get into the L–1011 program. He also questions the growth rate of 10 percent per year in airline traffic implicit in most of the market forecasts. Using what he considers a realistic rate of 5 percent growth he sees a much smaller market. His overall conclusion is that there is very little chance Lockheed can profit from this venture and a large chance that it will lose money. Will you comment on Professor Reinhardt's analysis?

Mr. STAATS. I understand a copy has been furnished our office and we would be happy to comment on it. I am afraid we cannot comment on it today.

Mr. GUTMANN. We could, Mr. Chairman, say this much, however. The professor develops a range. Again, that is a range of breakeven points, underscoring what Mr. Staats said earlier about the difficulty of estimating exactly what the costs of the new program are going to be. As I recall the range he said the break-even point is likely to be between 225 and 325 aircraft, Lockheed's aircraft estimate is right in the middle of this range that he suggests. With respect to his estimate——

Chairman PROXMIRE. I understand he says its has to be over 310, the staff informs me.

Mr. GUTMANN. Well, that is the upper limit of the range, as I read his statement. But now, with respect to his forecast of sales, we have discussed that previously here this morning and it is a very difficult thing to do. Lockheed's estimate could well be low, it could be high.

[The following information was subsequently supplied for the record by Mr. Staats and Chairman Proxmire, respectively:]

GAO COMMENTS ON PROFESSOR REINHARDT'S BREAK-EVEN ANALYSIS

Professor U. E. Reinhardt of Princeton University has authoried a paper on Break-Even Analysis for Lockheed's Tri Star, an application of financial theory. His break even analysis is an interesting theoretical exercise, which appears to assume that an industrial firm should always choose the investment opportunity with the greatest rate of return in the near term. In addition, Professor Reinhardt would add "lost investment opportunity costs" to actual production costs to determine the break-even sales figure.

In Lockheed's situation it seems that other considerations were overriding. For example, Lockheed forecast that its defense sales would decline about 40 percent in the next few years. In order to offset this estimated decline Lockheed made a decision to re-enter the commercial aircraft market, an area comparable to its major defense efforts.

By projecting discounted cash flows for production and sales income, Dr. Reinhardt attempts to show how much Lockheed lost by not investing its funds in some other way. This concept of discounted cash flows is a generally accepted method of determining return on investment and particularly for comparing *alternative* investment opportunities, but is not used for determining the break-even point for a particular investment decision. The break-even concept is an accounting device to estimate at what point expected costs will have been recovered.

Professor Reinhardt also questions the validity of the estimated air traffic growth of about 10 percent during the decade of the 1970's that was used as a basis for Lockheed's sales forecast. He believes a more realistic rate would be 5 percent per annum.

We examined the forecasts of airline traffic during the decade by various interested government agencies, aircraft manufacturers and industry association and found them to generally agree with the 10 percent per annum estimate of growth. The professor apparently places a much greater significance in the low rate of growth that occurred in the past 2 years. Most of the forecasters generally considered this recent experience as a temporary situation and not a basis to forecast future growth.

In addition, in view of the similarity in magnitude of investment, annual sales volume and estimated market it is likely that some or all of the other wide bodied passenger aircraft, DC–10, 747 and A–300B, if analyzed in the same manner would show similar results. It appears that other considerations beyond maximizing return on investment in the near term were important factors in the decisions to enter the market.

Finally, a significant portion of the funds used to finance development of the L–1011 were obtained from banks, customers deposits, and deferred payments to suppliers. It would seem unlikely that funds from these sources would be available to Lockheed to take advantage of alternative investments, e.g., financial securities. Thus, we do not believe it is appropriate to consider alternate investments of the total funds invested in the L–1011 program, since they would not necessarily be available to Lockheed for any other purpose.

REPLY BY U. E. REINHARDT, PH.D., TO A COMMENT BY THE COMPTROLLER GENERAL ON A BREAK-EVEN ANALYSIS FOR LOCKHEED'S TRI-STAR: AN APPLICATION OF FINANCIAL THEORY

I have read the Comptroller General's review of my paper on "A Break-Even Analysis for Lockheed's Tri-Star: An Application of Financial Theory" with great care and am at once surprised and dismayed to find reflected in that review an apparent lack of understanding of even the more basic principles of corporation finance. My paper could conceivably have been attacked, not without some legitimacy, on a number of points, to wit: the reliability of the raw data I had to use; my assumptions about the timing of the research and development costs;[1] my assumptions about learning coefficients or rates of production, and so forth.[2] But of all conceivable targets of criticism, the GAO chose to concentrate its attack on the one target that should, by now, be above criticism among enlightened analysts: the inherent soundness of the technique of "capital budgeting."

In connection with the use of "discounted cash flow" the GAO offers the following comment:

". . . This concept of discounted cash flow is a generally accepted method of determining return on investment and particularly for comparing *alternative* investment opportunities, but is not used for determining the break-even point for a particular investment decision. *The break-even concept is an accounting device to estimate at what point expected costs will have been recovered.* (Italics added)"

I have no quarrel with the notion that the break-even concept is "a device to estimate at what point expected costs will have been recovered," *as long as "costs" have been properly defined and measured.* The entire thrust of my essay is that in connection with an investment project a proper definition of costs recognizes the fact that corporate funds are not a free commodity, that is, that they involve costs that are either out-of-pocket (e.g., interest on bonds) or costs generally known as "opportunity costs." (i.e., the returns that could have been earned with funds elsewhere). This is by now a well-known proposition among both theoreticians and the more successful practitioners of corporation finance,[3] the GAO's assertion to the contrary notwithstanding.

To illustrate more forcefully the need for discounting, let us suppose that a person invests $10,000 in a 5-year project and that by the end of the project's uselife the revenue from the project has just barely covered the initial outlay of $10,000. Since the person could have deposited the funds in a bank at an annual compound rate of at least 4 percent for 5 years, that person can surely *not* be said to have "broken even" on the project. In fact, the person has suffered a loss equal to the total interest he could have earned on the funds committed to the project.

It does not take a great deal of analytic skill to graft the principle just illustrated onto the corporation, a legal person in its own right. Indeed, it is precisely this very sound principle that underlies the discounted-cash-flow technique, otherwise known as "capital budgeting." It is a technique that is widely known and used among the more progressive segments of the business community, and has been so used ever since Joel Dean's path-breaking effort to popularize the technique. It is true that some business firms or analysts still evaluate investment projects on such generally discredited criteria as the simple "payback" rule, the so-called "accounting rate of return" or *"break-even points" that exclude capital costs from the definition of costs.* I am surprised, however, to find the GAO among these old-fashioned analysts.

I also take issue with the GAO's assertion that Lockheed could not have procured from private sources investible funds "to take advantage of alternative investments." If my paper is read with any care at all, it will be noted that I thought these "alternative investments" to include not only financial securities,

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[1] The R. & D. phase of a new aircraft, for example, typically generates a cash-flow profile that looks somewhat like a symmetric beta-distribution.

[2] It may be doubted, however, that such criticisms would vitiate the general conclusions from my analysis.

[3] It may be worth pointing out that the Office of Management and the Budget also recognizes the principle of "opportunity costs of investible funds" by insisting that the cash flows associated with projects such as the space shuttle be discontinued at 10 percent. And that 10 percent discount rate was incorporated into each and every break-even analysis performed on the space shuttle.

but primarily business lines other than aero-space products. In fact, I make reference to diversification [through merger] into other product lines, and mention financial securities only as a limiting case. Can a private American corporation obtain funds in the private capital market for profitable diversification into business lines other than its established ones? I should have thought so, and I should have thought that the Comptroller General might agree. Such capital, at any rate, seems to have been readily available to this nation's large conglomerates—ITT, Northwest Industries, U.S. Industries, and Gulf and Western, to mention but a few. It might, in fact, be useful for Lockheed to imitate some of these conglomerates, at least to some extent. Perhaps there would then be less of a need for aid from the public sector.

There is, then, another basic principle of finance that bears repeating here: *in general, a corporation will not find it difficult to raise money in the private capital market so long as its proposed investment projects offer a reasonable prospect for profit, and so long as the capital market has faith in the corporation's management.* This principle will be recognized as one of the pillars of American capitalism. Again, I am mildly surprised that the GAO finds itself in disagreement with this fundamental precept of corporation finance.

The GAO goes on to suggest that if my analysis were applied to similar investment projects of Lockheed's competitors—e.g., the DC–10, the 747, and the A–300B—it would yield similarly dismal conclusions. I have two comments to offer in response to that proposition:

1. In view of the fact that neither McDonnell-Douglas nor Boeing have come before Congress to ask for public assistance—however indirect—the GAO's point in this regard may not be entirely relevant.

2. But even if one deemed the GAO's point to be relevant to the case at hand, it is clear that the profit potential of, say, the DC–10 is not independent of the absence or presence of the L–1011. In fact, if the public sector had seen its way to guarantee the financing of yet another airbus—perhaps one that might have been proposed by General Dynamics—then the profit picture of the competing airbuses would have been bleaker still. Thus it might just be the case that, on my analysis, the profit picture of the DC–10 would be bleak precisely *because* the public sector had arbitrarily sustained a rival aircraft.

The crucial question, it seems to me (and one I raise near the end of my paper) is whether it was, indeed, in the public interest to have the government guarantee the survival of two virtually identical aircraft at high average costs (and at the prospect of losses for both) when the alternative was to make do with only one of these aircraft produced, however, at lower average costs and perhaps on a basis profitable enough to sustain even the capital budgeting analysis I propose. The GAO does not address itself to that question at all.

I make no strong defense of my argument that the *long run* average annual growth rate in air traffic may be only as low as 5 percent. Indeed, a careful reading of my paper will reveal that I accept, for purposes of my discussion, the postulated 10 percent rate. The point is that even under that assumption the Tri-Star does not escape the appearance of a dubious project. Precisely what traffic growth will actually obtain in the future is an open question. It depends, for one, on the level of air fares charged by the airlines and on the so-called elasticity of demand for air travel. These are as yet matters of some uncertainty. At this stage any argument over future air traffic may even be somewhat beside the point for one simply does not perceive the large benefits (in terms of sales) Lockheed seems to expect from the alleged, high growth rate in air traffic. It is possible, after all, that Lockheed vastly overestimated its share of the supposedly favorable market for air buses.[4]

The one encouraging sign in the GAO analysis is the hint, however vague and undeveloped, that in this case "other considerations were overriding;" other, that is, than the profitability of the Tri-Star as such. Unfortunately the GAO does not take this theme any further (as it should have) and I shall therefore do so on the GAO's behalf. In all fairness, I do have to concede that there may be instances in which a corporation should undertake an investment project that is, by itself, unprofitable *if* that project serves as a first link in a longer range investment strategy and *if* that long run strategy is expected to be profitable overall. Although such investments are clearly long shots of considerable risk, a finan-

[4] It is illuminating, for example, to compare the number of major airlines that have committed themselves to the DC–10 with the number of major airlines that have opted for the L–1011 so far. The relative magnitude of these numbers may be indicative of the relative number of follow-on orders.

cially strong corporation might nevertheless be advised to undertake them. Whether it is an appropriate strategy for a financially weak company—such as Lockheed—is another matter entirely. I think it could at least be argued that a high risk strategy of this sort was not Lockheed's best option in 1968. The financial markets seem to agree.

It seems to be part of our folklore that propositions offered by a theoretician can obviously not hold in practice. The GAO critique of what it calls my "theoretical exercise" appears to be rooted in that folklore. It may therefore be pertinent to mention that my paper has been read by a number of distinguished practitioners in the aerospace industry who, while not accepting every one of my assumptions, nevertheless confirm that their own analysis of the Tri-Star project leads to conclusions strikingly similar to mine. Furthermore, my faith in the collective wisdom of the American capital market suggests, to me at least, that Lockheed's own optimistic analysis of the Tri-Star does not exactly find support in the commercial banks' refusal to finance the project without a federal loan guarantee or, for that matter, in Lockheed's appearing, hat in hand so to speak, before Congress and the American people.

Chairman PROXMIRE. Before I yield to Representative Blackburn again, let me just ask you a couple of more quick questions, first of all, Lockheed may seek public financing of an additional $70 to 100 million to finance a long-range version of the L–1011. I think you mentioned the L–1011 possibility. If this is done do you think the SEC registration material should include a reference to your report and Lockheed's potential future financial difficulties?

Mr. STAATS. Well, I have no idea of what they would do. I do not speculate on that but we would certainly feel that our report is relevant to any prospectus of this type. Particularly since we have had access to the company's records and to the public accounting firm, which has been doing Lockheed's work, and we believe that our report would certainly be relevant.

Chairman PROXMIRE. Then, will you promptly notify this committee and the Banking Committees if you have any further difficulties in examining the records of the Emergency Loan Guarantee Board?

Mr. STAATS. I certainly will.

Chairman PROXMIRE. I might put in the record, and I apologize again, Representative Blackburn, this statement by Mr. Reinhardt because it is so appropriate, we have referred to it so often here, and read one paragraph. He says:

> But even if one accepts, for the sake of argument, an assumed growth rate in air traffic of ten percent per annum, it is clear that Lockheed expected to sell only between 270 and 310 of the 775 aircrcaft required under those traffic conditions. In figures five and six, the range of points encompassed by this forecast is shown. * * *

This set of figures also lies substantially below the 800 million—5 percent break-even frontier as would, in all probability, the entire hand of demand schedules passing through area F. In other words, one may doubt that there existed in 1968 a feasible price-sales combination for the Tristar at which the program could have been expected to generate positive net present value, even if one projected nonrecurring costs of only 800, a cost of capital rate of only 5 percent and an annual traffic growth as high as 10 percent per year. The argument holds a fortiori, for cost of capital rates of 10 or 15 percent and/or for nonrecurring costs of $1 billion.

So this is a very careful analysis, and Professor Reinhardt, even providing the very optimistic assumptions, he says there is a very

considerable question that Lockheed can come out on this and, therefore, may be back asking for further government bailout.

Mr. STAATS. Mr. Chairman, I think it is important that we make it clear here that two different considerations are involved. One is whether the government will be repaid for the——

Chairman PROXMIRE. Yes indeed, that is right, I am glad you emphasized that because I did say that at one point because I am sure the government can be repaid for the government loan guarantee, that is correct, I agree with that.

Mr. STAATS. We are quite comfortable in the conclusion in our report which says that we do think that the government's interests with respect to the loan guarantee are protected.

Chairman PROXMIRE. Although you do not have an independent estimate of this $250 million, rather of the collateral, the value of the collateral?

Mr. STAATS. No.

Chairman PROXMIRE. Nevertheless, I accept that and I think that is a realistic conclusion.

Mr. STAATS. But our report concludes in the report where we say that on the basis of real property tax assessments and generally favorable earnings of the subsidiaries which in the 3-year average are $23.8 million after taxes and after an extraordinary loss of about $30 million, we believe the government's interests are being adequately safeguarded. So we see this as one piece of it.

You have also been addressing yourself to a situation that even though the government guarantee is repaid what happens if Lockheed, as a corporation, becomes insolvent because the market for this plane does not develop or for other reasons.

Chairman PROXMIRE. Right.

Mr. STAATS. That, it seems to me, is a separable issue. And this is going to depend a great deal on the growth in the market for aircraft.

Chairman PROXMIRE. Yes; but that separate issue is key, it is central, it is vital, because it brings us right back to the production of the defense weapons systems that they are responsible for producing.

Mr. STAATS. That is correct. I just wanted to be sure we were differentiating between these two kinds of judgments that have to be made.

Chairman PROXMIRE. Yes, sir.

Representative Blackburn.

Representative BLACKBURN. Thank you, Mr. Chairman.

Mr. Staats, do you have confidence in your staff, in their judgment?

Mr. STAATS. Well, I think so.

Representative BLACKBURN. You would not keep them on your staff if you thought their judgment was subject to serious question, would you?

Mr. STAATS. Well, not if I knew about it.

Representative BLACKBURN. Well, if a man named Reinhardt says your conclusions are all crazy, are you going to fire them all tomorrow?

Mr. STAATS. I would like to see his analysis. I personally have not seen it at all. Our staff received this, as you know, Mr. Blackburn,

only, I believe on Friday. They looked at it over the weekend but I have not personally seen it at all.

Representative BLACKBURN. Is it not fair to say that many of these conclusions that have been advanced here are basically business judgments, and judgments may later prove to be right, or they may later prove to be wrong; but the management of Lockheed had to make certain management judgments as to the prospective market for these airplanes and make plans based on those judgments, did they not?

Mr. STAATS. That is right. I think we are really making a judgment, I say we, the Government, in its analysis, and the company in its contractual relations on whether or not the market is going to develop, how much of this total market they are going to get as against what Douglas will get and whether they will be able to keep their costs down, so that they will maintain this break-even point in the range of 265 to 275. We cannot tell you, and I do not believe that Lockheed would contend that they can be absolutely certain that that market is going to develop, but they have made, as you say, they have made their judgment based on that kind of a forecast. They are a long ways between 167 and 275, I would certainly accept that.

Representative BLACKBURN. But in my own opinion, I think it is grossly unfair for Congressmen and Senators after the fact, to make extremely critical observations about what had to be essentially business judgments, and that is what we are dealing with, business judgments. When other people who have never had to make projections and take action based on those judgments, but are content to just criticize, I wonder what they are trying to accomplish.

Now, the question has been raised as to how much increase in passenger traffic is expected. The figures I have heard are that we will probably have between 12 and 13 percent traffic increase. Now, we had an actual lessening of that increase in the last year or so due to an economic slow down, did we not, but that is not the norm for a time of economic expansion, is it? Do you know those figures? These are not Lockheed's figures that they have dreamed up. They are basing their projections on estimates from the Department of Commerce, perhaps the FAA, CAB, and all of these agencies that are involved in the business of making such projections, is that not true?

Mr. STAATS. We, in our report, Mr. Blackburn, made an effort to obtain the projections of all the aircraft manufacturers, Commerce Department, and the Air Transport Association. That is the way we arrived at our conclusion that there are still—in the prepared statement today, we say "Our review of available forecasts of the worldwide demand for wide-bodied jet aircraft of the L–1011 and the DC–10 type through 1980 indicates that less than 40 percent of the demand has been thus far satisfied in the form of either orders or options received by the two manufacturers of the aircraft, and the practice in the past has been that orders are placed 2 or 3 years in advance," so we would make the forecasts on a 2 or 3 year period of time. That is the basis of our forecast on the figure we have arrived at. We have no independent expertise in this area ourselves, we would not claim it to be. But what we did was to try to get the best judgment we could from all the manufacturers, the Government and the Air Transport Association.

Representative BLACKBURN. Well, certainly using the data available to you which, I assume, is the same data available to Lockheed, you have no reason to suspect that Lockheed's judgment is grossly poor or inadequate, have you?

Mr. STAATS. No.

Representative BLACKBURN. As I read your report——

Mr. STAATS. I have no basis for making that——

Representative BLACKBURN. You essentially agree with their judgment to this point so far as projections of the L–1011 needs?

Mr. STAATS. We think the potential market is there, yes.

Representative BLACKBURN. Now the statement has been made that Lockheed is insolvent. If I recall my law studies, the definition of insolvency for a going concern is its inability to meet current debts as they arise. Now, is that no longer the definition of bankruptcy or is that something new for the Joint Economic Committee?

Mr. STAATS. I will have to defer to my lawyer colleague.

Mr. KELLER. I would agree with you, Mr. Blackburn, that your definition is correct. The question of whether a firm is solvent or not depends on its ability to pay its debts, its cash flow, its ongoing work and various other things, not just assets and liabilities at a particular time.

Representative BLACKBURN. If we applied that test of insolvency, that is, assets versus liabilities, to every American business concern and every American citizen the bankruptcy courts would not be big enough to handle the business, would they?

Mr. KELLER. There are times when I could not meet the test.

Representative BLACKBURN. There are times when I cannot meet the test, and I run into it quite often, and I expect there are a lot of people in the House and Senate who cannot meet that test at all and they would be somewhat chagrined to find out they have been defined by the Joint Economic Committee to now be bankrupt.

Let us get into another question here. When we evaluate the assets of a going concern those evaluations would be considerably different if there were a distressed sale of bankrupt assets, would that not be true?

Mr. STAATS. I think that would be correct.

Representative BLACKBURN. So when you consider the inventory of parts that have been built up for the L–1011, let us say, those parts have a very high value if they can be incorporated into a completed aircraft and sold, but if those parts are reduced to scrap metal, aluminum or what have you, and melted down for plastic toys or whatever else might be the case, the value will be reduced immediately to a very small fraction of what the value is now on the books of the company, is that not true?

Mr. STAATS. That would be correct.

Representative BLACKBURN. So one of the best ways to insure that Lockheed assets were reduced to a small fraction of their current value would be for Congress to take some precipitate action to force them into bankruptcy, is that not true?

Mr. STAATS. I do not know of any action that is designed to do that. I do think that at the time the Loan Guarantee Act was enacted this was of great concern, as you are well aware.

Representative BLACKBURN. And one of the considerations that many of us have in support of that loan was the loss to the Government, loss in taxes, in loss of jobs. Incidentally, we have heard a great deal in the last year from this committee about people who do not have jobs; it is one of the favorite themes that emanate from one of the microphones every time we have a hearing. Many of us in support of the loan were concerned there would be an awful lot of American skilled, very skilled workmen that would be out of employment completely if Lockheed were to fail and, frankly, it disturbs me that a forum of this sort could be used perhaps to create the impression that Lockheed, one of the biggest and most successful manufacturers in this country, is insolvent.

You do not conclude that Lockheed is insolvent, do you, under the current definitions and legal definitions of insolvency?

Mr. STAATS. I made that statement a few minutes ago, Mr. Blackburn, in response to the chairman's question.

Representative BLACKBURN. I just wanted to make sure I had not misunderstood something somewhere.

Then, I think it is fair to conclude then from your statement as well as the questions that have been asked here that based on the best judgments that you have available Lockhead is not an insolvent firm. It's ill, in all probability, and we understand that there could be major catastrophies and nobody would pay their debts, but under the best judgments that we have available at the present time, Lockheed will be able to repay the loan the Congress guaranteed and probably will be able to fulfill its defense contracts?

Mr. STAATS. Well, again our report, which was made to the Congress on December 6, about 2 weeks ago, reached the conclusion which I have just read into the record a minute ago, that this relates, we want to make certain you understand, to the judgment that Lockheed will be able to repay its loan guarantee. It is generating cash flow of such a nature, now that deliveries are being made, that this seems to be without question.

I think the longer term issue is whether or not Lockheed will be able to break even on its L–1011 program, and this is going to depend principally upon the growth of the market, how much of that market Lockheed gets as against the DC–10, and whether Lockheed will be able to keep its costs in line. That is a different question.

If you want to add a third dimension to it you have the question of whether or not Lockheed, as a corporation, with its total business from all of its contracts, all of its subsidiaries, will be able to continue to be able to meet its defense commitments. I think that is again something which has to be kept a separate question. They are in a profitable position, as you know, with respect to their other subsidiaries in their total. So that we can only hope and assume that that will be the case, but no one can be a hundred percent certain.

Representative BLACKBURN. I see my time has expired but I would like to perhaps even make this observation and then ask this question. If the major airline companies in the world who are the potential customers for the L–1011 were to conclude as a result of some of the statements made in this hearing in the form of questions or otherwise that Lockheed may not be able to survive until 1980 or

even for the next 2 or 3 years and keep the contracts that it now has, what is going to be the impact on Lockheed's ability to go out and sell airplanes?

Mr. STAATS. I do not really have any response to your question, Mr. Blackburn. I suppose it would be a matter of opinion.

Representative BLACKBURN. Do you not think it would tend to injure their capability of selling airplanes? I certainly, if I were in the market for wide-bodied short-range aircraft today, and I were going to be required as a potential purchaser to pay down several millions of dollars at the time I signed the contract, do you not think as a matter of good business judgment I might be deterred somewhat from signing that contract and paying the money down if I had any doubt at all about Lockheed's ability to perform?

Mr. STAATS. I did not understand the chairman to state this as his opinion. I understood him to raise it to me as a witness to question what my view was on the matter.

Representative BLACKBURN. I understand but I think you understand the point I am making here.

Mr. STAATS. Yes; I do.

Representative BLACKBURN. If the major potential purchasers of aircraft should conclude by perhaps some intemperate statements that this major supplier was in such financial dire straits, in fact they have been asked are they not insolvent because their assets do not meet their liabilities, that can bring about the very problem we are trying to avoid, that is, creating more serious problems for this major defense and civilian contractor.

I have no further questions, Mr. Chairman.

Chairman PROXMIRE. May I say, Mr. Staats, that any time the Senate or the House or the Congress decide that they will not get into a matter of this great importance for the taxpayers and for the defense of our country because they are afraid it might have an adverse effect on the market of the stock of that concern or even the existence of the concern, it seems to me it is a very sorry day.

It would seem to me this is a matter that should be made public. Certainly, potential stockholders and potential lenders to the Lockheed Corp. ought to know about it and they ought to know the opinions of the General Accounting Office, Lockheed's financial capability ought to be discussed and debated as freely and fully as possible. I am convinced that will be in the long-term interests of everyone involved. Perhaps it may have an adverse effect on this concern but I think that adverse effect is their fault, not the fact that it is being disclosed.

C–5 PROGRESS PAYMENTS

Now, let me get into the progress payments problem here because I think that is another very vital area and I do have a few questions and I apologize for the lateness of the hour. We are going to go ahead for another short while and then when we finish with you, Mr. Staats, we are going to ask Mr. Kitchen and Mr. Durham to come back in the afternoon.

In its comments to GAO the Air Force says that at the time the progress payments were made it was not able to conclude that Lock-

heed "would have sustained a significant loss on its performance." Is the Air Force saying that it did not know for sure that there were cost overruns on delivered work? Is that what they are saying? Let me repeat that question, Mr. Gutmann.

Mr. GUTMANN. Yes, please.

Chairman PROXMIRE. In its comment to GAO the Air Force says that at the time the progress payments were made it was not able to conclude that Lockheed "would have sustained a significant loss on its performance," and I am asking does this mean that the Air Force is saying it did not know for sure that there were cost overruns on delivered work?

Mr. GUTMANN. Yes; I think that is correct.

We have to modify that a little bit. If you qualify it in reference to cost overruns on delivered work there probably were cost overruns on delivered work. I think the Air Force is saying that they were not able to conclude at that time that the total costs would ultimatly exceed the ceiling price of the contract for all items.

LOOPHOLE USED

Chairman PROXMIRE. Let me ask further, I note in Lockheed's comments to GAO it says that the progress payments loophole was used because "specific cost data for each unit on this program would not be readily available from Lockheed's accounting system." Does this mean that Lockheed was not able to allocate actual costs to completed and delivered items while work was still in progress on other items?

Mr. GUTMANN. I think that is probably a true statement, Mr. Chairman. It is very difficult in a large program to allocate costs as between delivered work and undelivered work. It is a difficult problem.

Chairman PROXMIRE. Well, in fact though, did not the C–5 contract require Lockheed to report its actual costs monthly in the cost status analysis report, I should say, the CSAR?

Mr. GUTMANN. Yes.

Chairman PROXMIRE. Was it not possible for the Air Force and Lockheed to discover that there were cost overruns on delivered items by looking at the cost status analysis report?

Mr. GUTMANN. It should have been possible and I believe that is the report that ultimately disclosed to the Air Force their problem.

Chairman PROXMIRE. Then, does it not follow that both Lockheed and the Air Force knew progress payments were being made for cost overruns on completed and delivered work? Despite what Lockheed says about its accounting system, would they not have had to know from the SAR's?

Mr. GUTMANN. Well, the SAR's should have told them but I really should not speak to what the Air Force knew at the time, if that is your question.

Chairman PROXMIRE. Well, should they not look at them? What are they for, should they not have looked at them?

Mr. GUTMANN. Yes.

Chairman PROXMIRE. Should they not have been aware of it?

Mr. GUTMANN. Yes.

Chairman PROXMIRE. And if they looked at them would they not know?

Mr. GUTMANN. They should have, yes, sir.

Chairman PROXMIRE. Why is it not clear that they should have known?

Mr. GUTMANN. Well——

Chairman PROXMIRE. It is, they should have known, is that right?

Mr. GUTMANN. Well, I have agreed they should have known. I thought your question was did the Air Force know?

Chairman PROXMIRE. Well, what you are saying is that they should have known but they may not have. They may have neglected the SAR's.

Mr. GUTMANN. Yes, sir, that is possible.

Chairman PROXMIRE. Well, I wonder. And the reason for the payments, does it not seem that the Air Force knew it was going to increase the price anyway so why not pay for the overrun? Is this not sort of what the Air Force says in its comments to GAO?

Mr. GUTMANN. Yes; there came a point, as you know, in the history of the program when it was pretty clear after further analysis by the Department of Defense that the aircraft were needed and they were going to have to pay a higher price for them than was originally contemplated.

Chairman PROXMIRE. Does it not seem clear from the comments made by the Air Force and Lockheed to GAO that at the time the overpayments were being made it was agreed that they would be absorbed in whatever later action was taken?

Mr. GUTMANN. Yes, sir.

BAILOUT LAW

Chairman PROXMIRE. Now, you discussed the action taken by the Pentagon to bail Lockheed out of its financial problems in last year's GAO report, "Financial Capability of Lockheed Aircraft Corp. To Produce C–5A Aircraft." There is a section on Public Law 85–804, governing bailouts, in that report. The law states that the Pentagon can change contracts and otherwise come to the aid of its contractors, with or without consideration from the contractors, so long as it is deemed in the interests of national security, is that correct?

Mr. GUTMANN. Yes, sir.

Chairman PROXMIRE. Does not the law also say that it shall not be used for "the formalization of an informal agreement?"

Mr. KELLER. I believe it does but I also believe, Mr. Chairman, that the language refers to an initial informal arrangement to produce something followed later by the formalization of a contract, but I do not have the law about that.

Chairman PROXMIRE. Do you have any cases on that?

Mr. KELLER. I will look them up and submit them for the record, Mr. Chairman.

Chairman PROXMIRE. Will you do that?

[The following information was subsequently supplied for the record:]

There have not been any cases where we have interpreted the language concerning the formalization of an informal commitment under the act by an au-

thorized Government agency. The legislative history indicates that the act was intended to prohibit the validation of an informal purchase commitment except where it was impracticable to utilize normal procurement procedures. See House Report No. 2232, 85th Congress, pages 4 and 5; see Senate Report No. 2281, 85th Congress, page 4.

Chairman PROXMIRE. Is it possible that the Air Force and Lockheed had reached an informal agreement to allow Lockheed to retain the excess progress payments before the contract was restructured and made into a cost reimbursement agreement?

Mr. KELLER. I cannot really answer that at this point. I will submit it for the record.

Chairman PROXMIRE. Will you submit your opinion on that?

Mr. KELLER. Yes, sir.

[The following information was subsequently supplied for the record:]

The import of your question is that since the C-5A contract with Lockheed was restructured under authority of Public Law 85-804, would the prohibition in the law 50 U.C.S. 1432(f), against formalization of informal commitments apply to a preexisting informal agreement between Lockheed and the Air Force to retain progress payments.

We did not find evidence of an informal agreement concerning progress payments. However, even if we had found such an agreement its formalization would not have been prohibited by Public Law 85-804 because the law applies to purchase type transactions and then only if a finding cannot be made that it was impracticable to use normal procurement procedures. An agreement relating to the retention of progress payments does not constitute a purchase type transaction; therefore, Public Law 85-804 would not be applicable.

CONGRESS NOT TOLD ABOUT EXCESS PROGRESS PAYMENTS

Chairman PROXMIRE. On the matter of information getting to Congress about excess progress payments such as in this case, do you believe the facts were intentionally concealed from Congress or was there some other reason for not telling us?

Mr. STAATS. You are speaking about the progress payments?

Chairman PROXMIRE. Yes, sir. These excess progress payments, why were we not told about it?

Mr. STAATS. I do not think there was any concealment. I think it just goes to the fact they were using a method which was best from their point of view and still permissible under the regulations.

Chairman PROXMIRE. I understand DCAA wrote its report in 1970.

Mr. STAATS. In December of 1970.

Chairman PROXMIRE. We did not find out about it until this year, Congress did not find out about it until this year.

Mr. STAATS. That is true. But I do not think, I would not construe that necessarily as concealment. They may have been too slow in acting on the DCAA report, that is quite possible.

Chairman PROXMIRE. Why does it take 2 years for a report of this great importance to come to the attention of appropriate congressional committees?

Mr. STAATS. Well, it was in December of 1970, I believe, was the date of the report.

Chairman PROXMIRE. Well, less than 2 years. As I understand it was only because of your investigation that we found out that it took 2 years.

Mr. STAATS. That is correct.

Chairman PROXMIRE. We should not have to have to require a GAO investigation to get this kind of information.

EXCESS PAYMENTS MAY CREATE INCENTIVE TO BAIL OUT CONTRACTOR

Is it not possible that by building up such an enormous amount of excess progress payments in Lockheed's possession that the Air Force may have felt locked in with the Lockheed Corp., and when informed that Lockheed wanted more cash or it would halt production that the Air Force may have felt compelled to bail Lockheed out even further? In other words, could not the excess progress payments have acted like an incentive to pour good money after bad rather than taking other steps to solve the contract problems?

Mr. STAATS. I think that is always possible, Mr. Chairman. When the Government is put in a position of trying to sustain the cash flow for a company experiencing cost overruns, the day of reckoning has to come. This is not pointed at any particular company, this is part of what has been wrong with the type of contract as represented here.

Chairman PROXMIRE. This is why we should have known, had earlier notice of this while it was building up, been informed about it in advance to see what action could have been taken.

Mr. STAATS. I agree.

Chairman PROXMIRE. It has taken 2 years.

Can you recommend any measures that Congress might take to avoid being suprised by disclosures such as this in the future? What can we do to be assured that instances of excess or inappropriate progress payments will be promptly disclosed to the Congress?

Mr. STAATS. A principal reason, Mr. Chairman, that we went to the annual report on the status on weapons systems was to keep Congress better apprised of the situation for cost growth taking place. We started this as you know, in 1969. We will have another report to the Congress in, we hope at, the end of February or early March. This is one way. The development—

Chairman PROXMIRE. But that annual report did not show the excess progress payments, it did not show the progress payments were getting out of line.

Mr. STAATS. It shows cost overruns.

Chairman PROXMIRE. It does not show the progress payments.

Mr. STAATS. I do not think you can have—under the new regulations I do not believe you could have the type of situation which developed here. I believe that is no longer——

Chairman PROXMIRE. By knocking out option (C)?

Mr. STAATS. Right.

Chairman PROXMIRE. All right.

CHARGES MADE BY HENRY DURHAM

Let me get into one final area with you this morning, Mr. Staats. Let me say, first, that as you know, I have great admiration for the

courage and determination of Mr. Henry Durham, and coming forward as he did he performed a fine public service. His charges were so serious that we asked the General Accounting Office to check them out, that was one of the reasons we got into a lot of this. This they have done, the results are that they backed up Mr. Durham's charges in numerous instances. In some others they found that the evidence was insufficient for them to judge. And a few, they found that the charges were not substantiated. But all in all, I would say this is far from being a whitewash. The results of GAO's report vindicate Mr. Durham and many of his very serious charges. He should not feel that because it was not possible for all of them to be substantiated, that the GAO was in any way lax in its duties. Far from it.

The GAO and the Comptroller General, by nature, have to act as judges. That is how they have built their tremendous reputation. Consequently, when they do state that something is true, they are believed. And rightly so.

It is my view that their report substantiates such a sufficient portion of Mr. Durham's charges that he should feel that his efforts have been vindicated in large degree. I cannot agree with Mr. Durham, after having read the GAO report that they were lax in any way or that the report is a "whitewash" of Mr. Durham's charges.

I say that while you are here, although Mr. Durham is going to appear this afternoon, because I think that you deserve that. I think you have made a fair report, a report that I am sure he would not agree with, I am sure Mr. Kitchen must disagree with part of it. At any rate, I think it has been a most helpful one. Nevertheless, there are some very difficult situations here, and I would like to ask you to respond to those.

You made an initial report, an initial report was made by the GAO, before it was a final report, a temporary report, a tentative report, which seemed to confirm, a staff report which seemed to confirm a great deal more of what Mr. Durham alleged.

For instance, this charge: C–5A airplanes were moved to the flight line with thousands of parts missing, although Lockheed's records faultily show the part had been installed. GAO finding: The charge is unquestionably true and it is a significant problem.

Charge, hearing record page 1411, exhibit 1, improper removal of parts contributed to the missing parts problem.

GAO finding: Our review confirmed that Mr. Durham's testimony was substantially accurate.

There are a whole series of charges. I think we have made those available to you and I will not read them all but I would like to get your response to the ones I have read and any others that you would like to comment on.

Mr. STAATS. Well, Mr. Chairman, I appreciate your statement, and I am sorry that it was seen fit to label our effort here as a whitewash. I do not think it is warranted at all. A large number of charges which were made and which we agreed at your request to go

into to find out whether or not they could be supported or not supported, this has been a very difficult undertaking for us. It has taken a lot of time and it has been quite an expensive project for us. But let me say this, that it would be highly unique, I would say unheard of, situation if a report prepared by staff, whether it be our regional office or Washington office, was issued in the form of a first draft any more than a first draft of a committee report of the Congress reflected any motive if it were revised before it was issued by the full committee.

A regional office does not have access to all of the facts. It has to be in the nature of a rough draft, and that is the purpose of review here, that is the purpose of our contacting the contractor, that is the purpose of our contacting the agency.

Now, the Atlanta office, which prepared a rough draft, did not have access to all the information, and it was indeed a rough draft that was made public.

The fact that it was revised after it was reviewed here and after we obtained additional data from the contractor and the Air Force should not be a surprise to anyone. This is the way we do business. We have got to be sure that we can stand behind our reports. If we could not then we would be of very little value to the Congress.

We have gone through case by case on these charges, and I have here an analysis of the specific differences where the final report we made to the Congress differed from the charges. I also have an explanation case by case of how the final report differs from the rough draft prepared by our Atlanta office.

Chairman PROXMIRE. That is exactly what I wanted. All right, will you submit that for the record?

Mr. STAATS. I would be very happy to have that put into the record.

[The following information was subsequently supplied for the record:]

Analysis of the specific differences where the final GAO report made to the Congress differed from the charges, and where the final report differed from the Atlanta staff study follow:

DURHAM CHARGES

FINAL REPORT VERSUS ATLANTA STAFF DRAFT

Question: How does the final GAO report differ from the Atlanta staff draft?

Answer: The final report deals with 21 matters raised by Mr. Durham. One of these is still under study (that dealing with over design of Aerospace Ground Equipment). On another, the Atlanta Study was not complete (unnecessary procurement of parts).

Of the 19 cases dealt with in both reports, there was full agreement on 11, partial agreement on 2, and disagreement on 6. The reasons for the disagreements were either (1) *new facts*, or (2) *different interpretation* resulting from further study at GAO headquarters.

NEW FACTS

The Atlanta Staff Draft was found to be incorrect in the following cases where new facts were developed as a result of our subsequent audit.

Item	Page No.	Comment
Subterfuge at rollout ceremony of first aircraft on Mar. 2, 1968.	10	Atlanta partially agreed that there was subterfuge. We found that the Air Force issued a press release before the ceremony stating that this aircraft would not fly until June 1968, and Lockheed had notified Air Force in writing of item shortages.
Unwarranted delay in replacement of damaged parts.	15	Atlanta agreed. While evidence was found that some parts were damaged at earlier stages before reaching the flight line, we could not establish that these defects were detected at the earlier stage. However, inspection procedures in use disclosed these parts before delivery.
Lack of effective controls over expendable tools such as drill bits, reamers, cutters.	26	Atlanta agreed. However, we found that tools were furnished to employees as needed. This is consistent with practices at 2 other aerospace firms. In addition, it is generally impractical to provide a detailed control system for items that are small and inexpensive.
Problems permitted to exist by Air Force.	35	Atlanta agreed. Further facts revealed that the Air Force was aware of, and reporting on some of the problems cited in Mr. Durham's charges—including difficulties in controlling titanium fasterners, quality control, and out of sequence work. However, it was true that the Air Force did not direct the contractor to take specific corrective action because of the philosophy of "disengagement" practices under the total procurement package.
DIFFERENT INTERPRETATION		
Lack of inventory controls over raw materials.	28	Atlanta agreed. We noted that materials such as sheet metal, aluminum, and bar steel were purchased as needed for each job order, rather than drawn from a general stock because of the small quantities of equipment manufactured at Chattanooga. In our testimony, we concluded that the method of charging material directly to a job order when received was reasonable.
Lack of inventory controls over miscellaneous small parts.	30	Atlanta agreed. We found that items such as bolts, nuts, washers, and others costing from 1 penny to a few dollars each, were procured to fill specific production orders. In our opinion, it is generally impractical to provide detailed inventory control systems for items that are small and inexpensive. In our testimony, we concluded that this method was reasonable.
Schedule maintained to collect milestone payments.	38	Atlanta appeared to agree but did not fully assess the matter. There were 3 such payments. 1 was concerned with tooling for which final payment was not made until the 1st aircraft reached position No. 3. The 2d was concerned with delivering the 1st 5 aircraft to the flight test department. The Air Force withheld $3.7 million on these aircraft due to parts shortages. The 3d was a penalty charge for late delivery of the 1st 16 aircraft (exclusive of test aircraft). The Air Force stated that the total penalty of $11 million was assessed against Lockheed in determining the $200 million fixed-loss.
Ineffective audit by Lockheed's internal auditors.	42	Atlanta partially agreed. We found that Lockheed's internal auditors were aware of many of the problems at Marietta. Their reports were given wide distribution. Generally, their audits are not announced in advance.

Chairman PROXMIRE. Because I think Mr. Durham has a very strong point, he is a man who feels very strongly about this. He should. His life has been endangered and, as I said, Federal marshalls were at his home to protect him.

Mr. STAATS. I do not question Mr. Durham's motives or sincerity at all.

Chairman PROXMIRE. He is the one responsible for a good deal of new information we have on defense contracting that I think will be immensely valuable to our country.

GAO QUARTERLY AUDIT REPORTS

Let me get into the report very quickly. The evidence of inefficiency in this operation with respect to the C–5A is simply indisputable. Congress has authorized special funds, which I call bail out money, for Lockheed totaling over $500 million and has directed GAO to make quarterly audits of the payments from this fund. I would like to ask you to submit the GAO audit reports for the record.

[The following information was subsequently supplied for the record by Mr. Staats:]

REPORT TO THE CONGRESS

Audit Of Payments From Special Fund To Lockheed Aircraft Corporation For C-5A Aircraft Program During Period Ended June 30, 1971 B-162576

Department of Defense

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

AUG. 9,1973

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

B-162578

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

This is our initial report on the audit of payments from the special fund to Lockheed Aircraft Corporation for the C-5A aircraft program during the period ended June 30, 1971. This audit was made pursuant to section 504, Public Law 91-441, which authorizes $200 million of interim funding for the C-5A aircraft program to be paid through a special bank account. The law provides that Lockheed not be reimbursed for intercompany profits, bid and proposal costs, independent research and development costs, and other unsponsored technical costs, and depreciation and amortization expenses. The law provides also that the General Accounting Office audit payments from the special bank account on a quarterly basis and submit a report to the Congress not more than 30 days after the close of each quarter.

Payments to Lockheed from the special bank account started on June 16, 1971, and totaled $20.4 million by June 30, 1971. Our review revealed no payments to Lockheed that were contrary to the provisions of Public Law 91-441. Since payments to Lockheed were made during the last 2 weeks of June 1971, we had only a limited time to make our audit. Therefore we are continuing our examination and will include further comments on the results of our audit in subsequent reports.

Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of Defense; and the Secretary of the Air Force.

Comptroller General
of the United States

Contents

ABBREVIATIONS

DCAA	Defense Contract Audit Agency

CHAPTER 1

INTRODUCTION

In March 1970 the chairman of Lockheed's board of directors notified the Deputy Secretary of Defense that the company would require additional funding, over and above the Air Force estimate of the contract ceiling price, in order to complete development and production of 81 C-5A aircraft. He also advised the Deputy Secretary of Defense that it would be financially impossible for Lockheed to complete performance on the C-5A aircraft program, as well as other major defense programs, without further financing from the Department of Defense.

The Deputy Secretary of Defense informed the Congress of the Lockheed position and requested that it provide additional funding of $200 million, over the amount requested in the regular appropriation, as an interim measure to permit Lockheed to continue development and production of the C-5A aircraft.

The Congress authorized the $200 million by Public Law 91-441, section 504, approved October 7, 1970, to continue the C-5A aircraft program. (See app. I.) Section 504 specified that:

1. All payments from the $200 million fund be made through a special bank account for reasonable and allocable direct and indirect costs incurred on the C-5A aircraft program.

2. The contractor not be reimbursed for intercompany profits; bid and proposal costs; independent research and development costs; and other similar unsponsored technical effort costs; and depreciation and amortization costs on plant, property, or equipment.

3. These excluded costs not be recoverable under any other contract.

4. All payments from the special bank account be audited by the Defense Contract Audit Agency (DCAA) and the General Accounting Office.

5. The Comptroller General report to the Congress not more than 30 days after the close of each quarter on the results of the General Accounting Office audit.

CHAPTER 2

PAYMENTS FROM THE SPECIAL BANK ACCOUNT

Payments from the $200 million fund and from the special bank account were initiated on June 16, 1971, and the amounts deposited and withdrawn through June 30, 1971, were as follows:

		Special Bank account	$200 million fund
Beginning balance		None	$200,000,000
Deposits		$21,405,511	
Withdrawals:			
Material and other charges	$13,103,466		
Intercompany transactions:			
Charges $3,094,031			
Credits -7,505,352	-4,411,321		
Labor	4,793,896		
Overhead	6,916,967	20,403,008	$ 21,405,511
Balance at June 30, 1971		$ 1,002,503	$178,594,489

Procedures established by the Air Force to control withdrawals from the special bank account require that reimbursement vouchers be submitted by Lockheed to the Air Force contracting officer for approval. The Air Force contracting officer approves these payments subject to audit by DCAA. These vouchers are supported by detailed listings of material, labor, and overhead costs incurred on the C-5A aircraft program. The following comments describe the methods used by Lockheed to support withdrawals from the bank account.

MATERIAL AND OTHER CHARGES

Material costs and other miscellaneous charges paid from the special bank account through June 30, 1971, totaled $13,103,466. Payments were supported by purchase orders, vendors' invoices, and receiving reports.

To ensure prompt payment to vendors, Lockheed has developed a weekly report that shows all vendor accounts which have not been paid within 30 days. The total amount of

accounts payable outstanding more than 30 days and applicable to the C-5A aircraft program is to be deducted from the amount of reimbursement vouchers to Lockheed. Lockheed deducted from the first voucher $1 million to cover the estimated amount of all accounts payable related to the C-5A aircraft program that may remain unpaid for 30 days or longer during the first month.

The accounts payable report for July 2, 1971, showed a total of $183,889, which represented vendor accounts payable applicable to the program over 30 days old and which indicated that the amount withheld was more than adequate.

Intercompany transactions

Most development and production work on the C-5A aircraft program is being done by the Lockheed-Georgia Company, Marietta, Georgia, and by outside vendors and subcontractors. Some costs, however, are being incurred at the following Lockheed locations.

Lockheed Aircraft Corporation, Burbank, California
Lockheed-California Company, Burbank, California
Lockheed Aircraft Service Company, Ontario, California
Lockheed Electronics Company, Plainfield, New Jersey

These other locations periodically charge costs associated with their work on the C-5A aircraft to the Lockheed-Georgia Company according to established billing procedures. Although there were charges totaling $3,094,031 from other locations of Lockheed for work on the C-5A aircraft program, they were more than offset by intercompany credits of $7,505,352. These credits represent the excess of the amount paid for delivered items plus progress payments for undelivered items, compared with the amount reimbursable under the terms of the current contract. Effective May 31, 1971, the contract between Lockheed and the Air Force for C-5A aircraft was converted from a fixed-price incentive contract to a fixed loss, cost reimbursement contract.

LABOR COSTS

Labor costs totaling $4,793,896, for 964,001 direct labor hours, were paid to Lockheed from the special bank account through June 30, 1971. These costs and hours were

charged to specific C-5A aircraft work orders. Costs for indirect labor were charged to the C-5A aircraft program through overhead allocations.

OVERHEAD EXPENSES

Overhead expenses totaling $6,916,967 were paid from the special bank account during June 1971 on the basis of provisional overhead rates previously negotiated. Actual overhead rates are to be negotiated as of December 26, 1971, the end of the company's fiscal year.

Lockheed and the Air Force negotiate provisional overhead rates for use in cost reimbursement contract billings. During negotiations of 1971 rates, concluded in March 1971, costs which were unallowable under provisions of section XV of the Armed Services Procurement Regulation were excluded in establishing the provisional overhead rates.

The provisional overhead rate also was reduced to exclude those costs which are unallowable under Public Law 91-441. Such costs amounted to about $801,000 for the period ended June 30, 1971.

DEFENSE CONTRACT AUDIT AGENCY

The audit by DCAA at the Lockheed-Georgia Company in the past generally has been directed toward reviewing accounts payable, payroll accounting systems, inventory accounting systems, etc., on a cyclical basis. Through these audits DCAA's objective is to gain insight into Lockheed's accounting processes and to determine the adequacy of the company's system of management controls.

DCAA has developed special audit procedures for reviewing Lockheed's vouchers requesting withdrawals from the fund for deposit in the special bank account and for auditing payments from the bank account.

CHAPTER 3

GENERAL ACCOUNTING OFFICE AUDIT OF PAYMENTS FROM SPECIAL BANK ACCOUNT

Our review was made at the Lockheed-Georgia Company, Marietta, Georgia; Lockheed Aircraft Corporation and Lockheed-California Company, Burbank, California; and Lockheed Aircraft Service Company, Ontario, California.

We reviewed the DCAA audit of payments from the special bank account for material costs and other charges and tested the work performed. In addition, we selected transactions shown on withdrawal vouchers and traced the amounts to such documents as purchase orders, receiving reports, vendors' invoices, and work orders, to determine the accuracy and propriety of the amounts paid. We also examined into the reasonableness and correctness of the procedures used in allocating the cost of common usage materials.

We examined costs incurred on the C-5A aircraft program by Lockheed companies in California and charged to the Georgia Company. Our review was directed at testing the accuracy and allowability of labor, material, and overhead costs incurred in intercompany billings.

Our audit of labor costs incurred by Lockheed included: (1) a review of internal procedures and controls established to ensure that labor costs were accurately distributed to contracts and other programs, (2) a review of labor audits by DCAA and Lockheed's internal auditors, and (3) tests to determine whether labor costs appeared reasonable and applicable to the C-5A aircraft program.

In our review of overhead, we examined Air Force and Lockheed procedures used in estimating and negotiating provisional overhead rates. We also examined into the reasonableness of provisional overhead rates and the costs eliminated to comply with Public Law 91-441.

Our review revealed no payments to Lockheed for the period ended June 30, 1971, that were contrary to the provisions of Public Law 91-441. Since payments to Lockheed

were made during the last 2 weeks of June 1971, we had only a limited time to make our audit. Therefore we are continuing our examination and will include further comments on the results of our audit in subsequent reports.

APPENDIX

APPENDIX I

SECTION 504

PUBLIC LAW 91-441

OCTOBER 7, 1970

SEC. 504. (a) Of the total amount authorized to be appropriated by this Act for the procurement of the C-5A aircraft, $200,000,000 of such amount may not be obligated or expended until after the expiration of 30 days from the date upon which the Secretary of Defense submits to the Committees on Armed Services of the Senate and the House of Representatives a plan for the expenditure of such $200,000,000. In no event may all or any part of such $200,000,000 be obligated or expended except in accordance with such plan.

(b) The $200,000,000 referred to in subsection (a) of this section, following the submission of a plan pursuant to such subsection, may be expended only for the reasonable and allocable direct and indirect costs incurred by the prime contractor under a contract entered into with the United States to carry out the C-5A aircraft program. No part of such amount may be used for—

(1) direct cost of any other contract or activity of the prime contractor;

(2) profit on any materials, supplies, or services which are sold or transferred between any division, subsidiary, or affiliate of the prime contractor under the common control of the prime contractor and such division, subsidiary, or affiliate;

(3) bid and proposal costs, independent research and development costs, and the cost of other similar unsponsored technical effort; or

(4) depreciation and amortization costs on property, plant, or equipment.

Any of the costs referred to in the preceding sentence which would otherwise be allocable to any work funded by such $200,000,000 may not be allocated to other portions of the C-5A aircraft contract or to any other contract with the United States, but payments to C-5A aircraft subcontractors shall not be subject to the restrictions referred to in such sentence.

(c) Any payment from such $200,000,000 shall be made to the prime contractor through a special bank account from which such contractor may withdraw funds only after a request containing a detailed justification of the amount requested has been submitted to and approved by the contracting officer for the United States. All payments made from such special bank account shall be audited by the Defense Contract Audit Agency of the Department of Defense and, on a quarterly basis, by the General Accounting Office. The Comptroller General shall submit to the Congress not more than thirty days after the close of each quarter a report on the audit for such quarter performed by the General Accounting Office pursuant to this subsection.

(d) The restrictions and controls provided for in this section with respect to the $200,000,000 referred to in subsections (a) and (b) of this section shall be in addition to such other restrictions and controls as may be prescribed by the Secretary of Defense or the Secretary of the Air Force.

REPORT TO THE CONGRESS

Audit Of Payments From Special Fund To Lockheed Aircraft Corporation For C-5A Aircraft Program During The Quarter Ended September 30, 1971 B-162578

Department of Defense

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

NOV. 17, 1971

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

B-162578

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

This is our second report on the audit of payments from the special fund to Lockheed Aircraft Corporation for the C-5A aircraft program. This report covers the quarter ended September 30, 1971.

This audit was made pursuant to section 504, Public Law 91-441, which authorized $200 million of interim funding for the C-5A aircraft program to be paid through a special bank account. These funds may be expended only for the reasonable and allocable direct and indirect costs incurred by Lockheed on the C-5A aircraft program. The law also provides that these funds shall not be used to reimburse Lockheed for intercompany profits, bid and proposal costs, independent research and development costs, other unsponsored technical costs, and depreciation and amortization expenses. Under the law the General Accounting Office is required to audit payments from the special bank account on a quarterly basis and to submit a report to the Congress not more than 30 days after the close of each quarter.

Since June 16, 1971, the Air Force paid Lockheed $125,166,211 from the special bank account. (See appendix for the cumulative expenditures through September 30, 1971.) The amounts deposited in and withdrawn from the special fund and the special bank account for the quarter ended September 30, 1971, were as follows:

		Special bank account	$200 million fund
Balance as of July 1, 1971		$ 1,002,503	$178,594,489
Deposits		104,645,816	
Withdrawals			104,645,816
Labor	$19,066,763		
Overhead	31,838,554		
Material and other charges	54,489,940		
Intercompany transactions:			
Charges $4,359,211			
Credits -4,991,265	-632,054	104,763,203	
Balance as of September 30, 1971		$ 885,116	$ 73,948,673

LABOR COSTS

During the quarter ended September 30, 1971, the Air Force paid Lockheed $19,066,763 for labor costs incurred. Due to the shortage of wing assemblies created by a work stoppage at a subcontractor's plant,

the Lockheed-Georgia Company suspended, effective September 20, 1971, essentially all C-5A aircraft assembly operations and temporarily laid off about 2,400 employees. The subcontractor resumed work on October 18, 1971, and expected to begin delivery of wing assemblies early in November.

Because of the disruption of production due to the temporary lack of wing assemblies and the approaching completion of subassemblies for all C-5A aircraft, we are giving increased attention to the reasonableness of labor charges.

OVERHEAD EXPENSES

During the quarter overhead expenses totaling $31,838,554 were paid to Lockheed from the special bank account on the basis of negotiated provisional overhead rates. Lockheed and the Air Force negotiate provisional overhead rates for use in costs reimbursement contract billings. Actual overhead costs are to be negotiated as of December 26, 1971, the end of the company fiscal year.

The provisional overhead rate was reduced to exclude those costs which are unallowable under Public Law 91-441. Such costs amounted to $3,183,663 for the quarter ended September 30, 1971.

MATERIAL AND OTHER CHARGES

During the quarter material and other charges totaling $54,489,940 were paid to Lockheed from the special bank account.

To ensure prompt payment to vendors, Lockheed is not reimbursed for amounts owed to vendors which have not been paid within 30 days. At September 30, 1971, $885,116 had not been paid within 30 days, and this amount was deducted from the final reimbursement voucher for the quarter.

Intercompany transactions

During the quarter intercompany costs totaling $4,359,211 charged to the special bank account were more than offset by intercompany credits of $4,991,265. The credits represent the excess of amounts paid for delivered items plus progress payments for undelivered items over actual costs incurred prior to May 31, 1971, when the contract was converted to a cost-reimbursement type.

We noted that intercompany transactions were not being reconciled and processed for inclusion in reimbursement vouchers on a timely basis. Reconciliation of intercompany transactions essentially involves identifying and resolving differences between the records of the Georgia

company and other Lockheed companies. A Lockheed-Georgia Company official stated that about 81 percent of the amount involved had been reconciled as of October 4, 1971. Lockheed has agreed to intensify efforts to reconcile and complete the accounting for intercompany transactions.

SCOPE OF AUDIT

Our review was made at the Lockheed-Georgia Company, Marietta, Georgia; Lockheed Aircraft Corporation and Lockheed-California Company, Burbank, California; Lockheed Aircraft Service Company, Ontario, California; and Lockheed Electronics Company, Plainfield, New Jersey.

Our audit of labor costs included tests to determine whether those costs appeared reasonable and applicable to the C-5A aircraft program. In our review of overhead costs, we examined into the reasonableness of provisional overhead rates and the costs eliminated to comply with Public Law 91-441.

We reviewed selected material and other costs shown on reimbursement vouchers and traced the amounts to such documents as purchase orders, receiving reports, vendors' invoices, and work orders to determine the accuracy and propriety of the amounts paid. Our review of costs incurred on the C-5A aircraft program by other Lockheed companies was directed at testing the accuracy and allowability of labor, material, and overhead costs charged in intercompany billings. We reviewed also the Defense Contract Audit Agency audit of payments from the special bank account for labor, overhead, and material and other costs and tested the work performed.

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Our review revealed no payments to Lockheed Aircraft Corporation from the special bank account during the quarter ended September 30, 1971, that were contrary to Public Law 91-441. As indicated earlier in the report, however, we are giving increased attention to the reasonableness of the labor costs.

Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of Defense; and the Secretary of the Air Force.

Comptroller General
of the United States

APPENDIX

TOTAL AMOUNTS DEPOSITED AND WITHDRAWN

FROM THE SPECIAL BANK ACCOUNT AND

$200 MILLION FUND AS OF SEPTEMBER 30, 1971

		Special bank account	$200 million fund
BEGINNING BALANCE AS OF JUNE 16, 1971 (note a)		$ -	$200,000,000
DEPOSITS		126,051,327	
WITHDRAWALS			126,051,327
Labor	$23,860,659		
Overhead	38,755,521		
Material and other charges	67,593,406		
Intercompany transactions:			
Charges $ 7,453,242			
Credits -12,496,617	-5,043,375	125,166,211	
BALANCE AS OF SEPTEMBER 30, 1971		$ 885,116	$ 73,948,673

[a]Date of first payment from special bank account.

REPORT TO THE CONGRESS

Audit Of Payments From Special Bank Account To Lockheed Aircraft Corporation For The C-5A Aircraft Program During The Quarter Ended December 31, 1971 B-162578

Department of Defense

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

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

B-162578

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

This is our third report on the audit of payments from the special bank account to the Lockheed Aircraft Corporation for the C-5A aircraft program. This report covers the quarter ended December 31, 1971.

This audit was made pursuant to section 504 of Public Laws 91-441 and 92-156, the Armed Forces appropriation authorities for fiscal years 1971 and 1972, respectively. Public Law 91-441 authorized $200 million interim funding for the C-5A aircraft program, and Public Law 92-156 authorized $325.1 million for the program.

Both laws provide that (1) payments be made through a special bank account, (2) the funds be expended only for the reasonable and allocable direct and indirect costs incurred by Lockheed on the C-5A aircraft program, and (3) the funds not be used to reimburse Lockheed for intercompany profits, bid and proposal costs, independent research and development costs, similar unsponsored technical effort costs, and depreciation and amortization costs. These laws require the General Accounting Office to audit payments from the special bank account and to submit a report to the Congress not more than 30 days after the close of each quarter.

Since June 16, 1971, the Air Force has paid Lockheed $224,273,394 from the special bank account. (See appendix for the cumulative expenditures through December 31, 1971.) The amounts deposited in and withdrawn from the special bank account during the quarter ended December 31, 1971, were as follows:

			Special bank account	Funds authorized by Public Laws 91-441	Funds authorized by Public Laws 92-156
Beginning balance			$ 885,116	$73,948,673	$325,100,000
Deposits			98,857,803		
Withdrawals				72,778,975	26,078,828
Labor		$15,437,620			
Overhead		20,999,967			
Material and other charges		58,245,517			
Intercompany transactions:					
Charges	$6,888,295				
Credits	2,464,216	4,424,079	99,107,183		
Balance as of December 31, 1971			$ 635,736	$ 1,169,698	$299,021,172

OPPORTUNITY TO REDUCE COSTS
THROUGH MORE EFFICIENT USE OF MANPOWER

During the quarter ended December 31, 1971, the Air Force paid Lockheed $15,437,620 for labor costs charged to the C-5A aircraft contract. We examined into the reasonableness of these costs by performing a work-sampling study of Lockheed's direct labor force assigned to the assembly operations.

We selected for this examination the production assembly area because (1) it was a significant, concentrated segment of Lockheed's 7,000-man C-5A aircraft work force, (2) assembly activities were well suited to the application of industrial-engineering techniques, and (3) the Defense Contract Audit Agency had reported observing idle time in that area. Other major plant areas, such as the fabrication and flight-line operations areas, were not included in our review.

Using random- and statistical-sampling techniques, we selected about 200 of 1,400 hourly direct labor employees involved in assembly operations. During a 2-week period, we made over 17,000 observations of these employees to determine whether they were engaged in productive and job-related work or were engaged in nonproductive activity.

Our objective was to get a picture of worker activity under plant conditions as they existed at the time of the study. We did not measure worker efficiency, and we assumed that the employees being observed were working at a normal pace throughout the study period.

The study showed that 43.5 percent of the employees observed were involved in craft work; that is, they were physically working on assembly of the aircraft or its components. The study showed also that 30.9 percent of the workers were engaged in supporting activities necessary for the performance of the craft work. These activities include the functions of job preparation, planning and analysis, walking, and talking. The percentage of time involved in other activities, such as personal, housekeeping, and unavoidable delays, fell within a range generally considered to be acceptable within industry.

Our analysis showed, however, that about 8.6 percent of the production assembly employees were idle. By comparison, industry work standards do not provide for any idle time, and Lockheed officials told us that an allowance for idle time was not included in their procedures for establishing work standards. Lockheed officials told us also that they were unaware of any industry criteria for setting acceptable levels for idle time. Our analysis showed also that about 6.2 percent of the employees were absent from their work stations at the time of our observations, and we were unable to determine their whereabouts through discussions with supervisors or coworkers.

We attempted to obtain comparable data for worker activity from the aerospace industry and found that their statistical information was not compiled

in a similar manner. Therefore we were unable to compare the data we obtained with those of other aerospace contractors.

The table below summarizes the results of our study.

Category of worker activity	Percent of distribution (note a)	
Craft work		43.5
Activities necessary to support craft work:		
Walking	12.5	
Job preparation	7.9	
Talking	6.3	
Planning and analysis	4.2	30.9
Other activities:		
Personal	6.8	
Housekeeping	1.6	
Unavoidable delays	2.0	
Miscellaneous	.4	10.8
Idle time		8.6
Unobserved time		6.2
Total		100.0

[a]This percentage relates to activity only and not to efficiency of the employees being observed.

We presented the results of our study to Lockheed and Air Force officials and pointed out that management attention should be directed toward reducing the amount of time spent in the supporting activities necessary for the performance of craft work. We pointed out also that idle and unobserved time should be reduced to an absolute minimum. By reducing the time spent in these categories, we believe that Lockheed could increase its labor productivity.

Lockheed officials stated that they found the results of our study to be both informative and, as a whole, largely representative of performance conditions in the C-5A aircraft assembly area. They also expressed concern over the incidence of idle and unobserved time and indicated that they would increase management emphasis in this problem area. Air Force officials generally agreed with the results of the study. Both Air Force and Lockheed officials pointed out, however, that, at the time the observations were made, the assembly operations had not recovered fully from the disruptive effects of a previous strike at a subcontractor's plant which manufactured C-5A aircraft wing components.

SCOPE OF AUDIT

Our review was made at the Lockheed-Georgia Company, Marietta, Georgia; Lockheed Aircraft Corporation and Lockheed-California Company, Burbank, California; Lockheed Aircraft Service Company, Ontario, California; and Lockheed Electronics Company, Plainfield, New Jersey.

Our audit of labor costs included tests to determine whether those costs appeared reasonable and applicable to the C-5A aircraft program. During our review of overhead costs, we examined into the reasonableness of provisional overhead rates and the costs eliminated to comply with Public Laws 91-441 and 92-156.

We reviewed selected material and other costs shown on reimbursement vouchers and traced the amounts to such documents as purchase orders, receiving reports, vendors' invoices, and work orders, to determine the accuracy and propriety of the amounts paid. Our review of costs incurred on the C-5A aircraft program by other Lockheed companies was directed toward testing the accuracy and allowability of labor, material, and overhead costs charged in intercompany billings and the exclusion of intercompany profit. We reviewed also the Defense Contract Audit Agency's audit of payments from the special bank account for labor, overhead, material, and other costs and tested the work performed.

CONCLUSION

Our review revealed no payments to Lockheed Aircraft Corporation from the special bank account during the quarter ended December 31, 1971, with the possible exception of certain labor costs, that were contrary to Public Laws 91-441 and 92-156. As outlined earlier in the report, our tests indicated that certain labor costs for the C-5A aircraft production assembly operations could be reduced through more efficient use of manpower. Lockheed has agreed to increase management emphasis in this area.

RECOMMENDATION

We are recommending that the Air Force evaluate the actions of the contractor to reduce the time spent on the supporting activities necessary for craft work and the idle and unobserved time charged to the contract. We are recommending also that the Air Force give consideration to whether the Government is in a position to seek recovery from the contractor for such charges.

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Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of Defense; and the Secretary of the Air Force.

Comptroller General
of the United States

APPENDIX

TOTAL AMOUNTS DEPOSITED IN AND WITHDRAWN

FROM THE SPECIAL BANK ACCOUNT

DURING THE PERIOD

JUNE 16, 1971, TO DECEMBER 31, 1971

			Special bank account	Funds authorized by Public Laws 91-441	Funds authorized by Public Laws 92-156
BEGINNING BALANCE				$200,000,000	$325,100,000
DEPOSITS			$224,909,130		
WITHDRAWALS				198,830,302[a]	26,078,828[b]
Labor		$ 39,298,279			
Overhead		59,755,488			
Material and other charges		125,838,922			
Intercompany transactions:					
Charges	$14,341,537				
Credits	-14,960,832	-619,295	224,273,394		
BALANCE AS OF DECEMBER 31, 1971			$ 635,736	$ 1,169,698	$299,021,172

[a]Initial payment from this fund was on June 16, 1971.

[b]Initial payment from this fund was on December 1, 1971.

REPORT TO THE CONGRESS

Audit Of Payments From Special Bank Account To Lockheed Aircraft Corporation For The C-5 Aircraft Program During The Quarter Ended March 31, 1972 B-162578

Department of Defense

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

MAY 30, 1972

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

B-162578

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

This is our fourth report on the audit of payments from the special bank account to the Lockheed Aircraft Corporation for the C-5 aircraft program. This report covers the quarter ended March 31, 1972.

This audit was made pursuant to section 504 of Public Laws 91-441 and 92-156, the Armed Forces appropriation authorities for fiscal years 1971 and 1972, respectively. Public Law 91-441 authorized $200 million interim funding for the C-5 aircraft program, and Public Law 92-156 authorized $325.1 million for the program.

Both laws provide that (1) the payments be made through a special bank account, (2) the funds be expended only for the reasonable and allocable direct and indirect costs incurred by Lockheed on the C-5 aircraft program, and (3) the funds not be used to reimburse Lockheed for intercompany profits, bid and proposal (B&P) costs, independent research and development costs, similar unsponsored technical effort costs, and depreciation and amortization costs. These laws require the General Accounting Office to audit payments from the special bank account and to submit a report to the Congress not more than 30 days after the close of each quarter.

Since June 16, 1971, the Air Force has paid Lockheed $320,026,001 from the special bank account. (See appendix for the cumulative expenditures through March 31, 1972.) The amounts deposited in and withdrawn from the special bank account during the quarter ended March 31, 1972, were as follows:

			Special bank account	Funds authorized by Public Laws 91-441	Funds authorized by Public Laws 92-156
Beginning balance			$ 635,736	$1,169,698	$299,021,172
Deposits			95,572,436		
Withdrawals				930,219	94,642,217
Labor		$19,673,854			
Overhead		27,879,811			
Material and other charges		46,058,243			
Intercompany transactions:					
Charges	$2,153,672				
Credits	12,973	2,140,699	95,752,607		
Balance as of March 31, 1972			$ 455,565	$ 239,479	$204,378,955

SCOPE OF AUDIT

Our review was made at the Lockheed-Georgia Company, Marietta, Georgia; Lockheed Aircraft Corporation and Lockheed-California Company, Burbank, California; and Lockheed Electronics Company, Plainfield, New Jersey.

In our review of overhead costs, we examined into the reasonableness of provisional overhead rates and the costs eliminated to comply with Public Laws 91-441 and 92-156. Our audit of labor costs included tests to determine whether those costs appeared reasonable and applicable to the C-5 aircraft program.

We reviewed selected material and other costs shown on reimbursement vouchers and traced the amounts to such documents as purchase orders, receiving reports, vendors' invoices, and work orders to determine the accuracy and propriety of the amounts paid. Our review of costs incurred on the C-5 aircraft program by other Lockheed companies was directed toward testing the accuracy and allowability of labor, material, and overhead costs charged in intercompany billings and the exclusion of intercompany profit. We reviewed also the Defense Contract Audit Agency (DCAA) audit of payments from the special bank account for labor, overhead, material, and other costs.

Conclusion

Our review revealed no payments from the special bank account to Lockheed-Georgia during the quarter ended March 31, 1972, that were contrary to Public Laws 91-441 and 92-156. On two of the matters discussed below, however, we requested comments from the Department of Defense in respect to decisions on future payment practices. We also ascertained that actions were initiated, in response to findings presented in our third report, to improve labor productivity.

MANAGEMENT IMPROVEMENT OF LABOR PRODUCTIVITY

We reported the results of our work-sampling study of Lockheed-Georgia's direct labor force assigned to C-5 aircraft assembly operations during the quarter ended December 31, 1971. We suggested to Lockheed-Georgia management that attention be directed toward reducing the amount of time spent in supporting activities necessary for the performance of craft work and that the amount of idle and unobserved time be reduced to an absolute minimum.

We have been advised by a representative of Lockheed-Georgia that new control systems are being established, including (1) improved time-card handling, (2) means for enforcing timely observance of break periods, lunch periods, and shift starting- and stopping-time rules, and (3) job assignment and follow-up. Additional controls have been established over the in-plant movement of employees.

We also recommended that the Air Force evaluate the actions taken by the contractor. The Air Force has advised us that, although it may be too early

to see the results of the contractor's actions, the Air Force Plant Representative at Lockheed-Georgia reports that the overall tempo in the manufacturing area appears to have improved since the first of the year. The Air Force has advised us also that it is continuing to improve its capability to measure worker productivity.

INTERCOMPANY TRANSACTIONS

During the quarter intercompany charges totaling $2,140,699 were paid to Lockheed-Georgia from the account.

Our review of these interdivisional billings showed that Lockheed-California had billed Lockheed-Georgia $139,300 in duplicate overhead charges, of which $137,188 was charged to the special bank account. When we notified Lockheed-California of this, the duplicate billings were corrected and charges to the special bank account were adjusted.

FURTHER STUDY NEEDED OF BID AND PROPOSAL OVERHEAD COSTS

As indicated earlier, Public Laws 91-441 and 92-156 provide that Lockheed-Georgia not be reimbursed for B&P costs. Lockheed-Georgia deducted its direct (material and labor) B&P costs allocable to the C-5 aircraft program but did not deduct overhead costs of about $500,000 that for other purposes Lockheed had considered allocable to its B&P activities. We requested the Air Force to furnish us with its rationale for paying such costs. Upon receipt of the Air Force position, we plan to give further consideration to this matter.

WITHDRAWAL OF FUNDS FOR RETIREMENT CONTRIBUTIONS IN ADVANCE OF NEED

The Lockheed Aircraft Corporation has 10 separate retirement plans covering salaried and hourly employees of all divisions and subsidiaries, including the Lockheed-Georgia Company where most costs for the C-5 aircraft are incurred. Eight banks and trust companies serve as trustees for the plans, and they are authorized by Lockheed to receive, hold, and invest funds and to pay benefits. The annual amount each division must pay to the trustees is based on actuarial studies made by the corporate office.

Lockheed-Georgia accumulates retirement funds until the end of the year, and the funds then are remitted to the corporate office in approximately equal monthly installments during the first 9 months of the succeeding year. Before 1971 the corporate office paid the trustees monthly, which resulted in Lockheed's retention of the funds for 9 or 10 months. In 1971, Lockheed's working capital position deteriorated and the cash shortage required a deferral of payments to the trustees. As a result the corporate office did not make payments to the trustees on a monthly basis. Instead the payments were sporadic

and in varying amounts. The average time between the receipt of funds from the Government for retirement costs and payment to the trustees in 1971 was about 14 months.

During January, February, and March 1972, monthly installments were transferred to the corporate office. Lockheed officials advised us that the first payment of 1971 retirement costs was made in April 1972 and that monthly payments would continue through September 15, 1972. This payment procedure will result in Lockheed's retention of the funds for slightly less than the 14 months experienced in 1971.

Lockheed-Georgia's estimated annual retirement-fund contribution for 1972 is $10,907,709. About $6,200,000 of this contribution is applicable to the C-5 aircraft program. The transfer of funds to the corporate office, and subsequently to the trustees, will not begin until about January 1973 and will continue until about September 1973.

The Armed Services Procurement Regulation provides that contributions to pension and annuity plans, whether paid immediately or deferred, are allowed costs under Government contracts.

Supplemental Agreement number 1000, dated May 31, 1971, which changed the contract from a fixed-price-incentive contract to a cost-plus-fixed-loss contract, included a provision which stated that:

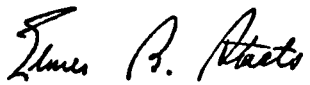
> "The contractor is required to submit a detailed justification to the Administrative Contracting Officer (ACO) to support requests for withdrawals of funds from the account. The justification is to be in the form of a listing of direct payrolls, direct material receipts/invoices, other direct or indirect allowable costs incurred which are reasonable and allocable in support of the C-5 program and which must be paid in a reasonable period of time." (Underscoring supplied.)

In order to appraise the reasonableness of Lockheed's practice in this instance, we made inquiries of several aerospace firms, as well as of the Air Force, regarding their policies with respect to retirement-fund contributions. We found inconsistent practices in that the period between the time payments were received by these contractors from the Government for retirement costs and the time payments were made by them to the trustees ranged anywhere from a month to a year or more.

It does not seem appropriate for the Government to make payments to contractors for their contributions to the employees' retirement funds significantly in advance of the time that the contractors are required to make payments to the trustees of the retirement funds. Further it appears to us that the Department of Defense should require consistent treatment of its contractors in this regard. Therefore we are recommending that the Department of Defense take action to

establish consistent policies that avoid making such payments significantly in advance of need.

Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of Defense; and the Secretary of the Air Force.



Comptroller General
of the United States

APPENDIX

TOTAL AMOUNTS DEPOSITED IN AND WITHDRAWN FROM

THE SPECIAL BANK ACCOUNT

DURING THE PERIOD JUNE 16, 1971, TO MARCH 31, 1972

			Special bank account	Funds authorized by Public Laws	
				91-441	92-156
BEGINNING BALANCE				$200,000,000	$325,100,000[a]
DEPOSITS			$320,481,566		
WITHDRAWALS				199,760,521[b]	120,721,045[c]
Labor		$ 58,972,133			
Overhead		87,635,300			
Material and other charges		171,897,166			
Intercompany transactions:					
Charges	$16,495,209				
Credits	14,973,807	1,521,402	320,026,001		
BALANCE AS OF MARCH 31, 1972			$ 455,565	$ 239,479	$204,378,955

[a]Public Law 92-204 appropriated $321.5 million which is $3.6 million less than authorized.

[b]Initial payment from this fund was on June 16, 1971.

[c]Initial payment for this fund was on December 1, 1971.

REPORT TO THE CONGRESS

Audit Of Payments From Special Bank Account To Lockheed Aircraft Corporation For The C-5 Aircraft Program During The Quarter Ended June 30, 1972 B-162578

Department of Defense

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

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

B-162578

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

This is our fifth report on the audit of payments from the special bank account to the Lockheed Aircraft Corporation for the C-5 aircraft program. This report covers the quarter ended June 30, 1972.

This audit was made pursuant to section 504 of Public Laws 91-441 and 92-156, the Armed Forces appropriation authorities for fiscal years 1971 and 1972, respectively. Public Law 91-441 authorized $200 million interim funding for the C-5 aircraft program, and Public Law 92-156 authorized $325.1 million for the program.

Both laws provide that (1) the payments be made through a special bank account, (2) the funds be expended only for the reasonable and allocable direct and indirect costs incurred by Lockheed on the C-5 aircraft program, and (3) the funds not be used to reimburse Lockheed for intercompany profits, bid and proposal (B&P) costs, independent research and developments costs, similar unsponsored technical effort costs, and depreciation and amortization costs. These laws require the General Accounting Office to audit payments from the special bank account and to submit a report to the Congress not more than 30 days after the close of each quarter.

Since June 16, 1971, the Department of the Air Force has paid Lockheed $386,215,942 from the special bank account. (See appendix for the cumulative expenditures through June 30, 1972.) The amounts deposited in and withdrawn from the special bank account during the quarter ended June 30, 1972, were as follows:

			Special bank account	Funds authorized by Public Laws 91-441	Funds authorized by Public Laws 92-156
Beginning balance			$ 455,565	$239,479	$204,378,955
Deposits			66,274,989		66,274,989
Withdrawals					
Labor		$15,083,767			
Overhead		21,832,022			
Material and other charges		27,699,609			
Intercompany transactions:					
Charges	$1,598,289				
Credits	23,746	1,574,543	66,189,941		
Balance as of June 30, 1972			$ 540,613	$239,479	$138,103,966

SCOPE OF AUDIT

Our review was made at the Lockheed-Georgia Company, Marietta, Ga. In our review of overhead costs, we examined into the reasonableness of provisional overhead rates and costs eliminated to comply with Public Laws 91-441 and 92-156. Our audit of labor costs included tests to determine whether those costs appeared reasonable and allocable to the C-5 aircraft program. To determine the accuracy and propriety of material and other costs, we traced selected charges on the reimbursement vouchers to such documents as purchase orders, vendors' invoices, receiving reports, and work orders. We verified that no intercompany profit was paid from the special bank account. Additionally we reviewed the Defense Contract Audit Agency audit of payments from the special bank account for labor, overhead, material, and other costs.

CONCLUSION

Our review revealed no payments from the special bank account to Lockheed-Georgia during the quarter ended June 30, 1972, that were contrary to Public Laws 91-441 and 92-156. However, two matters presented in our fourth report which could affect future payment practices have not been resolved. These matters, discussed below, will be given further consideration in future reporting periods.

FURTHER STUDY NEEDED OF BID AND PROPOSAL OVERHEAD COSTS

As indicated earlier, Public Laws 91-441 and 92-156 provide that Lockheed-Georgia not be reimbursed for B&P costs. In our prior report we stated that Lockheed-Georgia deducted its direct (material and labor) B&P costs allocable to the C-5 aircraft program but did not deduct applicable overhead costs of about $500,000 that for other purposes Lockheed had considered allocable to its B&P activities. We requested the Air Force to furnish us with its rationale for paying such costs.

We have received comments from the Air Force and Lockheed on this matter and are presently considering them in deciding whether these costs should be allowed for reimbursement under the acts.

WITHDRAWAL OF FUNDS FOR RETIREMENT CONTRIBUTIONS IN ADVANCE OF NEED

Our prior report showed that in 1971 Lockheed received payments from the Government for contribution to employees' retirement funds and held them an average of about 14 months before making payments to retirement fund trustees.

Our inquiry of several other aerospace firms, as well as the Air Force, disclosed inconsistencies in the length of time between payments by the Government to contractors for such contributions and the subsequent payments by contractors to trustees of the retirement funds. These time periods ranged from a month to a year or more.

It did not seem appropriate for the Government to make payments to contractors for their contributions to employees' retirement funds significantly in advance of the time that the contractors are required to make payments to the trustees of retirement funds. Further, it appeared to us that the Department of Defense should require consistent treatment of its contractors in this regard. We therefore recommended that the Department of Defense take action to establish consistent policies that avoid making such payments significantly in advance of need.

At the time our review work for this quarterly report was completed, the Department of Defense had not advised what action it might take concerning our recommendation.

Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of Defense; and the Secretary of the Air Force.

Comptroller General
of the United States

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APPENDIX

TOTAL AMOUNTS DEPOSITED IN AND WITHDRAWN FROM

THE SPECIAL BANK ACCOUNT

DURING THE PERIOD JUNE 16, 1971, TO JUNE 30, 1972

			Special bank account	Funds authorized by Public Laws 91-441	Funds authorized by Public Laws 92-156
BEGINNING BALANCE				$200,000,000	$325,100,000[a]
DEPOSITS			$386,756,555		
WITHDRAWALS				199,760,521[b]	186,996,034[c]
Labor		$ 74,055,900			
Overhead		109,467,322			
Material and other charges		199,596,775			
Intercompany transactions:					
Charges	$18,093,498				
Credits	14,997,553	3,095,945	386,215,942		
BALANCE AS OF JUNE 30, 1972			$ 540,613	$ 239,479	$138,103,966

[a]Public Law 92-204 appropriated $321.5 million which is $3.6 million less than authorized.

[b]Initial payment from this fund was made June 16, 1971.

[c]Initial payment from this fund was made on December 1, 1971.

REPORT TO THE CONGRESS

Audit Of Payments From Special Bank Account To Lockheed Aircraft Corporation For The C-5 Aircraft Program During The Quarter Ended September 30, 1972 B-162578

Department of Defense

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

NOV. 29, 1972

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

B-162578

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

This is our sixth report on the audit of payments from the special bank account to the Lockheed Aircraft Corporation for the C-5 aircraft program. This report covers the quarter ended September 30, 1972.

This audit was made pursuant to section 504 of Public Laws 91-441 and 92-156, the Armed Forces appropriation authorities for fiscal years 1971 and 1972, respectively. Public Law 91-441 authorized $200 million interim funding for the C-5 aircraft program, and Public Law 92-156 authorized $325.1 million for the program.

Both laws provide that (1) the payments be made through a special bank account, (2) the funds be expended only for the reasonable and allocable direct and indirect costs incurred by Lockheed on the C-5 aircraft program, and (3) the funds not be used to reimburse Lockheed for intercompany profits, bid and proposal (B&P) costs, independent research and development costs, similar unsponsored technical effort costs, and depreciation and amortization costs. These laws require the General Accounting Office to audit payments from the special bank account and to submit a report to the Congress not more than 30 days after the close of each quarter.

Since June 16, 1971, the Department of the Air Force has paid Lockheed $440,008,750 from the special bank account. (See appendix for the cumulative expenditures through September 30, 1972.) The amounts deposited in and withdrawn from the special bank account during the quarter ended September 30, 1972, were as follows:

			Special bank account	Funds authorized by Public Laws 91-441	Funds authorized by Public Laws 92-156
Beginning balance			$ 540,613	$239,479	$138,103,966
Deposits			53,964,239		
Withdrawals					53,964,239[a]
Labor		$13,155,092			
Overhead		17,561,103			
Material and other charges		22,095,349			
Intercompany transactions:					
Charges	$1,029,863				
Credits	48,599	981,264	53,792,808		
Balance as of September 30, 1972			$ 712,044	$239,479	$ 84,139,727

[a]Includes one payment of $3,652,239 paid from incorrect funds on September 27, 1972, but corrected on October 4, 1972.

SCOPE OF AUDIT

Our audit was made at the Lockheed-Georgia Company, Marietta, Georgia; Lockheed-California Company, Burbank, California; Lockheed Aircraft Service Company, Ontario, California; and Lockheed Electronics Company, Plainfield, New Jersey.

Our audit of labor costs included tests to determine whether these costs appeared reasonable and allocable to the C-5 aircraft program. In our review of overhead costs, we examined into the reasonableness of provisional overhead rates and costs eliminated to comply with Public Laws 91-441 and 92-156.

To determine the accuracy and propriety of material and other costs, we traced selected charges on the reimbursement vouchers to such documents as purchase orders, vendors' invoices, receiving reports, and work orders. We verified that no intercompany profit was paid from the special bank account.

We reviewed the Defense Contract Audit Agency audit of payments from the special bank account for labor, overhead, and material and other charges.

CONCLUSION

Our review revealed no payments from the special bank account to Lockheed-Georgia during the quarter ended September 30, 1972, that were contrary to Public Laws 91-441 and 92-156. However, two matters included in our fourth and fifth reports as unresolved issues which could affect future payment practices still have not been resolved. When these matters, which are discussed below, are resolved, we will show their disposition in our report.

FURTHER STUDY NEEDED OF BID AND PROPOSAL OVERHEAD COSTS

As indicated earlier, Public Laws 91-441 and 92-156 provide that Lockheed-Georgia not be reimbursed for B&P costs. In prior reports, we stated that Lockheed-Georgia deducted its direct (material and labor) B&P costs allocable to the C-5 aircraft program but did not deduct applicable overhead costs of about $500,000 that Lockheed had considered allocable for other purposes to its B&P activities. We have received comments from Lockheed and the Air Force on this matter and are presently considering whether these costs should be allowed for reimbursement under the acts.

WITHDRAWAL OF FUNDS FOR RETIREMENT CONTRIBUTIONS IN ADVANCE OF NEED

Our prior reports showed that in 1971 Lockheed received payments from the Government for contribution to employees' retirement funds and held them an average of about 14 months before making payments to retirement fund trustees.

Our inquiry of several other aerospace firms, as well as the Air Force, disclosed inconsistencies in the length of time between payments by the Government to contractors for such contributions and the subsequent payments by contractors to trustees of the retirement funds.

As a result, we recommended that the Department of Defense take action to establish consistent policies that avoid making such payments significantly in advance of need. The Department of Defense has not advised what action it might take concerning our recommendation.

Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of Defense; and the Secretary of the Air Force.

Elmer B. Staats

Comptroller General
of the United States

APPENDIX I

TOTAL AMOUNTS DEPOSITED IN AND WITHDRAWN FROM

THE SPECIAL BANK ACCOUNT

FROM JUNE 16, 1971, TO SEPTEMBER 30, 1972

			Special bank account	Funds authorized by Public Laws (note a) 91-441	92-156
BEGINNING BALANCE				$200,000,000	$325,100,000[b]
DEPOSITS			$440,720,794		
WITHDRAWALS				199,760,521[c]	240,960,273[d]
Labor		$ 87,210,992			
Overhead		127,028,425			
Material and other charges		221,692,124			
Intercompany transactions:					
Charges	$19,123,361				
Credits	15,046,152	4,077,209	440,008,750		
BALANCE AS OF SEPTEMBER 30, 1972			$ 712,044	$ 239,479	$ 84,139,727

[a]On September 26, 1972, Public Law 92-436 authorized $107,600 for fiscal year 1973. However, as of September 30, 1972, the appropriation bill had not been signed by the President.

[b]Public Law 92-204 appropriated $321.5 million, which is $3.6 million less than authorized.

[c]Initial payment from this fund was made on June 16, 1971.

[d]Initial payment from this fund was made on December 1, 1971. This amount also includes one payment of $3,652,239 paid from incorrect funds on September 27, 1972, but corrected on October 4, 1972.

Chairman PROXMIRE. I would like to ask you some questions about the audit reports. First, the second audit report stated GAO was giving increased attention to the reasonableness of labor charges, and the third report had quite a bit more to say about Lockheed's use of manpower. You will recall in that report a work-sampling study of the labor force found that almost 15 percent of the production assembly employees were either idle when observed or absent from their work stations. You reported that Lockhead officials stated your study was representative of performance standards in the C–5A aircraft assembly area and that they expressed concern about your findings. Can you discuss this matter and tell us whether the problems have been improved or solved?

Mr. GUTMANN. Yes.

With respect to the corrective actions that have been implemented by Lockheed on that subject, we have visited the plant, we have observed their corrective actions in process. They have established controls over the activities of their work force, they have, for example, guards stationed at locations where there had previously been people congesting and contributing to idle time.

Chairman PROXMIRE. Can you give us an estimate, you made a specific estimate at that time, 15 percent of the work force idle; what is it now, 10 percent, 5 percent?

Mr. GUTMANN. We have not made a new study, Mr. Chairman.

Chairman PROXMIRE. Is it less or more?

Mr. GUTMANN. We would suggest it is less but we really have no basis to say that other than the actions being taken by management to improve the situation. We have not made another analysis.

Chairman PROXMIRE. It is not pretty late in the game for this? This contract is pretty old now.

Mr. GUTMANN. Yes, it is. The contract is almost completed.

Chairman PROXMIRE. Are you able to estimate the effects on costs that absenteeism or idleness have caused on the C–5A?

Mr. GUTMANN. No, sir, because our sample was just that. It was a very small photograph, if you will, of a certain part of the assembly of the aircraft, and it was not possible really, for us to project from that to the entire aircraft program.

Chairman PROXMIRE. But as I said in my initial question on this, Lockheed officials shared your views and said this was representative of the performance standards in the C–5A assembly area?

Mr. GUTMANN. But we did not make an estimate.

Chairman PROXMIRE. Certainly, if Lockheed agreed with you we would say that was probably very likely, would you not?

Mr. GUTMANN. Yes, I think so. If Lockheed thought that 15 percent was true throughout the plant why——

Chairman PROXMIRE. In that case can you make an estimate of what this would mean in terms of cost?

Mr. GUTMANN. We would try, sir, yes, we do not have that with us today; we will try to supply it for the record.

[The following information was subsequently supplied for the record:]

The work sampling study we conducted showed us the conditions as they existed at that time and did not provide a basis for projecting or estimating what the conditions would be at any other time. Since our study showed only what conditions were in the assembly area, not plant-wide, we do not have information to estimate the total cost of idle and unobserved time.

BID AND PROPOSAL COSTS

Chairman PROXMIRE. The fourth report noted two new problems. First, the law that created the bail out fund prohibited reimbursement to Lockheed-Georgia for bid and proposal (B. & P.) costs. Yet, you found a payment of about $500,000 by the Air Force to Lockheed-Georgia for B. & P. How can you explain that? What has been done since you made your report about that?

Mr. GUTMANN. We do not have the current information as to what the Air Force has decided to do about that B. & P. The way it occurs, of course, is by Lockheed including the amounts in their costs and the auditors not taking it out.

Chairman PROXMIRE. In your current report you say it still has not been resolved?

Mr. GUTMANN. That is right.

WITHHOLDING OF RETIREMENT REIMBURSEMENTS

Chairman PROXMIRE. The other matter uncovered in the fourth report strikes me as highly significant. You found that Lockheed has been waiting an average of 14 months after receiving Government reimbursement for retirement costs before actually transferring this money to the trustees for the retirement funds. Lockheed-Georgia's retirement fund contribution was nearly $11 million for 1972, about $6.2 million of which is applicable to the C–5A. Can you comment further on this situation?

Mr. GUTMANN. Yes, sir. The Department of Defense has agreed that the 14 months is an unreasonable length of time. They have not yet decided just how to correct that situation. The prevailing opinion in the Department is that 90 days would be reasonable.

Chairman PROXMIRE. My heavens, this is more than a year, the Government gives them money for the retirement fund, and they hold on to it, they do not put it in the retirement fund?

Mr. GUTMANN. That is correct.

Chairman PROXMIRE. For more than a year.

Mr. GUTMANN. And that is why we reported it as an undesirable situation.

Chairman PROXMIRE. Can you not have a regulation requiring that it be promptly put in, at least 30 days or 2 weeks, for that matter, and certainly not 14 months? This is really outrageous.

Mr. GUTMANN. The Department of Defense is presently working on such a regulation that would limit it to a maximum of 90 days period of time before payments are made into the retirement fund.

Chairman PROXMIRE. Could the Government send the money directly to the trustees of the fund instead of the corporation?

Mr. GUTMANN. I suppose they could. I had not really considered that as a possibility. I am not sure whether the Department or the contractor has.

Chairman PROXMIRE. At any rate, Lockheed by holding onto the money gets an interest-free loan in effect for more than a year, at the Government's expense and at the expense of the workers retirement fund, is that right?

Mr. STAATS. That is the reason we criticized it, Mr. Chairman, exactly.

Chairman PROXMIRE. Right. You indicated in your report you checked several aerospace firms to see how they handle retirement cost payments. Can you tell us which other firms hold on to these funds for a month or more and how much money is involved?

Mr. GUTMANN. We do not have the specifics but we did check with some of them and we found they were ranging anywhere from 9 months to as high as 18 months but I do not have the names.

Chairman PROXMIRE. Will you get the names and provide them for the subcommittee?

Mr. GUTMANN. Yes, sir.

[The following information was subsequently supplied for the record:]

We obtained information from the following firms:

Boeing Company—pays the funds to the trustees as needed or prior to filing its income tax return.

Gruman Corp.—pays the funds to the trustees every ninety days.

McDonnell Douglas Corp.—pays the funds to the trustees monthly.

North American Rockwell Corp.—pays the funds to the trustees prior to filing its income tax return.

The Air Force provided the following information:

Aerojet General Corp.—pays the funds to the trustees prior to filing its income tax return.

General Dynamics Corp.—pays the funds to the trustees prior to filing its income tax return.

General Motors Corp.—pays the funds to the trustees monthly.

The above procedures in some cases resulted in contractors retaining pension funds in excess of 18 months.

Chairman PROXMIRE. This seems to be just outrageous.

Mr. STAATS. This is an undesirable practice.

Chairman PROXMIRE. I am glad you state that because I can see no merit in the use of these millions and millions of dollars of these funds made for the specific purpose of meeting a retirement fund obligation, and it is obviously an abuse of the taxpayer, on the one hand, and the retirement fund, on the other.

Mr. STAATS. Yes, we agree, Mr. Chairman, and that is one of the reasons we highlighted it here in this report.

Chairman PROXMIRE. Mr. Blackburn.

Representative BLACKBURN. I would like to take 10 minutes of silence, I think I would enjoy them. [Laughter.]

I have no further questions.

TOTAL PACKAGE PROCUREMENT CONTRACTS

Chairman PROXMIRE. We are going to hear this afternoon from Mr.—wait a minute, I think this is of sufficient importance so I just ask you two quick questions: You suggest that a prime cause of Lockheed's, Grumman's, and Litton's financial difficulties has been the total package procurement contracts under which they have been operating. You also point out that this kind of long-range, fixed-

price contract has now been abandoned by the Department of Defense.

First, how many total package procurement contracts are still in force, and what is the total value of those contracts?

We seem to keep hearing more and more about them.

Mr. STAATS. If it is agreeable, can we supply them for the record, Mr. Chairman?

Chairman PROXMIRE. I wish you would. I would like you to submit that for the record. We cannot bail out 10 or 15 programs still subject to these contracts.

[The following information was subsequently supplied for the record:]

Shown below are several current acquisition programs using contract structures which incorporate features characteristic of the total package concept. Also shown for each program is the current estimate for the total program.

Program:	*Current estimate: Total program at September 30, 1972* [1] *(millions)*
F–15	$7,802.0
F–5E	295.2
AWACS	2,661.3
F–14	5,302.5
S–3A	3,151.8
LHA	1,164.8
DD–963	[2] 2,750.3
AEGIS	484.1

[1] Total program estimates are not to be equated with contract prices, although they are inclusive of contract prices or contract price estimates.
[2] As of June 30, 1972, SAR.

Chairman PROXMIRE. Do you believe cost overruns are really a thing of the past and will not arise in the new milestone contracts established by Mr. Packard?

Mr. STAATS. I do not think we could be that optimistic about it, Mr. Chairman. If the new recommendations being circulated in the Pentagon and those which will be reflected in the Commission on Government Procurement's report are followed we certainly will have much less of it in the future than we have had in the past.

Chairman PROXMIRE. Well, I want to thank you very, very much. This afternoon we will have Mr. Kitchen and then Mr. Durham as our final witnesses today, at 2 o'clock.

Tomorrow morning we will hear from Gordon Rule, a Navy civilian procurement director, and Dean Girardot, an official with the Metal Trades Department, AFL–CIO, at Litton's Shipyards in Pascagoula, Miss.

Fred O'Green, president of Litton has declined to appear in these hearings at the present time, although he had earlier agreed to testify.

They will be resumed at 2 p.m.

[Whereupon, at 12:55 p.m., the subcommittee recessed, to resume at 2 p.m. today.]

AFTERNOON SESSION

Chairman PROXMIRE. The subcommittee will come to order.

This afternoon what I would like to do is ask both Mr. Kitchen and Mr. Durham to come together; we can have a constructive panel

here, a discussion of the problems. They are both involved in the same matters. And both you gentlemen, I understand, have brief statements and I would appreciate it if you could confine the statements to 10 minutes. The statements look good and concise and then we will get in to questioning.

Mr. Kitchen, you go right ahead, sir. We appreciate very, very much your coming.

STATEMENT OF LAWRENCE O. KITCHEN, PRESIDENT, LOCKHEED-GEORGIA CO.

Mr. KITCHEN. Mr. Chairman, I appreciate the opportunity to appear before your subcommittee.

My name is Lawrence O. Kitchen, president of the Lockheed-Georgia Co.

My remarks will be addressed to what I understand to be the purpose of these hearings which have probed deeply into a variety of defense procurement policies and practices, as related to the acquisition of major weapons systems.

Chairman PROXMIRE. Would you identify the gentleman with you and the gentlemen who are behind you.

Mr. KITCHEN. The gentleman on my left is Mr. A. H. Lorch, director of finance and administration at the Lockheed-Georgia Co. The gentlemen behind me are Mr. Bill Wilson from the Lockheed Aircraft Corp., Mr. Johnson and Mr. Ed Lightfoot.

More specifically, I trust my remarks will provide this subcommittee with some insight into the causes for cost growth in major weapons systems, such as the C–5. In so doing, I will respond to the inflammatory accusations made over a year ago by Mr. Henry Durham.

These accusations, mostly unwarranted, have been extremely damaging to the thousands of men and women of Lockheed who have worked so hard to produce highly useful weapons systems such as the C–5A.

Subsequent to these charges I was forced to remove a large part of my independent auditing staff—specifically, 13 members of that staff—from their normal tasks of monitoring operations for me and put them full time on gathering and investigating data related to the charges by Mr. Durham.

This investigation was massive and time consuming extending through the months of April and May 1972. The Lockheed auditors' efforts resulted in a 5-page summary document with 140 pages of backup information being submitted to the GAO on May 26, 1972. I would like to submit this summary plus the 140 pages of supporting data and comments and ask that they be made a part of the record.

Chairman PROXMIRE. They will be kept available in the subcommittee files, yes.

Mr. KITCHEN. Could the summary be made a part?

Chairman PROXMIRE. The summary will be made a part. The 140-page document will be kept available.

[The summary referred to follows:]

SUMMARY OF LOCKHEED'S COMMENTS ON THE STAFF STUDY PREPARED BY THE GAO ATLANTA REGIONAL OFFICE ON TESTIMONY OF HENRY M. DURHAM ALLEGING CERTAIN UNSATISFACTORY MANAGEMENT PRACTICES AT THE LOCKHEED-GEORGIA CO.

SEQUENCE OF THE LOCKHOOD COMMENTS

The 23 Exhibits in the GAO Staff Study deal with 27 allegations made by Mr. Durham in the same order as they were presented to the Senate subcommittee. As a result, like items are scattered irregularly through the GAO Staff Study. Some allegations are repetitious, and the listing of like items as separate charges unduly distorts the actual conditions at our plant.

In this summary we have grouped most of the allegations into basic categories as follows:

1. Allegations concerning the method of progress payments.
2. Allegations as to missing parts, unauthorized removal of parts, and erroneous assembly records.
3. Allegations relating to valuable small parts (VSP)—costs, physical handling, and inventory accountability.
4. Allegation concerning the Chattanooga fabrication plant—procurement practices, control of standard tools, plant security, and inventory control of material and parts.

Though based in part on limited facts, Mr. Durham's allegations are essentially unsupportable as a general condemnation of management practices on the C–5A Program. For this reason we take strong and specific exception to both the stated and the implied confirmations of these allegations in the Staff Study draft because no attempt is made to place the cited problems in perspective with respect to the program as a whole or to the overall operation of the business. We can understand how Mr. Durham was not in a position to do this. But the GAO was in a position to place individual specific problems into their proper overall context. The omission of related facts and perspective is seriously misleading.

In this regard, Lockheed's investigation indicates that information was available which would have refuted many of the broad generalized allegations of Mr. Durham. In some cases specific information was submitted to the GAO auditors in explanation and clarification of systems and controls, but this was not reflected in the Staff Study. Also, the Staff Study makes little effort to point out where the problems were minor or had only limited impact on the C–5A Program. Finally, the Staff Study gives inadequate recognition to the fact that effective corrective actions had been taken, and that most such actions had been initiated prior to the time Mr. Durham began to call out conditions which he believed represented problems.

Our specific comments regarding the groupings follow.

PROGRESS PAYMENTS

The GAO Staff Study does not specifically deal with Mr. Durham's allegations. Rather, it uses Mr. Durham's allegations as a springboard for additional erroneous allegations that indicate a lack of knowledge of applicable contract terms and conditions. The facts are that the progress payments were made in accordance with the provisions of the contract clause and applicable regulations and after due deliberation by the Air Force and Department of Defense.

More specifically:

1. The statement of GAO Staff Study confirming that "Lockheed did have significant financial incentive to move aircraft on schedule—in terms of avoiding up to $11 million in liquidated damages and receiving over $75 million in additional payments representing reimbursements of costs incurred for achieving certain schedule milestones," is erroneous as to the liquidated damages and misleading as to the additional payments.
2. The statement in the GAO Staff Study that "Lockheed did receive excess progress payments of about $400 million due to understating the value of the work completed, and overstating the value of work in process," is simply not correct.
3. The statement in the GAO Staff Study that "In fact the Air Force made an additional $705 million available for progress payments to Lockheed" is true. But it is stated in such a manner as to imply that these payments were improper. In fact, Lockheed was fully entitled to these payments.

MISSING PARTS

On this general subject there are three major areas that stand out in the various allegations made by Mr. Durham—missing parts, parts improperly removed without authorization, and erroneous assembly records. Allegations relating to these three areas are called out and discussed at length in the first section of Exhibit 1 of the GAO Staff Study. Allegations relating to one or more of these areas are again called out in the second section of Exhibit 1 and in nine additional Exhibits as well. The extent of the problem of missing parts is distorted because Mr. Durham makes several references to this broad subject in different parts of his testimony and the GAO Staff Study basically treats each of the references as a separate item.

To support his allegations, Mr. Durham relies in many cases on his own Interdepartmental Communications (IDCs) written to his management. Sources of the data for many of his IDCs were entries made to unverified lists of parts requested by shop personnel rather than the official aircraft assembly records. His data did reflect some individual situations at specific times in his areas of work, but they did not provide a sound basis to evaluate the overall situation involving the aircraft or the program in general. This fact was pointed out to Mr. Durham by both his co-workers and his management. The fact that, upon request, copies of these IDCs were provided to the GAO does not make his statements valid.

Mr. Durham's allegations dealing with so-called missing parts, unauthorized removal of parts, and inaccuracy of assembly records generally misrepresent the actual conditions at Lockheed-Georgia. While there were problems of these types at the start of the program, at no time were thousands of parts unaccounted for. The audit reports referenced in the GAO Staff Study contained information which shows that the actual quantity of parts involved was quite small, but this fact was not mentioned in the Staff Study. Nevertheless, Lockheed management was vitally interested in making sure that all parts were installed when and where they should be, that no parts were removed without proper authorization, and that the assembly records were accurate. Lockheed management was aware of these problems prior to their reporting by Mr. Durham and was taking action to resolve these problems. We continued to take action until they were satisfactorily resolved.

The extent of the problem concerning accuracy of the assembly records is overstated. Inaccurate entries to such records were generally the result of human error caused by misinterpretations or deviations from established procedures. Management took several steps to improve accuracy of the records. The basic reliability of these records was confirmed recently by a team of knowledgeable Quality Assurance personnel who were able to verify the complete traceability of parts installations, removals, and reinstallations through the assembly and airplane condition records for selected ships 0009, 0013, and 0016.

Despite the fact that Mr. Durham utilized unverified data which (1) misrepresent actual aircraft conditions and (2) overstate the number of parts not installed and the extent of unauthorized removal of parts, the GAO Staff Study says its review confirmed that his testimony and comments were substantially correct. This is a misleading oversimplification that fails to place all pertinent facts available to the GAO in a proper perspective.

VALUABLE SMALL PARTS (VSP)

Mr. Durham makes several allegations regarding VSP costs, physical handling, and inventory accountability. His allegations regarding VSP costs are based on earlier cost projections which in actuality have been substantially reduced—due primarily, as a matter of fact, to management's continued attention to this matter.

As for physical handling, at the beginning of the program we did encounter problems. These have been resolved satisfactorily by improved methods, training of employees, and effective salvage programs.

Contrary to Mr. Durham's allegation, Lockheed began early in the C–5A Program to exercise inventory accountability controls over VSP. Management immediately took steps to resolve these problems that arose and has continued to improve the controls as appropriate.

Because of improvements in physical handling and inventory controls of VSP, the total cost will be substantialy less than indicated by Mr. Durham.

Had the GAO auditors given recognition to all of the pertinent facts relating to this matter, there would have been no valid basis for their confirmation that Mr. Durham's testimony was substantially correct.

CHATTANOOGA FABRICATION PLANT

Mr. Durham makes a number of allegations regarding Chattanooga Fabrication Plant activities concerning procurement practices; control of standard tools; plant security; and inventory control of material, parts and miscellaneous small parts.

Actually, Mr. Durham's allegations fail to recognize or to objectively evaluate the controls provided over operations by both Chattanooga and Marietta management. The fact that Chattanooga was not only a relatively small operation but involved several functions about which Mr. Durham had only limited knowledge may have contributed to his misrepresentations.

The GAO Staff Study generally says that the Durham testimony and evidence are substantially accurate and valid. This confirmation of his broad generalized statements and distortions is misleading and subject to widespread misinterpretation. In some cases the testimony contains implications of irregularities in procurement, of complete lack of control of material and standard tools, and of lack of management knowledge of conditions. These charges in many cases are his personal opinions based on incomplete knowledge of control systems or total operations. The statement of confirmation in the GAO Staff Study in actuality is gravely misleading because it lends credence to the entire allegation—implications of irregularities, complete absence of controls, etc.—which essentially is not true.

With respect to procurement practices, Chattanooga had only a limited procurement function. It was authorized basically to purchase nonproductive, usage and maintenance materials, along with some production items.

All standard tools, except for expendable items such as cutters, drill bits, reamers, etc., were charged out to employees for accountability. And by procedure, employees were required at the time of termination to pay for tools not returned. In view of the high cost of accounting for expendable tools, the type and use of the tools, and the forecasted decline in employment at the plant, in 1970 management reviewed the control of such items and decided that to specifically account for these tools would not be economical.

Plant security procedures and practices were adequate for an operation of this type. The industrial area was fenced in, with a separate fenced in area for parking by employees. Employees were issued and required to wear badges and entrance to and exit from the plant were controlled. In addition, Plant Protection personnel from Marietta made periodic visits to Chattanooga and made appropriate investigations when problems developed.

As for inventory control of material, both Mr. Durham and the GAO Staff Study fail to recognize the overall control systems applied to the Chattanooga operations. Materials for the fabrication of airplane parts were basically controlled and supplied from Marietta, and the materials for the various AGE jobs were controlled and ordered on the basis of individual job requirements.

Mr. KITCHEN. On November 22 1972 the GAO submitted its report on the Durham charges after a comprehensive review from June to October 1972 of data and comments submitted by Lockheed on May 26 1972 and by the Air Force on July 13 1972, plus documentation made available to the GAO auditors by Lockheed. This report was made available to Lockheed by your subcommittee on December 4 of this year.

GAO FINDINGS

In our opinion this GAO report essentially substantiates our contention that there is little foundation to the charges made by Mr. Durham—and most specifically there is no foundation for his irresponsible and inflammatory charges of disastrously rotten management and the waste of untold millions of dollars. For example:

The GAO did not support the charge of subterfuge.

The GAO did not support the charge that parts had been unnecessarily procured.

The GAO did not support the charge of ineffective control of kits and parts in the field.

The GAO did not support the charge that layoffs and subsequent rehiring at Chattanooga could have been avoided.

The GAO did not find evidence to indicate improper movement of production airplanes in order to collect payments.

The GAO did not present any data to indicate that Lockheed management willfully concealed flaws in the C–5A during production.

The GAO did not support the charge of collusion between Lockheed and the Air Force.

The GAO did not support the charge that management was unaware of problems or that management failed to take corrective actions.

On the other hand:

The GAO report does support Lockheed's position that has been repeatedly stated.

The GAO agrees there was not a $30 million cost overrrun for titanium fasteners as alleged by Mr. Durham. Instead there was a cost increase of approximately $7 million because of engineering changes and new requirements for test articles not contemplated in the original estimate.

The GAO agrees that the practice of not providing detailed inventory controls over small and inexpensive tools is both pratical and consistent with industry practice.

The GAO agrees that Lockheed internal audit reports were an effective management tool, contrary to Mr. Durham's charge that they were ineffective.

The GAO agrees that Lockheed management was aware of problems encountered during the early period of performance under the C–5 aircraft contract.

The GAO agrees that Lockheed management did intitiate corrective actions as evidenced by audit reports and minutes of management meetings before Mr. Durham's charges were published.

LOCKHEED TOOK CORRECTIVE ACTIONS

It is true there were instances where aircraft assembly records did not accurately reflect the physical condition of the aircraft but management took corrective actions, and final records did reflect the true physical condition of the aircraft prior to delivery.

It also is true there were instances of parts being removed from aircraft without authorization but that such removals were made by individuals without the authority or approval of the management who continually tightened controls to minimize recurrence.

It is true that some parts were scrapped as a result of erroneous disposition instructions by individuals but management did initiate corrective actions and controls that would limit such errors and provide for a check and balance review of all scrap to avoid if at all possible mistakes made by such individuals.

There were problems related to control of titanium fasteners but management was aware of the problems in 1968 and initiated corrective actions to indoctrinate large numbers of new assembly workers, provide more restrictive controls of receipts and disbursements, and to salvage erroneously discarded titanium fasteners.

In general the GAO did determine that several other aerospace firms contacted experienced similar problems and conditions such as out-of-sequence work and missing parts on new aircraft programs. As with other aerospace firms, the GAO determined in Lockheed's case that management was aware of the problems and had directed management emphasis to correcting the problems.

I believe the November 22, 1972 GAO report is a balanced review of the Durham charges. However, it is regrettable that Mr. Durham made unfounded, exaggerated, erroneous and irresponsible generalizations, such as—"aircraft to be completely out of control;" "illegal removals were rampant;" "practices covered up the true amount of butchery * * *;" "there was deliberate subterfuge on the part of the Company and, I believe, the Air Force also;" "complete lack of integrity on Lockheed's part, the management * * *;" "gross negligence, waste and mismanagement."

Mr. Durham even went so far as to urge publicly and repeatedly that no Government contracts be awarded Lockheed until it purged its management.

The subsequent reports of his charges resulted in immeasurable damage to the Lockheed organization and its thousands of people.

CAUSES OF COST PROBLEMS

It is my conclusion that the procurement and cost problems in our industry today result from far broader and deeper rooted problems than those referred to by Mr. Durham.

In this regard the DOD, Congress and industry have made many statements to the effect that the Total Package Procurement contract as implemented was an unworkable concept for a major weapons system and was at the root of the problems that developed on the C–5 program. This was not known by either the Air Force or the contractor until it was too late to correct the problems that were generated during the early phases of the C–5 program. In fact, as interpreted and enforced by the Government, the original C–5A contract was impossible to perform.

I contend that among the root causes of cost growth for major weapons systems is any procurement process that does not permit meaningful milestone attainment prior to full commitment or—if total commitment is involved, as was the C–5A total package procurement, the process does not permit rational cost tradeoffs to minimize the effect of technology unknowns, nonavailability of resources, economic escalation, or ambiguous contractual language.

PROGRESS OF C–5 PROGRAM

Despite the agony, frustrations, and heartache felt by the Government and the contractor, and I might add the Congress, the C–5A program has progressed well as we overcame the initial and correct-

able problems attributable to the cause and effect of total package procurement. The C–5A is doing the basic job it was developed to do in support of this Nation's military strategy.

The airplane is operating daily with a payload of 175,000 pounds, and during the North Vietnam spring offensive, the C–5 frequently carried close to 200,000 pounds payload. In May, the C–5 transported M–41 tanks to Vietnam and the rapid offload capabilities allowed recorded ground times of about 30 minutes at Da Nang.

I think it appropriate to quote two military commanders regarding the C–5:

Gen. Jack J. Catton, former Commander, Military Airlift Command:

> Too often the negative aspects of the aircraft's performance are stressed. I think this is because one of the least understood facts of the C–5 is that it was purchased under a concurrent testing and production concept. Many of the alleged deficiencies of the C–5 are a result of operational aircraft being delivered while development testing was still in progress * * * the C–5 will fulfill the strategic airlift mission for which it was designed * * * that is the rapid deployment of outsized Army equipment and the troops necessary to operate that equipment. Our flexible response strategy would not be practical if it were necessary to station large garrisons of American fighting forces all over the world. Strategic airlift can give us the means to find the best mix of overseas garrisons—prepositioning—and mobility, enabling us to reduce our overseas forces to a level we can better support—and still meet our commitments *** so, you can see—and, even more important, a potential adversary can see —how we are able to exploit the speed and reliability of airlift to reduce the national investment in defense—and still strike faster—hit harder—and keep the peace through balanced deterrence. We couldn't do this without the C–5. That makes it quite a machine.

Adm. John S. McCain, Jr., Commander in Chief, Pacific, wrote to General Catton on August 30, 1972, and commented that the 1,312 missions by C–5's, C–141's, and other aircraft, which airlifted 15,058 passengers and 26,361 tons of cargo in a 2-month period were highly impressive. Admiral McCain stated, "These missions proved the feasilibity of flexible response as a cornerstone of our national strategy." He went on to say, "Of these missions, I was particularly pleased with the employment of the C–5 to expeditiously deliver critical M–48 and M–41 tanks from Japan and Conus depots to forward airfields in RVN."

Mr. Chairman, we have had our problems, which for the most part resulted from a procurement concept that did not work. Out of the legal dispute that surrounded the C–5 contract, we were forced to take a negotiated fixed loss of $200 million, plus more than $50 million in additional losses resulting from various disallowances—to my knowledge the highest loss ever suffered by any defense contractor on any defense contract, in spite of the intent and structuring of the original C–5A contract to prevent contractor windfall profits or catastrophic losses. Despite these problems, including the financial ones, we have applied all of our energies to correcting those problems as well as we could, and we hold our heads high while we voice our pride in products developed and built by the thousands of people of the Lockheed-Georgia Co. This concludes my statement, Mr. Chairman.

Chairman PROXMIRE. Thank you, Mr. Kitchen.

Mr. Durham.

STATEMENT OF HENRY M. DURHAM, FORMER EMPLOYEE, LOCKHEED-GEORGIA CO.

Mr. DURHAM. Mr. Chairman, I will introduce myself.

First of all, I want to express my appreciation for again being asked to testify before this subcommittee. Very seldom is a person given such a splendid opportunity to serve his country. Therefore, I consider it a privilege and an honor to be here today.

On September 29, 1971, I testified before this subcommittee. During the hearing, I submitted voluminous and detailed documentary and physical evidence on gross mismanagement, massive waste, collusion and other unbelieveable malpractices on the C–5 program. As a result, Senator Proxmire asked the General Accounting Office to investigate the charges.

GAO STAFF STUDY

As a result of the investigation, the General Accounting Office released a report in March of this year which substantiates and corroborates practically every aspect of the charges.

In his opening statement at the hearing held on Monday, March 27, 1972, Chairman Proxmire said in part:

> Generally speaking, the staff study corroborates nearly every aspect of Mr. Durham's charges. All of his documents and materials were found to be authentic, and additional evidence was discovered by the GAO in support of what Mr. Durham said and in support of some malpractices that even Mr. Durham was not aware of.

The GAO investigation which culminated in the GAO report released last March was an in-depth audit made by a team of experienced auditors over a period of approximately 4½ to 5 months. The auditors delved deeply into Lockheed records, questioned many people and witnesses, acquired pertinent documentation, verified facts and in effect, conducted a thorough investigation.

After the investigation was completed and the report written, the GAO people gave me the opportunity to read it. However, as in Lockheed's case, I was not given the opportunity to suggest any changes or comment on the report.

While the document was in my possession, I made copies and forwarded them to Senator Proxmire and members of his staff who subsequently, after some difficulty, obtained release of the report from the GAO Washington office prior to the March hearings.

In my opinion, the report in its original form would still be under wraps if copies had not been made available to Senator Proxmire.

COMPTROLLER GENERAL'S REPORT

This opinion was shockingly validated when I read the Comptroller General's report concerning the charges. The report bears little resemblance to the GAO report. Practically all of the key charges substantiated and reported by the GAO auditors who made the investigation have been mysteriously omitted, distorted or diluted. This is not just my opinion, but a matter of public record.

My testimony today is basically derived from making a compari-

son of the GAO report as reflected in the official hearing records with the Comptroller General's report.

The GAO report is contained in the official hearing record entitled: The Acquisition of Weapons Systems—Part 5. Therefore, I have included pertinent copies of the pages of the report as part of my testimony in order to provide a ready reference and to dispel any doubt of what the GAO auditors actually reported.

As we go through the testimony during this hearing, I ask you to compare what the GAO auditors who made the investigation actually found and honestly reported with what appears in the Comptroller General's report.

According to the Comptroller General's report, Lockheed management was aware of the problems and had initiated corrective actions before Mr. Durham's charges were published. However, I simply can't remember any announcements from Lockheed that they were mismanaging the program prior to publication of my charges. In fact, they have repeatedly and publicly denied that the charges are true. For instance, Mr. Everett A. Hayes, Lockheed corporate director of publicity, recently stated in an open letter to a Florida newspaper editor:

> Durham, despite his long service with Lockheed, was never in a position to have an overview of the C–5 program. His charges are based for the most part on meager or unrelated information and are made with no knowledge or understanding of the overall task of putting into production a program of the magnitude of the C–5.
>
> His allegations dealing with so-called missing parts, unauthorized removal of parts, and inaccuracy of assembly records categorically misrepresent conditions at Lockheed Georgia.

Obviously, Mr. Hayes has not had an opportunity to read the GAO report.

GAO STAFF STUDY FINDINGS

I would like to briefly comment on a few charges and GAO findings which will be discussed in more detail during the hearing. The GAO findings here are exact quotes from the GAO report or document:

(A) Charge: Hearing record, page 1408, exhibit 1: C–5 airplanes were moved to the flight line with thousands of parts missing although Lockheed records falsely showed the parts had been installed.

GAO finding: The charge is unquestionably true and was a significant problem.

(B) Charge: Hearing record, page 1411, exhibit 1: Improper removal of parts contributed to the missing parts problems.

GAO finding:

> Our review confirmed that Mr. Durham's testimony was substantially accurate.

(C) Charge: Hearing record, page 1412 exhibit 1: Lockheed moved assemblies and aircraft on a prescribed schedule, regardless of the state of completion, to receive credit and progress payments for being on schedule.

GAO finding:

> In summary, we found that the allegation that Lockheed had received excess progress payments, regardless of condition or schedule, to be correct. Lockheed

did receive excess progress payments of about $400 million due to understating the value of the work completed and overstating the value of work in process.

We also found that the Air Force was aware of the excess progress payment situation but failed to act on it. In fact, the Air Force made an additional $705 million available for progress payments to Lockheed.

(D) Charge: Hearing record, page 1414, exhibit 3: Overprocurement and misuse of valuable small parts. The company was facing a $30 million cost overrun on VSP due to overprocurement resulting from failure to control parts in production areas and cribs. VSP cost per aircraft should be approximately $560,000. However, cost was exceeding $1 million per ship.

GAO finding:

Our review confirmed that Mr. Durham's testimony is substantially accurate. In summary, Lockheed did project overprocurement of VSP—as Mr. Durham testified—due to unstatisfactory inventory and production controls.

(E) Charge: Hearing record, page 1417, exhibit 7: Procurement abuses at the Chattanooga plant. Exhorbitant prices were paid to vendors for material when the same material was available in Lockheed stores for a fraction of the price paid to the vendors.

GAO finding:

We determined that Mr. Durham's testimony and evidence were substantially accurate and valid. We obtained additional evidence that significant percentages of material and other items were procured from vendors although the items were available at substantially less cost through the Marietta plant stores inventory.

(F) Charge: Hearing record, page 1420, exhibit 8: Waste of tools and equipment at the Chattanooga plant. Standard tools at Chattanooga were completely out of control although many were very expensive.

GAO finding:

Our review confirmed that Mr. Durham's testimony is substantially accurate. We obtained additional evidence that significant quantities of tools were lost or stolen due to laxity of general plant security and the absence of specific controls over standard tools.

(G) Charge: Hearing record, page 1421, exhibit 9: Inadequate control over material at the Chattanooga plant. Material (raw stock, such as extrusion, bar steel, sheet metal, aluminum stock, etc.) was completely out of control. Extremely costly.

GAO finding:

Our review confirmed that Mr. Durham's testimony is substantially accurate and his evidence valid. We obtained additional evidence that a substantial but indeterminate amount of surplus and scrap raw material, finished parts, tools, equipment and miscellaneous small parts had been accumulated as a result of production waste, canceled Air Force orders, transfers from another Lockheed plant to the Chattanooga plant without a foreseeable need, and ineffective management controls.

(H) Charge: Hearing record, page 1423, exhibit 10.

Ineffective management and control over purchased parts and miscellaneous small parts resulted in unnecessary, duplicate procurement because the availability of parts on hand was not determined or controlled.

GAO finding:

Our review confirmed that Mr. Durham's testimony is substantially accurate. We obtained evidence that parts and material were ordered at the Chattanooga plant without knowledge of their cost, quantities in inventory, and justifiable need.

(I) Charge: Hearing record, page 1423, exhibit 11: Unnecessary procurement of miscellaneous small parts resulted at both the Chattanooga and Marietta plants because the Chattanooga inventories were overstocked and out of control.

GAO finding:

Our review confirmed that Mr. Durham's testimony is substantially accurate.

(J) Charge: Hearing record, page 1423, exhibit 15: The Lockheed shortage list and condition report for airplane serial 0023 showed only 30 open items when it actually had 1,084.

GAO finding:

We believe that Mr. Durham's statement concerning the open items on airplane, serial 0023, was accurate and the report valid.

(K) Charge: Hearing record, page 1426, exhibit 16: Millions of dollars worth of reworkable (salvageable) purchased parts were scrapped because of erroneous disposition and mishandling.

GAO finding:

Our review has confirmed that expensive purchased and subcontracted parts, which could have been salvaged, were erroneously discarded.

(L) Charge: Hearing record, page 1428, exhibit 20: There were no controls over parts and the stockrooms at Chattanooga.

GAO finding:

Our review confirmed that Mr. Durham's testimony is substantially accurate.

(M) Charge: Hearing record, page 1428, exhibit 19: About 45,439 parts had to be delivered to aircraft after they arrived at the flight line; 15,291 of these were missing parts and 5,294 were replacements for rejected parts.

GAO finding:

We believe that this example is substantially correct and demonstrates the magnitude of parts requirements and problems at the flight line.

GAO REPORT A WHITEWASH

This concludes my brief summary, except, Senator Proxmire, I heard what Comptroller General Staats said this morning, and I also heard what you said, but in all due respect and honesty I must say that in light of the foregoing summary, which is elaborated and commented on in the additional testimony that I am submitting for the record, I can only conclude that the Comptroller General's report presented to you today is a whitewash of the first magnitude. I am frankly at a loss to understand this report. It not only fails to address itself properly to all of the very serious allegations which the Comptroller General was asked to investigate but also ignores, obscures or reverses the findings arrived at by the General Accounting Office's own conscientious investigators. The evidence and documentation is available for all to see. Extracts from the GAO report are attached to my testimony. I ask everyone in the room to give it the attention it deserves because of the importance to all Americans.

Thank you, sir.

[Attachments to Mr. Durham's statement follow:]

[Extracts from the staff study prepared by the GAO Atlanta regional office and the report by the Comptroller General regarding charges of unsatisfactory management practices in the C–5 aircraft program at Lockheed-Georgia Co.]

CHARGES PERTAINING TO CHATTANOOGA, TENN.

EXHIBIT 7 (PT. 1) : PROCUREMENT ABUSES AT THE CHATTANOOGA PLANT

Since some very important and pertinent findings were omitted in the Comptroller General's report, I will cover the investigation more thoroughly.

See page 24—Comptroller General's report.

As shown on page 1417 of the official hearing record, the original GAO report stated:

"In describing procurement abuses at the Chattanooga plant, Mr. Durham testified that: I will show examples of exorbitant prices paid to vendors for material when the same material was available in Lockheed stores (at the Marietta plant) for a fraction of the price paid to vendors. The practice persisted despite repeated complaints on my part. Finally, a strong letter stopped it temporarily."

The GAO stated as shown on page 1418 that:

"We determined that Mr. Durham's testimony and evidence were substantially accurate and valid. We obtained additional evidence that significant percentages of material and other items were procured from vendors although the items were available at substantially less cost through the Marietta plant sotres inventory."

The GAO finding continues:

"These outside purchases were contrary to Lockheed-Georgia Company instructions issued in April 1970, re-emphasized in March 1971, which stated that there was no excuse for ordering material from outside sources and spending company funds when identical assets were available in Lockheed storerooms."

On page 25 of the Comptroller General's report, Lockheed indicates that materials procured by Chattanooga that were available in Marietta were the result of clerical error and were isolated cases. However, additional statements by the GAO in the GAO report shown on page 1418 of the hearing records show that this was not the case. The statement reads:

"Although we could not determine the total adverse effect or dollar impact resulting from these procurement practices, we did expand the review beyond the scope afforded by Mr. Durham's examples to establish that a pattern existed."

"Our expanded review of purchases from several vendors, during sample periods, showed that about nine percent of the miscellaneous parts purchased from two vendors were available through the Marietta Procurement System at 62 percent savings and 16 percent of material items purchased from another vendor were available at 77 percent savings. For example, vendors were paid $1,633 versus the Marietta cost of $622 for miscellaneous small parts and $500 versus the Marietta cost of $115 for material items."

Bear in mind that these are just test samples which are indicative of the entire system.

Lockheed's statement in the last paragraph on page 25 of the Comptroller General's report that it ordered parts separately to facilitate matching material and related paperwork, and that it saved money by facilitating the material receiving process thereby affording better control over the material and related paperwork is not true according to the GAO auditors in a finding shown on page 1418 of the official hearing report which states:

"Considering the confused state of the material, purchased parts, and small parts inventories and lack of controls, which are discussed in exihibits 10 and 11, it is understandable that material receipts could be controlled better by ordering one line item on one requisition."

The GAO statement continues in the last paragraph on page 1418 of the hearing record:

"The Chattanooga procurement supervisor told us that procurement personnel must not have checked the Marietta stores catalog adequately before ordering parts from vendors."

What the Chattanooga procurement supervisor said was that instead of finding out whether parts were available in the Lockheed stores the company procured parts from vendors at considerably higher costs.

The GAO statement continues:

"He also told us that Lockheed's costs for cutting material from stores would be so high that the vendors' price would be cheaper because the vendor warehoused, cut, and shipped the material."

The GAO statement continues:

"We believe that this position is clearly unrealistic because it negates the earlier Lockheed instructions; it does not consider the effect of minimum vendor charges and does not recognize that daily delivery service was provided routinely between the two Lockheed plants. Moreover, because of the lack of catalogs and price lists, the official could not have made adequate cost comparisons. He told us that the vendors wrote in the prices on almost all orders for material and miscellaneous small parts and that Chattanooga procurement personnel did not verify these prices."

This is an extremely significant finding and is indicative of disastrously rotten mismanagement—the Lockheed official admitted to the GAO auditors making the investigation, that Lockheed blindly ordered material and parts without checking prices and let the vendors write in the prices. Furthermore, Lockheed didn't even bother to verify the prices charged by those vendors. I possess many examples of very exhorbitant prices charged by vendors.

Does this look like a money saving operation as Lockheed contends?

EXHIBIT 7 (PT. 2): UNNECESSARY PROCUREMENT OF MAINTENANCE NUTS AND BOLTS

I must expand on the GAO findings since some very important and pertinent facts were omitted in the Comptroller General's report.

See page 31— comptroller General's report as shown on page 1419 of the official hearing records, the original GAO report said:

As an example of procurement abuses at the Chattanooga plant, Mr. Durham testified that:

"A salesman from one company would come to the plant, look in the bins and supply whatever he thought was needed. The problem is that he supplied far more expensive parts than were needed and as many as he thought he could get in the bins. For example, he sold Lockheed steel high-tensile bolts, plated bolts, etc., when plain old common stove bolts would do. No one in management questioned anything and went right on paying the bill. No bids were taken. A check showed that a regular hardware supply company could supply parts much cheaper. A real peculiar situation developed when the same salesman changed companies. The bolt account went with him. This is highly irregular. Lockheed is supposed to obtain parts by bid from companies—not individuals."

The GAO auditors stated further: (Page 1419)

"Our review confirmed that this charge was substantially accurate. We determined that, for ordinary plant maintenance purposes, Lockheed purchased the highest possible strength nuts and bolts—exceeding high aircraft specifications—at a cost of about $36,000 over a five year period from 1966 through 1970."

While this is not a great deal of money, it vividly demonstrates the caliber of the management.

The GAO statement continues: (Page 1419)

"These purchases were made without competition. Although the salesman apparently flimflammed both Lockheed and his employer, by establishing his own company and proceeding to represent both companies simultaneously, Lockheed issued each purchase order and renewed them on the basis that the items were normally available from only one source.

"We determined that the company could have saved about $30,400 or 84.5 percent of costs by purchasing lower grade items from other vendors. As a result of a Lockheed study of this matter in December 1970, the company began purchasing its needs from another vendor in 1971. Lockheed also issued this purchase order on the basis that the items were normally available from one source."

The study was not very effective since no bidding was required. Perhaps the vendor helped to make the study.

The GAO statement continues: (Page 1419)

"However, we determined that about 64 percent of the items included in the study were normally stocked at the Marietta plant and that the new vendors prices were about 33 percent higher."

This finding is very significant—the GAO auditors found and reported that a "so-called" Lockheed management improvement resulted in another one source

supplier with no bidding and that 64 percent of the items being purchased from this one vendor were available in Lockheed's own stores at 33 percent less than the price being paid the vendor.

For some reason, the Comptroller General failed to bring out these horrible but typical examples of mismanagement.

EXHIBIT 8: WASTE OF TOOLS AND EQUIPMENT AT THE CHATTANOOGA PLANT

I must also expand on this charge since very pertinent and important GAO findings were omitted in the Comptroller General's report.

See page 26—Comptroller General's report.

As shown on page 1420 of the official hearing record, the GAO report stated:

"Mr. Durham testified that:

"Standard tools of Chattanooga were completely out of control. (Standard tools consist of such items as drills, carbide cutters, bits, etc.) Many are very expensive. Incredible as it seems, there was no checkout control system or any effective controls. No one knew where anything was or who checked it out. The tool engineer in charge of security told me that $250 to $300 a week was being spent to replace pilfered or lost standard tools. He said this was a conservative figure. I found perfectly good tools rusting away in the back yard.'

'Example: Rusty drills found in an old water soaked cabinet thrown out in the back yard. They were immersed in water and ice when I found them. Since I had no jurisdiction over tools, I immediately pointed the condition out to the plant manager in person. Six months later they were still there, along with other costly equipment and material—rusting away. A control system for tools still had not been established by May of this year (1971).'"

The GAO auditors report continues:

"Our review confirmed that Mr. Durham's testimony is substantially accurate. We found his evidence—a written statement by a tool engineer and examples of rusty drill bits—are valid. We obtained additional evidence that significant quantities of tools were lost or stolen due to the laxity of general plant security and the absence of specific controls over standard tools.

"Although we note that the company spent a monthly average of about $12,000 to replace standard tools from May 1970 through May 1971, we could not determine the cost of losses as opposed to valid replacements because of the lack of records. There were no systems to control and record the inventory and issues of standard tools—except that there was a checkout system for some items such as precision gauges and micrometers. Even so, 111 gauges valued at $3,614 have been lost since 1966.

"The only estimate of losses we could obtain was in a written statement provided to Mr. Durham by the engineer responsible for procurement and handling of standard tools and plant security. He stated that:

'There was no checkout control of cutting tools to the production areas and regularly small but expensive tools have been reported issued and lost in the shop. It is a fair estimate that between $500 and $400 a week would be saved using some sort of locator control issue system. Security is so loose that company equipment can be taken almost at will with the inability of the management to know the amount of loss.'

"Plant officials and former employees told us that some of the items stolen were an air compressor, electric motor, power saw, several paint spray guns, socket wrenches, tires intended for C–5A ground support equipment (AGE), a micro-wave oven, a dollar bill change machine and a 200 pound tool box."

This refutes Lockheed's statement in the Comptroller General's report that standard tools, such as kit-type tools, power tools, and certain hand tools were stocked in cribs, charged out to employees and accounted for. If they were accounted for, the power saw, socket wrenches, etc., would not have been stolen.

The air compressor weighs about 2,000 pounds, is set on four wheels and is transported like a trailer.

The GAO statement continues: (Page 1420)

"In October 1970, the tool engineer recognized that costs of supplying standard tools and related equipment was rising. He proposed an inexpensive system to control issues of standard tools based primarily on use of numbered tags to identify the workers charged. In July 1971 (nine months later) the tool engineer again stressed the need for a complete inventory of standard tools as an essential task to identify and remove obsolete tools.

"We determined in January 1972 that there were no systems to control and record the inventory and issues of standard tools nor were there any records of losses."

The GAO report continues: (Page 1421)

"We believe that as a result of the lack of inventory and issue controls obsolete and excess standard tools were generated. An Air Force report of August 1971 showed that tools on hand were excess to reasonable requiremets and that a large quantity of tools from another Lockheed company had been put in stock but some had not been used. The tool engineer told us that as a result of the Air Force review, about two tons of standard tools were scrapped."

In view of these facts uncovered and reported by GAO auditors who made the investigation, the statement in the first paragraph on page 26 in the Comptroller General's report that it is generally impractical to provide a detailed inventory control system for items that are small and inexpensive doesn't hold water since the tools in question are obviously expensive as substantiated by the GAO auditors. Both the GAO and the Air Force revealed that excess tools were on hand to reasonable requirements.

The fact that large quantities of unneeded tools from another Lockheed company had been sent to Chattanooga is further evidence that the right hand didn't know what the left hand was doing. Proper management techniques would have provided a check system to identify tool requirements at Chattanooga and proper disposition for the balance. Could anyone say that the accumulation of two tons of tools which had to be scrapped is good management? Also, why did they wait for the Air Force to identify the problem?

In view of these awful practices reported by the GAO it is astonishing to learn from the Comptroller General's report on page 26, that procedures used by Lockheed to handle small tools at Chattanooga were consistant with the practices at two other aerospace firms. Is this an endorsement of the boneheaded malpractices reported by the GAO auditors in the official hearing records? Perhaps this explains, at least in part, the spiraling overruns reported on other military contracts.

EXHIBIT 9: INADEQUATE CONTROL OVER MATERIAL AT THE CHATTANOOGA PLANT

Again, the Comptroller General's report has omitted very important and pertinent findings reported by the GAO. For some reason, the Comptroller General divided exhibit 9 into two separate sections in his report entitled Lack of Inventory Control over Raw Materials and Mishandling Material.

As shown on page 1421 of the official hearing record the GAO auditors who made the investigation stated:

"In describing the lack of control over material, Mr. Durham testified that:

'Material (raw stock such as extrusion, bar steel, sheet metal, aluminum stock, etc.) was completely out of control. No one knew where anything was, including expensive castings and forgings. Material was being ordered every day when it was actually available if anybody had known it or knew where it was. Old material, new material, old rusty pipes, maintenance equipment, rubber goods, dirt, wood, trash, and other debris were all heaped together. Expensive castings and forgings were piled in old, rusty, water filled barrels or buried in the muck.

'I did manage to get this (scrap) cleaned up by dumping 42½ tons (a matter of record) of old material which had rusted and corroded beyond recognition. This enabled us to sort out what was left and get it under control. I established a catalog control system and set it into motion.'"

The GAO statement continues: (Page 1421)

"Our review confirmed that Mr. Durham's testimony is substantially accurate and his evidence valid. We obtained additional evidence that a substantial but indeterminant amount of surplus and scrap raw material, finished parts, tools, equipment, and miscellaneous small parts had been accumulated as a result of production waste, cancelled Air Force orders, transfers from another Lockheed plant to Chattanooga without a foreseeable need, and ineffective management controls. However, we were unable to determine the amount attributable to ineffective management because there were no perpetual inventory records of regular stock and no inventory records or other descriptive records of the surplus and scrap on hand at the time.

"In a memorandum for distribution dated September 1970, the Chattanooga plant manager stated that the accountability and handling of material was out of control. He stated that there were plans underway to install control systems and directed that in the meantime the indiscriminate ordering of material must cease. According to Mr. Durham's memorandum of March 22, 1971 approved by the plant manager, the purging and sorting of raw stock material was in process to provide an accurate determination of available material and a basis for inventory control and material handling.

"As a result of Mr. Durham's efforts, much of the surplus and scrap was sorted, identified and sold as scrap or stored properly in 32 large plywood boxes which he had built. About 603,500 pounds of material, equipment, and other items were sold as scrap for about $37,400 between June 1, 1970 and July 14, 1971.

The GAO audit report continues: (Page 1422)

"Plant officials told us that excess parts and material had been accumulated inside the plant and in the yard. Several officials, employees and former employees confirmed that the plant yard had been substantially covered with surplus and scrap items, much of which was unidentifiable.

"We believe that significant losses occurred unnecessarily during ensuing operations because, as recognized by the Chattanooga plant manager, management lost control over the procurement accountability, and handling of material. New materials were ordered indiscriminately according to the plant manager. Materials and parts were ordered without regard to stock on hand according to the procurement supervisor. A former procurement official confirmed this and told us that material and parts were routinely ordered to cover material lost in the shops and to replace mutilated material.

"Mr. Durham helped establish a closed crib storage system and issued instructions with the plant manager's approval to provide documentation and control over replacement for lost and damaged material. However, management did not establish inventory control over raw stock and purchased parts.

"As of August 1971, Lockheed planned corrective action to identify, use, or dispose of the excesses, however, much of this material, parts, and other items remained at the plant as of January 1972, as discussed earlier. During our review, Lockheed announced plans to sell the Chattanooga plant. No details were disclosed concerning disposition of excess materials and parts."

The statements by Lockheed on page 29 and by the Comptroller General on page 28 of the Comptroller General's report, regarding Chattanooga's policy of ordering AGE requirements by job rather than maintaining inventory controls are absolutely meaningless since the GAO auditors have unquestionably proven that parts and material were completely out of control.

The second statement under Lockheed Comments on page 29 of the Comptroller General's report is equally as puzzling. It states:

"In regard to the September 1970 memorandum which stated that the accountability and handling of material was out of control, Lockheed pointed out that this communication was written by Mr. Durham for the plant manager's signature."

How is this to be interpreted? Is Lockheed praising me for helping the plant manager with his communications like a good employee? Surely they aren't implying that a hand picked Lockheed plant manager would approve and sign such a significant memorandum without knowing the contents—utterly ridiculous.

As stated earlier, the Comptroller General's report divided exhibit 9 into two sections. Since I have already covered the first section above, I will now comment on the section reflected on page 33 of the Comptroller's report.

The first paragraph on page 33 states:

"Although there was apparently a large accumulation of equipment in the plant yard at Chattanooga during 1970, at the time we visited the plant in December 1971 we found the plant yard was in reasonably good condition with most material properly stored."

This statement is contradicted by the GAO auditor who made the investigation as is reflected in the GAO report on page 1423 of the hearing record. It states:

"As of August 1971, Lockheed planned corrective action to identify (they didn't know what they had), use, or dispose of the excess. However, much of this material, parts and other items remained at the plant as of January 1972, as discussed earlier."

Perhaps the Comptroller General means that the excesses had been piled or stacked more neatly. Even garbage looks better when it is compacted.

The Comptroller General's statement that there was apparently a large accumulation of equipment in the yard is completely contridicted by not only the GAO auditors who made the investigation but by the Chattanooga plant manager. For example, the GAO auditors made the following statement in the GAO report as shown on page 1421 of the hearing record:

"Our review confirmed that Mr. Durham's testimony is substantially accurate and his evidence valid. We obtained additional evidence that a substantial but indeterminate amount of surplus and scrap raw material, finished parts, tools, equipment, and miscellaneous small parts had been accumulated as a result of production waste, cancelled Air Force orders, transfers from another Lockheed plant without a foreseeable need and ineffective management controls."

The second paragraph on page 33 of the Comptroller General's report apparently supports the Lockheed excuse that the large amount of material accumulated in the yard was a temporary condition caused by (1) the cancellation of Air Force orders and (2) the movement of tooling and material from Lockheed Industrial products to the Chattanooga plant in addition to the normal accumulation of scrap from the production process is completely refuted by many statements made by the GAO auditors who investigated and reported the conditions. They attributed it to mismanagement. Therefore I again call your attention to the GAO report shown on page 1421 of the hearing record.

First of all, the Comptroller General, when referring to the movement of parts and material from Lockheed Industrial Products omitted the GAO finding that the material was moved to Chattanooga without a foreseeable need. Was it a good policy to move tons of unneeded parts, junk, etc. and dump it on top of an area that was already contaminated? Is it good management?

The Comptroller General referred to the normal accumulation of scrap from the production process. This could have had no bearing whatever. Production scrap, by Air Force procedure, is immediately dumped into scrap gondolas maintained specifically for the purpose. The material is never co-mingled with other material. The GAO auditor stated it properly when he referred to production waste. By that he meant excesses created through indiscriminant ordering of material, overprocurement, etc., which is certainly not normal.

If the Comptroller General did find production scrap in the storage area he should call for another Lockheed investigation.

The Comptroller General and Lockheed called it a temporary condition. However, this is refuted by findings appearing in both the GAO audit report and the Comptroller General's report.

Under Lockheed's comments on page 34 of the Comptroller General's report, Lockheed stated that in early 1970 plans were underway to make certain plant rearrangements and to improve housekeeping. Dates were established on April 14, 1970 to start the big cleanup. A report stated that material stored on the exterior grounds would be rearranged and put in order. Yet, the GAO report states as shown on page 1423 of the hearing report:

"As of August 1971, Lockheed planned corrective action to identify, use, or dispose of the excesses, however, much of this material, parts and other items remained at the plant as of January 1972, as discussed earlier. During our review, Lockheed announced plans to sell the Chattanooga plant. No details were disclosed concerning disposition of excess materials and parts."

From April 1970 until January 1972 is a year and nine months. Does this sound like a temporary condition as claimed by the Comptroller General and Lockheed?

The last paragraph on page 33 of the Comptroller General's report refers to 42½ tons of scrap. The last sentence in that paragraph states:

"Although the original cost of these items could not be determined, the sale was made at competitively established rates."

The official record shows that the 42½ tons of scrap steel was sold in May 1971 for $1,159. Is this a competitive price for 42½ tons of steel?

As stated in the GAO report as shown on page 1421, my original charge reported:

"I did manage to get this (scrap) cleaned up by dumping 42½ tons (a matter of record) of old material which had rusted and corroded beyond rec-

ognition. This enabled us to sort out what was left and get it under control."

The GAO report continues on page 1421:

"Although there were no records describing the 42½ tons cited by Mr. Durham, plant officials told us that the sale included unidentifiable raw materials, tools, and production scrap."

In October 1971, five months after the sale, Lockheed stated that the 42½ tons included a heavy monorail. They were trying to say that the 42½ tons was not all scrap aircraft material but something else. Why did they change their minds five months later? I was there directing the operation and made the report. The 42½ tons was definitely comprised of aircraft material.

The first paragraph at the top of page 34 states:

"The Manufacturing Services Department Manager explained that some titanium had been scrapped because it was excess due to engineering changes and because its metallic contents could not be determined."

A statement by the GAO auditors in the GAO report as shown on page 1422 indicates that the titanium stock mentioned was valued at about $30,000. Obviously the certification papers were lost and became disassociated from the titanium due to ineffective management controls.

Under Lockheed comments reflected on page 34 of the Comptroller General's report, Lockheed stated that there were some inexpensive. AGE castings for which no requirements existed stored outside in the drums in which they had been received from Marietta.

I have with me as evidence copies of two of the listings of castings I originally submitted to the GAO as exhibits in September. These castings, found in a rubble covered basket and water filled barrels were priced by an official located in the Marietta Purchasing Department. On one list, quantities of only thirteen different castings were valued at $10,488.55. The other lists shows additional castings in large quantities totaling over $50,000.00 for a total of over $60,000.00. Are these some of the inexpensive castings referred to by the Comptroller General in his report?

The last sentence in the second paragraph appearing under Lockheed comments on page 34 states that on August 12, 1970, just prior to Mr. Durham's employment at Chattanooga, the plant manager's activity report stated that "The back yard has been improved considerably and more time will be spent here as time allows."

I don't quite understand the significance of this statement since the terrible conditions reported and substantiated by the GAO were obviously present at Chattanooga while I was there.

I invite you to turn to page 1311, 1312, 1313 and 1314 in the official hearing records in order to view actual pictures taken of the material storage area in the yard at Chattanooga. How could the unbelievably horrible conditions depicted in these pictures represent an improvement?

EXHIBIT 10: QUESTIONABLE PROCUREMENT PRACTICES DUE TO LACK OF PARTS CONTROL AT THE CHATTANOOGA PLANT

Again, the Comptroller General's report has omitted very critical and pertinent findings uncovered, substantiated and reported by GAO auditors.

As shown on page 1423 of the original hearing report, the GAO stated:

"Mr. Durham testified that ineffective management and control over purchased parts and miscellaneous small parts resulted in unnecessary, duplicate procurement because the availability of parts on hand was not determined or controlled. He also cited in this exhibit examples of small parts purchased at excessive prices, which we discussed in exhibit 7."

(Note that this charge refers to purchased parts as well as miscellaneous small parts.)

The GAO statement continues:

"Our review confirmed that Mr. Durham's testimony is substantially accurate. We obtained evidence that parts and material were ordered at the Chattanooga plant without knowledge of their cost, quantities in inventory, and justifiable need. Physical counts of inventories, to support procurement action, would have been difficult in our opinion because there were no inventory records, the stockrooms were open cribs with parts and material scattered about, and usable parts were not cross-referenced to part number changes and substitute part numbers. Additionally, the carelessness of production workers resulted in unnecessary losses of and damages to parts and material being worked in process. Inadequate inspection resulted in entire lots of parts produced with

the same defect as the result of incorrect machine settings. Procurement of replacements without documenting losses and damages was routine."

I have available with me copies of authentic Lookheed documentation which show examples of parts purchased at exhorbitant prices from vendors although parts were available in Lockheed's own stores at less cost. These same examples were included in the September exhibits and made available to the GAO shortly thereafter.

EXHIBIT 11: UNNECESSARY PROCUREMENT OF MISCELLANEOUS SMALL PARTS DUE TO LACK OF INVENTORY CONTROL AT THE CHATTANOOGA PLANT

I must expand on this charge since the Comptroller General's report omits very serious charges which were substantiated by the GAO auditors who conducted the investigation.

In the GAO report as shown on page 1423 of the official hearing record, the GAO states:

"Mr. Durham testified that unnecessary procurement of miscellaneous small parts resulted at both the Chattanooga and Marietta plants because the Chattanooga inventories were overstocked and out of control. He said that as a result of poor management, including purchasing without checking available stock and the closure of another Lockheed plant in Atlanta, Georgia, about 4,894 line items of miscellaneous small parts had been accumulated at the Chattanooga plant—although a review of engineering requirements showed that only 813 line items were needed."

The GAO report continued: (Page 1424)

"Our review confirmed that Mr. Durham's testimony is substantially accurate. Both the Air Force Plant Representative at the Marietta plant and Lockheed officials at the Chattanooga plant confirmed that excesses had been accumulated.

"The Manufacturing Services Department Manager generally agreed that Mr. Durham identified the excesses, but he stated that more than 900 parts were needed—rather than 813 (a minor point). He told us that Mr. Durham had organized the parts crib, obtained storage bins, and identified needed parts. He told us also that at January 1972 about 3,000 excess miscellaneous small parts were still on hand.

"Our discussion under exhibits 7 and 10 further demonstrates that inventories were not controlled, perpetul inventories were not maintained and that procurement action was taken without knowledge of available stock on hand."

The Comptroller General's report on page 30, paragraph 1, states that Chattanooga did not maintain inventory controls over MSP because it was purchased to fill the requirements of specific production orders. Lockheed advised us that, due to the nature of MSP (i.e., high usage, low cost, and small size) and the fact that MSP usage normally exceeded requirements, it was standard practice to procure more parts than required. In addition, it is generally impractical to provide a detailed inventory control system for items that are small and inexpensive.

The GAO auditors who performed the investigation and substantiated my charges certainly don't agree with the Comptroller General's and Lockheed's position as evidenced in the GAO report. For example, on page 1423 of the official hearing record under exhibit 10, the GAO stated:

"Mr. Durham testified that ineffective management and control over purchased parts and MSP resulted in unnecessary duplicate procurement because the availability of parts on hand was not determined or controlled. He also cited in this exhibit examples of small parts purchased at excessive prices which we discussed in exhibit 7."

The GAO report continues: (Page 1423)

"Our review confirmed that Mr. Durham's testimony is substantially accurate. We obtained evidence that parts and material were ordered at the Chattanooga plant without knowledge of their cost, quantities in inventory, and justifiable need. Physical counts of inventories, to support procurement action, would have been difficult in our operation because there were no inventory records, the stock rooms were open cribs with parts and material scattered about, and usable parts were not cross-referenced to part number changes and substitute part numbers."

The GAO report continued:

"Although we could not determine the extent of unnecessary procurement—because of the absence of controls and inventory records—plant officials and

former employees told us that unnecessary procurements resulted from the factors above. The Manufacturing Services Department Manager told us that one of Mr. Durham's best achievements was to provide for proper cross referencing of part number changes. (AN INVENTORY CONTROL PROCEDURE). The department manager also said that Mr. Durham established separate, closed crib storerooms for purchased parts and miscellaneous small parts in numerical part number sequence (MORE INVENTORY CONTROL PROCEDURES)"

Therefore, not only the GAO but Lockheed management recognized the need for inventory controls as evidenced by the Manufacturing Services Department Manager's statement.

The GAO report is replete with statements by GAO auditors proving that non-existant or ineffectual inventory controls were not the only controls which were absent or very poorly managed. To cite just a few examples, page 1420, paragraph 4—official hearing report:

"Although we note that the company spent a monthly average of about $12,000 to replace standard tools from May 1970 through May 1971, we could not determine the cost of losses as opposed to valid replacements because of the lack of records."

Page 1423—Official hearing report—middle of second paragraph under exhibit 10:

"Additionally, the carelessness of production workers resulted in unnecessary losses of and damages to parts and material being worked in process. Inadequate inspections resulted in entire lots of parts produced with the same defect as the result of incorrect machine settings."

In these cases, proper inspection procedures would have not only detected the defects but recorded the defects on discrepancy reports (DR's) which, according to procedure, would have prevented recurrences.

In the last sentence in the second paragraph under exhibit 10, the GAO auditor stated:

"Procurement of replacements without documenting losses and damages, was routine."

This means that Lockheeds procurement section was blindly and routinely buying replacement parts without the proper authorization or documentation or even questioning why.

Page 1429 of the official hearing record—item 13 at the top of the page—reads as follows:

"In some instances standard hours would be credited to the cost centers before the shop orders and work could be inspected."

This GAO finding is very significant. Chattanooga's and Marietta's production performance was measured on the basis of standard hour performance. In order to receive credit for standard hours on shop orders, the work had to be accomplished and certified as acceptable and complete by quality control through the official inspection process.

Here was a member of Lockheed management admitting to the GAO that the company fraudently received credit for work which had not been accomplished. This practice was prevalent in Marietta also as proven by the GAO who substantiated my charges that Lockheed received hundreds of millions of dollars in progress payments for work which had not been accomplished.

I suggest that you carefully peruse exhibit 21 where it is shown that serious charges were not only substantiated by the GAO but also validated by the Lockheed Manufacturing Services Manager.

Referring back to page 30 of the Comptroller General's report—second paragraph which states:

"An Air Force Plant Representative's report of August 2, 1971, indicated that only 813 of the 4,894 MSP were needed for the current assembly orders. The report stated that, when orders were cancelled, these parts were neither removed nor sent back to Marietta, but were held in stock for possible future orders."

I can't understand why the Comptroller General would seemingly be supporting such a practice; especially since thhe GAO auditors stated in the GAO report that it was against company directives. In fact, Mr. Paul Frech, the Directeor of Manufacturing, wrote a directive which was approved by the signature of Mr. H. Lee Poore, the Executive Vice President. The letter reads in part:

"Of primary importance at the present time is that all material not needed or unused be returned to either productive or non-productive inventories. Each

of you are urged to review your present on hand stock of MSP/VSP, raw material and non-productive supplies and any which will not be used in a timely manner should be returned to productive stores. Remember that material you do not need in your area may be urgently needed by some other area in the plant."

Why would the Comptroller General seemingly support a policy which violates Lockheed procedures?

I have available a copy of the letter for inclusion in the exhibits.

A little grammer school arithmetic shows that 813 parts subtracted from 4,894 parts leaves 4,081 different part numbers rotting away in stock. Now, these were 4,081 different part numbers and the quantities in stock on each part number ranged up into the hundreds—even thousands in each case. Therefore, a lot of money is involved. Suppose there were 100 parts in stock on each part number at $2.50 each (conservative figures). 4,081 X 100 would equal 408,100 unneeded parts. Multiply this by $2.50 and the total is $1,020,250.00 worth of unneeded parts.

Despite money being wasted and the known violations of Lockheed's procedures, the Comptroller General's report offers no criticism. The letter approved by Mr. Poore continued:

"As many of you know, the per ship cost of MSP and VSP for a C–5 exceeds the total bill of material cost for a C–141 (aircraft)."

What this means is that the cost of nuts, bolts, screws and fasteners on the C–5 was more than the cost of an entire C–141 Military transport.

The letter continues:

"Analysis of recent requisitions for such supplies and materials indicate a very definite need for more careful examination of individual requirements within all departments. For example, a substantial number of organizations are presently placing orders for material on a direct charge basis when such material is readily available in stores.

"There is no excuse for ordering material from outside sources and spending company funds when we have available in our storerooms the identical assets."

Mr. Frech is confirming my charge and the GAO findings that a substantial amount of material was being ordered from vendors when the same material was available in Lockheed stores. A substantial number of organizations added up to a substantial amount of money.

The Comptroller General's statement in the first paragraph on page 30 advising that it was Lockheed's standard practice to procure more MSP parts than reqiured is certainly true. To prove this, he shows in the second paragraph that over 4,000 unneeded parts were rusting away in stock in violation of Mr. Poore's own procedure which emphatically orders that all unneeded parts be returned to stores because of their need in other areas.

The Comptroller General's statement in paragraph 1, page 30 that it is generally impractical to provide a detailed inventory control system for items that are small and inexpensive is refuted by both Mr. Frech and Mr. Poore in the aforementioned directive where they specifically issue instructions to estalish such controls. The directive states:

"Carefully examine each request for material initiated by your organization to determine that the material is actually needed, and that no more than one month's supply of any material is ordered at one time.

"When replenishment supplies are ordered, you are expected to adequately forecast your needs for raw materials, non-productive and MSP/VSP supplies as part of your normal planning activities. Accordingly, it is requested that when your one month's supply reaches a two weeks supply level, you reorder a one month's supply."

In this official directive, none other than the Executive Vice-President is bemoaning the absence of inventory controls over MSP and VSP, and ordering the immediate establishment of inventory control systems.

Why then did the Comptroller General and Lockheed state that inventory controls aren't necessary as reflected on page 30 of the Comptroller General's report?

EXHIBIT 12: INEFFECTIVE WORK SCHEDULING RESULTED IN UNNECESSARY PERSONNEL LAYOFF AND REHIRE COSTS AT THE CHATTANOOGA PLANT

I shall expand on this charge and findings which are covered on page 27 of the Comptroller General's report and in the GAO report on page 1424 of the official hearing record which states in part:

"Mr. Durham testified that effective work scheduling and proper planning could have prevented a break in the work load which caused the layoff or production personnel and subsequent rehire, almost immediately, at great expense.

"Our review confirmed that a significant layoff occurred in March 1971. However, we could not fully substantiate Mr. Durham's testimony because the personnel did not receive severance pay. Of 74 employees laid off, 24 were rehired. The extra expense comprised administrative costs. The workload associated with the rehire was transferred to the Chattanooga plant from the Marietta plant. The plant manager told us that before the layoff, he was not aware that the work would be transferred."

This represented a typical "bonehead" fumble. Why didn't the plant manager consult with the Director of Manufacturing and examine the load charts and other data which showed the pending work load. The load figures were known all along but management failed to capitalize on the knowledge and spread the work load out. Load leveling is an effective management tool when used properly.

I have with me a copy of the official Lockheed forecast chart which conclusively shows the pending heavy work load existing at that time. Therefore the layoff and "panic" recall of the people could have been avoided.

The Comptroller General failed to mention this aspect of the problem although the chart referred to above was included in the September exhibits and made available to the GAO.

EXHIBIT 20: LACK OF CONTROL OVER THE STOCKROOM AT THE CHATTANOOGA PLANT

This charge is not covered by the Comptroller General's report to any degree.

The GAO report shown on page 1428 of the hearing record states:

"Mr. Durham testified that there were no controls over parts and the stockroom at the Chattanooga plant."

Our review confirmed that Mr. Durham's testimony is substantially accurate. The lack of controls is discussed under exhibits 9, 10 and 11.

EXHIBIT 21: CONTROL PROCEDURES NEEDED AT THE CHATTANOOGA PLANT

Since the Comptroller General's report failed to cover this significant charge. I will expand on it as necessary.

The GAO report as shown on page 1428 of the hearing record states:

"This exhibit consists of a letter which Mr. Durham wrote to the Chattanooga plant manager in May 1971 to emphasize the need to follow control procedures which he had initiated and to establish controls over standard tools. The letter also contains a summary of conditions which existed during Mr. Durham's employment at the plant."

These conditions and need for controls were discussed under exhibits 7, 8, 9, 10 and 11 which confirm that Mr. Durham's testimony was substantially accurate. We also specifically discussed the letter with the Manufacturing Services Department Manager who told us that the charges were valid—although the extent of the losses and waste was probably not as great as Mr. Durham indicated. In summary, the charges were as follows:

(1) Raw material was purchased although quantities were available in stock.

(2) Miscellaneous small parts were purchased without determining quantities on hand.

(3) Raw stock, purchased parts and miscellaneous small parts were purchased from vendors rather than ordering it from the Marietta plant stockroom at lesser cost.

(4) There were no controls over the stockroom and inventories.

(5) Shop orders were not assigned for production on a first-in, first-out basis.

(6) Of about 4,800 line items of miscellaneous small parts on hand only 813 were needed.

(7) The Planning Department would change part numbers on parts lists without notifying the Production Control Department.

(8) The matching of material and parts with related shop orders was not controlled.

(9) Material lost or damaged in production could be replaced easily by telephoning procurement personnel so that waste would be concealed.

(10) Material and parts listings were not kept current as to part number changes.

(11) Loss of control over standard tools resulted in replacement costs of $250 to $300 weekly.

(12) Supervision was lax.

(13) In some instances, standard hours would be credited to the cost centers before the shop orders and work could be inspected.

Note: Not only did the GAO substantiate these charges but they were also validated by the Chattanooga Manufacturing Services Department manager.

EXHIBIT 22: OVERDESIGN OF AEROSPACE GROUND EQUIPMENT AND USE OF AIRCRAFT SPECIFICATIONS IN ITS MANUFACTURE UNNECESSARILY INCREASED COSTS

I will expand on the charges covered on page 23 of the Comptroller General's report since he failed to fully clarify it.

The charge is stated in the GAO audit report shown on page 1429 of the official hearing records—as follows:

"Mr. Durham testified that the cost of aerospace ground equipment (AGE) was unnecessarily increased because the parts and equipment were overdesigned and unnecessarily made to aircraft specifications. He said this was done to decrease competition and increase profits at Lockheed and the aerospace industry. Much of the equipment was manufactured in the Chattanooga plant wherein management did not maintain cost control procedures over purchasing —parts used were more expensive than commercial hardware because of the close tolerances and other specifications used."

AGE equipment is used for handling misiles, engines, wheels, tools, aircraft servicing equipment and similar items. Therefore it seems ridiculous that all parts, materials and equipment used in the manufacture of AGE equipment must be to military specifications and tolerances precisely the same as aircraft parts thereby tremendously increasing the cost of the equipment.

The cost of parts such as nuts, bolts, and other parts made to military specifications greatly exceeds the cost of corresponding commercial parts thereby increasing the costs to the taxpayers.

Also, Lockheed paid very little attention to costs as indicated above where the GAO determined that Chattanooga procurement ordered material and parts blindly and let the vendors apply the prices.

To prove this, I have available specific examples comprised of authentic Lockheed documents. The examples were presented as evidence in the September hearings and are illustrated in the hearing records.

(A) Page 1308—Hearing record:

"Lockheed paid the General Aerospace Materials Company $10.00 for one piece of plate 4130 steel—Length 4⅛", width 1⅛" and thickness .13".

A check with Jenks Metals in Atlanta showed that the very same piece can be purchased already cut for .38 cents each.

(B) Page 1310—Hearing record:

"Lockheed paid Special Metals, Inc., $25.00 for one each stainless steel rod —length 6", diameter ½", condition H 1150 and type 17–4PH.

"A check with Jenks Metals in Atlanta showed that the very same piece can be purchased already cut for $1.83 each."

(C) Page 1320—Hearing record:

"Lockheed paid the Dutch Valley Supply Company $65.00 each for NAS bolts. Length 3½ inches, ⅜ inch diameter.

"A check with the Georgia Nut and Bolt Company shows that the same ⅜–16 x 5 plated slot head machine screw can be purchased commercially for $13.89 per hundred."

The fact that the Air Force approved Lockheed's design of AGE equipment, as mentioned on page 23 of the Comptroller General's report doesn't prove anything except that Lockheed and the Air Force agree with each other and that is certainly nothing new.

In the first paragraph on page 23 of his report, the Comptroller General said:

"We are also comparing AGE Lockheed provided for the C–5 aircraft with similar equipment provided for other aircraft systems."

I hope the C–130 and C–141 programs are among those being checked because both systems use standard commercial hardware parts for manufacturing AGE for those aircraft. I believe this fact is of significant importance when considering this matter.

It is my opinion that if the Air Force openly bid for AGE equipment manufactured commercially, any good commercial manufacturing company could bid and get a slice of the cake. However, by designing the products to aircraft specifications, Lockheed and associates can continue to reap exhorbitant profits.

—

CHARGES PERTAINING TO MARIETTA, GA.

EXHIBIT 1 (SEC. 1): ERRONEOUS AIRPLANE ASSEMBLY RECORDS CAUSED OUT-OF-STATION INSTALLATION OF PARTS AND GENERATED ERRONEOUS PARTS REQUIREMENTS

I must expand on this charge which begins on page 1408 of the official hearing report since very important, serious, and pertinent GAO findings were omitted from the Comptroller General's report. See page 7, 8, and 9—Comptroller General' report as shown on page 1408 of the official hearing record. The GAO auditors who performel the investigation stated:

"Mr. Durham testified that C–5 airplanes were moved to flight line with thousands of missing parts and assemblies—although assembly records showed them to be complete except for a few engineering changes and other installations normally planned at the flight line. He stated further that (1) assembly records erroneously showed that other parts had not been installed when in fact they had been (2) substantial, additional costs were incurred to identify, procure, and transport the missing parts as their need became apparent (3) parts had been improperly removed without authorization after inspection, and (4) Lockheed maintained the subterfuge to appear to be on schedule and to receive progress payments from the Air Force which allowed the unsatisfactory conditions to prevail."

Page 7, Paragraph 4 of the Comptroller General's report states:

"On December 31, 1969, Lockheed's auditors issued on interim report which indicated that an unusually large number of parts had been missing from C–5 airplanes delivered to the flight line and that procedures had not required reconciling assembly records or verifying that work had been performed."

On Page 1410, Paragraph 5—Hearing records, the GAO report states:

"On December 31, 1969, Lockheed internal auditors reported that an unusually large number of parts were missing from C–5 airplanes delivered to the flight line which had been reported as installed. The auditors recognized that procedures did not require reconciliation of the various assembly records and visual verification that operations were in fact performed."

A very critical point omitted in the Comptroller General's statement is that as reflected in the GAO report, the Lockheed audit document specifically stated that an unusually large number of parts were missing from C–5 airplanes delivered to the flight line which had been reported as installed.

The audit report itself is even more emphatic and states in part:

"Our own tests confirmed the fact, that an unusually large number of parts were missing from C–5 airplanes delivered to the flight line although the airplane records indicated that the parts had been installed."

The audit report was not an interim audit as stated, but an official Lockheed internal audit report. I brought a copy with me which I will place in the exhibits.

This is extremely significant because it proves one of my major charges that Lockheed was taking credit for installing thousands of parts in order to receive credit for performing the work when in fact, the work had not been accomplished.

Page 7, Paragraph 4 of the Comptroller General's report continues:

"Lockheed officials replied that (1) because the assembly line had not been stabilized, it would not be practical to implement corrective action until aircraft 0014 reached the flight line, (2) additional personnel would be assigned to take corrective action and (3) records would be audited more frequently."

Page 8, last paragraph of the Comptroller General's report states:

"A Lockheed internal audit report of aircraft 0019 indicated that the conditions found previously still existed to some extent but that there was a down-

ward trend in the variances between the physical status of the aircraft and the status of the production/inspection records."

For some reason, the above statement appearing in the Comptroller General's report does not at all agree with the actual findings reported by the GAO auditors who made the investigation. This can be seen in the GAO statement appearing on page 1411—Paragraph 2 of the official hearing record. The report states:

"An internal audit report of May 28, 1970, stated that an investigation of airplane serial 0019 showed that the unsatisfactory conditions previously found on airplane, serial 0013, still existed and continued to significantly affect the quality, cost, and schedule of C–5 assembly operations. The Director of Manufacturing Operations outlined corrective action similar to those he had proposed earlier in reply to the February 16, 1970, audit report. He explained that airplane, serial 0019, was almost complete before the earlier corrective action had been implemented and that there had not been sufficient time to experience improvements."

The paragraph at the top of page 9 of the Comptroller General's report states:

"The Lockheed internal audit staff planned a follow-up examination on aircraft 0025. However, because its examination on aircraft 0019 indicated that corrective actions were having the desired effect, this follow-up audit was postponed. Lockheed's internal audits subsequently selected aircraft 0045 for examination and in a report dated May 25, 1971, stated that corrective action had been fully effective."

Since aircraft 0045 was more than halfway through the 81 unit contract some improvement should certainly have been expected.

However, as previously pointed out, the GAO auditors do not at all agree with the Comptroller General's statement that significant improvements had been experienced on aircraft 0019 and that no follow-up audits were required, as can be seen in the official GAO report shown on page 1411, Paragraph 1, which conclusively proves that there had been no improvements on aircraft serials higher than aircraft 0019. The report states:

"An internal audit report of March 13, 1970, re-emphasized the earlier findings that procedures did not require reconciliation of assemb'y records or usual verification of work performed."

Other Lockheed reports showed that the missing parts problems continued as follows:

"During the period from March 6, 1970, to April 6, 1970, (one month) 893 missing parts were reported for airplane serial 0020; 1,038 for airplane serial 0021; and 1,120 for airplane serial 0022 at the final assembly area. A report of March 16, 1970, showed that 1,084 parts were reported missing from airplane serial 0023 but had not been included on shortage list. A report of April 27, 1970, showed that a daily average of 257 parts requirements were processed as a direct result of missing parts in the final assembly area."

I have available a copy on one of the authentic Lockheed reports which confirm these findings and will include it in the exhibits.

In view of the importance and significance of thse official GAO findings it is difficult to understand why the Comptroller General' report didn't show the facts completely.

One of the most significant aspects of the GAO report is that the GAO auditors proved that critically unacceptable conditions still existed on high serial aircraft despite repeated dispatches from Lockheed's management and the Lockheed publicity department stating that only a few miscellaneous and rather insignificant problems existed on the first few aircraft. The findings also make the Lockheed statement that everything looked so good on aircraft 0019 that audits were postponed until over a year later on aircraft 0045 utterly ridiculous.

In view of all the proven conditions confirmed by the GAO. Lockheed's own reports, Lockheed's admissions and the GAO's confirmation that the company waited until 26 aircraft had gone down the drain (aircraft 0019 to 0045) before auditing another C–5. is absolutely unbelievable and should clearly demonstrate the caliber of Lockheed's management on the C–5 program.

The chart appearing on page 8 of the Comptroller General's report is deceiving. The chart does not reflect flight line requirements but high volumes of parts which were required on aircraft after the planes reached the flight line

from the manufacturing area. The vast majority of them were parts which should have been installed prior to moving to the flight line.

For some mysterious reason, the titles of the categories on the chart have been changed in the Comptroller General's report. The correct version is shown on page 1411 of the official hearing records. Also, please read the GAO's statement proceeding the chart at the bottom of page 1410 which states:

"During a special review meeting on February 21, 1970, the Director of Manufacturing Control identified parts requirements, including missing parts for airplanes—serials 0009 through 0016 at the flight line as follows:

The correct titles of the categories must be changed as reflected on page 1411 of the official hearing records before getting into the guts of the matter.

Inconsistencies—Should be—Missing parts. Missing parts is the correct title as pointed out by both the GAO and Lockheed. Missing parts are parts which were reported by Lockheed as installed but were still missing from the aircraft.

Damaged or Unsuitable Parts—Should be—Discrepancy Reports. As can be seen, discrepancy report is the correct title. These figures reflect the number of rejected parts incurred on aircraft after they reached the flight line. In each case, a discrepancy report (DR) was written and a replacement part obtained. DR's are written against damaged or mutilated parts resulting from poor workmanship.

Known Shortages and Parts to be Installed—Should be—Other. These figures represent parts which were known to be short and which for the most part should have been installed before the aircraft reached the flight line and a comparatively few parts reprogramed for the flight line as the result of manufacturing change notices.

The last paragraph on page 7 of the Comptroller General's report states:

"A subsequent audit of aircraft 0013 was undertaken at Lockheed management's request to determine the extent and cause of the missing part problem. The report stated that:

'* * * parts were missing from the airplane but had been recorded as installed. An inspector had verified that some had been installed.

'* * * parts were missing from some feeder plant assemblies and sub-contractor assemblies but had not been reported as missing on assembly records.

'* * * parts reported as missing had been installed.'"

One of the most important findings reported by the GAO auditors in this area was omitted from the Comptroller General's report as can be seen by referring to page 1410, paragraph 6 of the official hearing record where the GAO auditor stated:

"A subsequent internal audit report of February 16, 1970, covering airplane serial 0013, identified that:

'parts shown as installed on production and inspection records had been removed without authorization.'"

Why was this important finding reported in the GAO report deleted from the Comptroller General's report since it supports one of the serious charges that parts had been improperly removed without authorization after inspection?

As shown in the GAO report on page 1409, paragraph 1, of the hearing record, a Lockheed statement regarding the missing part problems advised in part that "parts shortages, missing parts and out of station work are an inherent product of the environment of a concurrent development and production program in its early stages."

Since missing parts and associated problems were found to be rampant on aircraft serials up in the 20's, were these considered to be part of the concurrent development and production program in its early stages?

The GAO auditors obviously didn't agree with the Lockheed position as stated in Pargraph 5, Page 1409:

"In our opinion, the reason for inaccurate assembly records can not be associated with other problems which may have been caused by the concurrent C–5 development and production program."

The GAO goes on to say in pargraph 6 that:

"We doubt that the true cost impart of the missing parts problem can now, in retrospect, be isolated because assembly records were erroneous and because a great number of engineering changes occurred."

Other important facts and figures contained in the original audit report were omitted from the Comptroller General's report but are too numerous to mention here. I mainly wanted to point out some of the more significant omissions and distortions.

EXHIBIT 1 (SEC. 2) : IMPROPER REMOVAL OF PARTS CONTRIBUTED TO THE MISSING PARTS PROBLEM

I must also expand on this charge which begins on page 1411 of the official hearing report since very important, pertinent findings were omitted from the Comptroller General's report.

See pages 21 and 22—Comptroller General's report.

As shown on page 1411 of the official hearing records the GAO auditors stated:

"Mr. Durham testified that thousands of parts were improperly removed after being installed and inspected. He said parts were removed without proper authorization and were installed on other airplanes."

Page 21, paragraph 2, of the Comptroller General's report states:

"We found that, during assembly, some parts were removed from aircraft without proper authorization. We could not determine the extent of these removals because such actions would not have been recorded because they violated Lockheed's production control procedures."

The GAO auditors who made the investigation viewed the problem a little differently as stated on page 1411, second paragraph from the bottom of the page:

"Our review confirmed that Mr. Durham's testimony was substantially accurate. However, we were unable to determine the cost impact of improperly removed parts. In addition to the documentation provided by Mr. Durham, which we believe supports his testimony, we obtained other Lockheed reports showing that unauthorized removal of parts was a significant problem which was reported to management."

While the Comptroller General reported that some parts were removed from aircraft without proper authorization, the GAO auditors who made the actual investigation reported it as a significant problem.

The chart depicted on page 21 of the Comptroller General's report showing where Lockheed auditors checked a sample of missing parts on certain aircraft to determine how many were the result of unauthorized removals omits the percentage figures which were contained in the original audit report as shown on page 1412 of the hearing record. The chart should read as follows:

Airplane serials	Number of missing parts	Number of parts improperly removed	Percentage
0009 and 0010	160	13	8.7
0012	160	12	7.5
0013	124	12	9.7
0019	63	31	49.2

This chart shows that 49.2 percent of the missing parts investigated on aircraft 0019 were the result of unauthorized removals when this sample audit was made on May 28, 1970. Is this the improvement that Lockheed was talking about earlier on aircraft 0019?

On page 1412 of the official hearing records in the paragraph beginning at the top of the page, the GAO report continued:

"Mr. Durham provided an example wherein another Lockheed official reported in April 1970 that as a result of an audit to determine if parts had been improperly removed from main landing gear assemblies for airplane serials 0033 through 0036—26 parts had been removed."

Did the reports on high serial aircraft of this nature prompt the statement in the Comptroller General's report that no audits were needed after aircraft 0019 for over a year because of significant improvements?

EXHIBIT 1 (SEC. 3) : AIR FORCE PROGRESS PAYMENTS TO LOCKHEED WERE EXCESSIVE BECAUSE WORK WAS INCOMPLETE AND WORK IN PROCESS OVERSTATED

I must expand on this most serious charge since the Comptroller General's report does not cover the important and significant findings as uncovered and reported by the GAO auditors who made the investigation.

See pages 38, 39, 40 and 41 of the Comptroller General's report.

As shown on page 1412 of the official hearing record the GAO auditors who performed the investigation stated:

"Mr. Durham testified that Lockheed moved assemblies and aircraft on a prescribed schedule, regardless of the state of completion, to receive credit and progress payments for being on schedule."

The GAO report continued on page 1412 of the official hearing record as follows:

"Our review confirmed that Lockheed did have significant financial incentive to move aircraft on schedule—in terms of avoiding up to $11 million in liquidated damages and receiving over $75 million in additional payments representing re-imbursements of cost incurred for achieving certain schedule milestones. In addition, the original contract clause limiting progress payments was not enforced and as a result, Lockheed was paid about $400 million in advance of contractual requirements, according to a February 1970 DCAA report of the overpayment. Although the DCAA estimated that these overpayments would increase, the gair Force did not reduce progress payments as a result of the DCAA report because it was not considered in the best interest of the Air Force. In contrast the Air Force subsequently made an additional $705 million available through May 31, 1971, for progress payments to Lockheed."

This amounts to an overpayment of over $1 billion dollars.

On page 1413 of the hearing record the GAO report states:

"On March 10, 1970, the DCAA advised the Comptroller of the Air Force that: 'Based on a further analysis of the contractors' progress payment requests, the attached report indicates that current overpayments on contract No. AF33(657)-15053 amount to about $400,000,000. This exceeds the entire net worth of the Lockheed Aircraft Corporation as of December 29, 1968, as shown on the published report to the stockholders. The overpayment condition results from cost overruns attributable to delivered items.' "

On page 1414 of the hearing record, the GAO auditors who made the investigation stated:

"In summary, we found that the allegation that Lockheed had received excess progress payments, regardless of condition or schedule, to be correct. Lockheed did receive excess progress payments of about $400 million due to understating the value of the work completed and overstating the value of work in process."

"We also found that the Air Force was aware of the excess progress payment situation but failed to act on it. In fact the Air Force made an additional $705 million available for progress payments to Lockheed. We also noted that the same situation of excess progress payments may have existed with respect to major subcontractors, but neither the DCAA nor the Air Force toook action to examine the matter."

For some reason, these findings by the GAO corroborating my testimony were omitted from the Comptroller General's report. The comments by the Comptroller relating to tooling milestones and related data was not even mentioned in my original charges as can be seen on page 1412 where the GAO correctly stated the charge as follows:

"Mr. Durham testified that Lockheed moved assemblies and aircraft on a prescribed schedule regardless of the state of completion to receive credit and progress payments for being on schedule."

The charge doesn't say anything about tooling milestones. It is difficult to understand why the Comptroller General didn't cover the real charges and finding reported by the GAO auditors who made the investigation and corroborated this unbelievably serious charge involving the misappropriation of over a billion dollars of the taxpayer's money. In the banking business, it would be called embezzlement. In the trucking business. it would be called highway robbery. I don't know what it's called in military industrial complex circles.

One of the worst aspects of this fraud is that the overpayment described herein was concealed from both Congress and the American people last summer during the debate on the Lockheed bail out bill. It would still be under wraps if the DCAA document had not been uncovered and exposed by Senator Proxmire in the March hearings.

EXHIBIT 2: AIRCRAFT CONDITIONS REPORT ON MISSING PARTS

This charge is basically covered under Exhibit 1 which has been discussed.

On Page 1414 under EXHIBIT 2, the GAO report stated:

"Mr. Durham provided a report dated March 16, 1970, which describes the inaccuracies of records of parts installed on airplanes being built and the number of parts missing from airplanes upon their arrival at the final assembly area.

"We believe that the report is valid and provides an accurate description of conditions. Lockheed officials provided us a copy of the same report. Our discussion of these conditions and problems is presented under exhibit 1."

This statement by the GAO auditors who made the investigation substantiates the charges.

EXHIBIT 3: OVERPROCUREMENT AND MISUSE OF VALUABLE SMALL PARTS

This subject is covered on pages 12, 13 and 14 in the Comptroller General's report. However, since his report does not get into the guts of the matter but sort of skims around on the surface, I must it more thoroughly.

As reflected in the GAO report shown on page 1414 of the official hearing record, the auditors who made the investigation stated:

Mr. Durham testified: (In part)

"Report shows that as of May 1, 1970, the company was facing a $30,000,000 cost overrun on VSP due to overprocurement resulting from failure to control parts in production areas and cribs—mostly production areas. The report shows that VSP cost per aircraft should be approximately $560,000. However, the actual cost was exceeding $1,000,000 per ship.

"VSP was scattered on floors, tables, in boxes, heaps—all over the place. It was being swept up and dumped.

"No one knew what or how much had been delivered out to the shops.

"Basically the reason for the overrun was not due to cost but to misuse and failure to establish and maintain an adequate inventory accountability system."

The statement by the GAO concerning the charge is reflected in the GAO report shown on page 1415 of the hearing record which said:

"Our review confirmed that Mr. Durham's tetimony is substantially accurate."

One significant example omitted in the Comptroller General's statement but reported by the GAO, typifies Lockheed's mismanagement of VSP. As shown on page 1415 of the hearing record which states:

"We determined that VSP valued at about $1.9 million had been declared surplus as of January 1972. Of this, fasteners valued at $1.3 million were recently sold for $2,800 even though Lockheed had previously advised the Air Force that the fasteners were commercial catalog items. Presumably, if these fasteners were catalog items, they could have been returned to vendors or sold to other users.

The GAO report continues on page 1416 of the hearing record:

"In summary, Lockheed did project overprocurement of VSP—as Mr. Durham testified—due to unsatisfactory inventory and production controls. Moreover, Lockheed's inability to control manufacturing tolerances and to determine specific engineering requirements for VSP led to procurement based on forecasts rather than known needs and ultimately to procurement based on usage rates. Subsequently, inaccurate inventory records and misuse of fasteners by production personnel led to inaccurate usage rates and procurement, which generated surplus quantities of VSP to be sold as scrap. Although Lockheed internal audits identified many of the problems and the need for corrective action, in our opinion the audit reports were not totally effective because there was generally no identification of the cost impact or adverse effect of the problems noted. This may have been omitted to avoid embarrassing management."

What's a little embarrassment compared to saving a few million dollars?

In view of the GAO findings, Lockheeds comments on page 14 of the Comptroller General's report are meaningless.

Incidently, in the second paragraph of page 12 of his report, the Comptroller General mentioned that he could not find a report showing that as of May 1, 1970, Lockheed had faced a cost overrun of about $30 million due to overprocurement of VSP resulting from inadequate controls. Therefore, I brought a copy of the report which was not only included in the September hearing exhibits as Exhibit A, Section 3, but provided to the GAO. This report dated May 1, 1970, was originally submitted by me to the President of the Lockheed Georgia Company in a futile attempt to initiate corrective action.

EXHIBIT 4: REPORT OF MISSING PARTS, ERRONEOUS ASSEMBLY RECORDS AND DUPLICATE PARTS ISSUES

The discussion of erroneous assembly records and missing parts is presented under Exhibit 1.

EXHIBIT 5: UNNECESSARY DUPLICATE PROCUREMENT AND MULTIPLE ISSUES OF PARTS CAUSED BY LACK OF PARTS INVENTORY CONTROL

Although I submitted several examples including Lockheed records in support of this charge, it is not specifically covered in the Comptroller General's report.

The GAO report as shown on Page 1417 of the hearing record stated:

"Mr. Durham provided a report showing an example wherein parts to be installed were lost and caused unnecessary, duplicate procurement and delivery of replacement parts.

"Because we expect that a major effort is required, review of this aspect of Mr. Durham's testimony will be considered in our continuing review—as discussed under Exhibit 4."

I have examples with me and will re-submit them as exhibits.

EXHIBIT 6: UNNECESSARY SHIPMENT OF PARTS TO PALMDALE, CALIF.

Since the Comptroller General's report treats this charge lightly, I will cover it in the detail it deserves.

See page 18 of the Comptroller General's report.

As shown on page 1417 of the hearing records, the GAO report stated:

"Mr. Durham testified that because of poor planning, parts were assembled into kits and shipped to the field at great expense but were not needed—or were incomplete and could not be fully utilized. Control over kits and parts in the field was ineffective. Mr. Durham's testimony is partially substantiated by a Lockheed report of April 28, 1970, provided to us by Lockheed officials. The report shows that these kits were being returned from the Palmdale plant to the Marietta plant for restocking and future use. The report shows that these kits were not part of the C–5 A modification program planned at Palmdale and therefore were not used. We did not determine the reasons for their initial shipment to Palmdale.

The kits in question were shipped to Palmdale at the instructions of Lockheed management to be installed on aircrafts 0001, 0002 and 0009 while these units were undergoing wing modification due to the well known structural defects found on C–5 wings. However, the wing modification program was such a tremendous problem and involved so much work that the kits could not be installed. Since the Comptroller General's report failed to mention this aspect of the problem, I brought a copy of the official Lockheed letter and am submitting it as an exhibit.

I do admit that like the C–5 landing gears, the C–5 wings are an extremely touchy subject. Another aspect that the Comptroller General's report fails to mention is the fact that each kit consisted of numerous parts. Therefore, it was extremely poor planning to go to the great expense of gathering, sorting, kitting and packaging thousands of parts, shipping them thousands of miles by premium transportation for such incredible blunders that added immeasurably to the costs.

EXHIBIT 13: INCOMPLETE AIRPLANE AT ROLLOUT

This item is covered on pages 10 and 11 of the Comptroller General's report. The GAO report shown on page 1424 of the official hearing report states:

"In describing how airplanes were moved to the flight line with a substantial number of missing parts, although parts installation records indicated they were complete, Mr. Durham testified that:

"As previously mentioned, the subterfuge began on Saturday, March 12, 1968, with the roll-out of ship 0001 and continued. It rolled out with slave landing gears, false leading edges, dummy visor (nose of aircraft) and other faked components."

"Mr. Poore's statement in the September hearing that the visor was functional on airplane 0001 at rollout was refuted by GAO auditors in the GAO report shown on page 1425 of the official hearing records as follows:

"We noted that on July 23, 1971, the Air Force Plant Representative advised the Air Force systems command that Lockheed's statement concerning the visor was not completely accurate because operation of the visor was restricted. The representative stated:

"It is also true that some panels, etc, were units installed in place of parts which were short, and in other cases, installed parts required additional work before being suitable for flight. This is a common practice at rollouts." '"

The GAO report continued:

"Based on the above, we believe that Mr. Durham's testimony was generally accurate and that neither Lockheed nor the Air Force substantially disagreed —except that Lockheed denied the subterfuge."

The Comptroller General failed to mention a signed affidavit from a former Lockheed department manager who had held a responsible position, was well thought of but had resigned in disgust. I will not repeat his name because he is fearful of reprisals against him and his family. However, I am resubmitting the document. which is extremely enlightening, as an exhibit.

The letter reads in part:

"Lockheed's problems are widefold and came to my attention with the introduction of aircraft 0001 into the flight test program. This ship, which was supposed to be complete in every detail except for scattered engineering changes, came into the test program a virtual skeleton—missing many large structural assemblies, thousands of smaller parts and electronic components. When the ship was 'rolled out' for the inspection of President Johnson and other dignitaries, many portions of the ship has been hastily constructed from plywood and paper and were installed strictly for show. A complete "teardown" of the aircraft took place immediately after the President's inspection.

"A separate stockroom had to be set up to handle the thousands of parts sent to the flight test department to support an aircraft undergoing major assembly in an area where it was supposed to have only minor changes before flight. The work was so confused and uncoordinated that the ship's maiden flight had to be postponed three times due to finding more and more areas supposedly completed but as yet in unacceptable condition."

Since this evidence was in the possession of the Comptroller General, it is amazing that he found no evidence of subterfuge in the roll out of aircraft 0001.

EXHIBIT 14: PRODUCTION COSTS WERE UNNECESSARILY INCREASED BY USING DISTANT FEEDER PLANTS FOR PARTS ASSEMBLY

This charge is not completely covered in the Comptroller General's report. Therefore, I shall cover it more throughly.

See page 16—Comptroller General's report.

The complete charge as stated in the GAO report shown on page 1425 of the hearing record is as follows:

"Mr. Durham testified that production cost were unnecessarily increased by shipping parts and equipment to distant feeder plants for assembly of components to be returned to the Marietta plant. He also said that thousands of parts were missing from the feeder plant assemblies on arrival at the Marietta plant due to poor planning and workmanship and the need to meet schedules."

As shown on page 16, the Comptroller General's report did not substantiate the first part of the charge but found that sub-assembly plant costs were less

than costs at the main plant because cheaper labor costs had more than offset additional transportation and other costs. The Comptroller General failed to mention that the 1967 study mentioned in his report was made before a single C–5 sub-assembly plant had been established and was conducted on the only feeder plant in existence—a plant at Clarksburg, West Virginia, whose work was comprised of approximately 90% C–130 work.

Also, the Comptroller General failed to mention the second part of my charges concerning missing feeder plant parts. However, the GAO report did comment as shown on page 1425 of the hearing record:

"Regarding incomplete feeder plant assemblies, Mr. Durham provided a report dated October 13, 1969, showing that an investigation of 160 parts of airplanes serials 0009 and 0010 disclosed that 108 or 67.5 percent were missing. Of these missing parts, 56 were components of feeder plant and sub-contracted assemblies. We believe the report is valid; however, we did not verify the number of parts specifically attributable to feeder plant operations. This aspect will be considered in our continuing review."

It was my experience that the thousands of parts missing from assemblies shipped from feeder plants added to the costs because whenever missing parts were discovered, which was often, replacement had to be ordered and shipped from applicable feeder plants for installation on the assemblies. Frequently premium transportation was employed, adding to the costs. The constant "rota testing" of thousands of parts was extremely costly.

EXHIBIT 15

The shortage list and condition report on airplane, serial 0023, were erroneous.

Again, the Comptroller General's report omits critical and pertinent GAO findings.

See pages 7, 8, and 9—Comptroller General's report.

The GAO report as shown on page 1426 of the hearing record states:

"Mr. Durham testified that although the shortage list and condition report for airplane serial 0023 showed only 30 open items (parts not installed) it actually had 1,084 open items on arrival at the final assembly area on March 11, 1970. Mr. Durham provided a report to substantiate these conditions and to rebut Lockheeds contention that such problems existed only on the first few airplanes."

The GAO statement continues:

"We believe that Mr. Durham's statement concerning the open items on airplane, serial 0023, was accurate and the report valid. The information was substantiated in a report dated March 16, 1970, prepared by Mr. Durham and provided to us by Lockheed officials."

Again, this statement by GAO auditors who made the investigation conflicts with those made on page 9 in the Comptroller General's report which states:

"The Lockheed internal audit staff planned a followup examination on aircraft 0025. However because its examination on Aircraft 0019 indicated that corrective actions were having the desired effect, this followup audit was postponed."

As previously reported, GAO auditors reported no improvement on aircraft 0019.

Why then, would the Comptroller General's report show only a meaningless Lockheed statement when the GAO audit report is replete with proof that serious missing part and related malpractices not only existed on 0019 but on higher serial aircraft as well.

EXHIBIT 16

Reworkable parts were erroneously scrapped.

The Comptroller General's report, while vaguely supporting this charge, does not reveal all of the most pertinent facts.

See page 17—Comptroller General's report.

The GAO report as shown on page 1426 of the hearing records reads in part:

"Our review has confirmed that expensive purchased parts and subcontracted parts which could have been salvaged, were erroneously discarded. However, we were unable to determine the total adverse effect—the value of the discarded items."

The Lockheed comment shown on page 17 of the final report that some workable purchased parts were scrapped because relatively inexperienced employees failed to comply with published procedures simply does not hold water. This is illustrated by a statement contained in the GAO report as reported on page 1426 of the hearing record (and mentioned on page 17 of the Comptroller General's report—as follows:

"Planning officials reported on April 14, 1970 that investigations had shown that expensive salvageable parts and assemblies had been erroneously discarded for various reasons. The report recommended corrective procedures for subcontract and vendor parts and assemblies and also in-plant manufactured items, with the intent to require tool planners to specify attachment of proper, color-coded tags to parts removed by MCN and LDCN documents. Previously, colored tags had been attached by production personnel based on their interpretation of information shown on the MCN and LDCN documents."

The Lockheed management people responsible for manufacturing paper recognized the need to change the procedures which refutes Lockheeds claim that the procedures were satisfactory.

To illustrate the magnitude of the problem, it must be recognized that the parts "throw away" problem was not discovered until April, 1970. Bu that time, over twenty C–5's had processed through manufacturing to the flight line. This means that untold thousands of salvageable purchased and subcontracted parts had gone down the drain before the problem was detected. Each one had to be repurchased.

Another important point worth mentioning is the fact that by Lockheeds own admission as shown on page 17 of the Comptroller General's report under Lockheed comments, it was not possible to determine the exact number of reworkable purchased parts which were scrapped. This proves that Lockheed had no accountability over expensive purchased and subcontracted parts.

It would have helped if the Comptroller General had covered these very important points in his report.

EXHIBIT 17

Incomplete parts kits sent to Eglin Air Force Base.

Again, the Comptroller General's report conflicts with the findings reported by the GAO auditors who made the investigation.

The GAO report as shown on page 1427 of the official hearing record states:

"Mr. Durham testified that part kits sent to Eglin Air Force Base, Florida to provide for engineering changes were found to be incomplete due to omission of needed parts on related parts lists. He cited an earlier report, which he submitted in November 1969, advising that kits were incomplete due to incomplete parts lists, kits were not being controlled after receipt, and parts were scattered about."

The Comptroller General's report states on page 7:

"Records made available to us indicate that personnel installing the kits at Eglin Air Force Base encountered only minor problems with the kits."

Now, this is very strange in view of findings reported in the GAO report as shown on page 1427 of the hearing records—as follows:

"Our review confirmed that Mr. Durham's testimony was substantially accurate. In discussing Mr. Durham's report, the Director of Manufacturing Control validated the report by giving us a copy and stating that initially, planning papers and parts lists were incomplete because field installations was not provided for. Kits did not include miscellaneous small parts, fasteners and other items which were available in the main plant but not at other bases. He said there were problems initially, but they have been corrected.

To better define this problem, what this meant, among other things, was that Lockheed sent thousands of parts to Eglin Air Force Base to be installed along with a lot of people to install them without sending many of the connecting parts and non-productive material and absolutely none of the thousands of different nuts, bolts, screws or fasteners required to install them. It isn't difficult to visualize the utter confusion resulting from this type of mismanagement.

I remember one ridiculous episode which would be funny under different circumstances. A production manager, discovering upon his arrival at Eglin that no bolts, nuts, fasteners etc. were available called back to Marietta in desperation requesting a large assortment. Since there was no planning documentation

defining what parts were needed, people at Marietta ran around the plant like a bunch of blind dogs in a meat market gathering handfuls of all the different size screws, nuts, bolts, fasteners etc.; threw it all together in a large bucket and rushed the bucket to Eglin.

The official Lockheed report cited above which the GAO said was validated by the Lockheed Director of Manufacturing Control states in part:

"Mr. Ferrell found that absolutely no control is being exercised over RIC kits when or after they are received (at Eglin). Parts in general are out of control. For example, some RIC kits were piled under a coat rack in the corner of the climatic test hanger. All of these kits were partially opened. Blueprints and parts were strewn on the floor, laying on cabinets etc. Also, parts were stacked up in hallways and on top of desks, file cabinets, and elsewhere. Special metal cages had been provided by test support to contain RIC kits. However, they were being used to store hoses, tape, raw material, removed parts from aircraft, blueprints, mixed MSP, light bulbs, AGE equipment and miscellaneous junk."

Since the GAO substantially confirmed the accuracy of the charges and specifically stated that the above report is valid, how can the Comptroller General's report state that only minor problems were encountered with the kits at Eglin.

I am including a copy of the report in the exhibits.

EXHIBIT 18

Numerous Discrepancy Reports were written at the flight line for damaged parts which had been ignored by quality control.

Again the Comptroller General's report conflicts sharply with the findings uncovered and reported by the GAO auditors who made the investigation.

See page 15—Comptroller General's report.

As shown on page 1427 of the official hearing records, the GAO report states:

"Mr. Durham testified that numerous damaged parts which had been ignored by the quality control department were identified at the flight line. This resulted in replacement of parts from vendors at premium prices, shipped air express with thousands of hours of overtime. He provided a report showing that 6,746 parts were rejected on airplanes—serials 0009 through 0013—after their arrival at the flight line."

The Comptroller General's report states that available records showed that there had been only 2,481 discrepancy reports (DR's) written at the flight line on aircrafts 0009, 0010, 0011, 0012, and 0013.

In contrast, the GAO report stated:

"Although we have not determined the adverse effect or cost impact of the problem, we believe that Mr. Durham's testimony is correct in describing the magnitude of rejected parts identified at the flight line. This is substantiated by another Lockheed report dated February 21, 1970, which shows that about 50,000 parts were required for airplanes—serials 0009 through 0016—after their arrival at the flight line including 8,200 parts required to replace damaged and unsuitable parts."

The chart referred to above by the GAO is shown in the Comptroller General's own report on page 8—Therefore, why did he only refer to 2,481 discrepancy reports?? At any rate, this chart dated February 21, 1970 does show a total of 8,200 rejected parts (damaged or unsuitable parts accumulated on ships 0009 through 0016). Simple arithmetic shows that 6,850 of these occurred on aircrafts 0009 through 0013.

Getting back to the 2,481 DR figure referred to by the Comptroller General —There is a very simple explanation which I am surprised he didn't mention in his report.

As confirmed by the Comptroller General on page 15 of this report a total of 2,481 DR's were written on ships 0009, 0010, 0011, 0012 and 0013 at the flight line. The Comptroller General also confirmed on page 8 in his report that the number of DR's on the same aircraft totaled 6,850. The difference between the two figures is 4,369.

$$\begin{array}{r} 6{,}850 \\ -2{,}481 \\ \hline = 4{,}369 \text{ difference} \end{array}$$

This means that 4,369 of the recorded DR's occurred before the aircraft reached the flight line. Therefore both the Comptroller General and the GAO have completely refuted Lockheeds statement (on page 15 of the Comptroller General's report) that both the Lockheed and the Air Force Quality Assurance Programs were such that a damaged part might "occasionally" be overlooked during manufacturing.

I wonder if the 8,200 DR count shown on Lockheeds own chart on page 8 of the Comptroller General's report is considered "occasional."

I also wonder if anyone can explain the inconsistant figures appearing on pages 8 and 15 in the Comptroller General's report?

EXHIBIT 19

Report of parts delivered for airplanes after their arrival at the flight line and flight test areas.

This charge is not covered adequately in the Comptroller General's report. Therefore, I will cover it more thoroughly.

See pages 7, 8, and 9—Comptroller General's report.

The GAO report shown on page 1428 in the official hearing records states in part:

"Mr. Durham provided a report showing that as of January 23, 1970, about 45,439 parts had been delivered to airplanes—serials 0009 through 0014—after they arrived at the flight line and flight test areas. The report shows that 15,291 of these were missing parts and 5,294 were replacements for rejected parts. We believe that this example is substantially correct and demonstrates the magnitude of parts requirements and problems at the flight line. It is supported by a report of February 21, 1970, provided by Lockheed officials which shows that almost 50,000 parts were delivered of which 18,350 were missing parts and 8,200 were replacements for damaged or unsuitable parts."

Under Lockheed comments on page 9, Lockheed stated that, there were some problems at the start of the program. I wonder if 18,350 missing parts and 8,200 rejected parts on aircrafts 0009 through 0016 at the flight line is considered just "some problems at the start of the program?"

EXHIBIT 23

Lockheed and Air Force Audits were ineffective.

Since the Comptroller General's report praises Lockheeds audits I will cover the subject thoroughly.

See page 42—Comptroller General's report.

This charge as cited in the GAO report shown on page 1429 in the hearing records is as follows:

"Mr. Durham testified that Lockheeds internal auditing system was obviously ineffective or restrained. He indicated that advance notices of audits provided management the opportunity to conceal problems. He stated also that Air Force personnel were negligent in allowing unsatisfactory conditions to prevail."

The GAO report continues:

"We believe that Lockheed internal auditors were aware of the major problems cited by Mr. Durham and reported them the management together with recommendations for corrective action. These reports were given wide distribution and were sent to corporate officers. Followup audits were made to evaluate corrective action. However, we noted that audit reports generally did not identify the cost impact or effect of deficiencies noted and therefore, in our opinion did not adequately demonstrate the need for corrective action. In addition, we believe that Chattanooga plant operations were not audited frequently enough. We were told that only one audit was made."

The GAO report is replete with other examples of ineffective Lockheed auditing. Some examples are as follows:

Page 1409—middle of paragraph 5:

"Although Lockheed internal auditors recommended corrective action in December, 1969, about the time when airplane serial 0014 was being moved to the flight line, the problems continued in March 1970, when airplane serial 0023 was in final assembly."

Page 1409—paragraph 6 in part:

"Although these problems were apparently of concern to management none of the records provided to us—including internal audit reports—indicated that the resulting cost impact was ever measured."

Page 1416—last paragraph:

"Although Lockheed internal audits identified many of the problems and the need for corrective action, in our opinion the audit reports were not totally effective because there was generally no identification of the cost impact or adverse effect of the problems noted. This may have been omitted to avoid embarrassing management."

Page 1422—last paragraph:

"As a result of Mr. Durham's charges, the Air Force Plant Representative and his staff received some operations at the plant (Chattanooga). However, we believe that the effect was incomplete and the report somewhat misleading because the scope and depth of the review were limited. The report states that a small group of personnel visited the plant during the afternoon of July 27, 1971, to review plant operations; especially purchasing, inventory control, and actions regarding material discrepancy reports. Review of procurement was limited to about 3 hours and, in our opinion, erroneously led the team to conclude that the procurement system was satisfactory."

In view of these findings and statements made by the GAO auditors who investigated the situation it is difficult to determine how the Comptroller General or anyone else arrived at the conclusion reflected on page 42 of the Comptroller General's report, which states:

"In our opinion, the internal audit reports were an effective management tool."

I would like to comment on the charge entitled unnecessary procurement of parts covered on page 5 of the Comptroller General's report.

This was not submitted as one of the 23 major charges but was one of many notes submitted as evidence. It was not covered by the GAO report.

The GAO findings appear to be valid with regard to this particular item.

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

FIRST SESSION

AND

SECOND SESSION

PART 5

SEPTEMBER 28 AND 29, 1971, AND MARCH 27, 28, AND 29, 1972

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(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

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The engineer constantly seeks design improvements and would like limitless time to perfect his invention. Tooling and fabrication personnel are impatient for the final design. Manufacturing, with jigs and fixtures installed, presses fabrication and purchasing for parts delivery. Production control monitors the receipt and dispersion of parts. Flight test evaluates the finished product and may recommend changes that challenge the flexibility and resourcefulness of all branches back to preliminary design.

And quality assurance and inspection interject their requisites at each step in the intricate process that transforms lines that are on paper to living mechanisms.

Without disciplined disciplines and a willingness to relinquish individual aims for the good of the whole, the process would falter and finally fail. It must include a certain amount of flexibility. Each unit in the complex organization must at times agree to compromise—not in quality or safety, but in function—if that is the best way to get the job done.

Every company is an entity. The elements within it are not. So the company is run to satisfy its commitments, and separate elements that combine to make it an entity must relegate themselves to roles in support of the company charter. Self-serving for the sake of self-service weakens the ability of any industrial organization to serve its customers and honor the confidence shareholders place in it.

I have been in this aircraft business since 1936. And I am proud to have been associated with the Lockheed Aircraft Corp. since January 1939; and the Lockheed-Georgia Co. since February 1951. I know of no other company, or group of people, who could have met so well the many challenges we faced in the past 5 years.

Thank you, sir.

Chairman PROXMIRE. Thank you, Mr. Poore.

EXAMPLES OF EXORBITANT PRICES

Mr. Durham, in exhibit 7 of your prepared statement you show examples of exorbitant prices paid for material. Can you show us these examples?

Mr. DURHAM. Yes, sir.

On May 12, 1971, Lockheed received 14 pieces of sheet steel, size 2 inches by 2 inches, 0.035 thick, from Tull Metal, at a cost of $1.71 each, or a total of $23.94. The official computer inquiry, Lockheed's computer inquiry, showed 468 square feet available in Lockheed's Marietta stores at slightly over 67 cents per square foot. Lockheed could have obtained 1 square foot at its own stores for 67 cents instead of paying Tull Metal $23.94.

Here is a shop order, requisition, and a Lockheed computer sheet.

Another example: On May 2, 1971, Lockheed ordered 14 pieces of sheet steel, size 2 by 2, 0.035 thick, the same size, for $1.38 each, a total of $19.32, paid to Tull Metal. An official Lockheed computer sheet showed 468 square feet again available in their Lockheed stores at 67 cents, the same cost.

So, obviously, they could have paid 67 cents instead of $19.32.

Chairman PROXMIRE. You say that in both these cases the inventory records show that there was plenty available when these additional purchases were made?

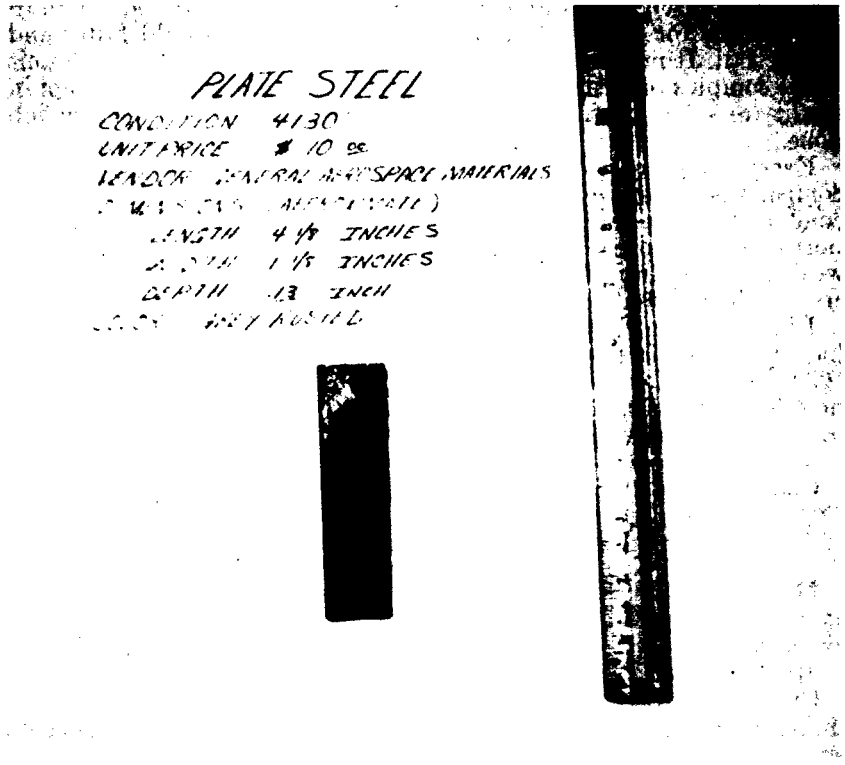
Mr. DURHAM. Absolutely. And I have a copy of those records.

Chairman PROXMIRE. Do you have actual hardware samples to show?

Mr. DURHAM. Yes, sir; I have some.

This piece of metal I show here was going to be thrown out. And in the process of trying to audit and find out what the problems were and how to solve them, I found that for this piece of metal, 0.13 by 1.0 plate steel 4130, 4 inches long, Lockheed paid $10 to the General Aerospace Metals Corp., Dixie Metals Division.

(A photograph of the piece of metal referred to above follows:)



Chairman PROXMIRE. How much do you think that is worth?

Mr. DURHAM. I would not give you more than a couple of dollars for it, myself, if that much.

Chairman PROXMIRE. How do you evaluate whether the $10 is excessive or whether it is correct?

Mr. DURHAM. I promise you that anybody familiar with metals will tell you that this piece of metal is not worth $10.

Chairman PROXMIRE. Mr. Poore, would you like to comment on this?

Mr. POORE. I am sorry, I can't. I do not know what the content of the metal is.

I would like to comment on the two previous areas, with which I am somewhat familiar.

was really due to lack of controls, failure to install proper management systems and procedures and to have control over the business. And this is just one example of many, I might say.

Chairman PROXMIRE. The examples you are giving represent very, very small amounts of money, although they may be symptomatic of an enormous cost.

Can you tell us why spending $10 in one case and $25 in another would result in hundreds of thousands or perhaps millions of dollars in excessive costs?

Mr. DURHAM. Well, for example, as I mentioned in my oral statement, I have documentation that shows that Lockheed scrapped 42½ tons of material, which was steel, primarily, that had rusted and corroded beyond recognition. It was stacked in a backyard on racks completely out of control. It has been there so long that even the quality control people and others that I contacted could not identify it as being safe for usage on aircraft. As you probably know, aircraft parts have to be made precisely. You have to be sure what type of material it is; you can't guess, obviously. So, we scrapped the material. I have the record. Forty-two and a half tons of steel.

(Photographs of above-stated conditions follow:)

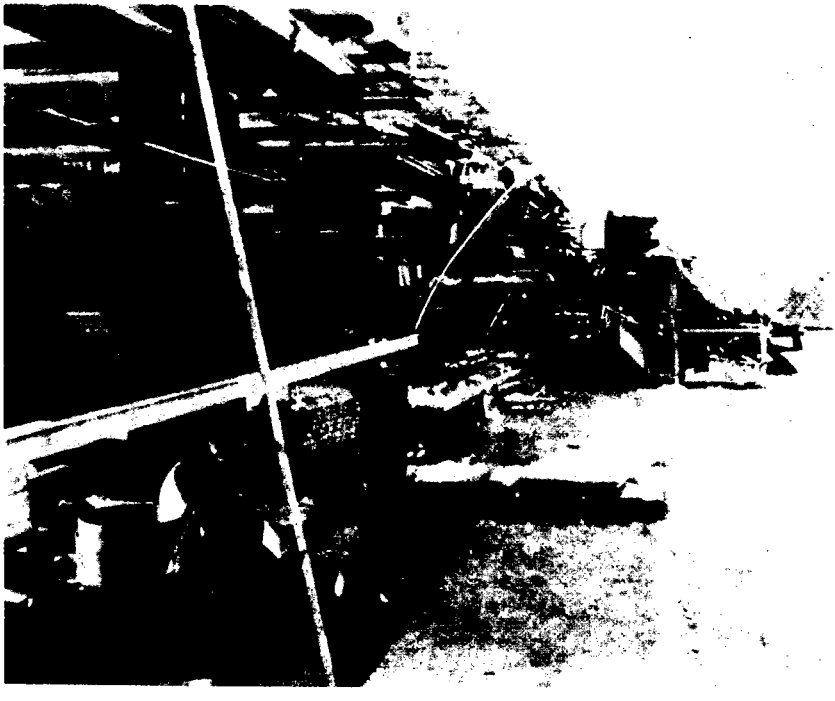


FIGURE 1.—View of material racks containing titanium at over $20 per pound

FIGURE 2.—Armorplate still in crates, very expensive, rusting away according to stripper; purchased several years ago; over $300 per sheet.

FIGURE 3.—Another view of armorplate with rubber facing rotted off.

FIGURE 4.—Titanium out of control; buying every day.

(1313)

FIGURE 5.—Partial view of material racks. Typical out-of-control condition. Impossible to find anything except by searching or attempting to comb area.

Mr. DURHAM. And a lot of that was material which was still in the cut sizes that came from various vendors at one time or another.

Chairman PROXMIRE. What then would you estimate the value of that to be or the cost?

Mr. DURHAM. It would have to be in the hundreds of thousands of dollars.

However, Lockheed received from Siskin Steel a little over a thousand dollars for the steel because by that time it was just rusted steel being sold as scrap. And that type of thing just stuck in my craw.

Chairman PROXMIRE. Mr. Poore, do you want to comment on that?

Mr. POORE. This is something new that I have not heard of before, Mr. Chairman. I will be glad to look into it and submit our findings for the record, if you desire.

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

Lockheed did in fact sell 85,850 pounds of miscellaneous steel scrap, among other material at the Chattanooga Plant, to Siskin Steel and Supply Company. This transaction is documented on Lockheed MSO (Material Sales Order) No. 43873, dated 5–5–71. Sale price for this line item of scrap was $1,158.98.

It is Lockheed policy to sell scrap to the highest bidder on the basis of a semi-annual competitive award. Siskin Steel and Supply Company submitted the high bid for scrap for the 6-month period during which the aforementioned activity transpired.

Included in this line of steel scrap was a large test fixture moved from LIP (Lockheed Industrial Products) of Atlanta, Georgia, to the Chattanooga Plant for possible use. Later this fixture was dispositioned for scrap at Chattanooga since no use was evident. This one item alone weighed 8 tons (16,000 pounds). Also included in this lot of scrap material was structural mono-rail removed from LIP as well as redundant steel material resulting from cancellation of Aerospace Ground Equipment orders originally ordered from Chattanooga by the Air Force.

The scrap steel generated by both LIP and Chattanooga was rounded up during the course of a routing clean-up effort. Dispositioning and sale of this material was in accord with procedures approved both by the Company and the Air Force.

Finally, it should be noted that none of the scrap material resulted from air vehicle requirements. The sale of this amount of steel material was the result of a Lockheed decision to dispose of otherwise unusable bits and pieces of fabricated, partially fabricated and stock material. Although with no identifiable need, most of the material had been held for varying periods of time in anticipation of a need.

Any implication that material disposed of in this transaction was procured without justification, disposed of without due consideration to requirements or that needed material was ineptly stored or handled is not correct.

Chairman PROXMIRE. On your exhibit 8, you state that you took samples of expensive tools left out and left to rust, Mr. Durham.

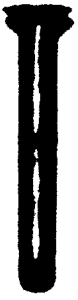
Can you show us examples of these?

Mr. DURHAM. Yes, exhibit 8.

I want to say here now that these tools I am going to show were found in the backyard at Chattanooga. I personally found them rusting in an old dirty, trashy waterfilled container. I pointed this out to the plant manager because at the time I did not really have any jurisdiction over that portion of the business. Months later, the stuff was still there. This is an example of it.

(A photograph of the tools referred to above follows:)

BOLT
PART NUMBER NAS 1628-50
UNIT PRICE $65.00
VENDOR DUTCH VALLEY SUPPLY CO
DIMENSIONS (APPROXIMATE)
LENGTH 3 1/2 INCHES
HEAD 15/16 DIAMETER
BASE 3/8 DIAMETER
COLOR GOLD



Chairman PROXMIRE. $65 for that one bolt?

Mr. DURHAM. Yes, sir. And I have the requisition to prove it.

Chairman PROXMIRE. You say $65?

Mr. DURHAM. Yes, sir.

Chairman PROXMIRE. Mr. Poore, would you comment on that? That seems extraordinarily high.

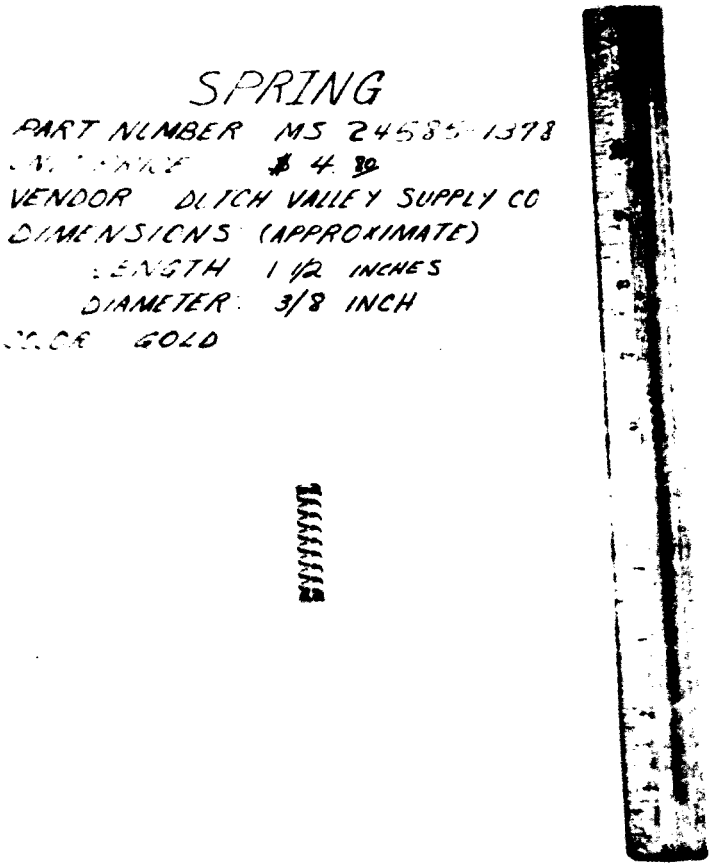
Mr. POORE. I am afraid I can't comment on that. I don't know what the bolt is, what material. I do not know whether it is titanium, platinum, or just what it is.

Chairman PROXMIRE. Do your records indicate what the material is, Mr. Durham?

Mr. DURHAM. No, sir, but it is a standard NAS bolt, standard aircraft bolt.

Mr. POORE. I would be very happy to look into this and report back to the committee in detail.

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



Chairman PROXMIRE. How much was paid for that little spring?

Mr. DURHAM. $4.80 each.

Of course, they bought six of them. But, anyway, in my opinion, it is not worth $4.80.

These are just good examples.

Chairman PROXMIRE. What is it worth?

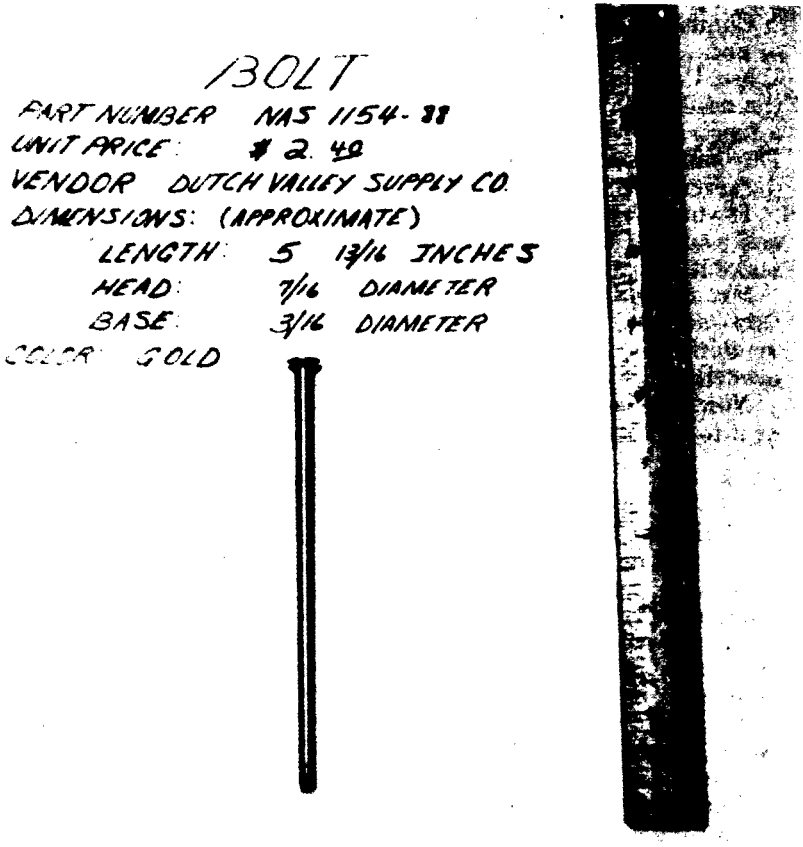
Mr. DURHAM. In my opinion, maybe a dollar.

And besides that, I believe you can use commercial stuff for this, too. Anyway, $4.80, to me, is a terribly exorbitant price.

You must bear in mind, sir, that these things, I am just showing you, are examples of many.

On April 1, 1969, Lockheed purchased 240 bolts from the Dutch Valley Supply Co. As of April 26, 1971, the parts were still in stock with this requisition.

(A photograph of the bolt referred to above follows:)



Mr. DURHAM. As I say, in each of these cases, I have the requisitions. And Lockheed paid $2.40 for 240 of these or $576 total.

On October 10, 1969, approximately 2 months later, Lockheed paid $2.95 apiece for 80 of the same identical bolts from the same vendor. This time Lockheed paid $236 for 80 bolts. In other words, they paid 55 cents more per bolt approximately 2 months later, directly from the vendor, for Chattanooga. This is the bolt right here. It is sort of a long, slim job. But 55 cents difference in price 2 months later——

Chairman PROXMIRE. Can you explain that kind of action, Mr. Poore, why they would pay so much more over a period of time?

Mr. POORE. Occasions like this, sir, could happen according to the quality of bolts that you have got to buy. Now, if a vendor has to special-make three or four bolts of that type, you are going to pay a reasonably high price because of the set-up——

Chairman PROXMIRE. What were the quantities, Mr. Durham?

Mr. POORE. May I finish, please, sir?

Chairman PROXMIRE. Yes, I beg your pardon.

Mr. POORE. If you wanted to compare the costs of buying two or three when you are in an emergency and need these things to that of buying 2,000 or 3,000, there is a tremendous differential in price.

Mr. Staats, let me conclude by saying at the end of your statement you make some suggestions about where attention ought to be given to follow up the staff study and complete the investigation. I think those are excellent suggestions, and I would hope your office would act on them promptly and report back to the subcommittee.

Can you give us an idea how long it will take?

Mr. STAATS. No, sir; I cannot. I would like also to say we would be glad to do this, but in order to be able to do it, we must have an understanding with you that this report and the same draft report that has been made available to Mr. Durham will also be made available to the contractors and the Defense Department.

Chairman PROXMIRE. By all means.

Thank you again. This has been a most helpful hearing.

The subcommittee will reconvene its hearing tomorrow morning at 10 o'clock in this room.

(Whereupon, at 12:20 p.m., the subcommittee recessed, to reconvene at 10 a.m., Tuesday, March 28, 1972.)

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

U.S. GENERAL ACCOUNTING OFFICE,
Washington, D.C., March 24, 1972.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee, Subcommittee on Priorities and Economy in Government, U.S. Congress.

DEAR MR. CHAIRMAN: Mr. Kaufman of your staff has requested a copy of the draft of our proposed response to your letter of October 12 in which you requested the GAO to investigate charges and verify the evidence presented to your Committee by Mr. Henry M. Durham, a former employee of the Lockheed Corporation, concerning alleged unsatisfactory management practices of the Lockheed-Georgia Company.

We had hoped that a response to your letter could be completed in advance of the hearings scheduled to be held on Monday, March 27 (dealing with shipbuilders' claims and the allegations made by Mr. Durham. While we have received a staff study from our Atlanta office, it appears that additional field work may be required. Moreover, there has not been an opportunity for a review in the normal manner within the GAO which would be required to fully evaluate the study before rendering it as a GAO report to your Committee.

The Comptroller General advises me that transmittal of the Atlanta staff study to your staff is in accord with your wishes with the view to having it in your hands prior to the hearings on Monday. Because of other high priority matters, the Comptroller General has not been able to review the materials but will be able to advise you Monday as to the status of the GAO report.

If for any reason you should wish to make the Atlanta staff study available publicly, we would appreciate your releasing a copy of this letter with it.

Sincerely,

R. W. GUTMANN, *Director.*

Enclosure.

[Staff Study on testimony by Mr. Henry M. Durham, concerning allegations of unsatisfactory management practices at the Lockheed-Georgia Co. Atlanta regional office]

EXHIBIT 1

ERRONEOUS AIRPLANE ASSEMBLY RECORDS CAUSED OUT-OF-STATION INSTALLATION OF PARTS AND GENERATED ERRONEOUS PARTS REQUIREMENTS

Mr. Durham testified that C–5 airplanes were moved to the flight line with thousands of missing parts and assemblies—although assembly records showed them to be complete except for a few engineering changes and other installations normally planned at the flight line. He stated further that (1) assembly records

erroneously showed that other parts had not been installed, when in fact they had been, (2) substantial additional costs were incurred to identify, procure, and transport the missing parts as their need became apparent, (3) parts had been improperly removed without authorization after inspection, and (4) Lockheed maintained the subterfuge to appear to be on schedule and to receive progress payments from the Air Force, which allowed the unsatisfactory conditions to prevail.

Regarding the missing parts problems, Lockheed advised the Joint Economic Committee on October 7, 1971, that:

* * * * * * *

"Parts shortages, missing parts, and out-of-station work (installed later on in the production process) are an inherent product of the environment of a concurrent development and production program in its early stages.

"These problems were recognized and acted upon by management independently of Mr. Durham and prior to any suggestions by him. All of the conditions, relating to parts problems, were well known to Lockheed top management. Coordination meetings were held weekly for the purpose of reviewing production schedules, changes, and parts availability to ensure that parts shortages were handled properly. Bimonthly meetings were held between officials of the Lockheed-Georgia Company and Corporate officials to bring additional management attention to these conditions. In 1968, 1969, and 1970 a series of special Saturday and Sunday C–5 Program Review meetings, between Lockheed-Georgia and Corporate Management, were held specifically to review the status of missing parts and out-of-station work. Internal audits reflect continuing improvement in this area resulting from constant management attention to the problem."

* * * * * * *

Except for Lockheed's indications that adequate corrective action was taken in a timely manner, our review confirmed that the testimony and comments by both parties were substantially correct and were supported by several memorandums from Mr. Durham and other Lockheed personnel, minutes of special corporate meetings, internal audit reports, and replies from management to internal auditors. The records provided to us by Lockheed officials do show management's awareness of the problems and necessarily demonstrate that significant problems existed—largely as a result of inaccurate assembly records.

In our opinion, the reasons for inaccurate assembly records cannot be associated with other problems which may have been caused by the concurrent C–5 development and production program. Although Lockheed internal auditors recommended corrective action in December 1969, about the time when airplane serial 0014 was being moved to the flight line, the problems continued in March 1970, when airplane serial 0023 was in final assembly. An audit report of May 1970 identified unsatisfactory conditions on airplane serial 0019, but the next scheduled audit covered airplane 0045 and the report of May 1971 stated that adequate controls had been provided and performance was considered satisfactory.

Although these problems were apparently of concern to management and were considered inherent in the concurrent development and production program, none of the records provided to us—including internal audit reports—indicates that the resulting cost impact was ever measured. We doubt that the true cost impact of the missing parts problems can now, in retrospect, be isolated because assembly records were erroneous and because a great number of engineering changes occurred. However, we will consider cost impact to the extent possible in our continuing review as discussed under exhibit 4. We will also consider whether corrective actions taken by Lockheed are currently effective.

Concerning Mr. Durham professionally, Lockheed officials told us that he was competent and knowledgeable in regard to production control procedures and had a good record of steady progress within the company. The officials cautioned us that none of their statements should be construed as indicating that Mr. Durham was a disgruntled ex-employee. They provided us file copies of most of Mr. Durham's reports—thus showing that reports which he had submitted to the Joint Economic Committee on missing parts were valid documents prepared in the ordinary course of his employment.

We noted that neither the Air Force nor the Defense Contract Audit Agency (DCAA) specifically investigated by Mr. Durham's charges on the missing parts problems. Air Force officials told us that the Quality Assurance Division of the

Air Force Plant Representative's office tested Lockheed's records and reported their findings, but did not retain records beyond one year. The DCAA had not reviewed the accuracy of assembly records or conditions of missing parts—even though Lockheed's internal audit reports were distributed to the audit agency.

In the testimony, Mr. Durham cited conditions of missing parts and inaccurate assembly records in exhibits 1, 2, 4, 13, 14, 15, and 19—showing for example that:

10,000 parts were delivered for airplane, serial 0008, but 4,000 parts were later returned as not needed.

15,291 missing parts and 5,294 rejected parts were identified on airplanes—serials 0009 through 0014—after their arrival at the flight line.

Assembly records indicated only 30 missing parts on airplane—serial 0023, but an audit on its arrival at the flight line showed that 1,080 parts were missing.

On October 13, 1969, Mr. Durham reported to the Production Control Division Manager that about 1,000 missing parts requirements had been received against airplane serial 0009 and were attributable to the following:

Condition:	*Number of parts*
Missing from aircraft—reported installed	675
Missing and reported as missing	163
Removed/not reinstalled—no record	82
Not missing but reported as missing	55
Not valid engineering requirements	25
Total	1,000

As a result of a special corporate meeting held on October 25, 1969, to resolve the continuing problems of missing parts and out-of-station installations, Mr. D. J. Haughton, Chairman of the Board of Lockheed Aircraft Corporation, directed the establishment of a flight line data control center to coordinate and reconcile aircraft assembly records and establish accurate parts requirements. On November 17, 1969, Mr. Durham recognized that the control center was functional.

On December 31, 1969, Lockheed internal auditors reported that an unusually large number of parts were missing from C–5 airplanes delivered to the flight line, which had been reported as installed. The auditors recognized that procedures did not require reconciliation of the various assembly records and visual verification that operations were in fact performed. They concluded that there was no assurance that all required parts would be installed according to the manufacturing plan and that records would accurately show the work done.

In reply to the audit, Lockheed officials stated that the need to determine the reasons for differences in the status of installed parts between the records and the airplanes had been recognized, but because the assembly line had not become stabilized, it had not been practical to start corrective actions until airplane, serial 0014, reached the flight line on December 18, 1969. In addition, the Project Inspector stated that additional personnel would be assigned to take corrective action and that audits of records would be increased.

A subsequent internal audit report of February 16, 1970, covering airplane, serial 0013, identified that:

Parts shown as installed on production and inspection records had been removed without authorization.

Parts were missing from the airplane but were recorded as installed. Some had been verified by an inspector.

Parts were missing from some feeder plant and subcontractor assemblies but were not reported as missing on assembly records.

Parts reported as missing were found to be installed.

The February audit report stated that the quality, schedule, and cost of the C–5 assembly operations were significantly affected because of inadequate administrative controls over assembly work. In reply, the Director of Manufacturing Operations stated that corrective action would be taken, with periodic audits, to assure accurate documentation of work performed and feedback on deficiencies noted.

During a special review meeting on February 21, 1970, the Director of Manufacturing Control identified parts requirements, including missing parts, for airplanes—serials 0009 through 0016—at the flight line as follows:

	Number of parts requirements caused by—			
	Missing parts	Discrepancy reports	Other	Total
Airplane serial:				
0009	4,000	1,500	4,943	10,443
0010	3,750	1,300	4,692	9,742
0011	3,300	1,750	3,915	8,965
0012	3,000	1,300	2,882	7,182
0013	1,750	1,000	2,414	5,164
0014	1,300	500	2,843	4,643
0015	650	450	875	1,975
0016	600	400	875	1,875
Total	18,350	8,200	23,439	49,989

Legend: Missing parts—Represents inconsistencies in the assembly records when reconciled at the flight line—some of which may have been installed as in a test on airplanes, serials 0009 and 0010, wherein 9 percent of the missing parts had been installed or were not needed. Discrepancy reports—Represents damaged or unsuitable parts replaced at the flight line. Other—Represents parts that were available but not installed, manufacturing change notices, and parts shortages.

An internal audit report of March 13, 1970, reemphasized the earlier findings that procedures did not require reconciliation of assembly records or visual verification of work performed. Other Lockheed reports showed that the missing parts problems continued as follows:

During the period from March 6, 1970, to April 6, 1970, 893 missing parts were reported for airplane, serial 0020; 1,038 for airplane, serial 0021; and 1,120 for airplane, serial 0022 at the final assemply area.

A report of March 16, 1970, showed that 1,084 parts were reported missing from airplane, serial 0023, but had not been included on shortage lists.

A report of April 27, 1970, showed that a daily average of 257 parts requirements were processed as a direct result of missing parts in the final assembly area.

An internal audit report of May 28, 1970, stated that an investigation of airplane, serial 0019, showed that the unsatisfactory conditions previously found on airplane, serial 0013, still existed and continued to significantly effect the quality, cost, and schedule of C–5 assembly operations. The Director of Manufacturing Operations outlined corrective actions similar to those he had proposed earlier in reply to the February 16, 1970, audit report. He explained that airplane, serial 0019, was almost complete before the earlier corrective action had been implemented and that there had not been sufficient time to experience improvements.

As noted above, reports in March and April 1970 showed numerous missing parts for airplanes—serials 0020, 0021, 0022, and 0023. However, the next internal audit was not made until over a year later, This audit covered airplane, serial 0045, and the report, dated May 25, 1971, stated that adequate administrative controls had been provided for maintaining production and inspection records and that performance was satisfactory.

IMPROPER REMOVAL OF PARTS CONTRIBUTED TO THE MISSING PARTS PROBLEMS

Mr. Durham testified that thousands of parts were improperly removed after being installed and inspected. He said parts were removed without proper authorization and were installed on other airplanes.

Our review confirmed that Mr. Durham's testimony was substantially accurate. However, we were unable to determine the cost impact of improperly removed parts. In addition to the documentation provided by Mr. Durham, which we believe supports his testimony, we obtained other Lockheed reports showing that unauthorized removal of parts was a significant problem which was reported to management.

Mr. Durham provided a statement, written by a former Lockheed official, citing Lockheed's inability to control the cannibalization of C–5 landing gear parts and other large assemblies during the flight test program. The official said "hundreds of parts were removed from new landing gears for installation on other airplanes and that no records were kept of the items removed.

Mr. Durham provided an example wherein another Lockheed official reported in April 1970 that, as a result of an audit to determine if parts had been improperly removed from main landing gear assemblies for airplanes—serials 0033 through 0036—26 parts had been removed.

We noted that Lockheed management was made aware of unauthorized removals by internal audit reports and other memorandums on the status of investigations of missing parts. Results of these investigations are as follows:

Date of report	Airplane serials	Number of missing parts investigated	Number of parts improperly removed	Percentage
Oct. 13, 1969	0009 and 0010	160	13	8.7
Dec. 19, 1969	0012	160	12	7.5
Feb. 16, 1970	0013	124	12	9.7
May 28, 1970	0019	63	31	49.2

AIR FORCE PROGRESS PAYMENTS TO LOCKHEED WERE EXCESSIVE BECAUSE WORK WAS INCOMPLETE AND WORK-IN-PROCESS OVERSTATED

Mr. Durham testified that Lockheed moved assemblies and aircraft on a prescribed schedule, regardless of the state of completion, to receive credit and progress payments for being on schedule.

Mr. Poore, Executive Vice-President, Lockheed-Georgia Company testified that (1) payments to Lockheed were based on a percentage of costs incurred, (2) the Air Force withheld funds from these payments for shortages of parts and/or work on delivered aircraft, and (3) payments to Lockheed were carefully controlled and audited by the Air Force Plant Representative (AFPRO) and the Defense Contract Audit Agency (DCAA).

Our review confirmed that Lockheed did have significant financial incentives to move aircraft on schedule—in terms of avoiding up to $11 million in liquidated damages and receiving over $75 million in additional payments representing reimbursements of costs incurred for achieving certain schedule milestones. In addition, the original contract clause limiting progress payments was not enforced, and as a result, Lockheed was paid about $400 million in advance of contractual requirements, according to a February 1970 DCAA report of the overpayment. Although the DCAA estimated that these overpayments would increase the Air Force did not reduce progress payments as a result of the DCAA report because it was not considered in the best interests of the Air Force. In contrast, the Air Force subsequently made an additional $705 million available through May 31, 1971, for progress payments to Lockheed. This was part of a financial plan approved by the Secretary of the Air Force and the DOD Contract Finance Committee to legally fund Lockheed, pending execution of the proposed restructured contract.

The original contract provided for liquidated damages of $12,000 a day, up to $11 million, for late delivery of the first 16 airplanes. Although Lockheed was issued a notice of delinquency, the liquidated damages clause was not applied and was deleted in converting the contract.

The original contract provided additional payments for achieving specific milestones associated with initial tooling and completing certain steps of the test program including making the first five aircraft available for the test program. Although the contract provided for regular progress payments to Lockheed primarily based on 90 percent of costs incurred, the additional payments of $75 million were for the net difference between (1) the proposed target billing price for the milestone events and (2) the amount assumed to have been paid to date in progress payments for the events—as determined by liquidation rates specified in the contract.

For example, Lockheed received an additional payment of $18 million for initial tooling when the first C–5 reached a certain assembly line position. Because the target billing price specified for initial tooling was $99.3 million and the contractual liquidation rate was 81.8 percent, it was assumed that Lockheed had already been paid 81.8 percent of $99.3 million. Thus, the additional payment represented 18.2 percent of $99.3 million or $18 million.

Questions regarding the possibility or need of reducing progress payments had been a matter of concern to the AFPRO since 1968. An AFPRO letter of November 26, 1968, requested advice of the PCO on whether the contemplated action to reduce the rate of progress payments should be pursued—taking into consideration Lockheed's production and quality control difficulties, whether the resulting demands for increased working capital could endanger Lockheed's ability to continue performance, and whether the contemplated action would be improper or tantamount to breach of contract. The C–5 System Program Office (SPO) replied in December 1968 that reducing the rate of progress payments would not be in the best interests of the Air Force at that time—but Lockheed could be requested to provide information about adjustments to subcontractor's progress payments rates.

On February 3, 1969, the AFPRO advised Lockheed that:

1. Consideration was being given to suspending progress payments and increasing the liquidation rate to 100 percent.

2. Cost and schedule studies lead to the conclusion that Lockheed has so failed to make progress as to endanger performance of subject contract, the unliquidated progress payments exceed the fair value of the work accomplished on the undelivered portion of the contract, and Lockheed was realizing less profit than the estimated profit used for establishing the liquidation rate.

The AFPRO position was reiterated to Lockheed by letter of May 27, 1969, in which he also requested financial data on credit and projected cash requirements—for assessing in accordance with ASPR the effect of reducing progress payments. Lockheed replied on June 18, 1969, that total performance would be substantially in accordance with contractural requirements and that no change in the progress payment was justified. On June 27, 1969, the AFPRO advised ASD of Lockheed's position and requested ASD's review and guidance on the matter. And on October 21, 1969, the Air Force Systems Command advised ASD that when current negotiations were completed, the SPO and the AFPRO would jointly establish the proper adjustment to progress payment and liquidation rates—timely action would be taken to increase liquidation rates to assure that unliquidated progress payments do not exceed the fair value of work accomplished on the undelivered portion of the contract.

On January 21, 1970, the AFPRO advised the C–5 SPO that the Resident DCAA Auditor was in the process of taking formal exception to the methods used by Lockheed in developing costs applicable to items delivered, invoiced, and accepted for purposes of progress payments because Lockheed was not utilizing cost estimates in consonance with its records and other reports and therefore was deviating from the ASPR and progress payment instructions without proper authorization. The AFPRO requested guidance as to whether Lockheed should be permitted to continue using its methods.

On March 10, 1970, the DCAA advised the Controller of the Air Force that:

* * * * * * *

"Based on a further analysis of the contractor's progress payment requests, the attached report indicates that current overpayments on Contract No. AF 33(657)–15053 amount to about $400,000,000. This exceeds the entire net worth of the Lockheed Aircraft Corporation as of December 29, 1968, as shown on its published report to the stockholders. The overpayment condition results from cost overruns attributable to delivered items.

The report explains that the contractor has been computing the progress payment limitation by using the contract price of the delivered items rather than the experienced costs of delivered items, thereby inflating the costs eligibile for progress payment.

The subject report reiterates the concern expressed in Report No. 118–10–0–0059 [December 12, 1969] over the contractor's financing problems. It is the auditor's opinion that, even if funds were provided to the contractor to the ceiling price level, there is a strong possibility that financing problems would preclude the contractor from delivering the total number of airplanes ordered."

AFPRO officials told us that:

1. Questions of excess progress payments had not been finalized.

2. Neither Headquarters ASD nor the AFPRO have any record of receiving formal responses from higher headquarters to our inquiries and/or advice as to action deemed appropriate in connection with the audit reports.

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3. Because of terms under the converted contract, it appears that the auditor's questions are academic and no action appears necessary, appropriate, or permissable.

Thus, the Air Force did not reduce progress payments to Lockheed as a result of the DCAA report of overpayments. We found that the Air Force, subsequent to the report, made available through May 31, 1971, an additional $705 million for progress payments to Lockheed. As stated above, this was part of a plan approved by the Secretary of the Air Force and the DOD Contract Finance Committee to legally fund Lockheed pending execution of the proposal restructured contract. Effective May 31, 1971, the contract was converted to cost reimbursement type and the limitation on payments clause was deleted.

These funds were made available by the following means:

	Millions
Increased contract ceiling price due to interim repricing adjustments because of the exercise of run B option	$300
Increased allowable incurred costs from 90 percent to 100 percent of the ceiling price	148
Increased ceiling price for provisionally ordered items. (spares and age)	82
Ceiling price adjustments for abnormal fluctuations in the economy	143
Ceiling price adjustment for undefinitized change orders	32
Total made available for progress payments from Feb. 21, 1970, to May 31, 1971	705

We also noted that the AFPRO by letter dated January 26, 1970, admonished Lockheed to review those subcontracts providing progress payments and to effect adjustments when required to bring unliquidated payments in line with the current positions of the subcontracts. AFPRO personnel stated that an audit was not requested from DCAA concerning unliquidated payments to subcontractors and no further follow-up was made by the AFPRO after the January letter to Lockheed.

The DCAA Resident Auditor stated that an audit of the subcontractors' unliquidated progress payments in comparison with the value of the work in process was not made because it would be a waste of audit effort since the Air Force had not taken any action concerning overpayments to Lockheed on the prime contract.

In summary, we found that the allegation that Lockheed had received excess progress payments, regardless of condition or schedule, to be correct. Lockheed did receive excess progress payments of about $400 million due to understating the value of the work completed and overstating the value of work in process.

We also found that the Air Force was aware of the excess progress payment situation, but failed to act on it. In fact the Air Force made an additional $705 million available for progress payments to Lockheed. We also noted that the same situation of excess progress payments may have existed with respect to major subcontractors, but neither the DCAA nor the Air Force took action to examine into the matter.

EXHIBIT 2

AIRCRAFT CONDITION REPORT ON MISSING PARTS

Mr. Durham provided a report dated March 16, 1970, which describes the inaccuracies of records of parts installed on airplanes being built and the number of parts missing from airplanes upon their arrival at the final assembly area.

We believe that the report is valid and provides an accurate description of conditions. Lockheed officials provided us a copy of the same report. Our discussion of these conditions and problems is presented under exhibit 1.

EXHIBIT 3

OVERPROCUREMENT AND MISUSE OF VALUABLE SMALL PARTS

Concerning valuable small parts (VSP), bolt-like fasteners made mostly of titanium, Mr. Durham testified that:

"Report shows that as of May 1, 1970, the Company was facing a $30,000,000 cost overrun on VSP due to over-procurement resulting from failure to control parts in production areas and cribs—mostly production areas. The report shows

that VSP cost per aircraft [should be] approximately $560.000. However, the [actual] cost was exceeding $1,000,000 per ship.

This information was verified by the Company Industrial Engineer assigned to * * * straighten out the mess * * *.

* * * * * * *

This was money straight down the drain, impossible to be recovered. The best the Company could ever hope to do would be to bring the cost per aircraft back down to what it was supposed to be ($560,000) at some point.

At the time I checked, Ships 0025 and 0026 were in final assembly and had therefore received most of the VSP since 95 percent or more is installed above—(or earlier than Final Assembly). For the sake of even figures, a $500,000 overrun on 26 aircraft would be * * * $13,000,000.

* * * * * * *

VSP was scattered on floors, tables, in boxes, heaps—all over the place. It was being swept up and dumped. Finally, somebody caught on and started sending it to the Lockheed Ventura Company to be sorted out at 6 cents per item.

The cost of VSP averaged 16 cents to $37.50 each according to [the industrial engineer].

No one knew what or how much had been disbursed out to the shops.

Basically the reason for the over-run was not due to cost but to misuse and failure to establish and maintain an adequate inventory accountability system."

Our review confirmed that Mr. Durham's testimony is substantially accurate. Beginning early in 1968, Lockheed officials recognized that serious problems of inventory and production control were causing overprocurement and high surplus and scrappage rates for valuable small parts (VSP) consisting almost entirely of titanium fasteners. However, controls had not proved effective and in February 1970 the company projected a $25 million overrun which was used to justify a new data processing control system. In July 1970 the company determined that additional controls would save about $3.8 million.

At August 1970, after establishing the new control system, an overrun of about $21.3 million was indicated based on total planned procurement of about $67 million—at an average cost of about $807,000 for each airplane. In contrast, the planned bill of materials cost of VSP for each airplane was $550,000. Lockheed recognized that for airplanes produced initially, VSP costs totaled about $1.9 million each, due in part to design changes, but had decreased to about $350,000 for the 44th airplane.

We estimated that the current overrun at January 1972 will be about $10.4 million—based on the most recent, available company projection in July 1971 that procurement of titanium fasteners will total about $56 million at an average cost of about $674,800 for 81 airplanes and 2 test articles.

Although we did not verify current costs, we believe that the apparent reduction of the overrun is due to increased inventory and production controls and to significant use of substitute steel and aluminum fasteners which were substantially cheaper. The quantity of titanium fasteners used on each airplane was decreased from about 1,100,000 to 900,000—an 18 percent reduction in quantity and cost.

Earlier in the program, to help reduce aircraft weight, Lockheed had increased it usage of titanium fasteners, at substantially higher costs, to the extent that 1,100,000 of the 2,000,000 fasteners in the aircraft were titanium. Lockheed had been so concerned about weight that it ordered titanium fasteners with length increments of 1/32 inch rather than the standard 1/16 inch. However, according to one Lockheed official, much of the emphasis on weight reduction was curtailed after the Air Force insisted on installing a 300 pound work platform in each C–5A.

We determined that VSP valued at about $1.9 million has been declared surplus as of January 1972. Of this, fasteners valued at $1.3 million were recently sold for $2,800 even though Lockheed had previously advised the Air Force that the fasteners were commercial catalog items. Presumably, if these fasteners were catalog items they could have been returned to the vendors or sold to other users.

According to Lockheed officials, internal audit reports, and other documentation, overprocurement of fasteners was due to the following fatcors:

1. Procurement was initially based on forecasts rather than specific engineering requirements which could not be identified because manufacturing tolerances could not be precisely controlled. As a result, an excessive range of fastener lengths was procured to assure the availability of correct fastener lengths.

An internal audit report of February 1968 stated that because VSP requirements had not been stabilized, some purchases based on advance requirements may not be used and VSP on hand which cost $408,000 was excess. The report also showed that VSP requirements for each airplane had not been reconciled between engineering and manufacturing personnel. However, the auditors concluded that actions which resulted in the above were necessary at the time.

2. According to an internal audit report of September 1969, adequate controls had not been provided over the disbursement, handling, and usage of fasteners. Excess quantities were held by production personnel, mishandling was widespread, and usage appeared too high. Inactive VSP valued at $1.5 million was identified and controls were recommended to assure its use. Excess VSP valued at $500,000 was identified.

3. In reply to the September 1969 audit the Director of Manufacturing Operations stated in August 1970 that initial plans were to control VSP usage based on engineering requirements, but because of the high rate of changes the paperwork could not be processed. He said the then current system based on physical counts involved a considerable amount of record keeping and was difficult to maintain. He said that the failure to process the high rate of changes, coupled with discrepancies in original parts counts, resulted in erroneous requirements data and improper procurement. He said that inventory controls were unsatisfactory because control of VSP was lost after disbursement and that significant amounts of VSP were continually recycled through the system for cleaning and sorting by another company.

The Director advised that $872,000 of the $1,500,000 VSP identified earlier could not be used and would be surplused.

4. An official told us that initially many workers were mechanically inept and wasted VSP. The small fasteners were easily dropped and at times the production floor was covered with them. Because the fasteners cost from $.16 to $35.00 each, they were collected and sent to a subcontractor for cleaning and sorting.

The initial purchase order was issued in July 1968 and provided for this service at $6 a pound. Although this rate was changed and is now $.0575 for each fastener, Lockheed paid about $906,000 through December 1971 for cleaning and sorting 52,410 pounds from which Lockheed recovered 43,667 pounds of VSP; 1,334 pounds of miscellaneous small parts; and 6,047 pounds of scrap.

In reply to the September 1969 audit report, the Director of Manufacturing Operations stated that to avoid a serious loss, a pilot system based on usage was developed. All crib transactions were to be recorded by charge cards and keypunched to accumulate usage and procurement data. However, an internal audit report dated December 1970, showed that inventory reports were erroneous and that excessive procurement was still possible. To correct this deficiency the Director of Manufacturing Operations stated that physical inventories would be made more frequently.

We noted in a report dated January 19, 1970, by the Contract Management Division of the Air Force Systems Command that the Air Force had found significant problems in Lockheed's procurement of titanium fasteners, including possible price fixing. The report concluded that Lockheed and the Air Force Plant Representative should aggressively pursue the problems. Lockheed officials agreed. However, the Air Force Plant Representatives has not determined whether corrective action was taken.

The report questioned (1) whether Lockheed could have considered procurement from unlicensed vendors, holding them harmless from patent infringement liability—since the patents had not been contested and were of doubtful validity and (2) whether Lockheed obtained adequate price competition—since vendor's quotes were sometimes identical to the fifth decimal place for the same quantities and since Lockheed had not established that the fasteners were commercial, catalog items sold in substantial quantities to the general public.

In summary, Lockheed did project overprocurement of VSP—as Mr. Durham testified—due to unsatisfactory inventory and production controls. Moreover, Lockheed's inability to control manufacturing tolerances and to determine specific engineering requirements for VSP led to procurement based on forecasts rather than known needs and ultimately to procurement based on usage rates. Subsequently, inaccurate inventory records and misuse of fasteners by production personnel led to inaccurate usage rates and procurement, which generated surplus quantities of VSP to be sold as scrap.

Although Lockheed internal audits identified many of the problems and the need for corrective action, in our opinion the audit reports were not totally ef-

fective because there was generally no identification of the cost impact or adverse effect of the problems noted. This may have been omitted to avoid embarrassing management.

We also noted that the DCAA had not reviewed Mr. Durham's charges concerning VSP and had not previously reviewed inventory and production controls over VSP—even though the pertinent Lockheed audit reports were distributed to the DCAA.

Air Force Plant Representative offiicals did not investigate Mr. Durham's charges or determine whether corrective action was taken on procurement problems identified by the Air Force report.

EXHIBIT 4

REPORT OF MISSING PARTS, ERRONEOUS ASSEMBLY RECORDS, AND DUPLICATE PARTS ISSUES

Mr. Durham provided reports citing examples of erroneous airplane assembly records and the resulting adverse effects in terms of missing parts and duplicate issues of parts already installed. The reports cite unnecessary reprocurement actions resulting from erroneous parts requirements which were generated by erroneous assembly records.

Our discussion of erroneous assembly records and missing parts is presented under exhibit 1. However, the review of Lockheed's procurement, use, and disposition of parts and part kits is expected to require a major effort to identify the extent of unnecessary. duplicate procurement. Accordingly. we will consider this aspect in our continuing review of the management of parts and parts kits. Portions of Mr. Durham's testimony concerning unnecessary reprocurement, resulting from various causes, are included also under exhibits 5, 6, 14, 17, and 18. Because of their significance, these factors will be considered in greater detail in our continuing review.

EXHIBIT 5

UNNECESSARY, DUPLICATE PROCUREMENT AND MULTIPLE ISSUES OF PARTS CAUSED BY LACK OF PARTS INVENTORY CONTROL

Mr. Durham provided a report showing an example wherein parts to be installed were lost and caused unnecessary, duplicate procurement and delivery of replacement parts. Inventory control over parts was lost. Unnecessary procurement resulted also because duplicate orders were issued for replacement of damaged parts.

Because we expect that a major audit effort is required, review of this aspect of Mr. Durham's testimony will be considered in our continuing review—as discussed under exhibit 4.

EXHIBIT 6

UNNECESSARY SHIPMENT OF PART KITS TO PALMDALE, CALIF.

Mr. Durham testified that because of poor planning, parts were assembled into kits and shipped to the field at great expense but were not needed—or were incomplete and could not be fully utilized. Control over kits aud parts in the field was ineffective.

Mr. Durham's testimony is partially substantiated by a Lockheed report of April 28, 1970, provided to us by Lockheed officials. The report shows that numerous part kits were being returned from the Palmdale plant to the Marietta plant for restocking and future use. The report shows that these kits were not part of the C–5A modification program planned at Palmdale and therefore were not used. We did not determine the reasons for their initial shipment to Palmdale. However, we intend to review the utilization of parts and part kits as discussed under exhibit 4.

EXHIBIT 7

PROCUREMENT ABUSES AT THE CHATTANOOGA PLANT

In describing procurement abuses at the Chattanooga plant, Mr. Durham testified that:

* * * * * * *

"I will show examples of exorbitant prices paid to vendors for material when the same material was available in Lockheed stores [at the Marietta plant] for a fraction of the price paid to the vendors.

* * * * * * *

The practice * * * persisted despite repeated complaints on my part. Finally, a strong letter stopped it temporarily."

* * * * * * *

We determined that Mr. Durham's testimony and evidence were substantially accurate and valid. We obtained additional evidence that significant percentages of material and other items were procured from vendors although the items were available at substantially less cost through the Marietta plant stores inventory.

These outside purchases were contrary to Lockheed-Georgia Company instructions issued in April 1970, reemphasized in March 1971, which stated that there was no excuse for ordering material from outside sources and spending company funds when identical assets were available in Lockheed storerooms. We also determined that material was frequently purchased on the basis of one item on each order form, thereby unnecessarily incurring the vendor's minimum charge for each order. Moreover, material and parts were ordered without knowledge of stock on hand at the Chattanooga plant and without knowledge of cost—because neither perpetual inventory records nor price lists were maintained. Consequently, billing prices were not verified—even though this deficiency was disclosed.

Although we could not determine the total adverse effect or dollar impact resulting from these procurement practices, we did expand the review beyond the scope afforded by Mr. Durham's examples to establish that a pattern existed.

A procurement official at Chattanooga verified that examples and documentation provided by Mr. Durham were valid and showed that items purchased from vendors were available at lesser cost from the Marietta storeroom. Our analysis of his 20 examples showed that the vendors charged $1,516 or more than 3 times the cost that would have been incurred if the items had been obtained from Marietta stores.

Our expanded review of purchases from several vendors, during sample periods, showed that about 9 percent of the miscellaneous parts purchased from two vendors were available through the Marietta procurement system at 62 percent savings and 16 percent of material items purchased from another vendor were available at 77 percent savings. For example, vendors were paid $1,633 versus the Marietta cost of $622 for miscellaneous small parts and $500 versus the Marietta cost of $115 for material items.

We determined that during a 3-month sample period in 1971, 217 or 44 percent of 489 orders for material incurred the vendor's minimum order charge of $5 ($4 prior to April 3, 1971) which could have been avoided or minimized by combining the orders and processing fewer order forms. A former procurement official told us that although he began to combine orders, he was forbidden to continue because management said material receipts were more easily controlled if ordered separately.

Considering the confused state of the material, purchased parts, and miscellaneous small parts inventories and the lack of controls, which are discussed in exhibits 10 and 11, it is understandable that material receipts could be controlled better by ordering one line item on one requisition. We noted many examples wherein the same materials with the same dimensions were ordered separately on the same day—sometimes on consecutively numbered forms. Minimum charges were also incurred on some examples cited by Mr. Durham wherein the items were already available in the Marietta storeroom.

The Chattanooga procurement supervisor told us that procurement personnel must not have checked the Marietta stores catalog adequately before ordering parts from vendors. He also told us that Lockheed's costs for cutting material from stores would be so high that the vendor's price would be cheaper because the vendor warehoused, cut, and shipped the material. We believe that this position is clearly unrealistic because it negates the earlier Lockheed instructions; it does not consider the effect of minimum vendor charges, and does not recognize that daily delivery service was provided routinely between the two Lockheed plants. Moreover, because of the lack of catalogs and price lists, the official could not have made adequate cost comparisons. He told us that the vendors wrote in the prices on almost all orders for material and miscellaneous

small parts and that Chattanooga procurement personnel did not verify these prices.

In contrast to our findings, the Air Force Plant Representative and his staff concluded after a 3-hour review in July 1971 that the Chattanooga "procurement system was satisfactory" and that "All items of purchased parts or raw material for manufacture are purchased by the Materiel Branch at Marietta."

UNNECESSARY PROCUREMENT OF MAINTENANCE NUTS AND BOLTS

As an example of procurement abuses at the Chattanooga plant, Mr. Durham testified that:

"A salesman from one company would come to the Plant, look in the bins and supply whatever he thought was needed. The problem is that he supplied far more expensive parts than were needed and as many as he thought he could get in the bins. For example, he sold Lockheed steel high-tensile bolts, plated bolts, etc., when plain old common stove bolts would do. No one in management questioned anything and went right on paying the bill. No bids were taken. A check showed that a * * * regular hardware supply company could supply parts much cheaper. A real peculiar situation developed when this same salesman changed companies. The bolt account went with him. This is highly irregular. Lockheed is supposed to obtain parts by bid from companies—not individuals."

* * * * * * *

Our review confirmed that this charge was substantially accurate. We determined that, for ordinary plant maintenance purposes, Lockheed purchased the highest possible strength nuts and bolts—exceeding high aircraft specifications—at a cost of about $36,000 over a 5-year period from 1966 through 1970. These purchases were made without competition. Although the salesman apparently flimflammed both Lockheed and his employer, by establishing his own company and proceeding to represent both companies simultaneously, Lockheed issued each purchase order and renewed them on the basis that the items were normally available from only one source.

We determined that the company could have saved about $30,400 or 84.5 percent of costs by purchasing lower grade items from other vendors. As a result of a Lockheed study of this matter in December 1970, the company began purchasing its needs from another vendor in 1971. Lockheed also issued this purchase order on the basis that the items were normally available from only one source. However, we determined that about 64 percent of the items included in the study were normally stocked at the Marietta plant and that the new vendor's prices were about 33 percent higher. We noted that Chattanooga plant officials had been directed to maximize use of the cheaper Marietta stock and that delivery trucks provided daily service between the plants.

A Chattanooga official told us that a Marietta plant official initially introduced the salesman as representing the selected company. The officials said that in 1969 the salesman began representing another company. We determined that he was fired in July 1970 by one company for simultaneously representing both companies and that he is currently president of the other company.

Annual purchases from both companies ranged from about $4,700 in 1966 to $9,500 in 1969, but decreased to $1,400 in 1971. Purchases from the new vendor selected in 1971 totaled only about $1,200 during the year. Thus, annual purchases of maintenance items decreased substantially in 1971 because of decreased requirements and lower prices.

Because they had no vendor catalogs or price lists at the Chattanooga plant until early 1971, procurement officials there were unable to determine that the prices were reasonable. Moreover, invoiced unit prices of items received could not be verified. Procurement officials said that they relied on the manager of maintenance and general plant service to order whatever was necessary.

The maintenance manager told us that although he did not have a price list either, he knew the higher grade items were more expensive. He said that he, rather than the salesman, was responsible for ordering maintenance nuts and bolts, including determining the quality and quantity needed. He said that he could not explain why he bought a range of high quality items without adequate cost comparisons.

EXHIBIT 8

WASTE OF TOOLS AND EQUIPMENT AT THE CHATTANOOGA PLANT

Mr. Durham testified that:

"Standard tools of Chattanooga were completely out of control. (Standard tools consist of such items as drills, carbide cutters, bits, etc.) Many are very expensive. Incredible as it seems, there was no checkout control system or any effective controls. No one knew where anything was or who checked it out. The tool engineers in charge of security told me that $250 to $300 a week was being spent to replace pilfered or lost standard tools. He said this was a conservative figure. I found perfectly good tools rusting away in the back yard * * *.

Example: Rusty drills found in an old water-soaked cabinet thrown out in the back yard. They were immersed in water and ice when I found them. Since I had no jurisdiction over tools, I immediately pointed the condition out to the plant manager in person. Six months later, they were still there, along with other costly equipment and material—rusting away.

* * * * * * *

A control system for tools still had not been established by May of this year (1971)."

Our review confirmed that Mr. Durham's testimony is substantially accurate. We found that his evidence—a written statement by a tool engineer and examples of rusty drill bits—are valid. We obtained additional evidence that significant quantities of tools were lost or stolen due to the laxity of general plant security and the absence of specific controls over standard tools.

Although we note that the company spent a monthly average of about $12,000 to replace standard tools, from May 1970 through May 1971, we could not determine the cost of losses as opposed to valid replacements because of the lack of records. There were no systems to control and record the inventory and issues of standard tools—except that there was a check out system for some items such as precision gauges and micrometers. Even so, 111 gauges valued as $3,614 have been lost since 1966.

The only estimate of losses we could obtain was in a written statement provided to Mr. Durham by the engineer responsible for procurement and handling of standard tools and plant security. He stated that:

* * * * * * *

"There was no check out control of cutting tools to the production areas and regularly small but expensive tools have been reported issued and lost in the shop. It is a fair estimate that between $500 and $400 a week would be saved using some sort of locator control issue system. Security is so loose that company equipment can be taken almost at will with the inability of the management to know the amount of loss."

* * * * * * *

In May 1970 the Chattanooga plant manager recognized that equipment and material were being stolen due to the lack of security and recommended installing a closed circuit television system at a cost of about $4,400, completing the surrounding fence, and increasing effectiveness of the guards. Except for the fence, his plan was not approved.

Plant officials and former employees told us that some of the items stolen were an air compressor, electric motor, power saw, several paint spray guns, socket wrenches, tires intended for C-5A ground support equipment, a micro-wave oven, a dollar bill change machine, and a 200-pound tool box.

In May 1970 the plant manager recognized the need to regain a favorable standard tool budget position and eliminate accumulation of tools in stock—including drill bits in need of grinding. He directed taking a complete inventory to better control and use tools in stock and monitoring the budget and procurement actions.

In October 1970 the tool engineer recognized that costs of supplying standard tools and related equipment was rising. He proposed an inexpensive system to control issues of standard tools based primarily on use of numbered tags to identify the workers charged. In July 1971 the tool engineer again stressed the need for a complete inventory of standard tools as an essential task to identify and remove obsolete tools.

We determined in January 1972 that there were no systems to control and record the inventory and issues of standard tools nor were there any records of

losses. Plant officials told us that issue controls had not been established because the costs of controls would exceed the cost of lost tools. However, the tool engineer told us that the costs of controls would be minor and that only the cost of identification tags for each worker need be considered.

We believe that as a result of the lack of inventory and issue controls, obsolete and excess standard tools were generated. An Air Force report of August 1971 showed that tools on hand were excess to reasonable requirements and that a large quantity of tools from another Lockheed company had been put in stock, but some had not been used. The tool engineer told us that as a result of the Air Force review about 2 tons of standard tools were scrapped.

In regard to Mr. Durham's exhibit of drill bits which he found rusting in the plant yard, Lockheed officials told us and the subcommittee that only about half a shoe box of drills was found. They said the drills were in a cabinet of a fixture transferred in from another Lockheed company and stored in the back yard. However, an employee and a former employee told us that they observed substantially more drill bits and other cutters. These conflicting statements could not be verified because of the lack of records.

EXHIBIT 9

INADEQUATE CONTROL OVER MATERIAL AT THE CHATTANOOGA PLANT

In describing the lack of control over material, Mr. Durham testified that: "Material (raw stock such as extrusion, bar steel, sheet metal, aluminum stock, etc.) was completely out of control * * *. No one knew where anything was, including expensive castings and forgings. Material * * * [was] being ordered every day when it was actually available if anybody had known it or knew where it was. Old scrapped material, new material, old rusty pipes, maintenance equipment, rubber goods, dirt, wood, trash, and other debris were all heaped together. Expensive castings and forgings were piled in old, rusty, water-filled barrels or buried in the muck.

* * * * * * *

* * * I did manage to get this [scrap] cleaned up by dumping 42½ tons (a matter of record) of old material which had rusted and corroded beyond recognition. This enabled us to sort out what was left and get it under control. I established a catalog control system and set it into motion."

* * * * * * *

Our review confirmed that Mr. Durham's testimony is substantially accurate and his evidence valid. We obtained additional evidence that a substantial but indeterminate amount of surplus and scrap raw material, finished parts, tools, equipment, and miscellaneous small parts had been accumulated as a result of production waste, canceled Air Force orders, transfers from another Lockheed plant to the Chattanooga plant without a foreseeable need, and ineffective management controls. However, we were unable to determine the amount attributable to ineffective management because there were no perpetual inventory records of regular stock and no inventory records or other descriptive records of the surplus and scrap on hand at the time.

In a memorandum for distribution dated September 1970, the Chattanooga plant manager stated that the accountability and handling of material was out of control. He stated that there were plans underway to install control systems and directed that in the meantime the indiscriminate ordering of material must cease. According to Mr. Durham's memorandum of March 22, 1971, approved by the plant manager, the purging and sorting of raw stock material was in process to provide an accurate determination of available material and a basis for inventory control and material handling.

As a result of Mr. Durham's efforts, much of the surplus and scrap was sorted, identified, and sold as scrap or stored properly in 32 large plywood boxes which he had built. About 603,500 pounds of material, equipment, and other items were sold as scrap for about $37,400 between June 1, 1970, and July 14, 1971. Other material and parts valued at about $77,000 were set aside for transfer to the Department of Health, Education, and Welfare. About 1,200 line items of miscellaneous small parts were transferred to the Marietta plant. Mr. Durham initiated a system to control and locate the stored surplus and another system to eliminate the practice by which production personnel could easily and without

proper authorizing documents obtain replacements for material and parts lost in the shops or damaged.

Plant officials told us that excess parts and material had been accumulated inside the plant and in the yard. Several officials, employees, and former employees confirmed that the plant yard had been substantially covered with surplus and scrap items, much of which was unidentifiable.

One former employee told us that it was difficult to drive a forklift in the yard because it was so completely filled with junk, excess raw materials, titanium stock, test fixtures, electric motors, caster wheels, castings, forgings, lathes, and other miscellaneous items. He said the rain and weather had corroded or damaged some of the items, including partial frames for C–5 Aerial Delivery System Trailers, which had collected water and burst in freezing weather. An Air Force inspection in July 1971 showed that a considerable number of these frames were still stored outside and unprotected. However, we observed in January 1972 that they had been moved inside the plant.

Another former employee generally confirmed the condition of surplus/excess material and told us that titanium stock valued at about $30,000 could not be used because the related certification papers were not available. The Manufacturing Services Department Manager told us that the titanium was scrapped because it was excess due to engineering changes and its content could not be determined due to lack of certification papers.

Although there were no records describing the 42½ tons cited by Mr. Durham, plant officials told us that the sale included unidentifiable raw materials, tools, and production scrap. On October 7, 1971, Lockheed advised the subcommittee that as a result of closing a facility in Atlanta, Georgia, considerable stock and equipment was transferred to the Chattanooga plant including a large 8-ton test fixture, a structural monorail, scrap steel, several metal cabinets, and metal work benches. Lockheed stated that these items could not be used at Chattanooga and were stored outside. Lockheed stated that the 42½ tons of scrap were sold in May 1971 for $1,159.

We observed and photographed the excess parts and material stored in plywood boxes and in the yard. The excess included miscellaneous small parts; purchased parts for production of missile dollies; frames and tires for C–5 Aerial Delivery System Trailers; extrusions, raw stock, finished parts, castings, and forgings for C–5 loading docks; casters for C–5 engine maintenance platforms; and various forgings, castings, standard tools, project tools, and shop aids for producing C–5 and other aircraft parts and ground support equipment.

Because of the lack of records, we could not determine the adverse effect or dollar impact of inadequate control over this material and other items, in terms of deterioration of the items on hand and unnecessary, duplicate procurement of items already available. Neither could Lockheed management. Moreover, since acquisition of the Chattanooga plant in February 1966, the plant operations were internally audited only once. The internal audit report of May 9, 1967, disclosed no major deficiencies. It stated that there was no accumulation of excess material and that controls were adequate over material and parts inventories, tools, procurement, and production control.

We believe that significant losses occurred unnecessarily during ensuing operations because, as recognized by the Chattanooga plant manager, management lost control over the procurement, accountability, and handling of material. New materials were ordered indiscriminately according to the plant manager. Materials and parts were ordered without regard to stock on hand according to the procurement supervisor. A former procurement official confirmed this and told us that material and parts were routinely ordered to cover material lost in the shops and to replace mutilated material. One former production worker told us that workers could easily obtain replacement parts and material by getting it from the open-crib storage areas or having it ordered by procurement officials without having to furnish documentation.

Mr. Durham helped establish a closed-crib storage system and issued instructions with the plant manager's approval to provide documentation and control over replacement for lost and damaged material. However, management did not establish inventory control over raw stock and purchased parts.

As a result of Mr. Durham's charges, the Air Force Plant Representative and his staff reviewed some operations at the plant. However, we believe that the effort was incomplete and the report somewhat misleading because the scope and depth of review were limited. The report states that a small group of personnel visited the plant during the afternoon of July 27, 1971, to review plant operations, especially purchasing, inventory control, and actions regarding mate-

rial discrepancy reports. Review of procurement was limited to about 3 hours and, in our opinion, erroneously led the team to conclude that the procurement system was satisfactory. Although no specific corrective actions were recommended, the report confirmed or stated that:

1. In February 1971, Mr. Durham demonstrated that only 813 line items of miscellaneous small parts were needed although 4,894 line items had been accumulated, but then current policy did not require reporting these to the Marietta plant for possible use. Subsequently, about 1,200 line items were sent to Marietta. The excess items were due to AGE cancellations and transfer of inventory from Lockheed Industrial Products Company.
2. Due to canceled orders, only half of the parts currently stocked were needed.
3. A considerable number of trailer chassis were excess due to canceled orders, but they were stored unprotected.
4. Nearly all material, castings, and forgings stored outside were left over from canceled Air Force orders.
5. Because entire lots of parts were produced with the same defects in each part, it is obvious that first-piece inspections were inadequate to assure correct machine set-ups.
6. Tools were on hand in excess of any reasonable requirement and had not been used in some time.

As of August 1971, Lockheed planned corrective action to identify, use, or dispose of the excesses, however, much of this material, parts, and other items remained at the plant as of January 1972, as discussed earlier. During our review Lockheed announced plans to sell the Chattanooga plant. No details were disclosed concerning disposition of excess materials and parts.

EXHIBIT 10

QUESTIONABLE PROCUREMENT PRACTICES DUE TO LACK OF PARTS CONTROL AT THE CHATTANOOGA PLANT

Mr. Durham testified that ineffective management and control over purchased parts and miscellaneous small parts resulted in unnecessary, duplicate procurement because the availability of parts on hand was not determined or controlled. He also cited in this exhibit examples of small parts purchased at excessive prices, which we discussed in exhibit 7.

Our review confirmed that Mr. Durham's testimony is substantially accurate. We obtained evidence that parts and material were ordered at the Chattanooga plant without knowledge of their cost, quantities in inventory, and justifiable need. Physical counts of inventories, to support procurement action, would have been difficult in our opinion because there were no inventory records, the stockrooms were open-cribs with parts and material scattered about, and usable parts were not cross-referenced to part number changes and substitute part numbers. Additionally, the carelessness of production workers resulted in unnecessary losses of and damages to parts and material being worked in process. Inadequate inspections resulted in entire lots of parts produced with the same defect as the result of incorrect machine settings. Procurement of replacements, without documenting losses and damages, was routine. These factors are discussed in greater detail in exhibits 7, 9, and 11.

Although we could not determine the extent of unnecessary procurement—because of the absence of controls and inventory records—plant officials and former employees told us that unnecessary procurements resulted from the factors cited above. The Manufacturing Services Department manager told us that one of Mr. Durham's best achievements was to provide for proper cross-referencing of part number changes. The department manager also said that Mr. Durham established separate, closed-crib storerooms for purchased parts and miscellaneous small parts in numerical part number sequence.

EXHIBIT 11

UNNECESSARY PROCUREMENT OF MISCELLANEOUS SMALL PARTS DUE TO LACK OF INVENTORY CONTROL AT THE CHATTANOOGA PLANT

Mr. Durham testified that unnecessary procurement of miscellaneous small parts resulted at both the Chattanooga and Marietta plants because the Chattanooga inventories were overstocked and out of control. He said that as a result of poor management, including purchasing without checking available stock, and

EXHIBIT 15

THE SHORTAGE LIST AND CONDITION REPORT ON AIRPLANE, SERIAL 0023, WERE ERRONEOUS

Mr. Durham testified that although the shortage list and condition report for airplane, serial 0023, showed only 30 open items (parts not installed) it actually had 1,084 open items on arrival at the final assembly area on March 11, 1970. Mr. Durham provided a report to substantiate these conditions and to rebut Lockheed's contention that such problems existed only on the first few airplanes.

We believe that Mr. Durham's statement concerning the open items on airplane, serial 0023, was accurate and the report valid. The information was substantiated in a report dated March 16, 1970, prepared by Mr. Durham and provided to us by Lockheed officials. Additional information on the inaccuracies of assembly records and missing parts is discussed under exhibit 1.

EXHIBIT 16

REWORKABLE PARTS WERE ERRONEOUSLY SCRAPPED

Mr. Durham testified that millions of dollars worth of reworkable purchased parts were scrapped because of erroneous disposition instructions generated as follows:

"Frequently due to engineering changes, parts must be removed from aircraft and replaced with later or higher configurations. Where possible, planning calls for purchased type parts to be removed and returned to vendors for updating * * * at factories. Small fabricated-type parts which cannot be reworked are dispositioned [in the] shop. The problem was that the planning paper called for thousands upon thousands of parts to be scrapped, which should have been returned to vendors for rework. A company auditor trying to find out what was causing over-procurement and re-purchasing activities discovered the problem. * * * causing over-procurement and re-purchasing activities discovered the problem. * * *

In my opinion, the Planning Division faced with a voluminous backlog of paperwork resulting from engineering changes, was unable to process work package on schedule. Under great pressure, bordering on panic to reduce the number of behind schedule engineering packages, they took the easy way out and coded the paperwork scrap rather than taking time to perform the necessary research and call for paper dispositions. Usually the name of the game in any situation was to make schedule, regardless of the price. * * *"

Mr. Durham also referred to his letter of April 17, 1970, to the President of Lockheed-Georgia Company, in which he stated that scrappage was due to mishandling and tagging of parts by Production, Quality Control, and Production Control divisions and to erroneous instructions on planning documents, such as the Manufacturing Change Notice (MCN) and the Liaison Drawing Change Notice (LDCN). The letter also shows that procedures required the production departments to tag parts according to instructions, the quality control departments to verify and stamp the tags, and the production control department to route the parts.

Our review has confirmed that expensive purchased and subcontracted parts, which could have been salvaged, were erroneously discarded. However, we were unable to determine the total adverse effect—the value of the discarded items.

Lockheed records demonstrate that the problem existed. One such record by Mr. Durham in November 1969 emphasized the need to properly tag parts planned for rework, with reference to the MCN or LDCN.

Planning officials reported on April 14, 1970, that investigation had shown that expensive salvageable parts and assemblies had been erroneously discarded for various reasons. The report recommended corrective procedures for subcontract and vendor parts and assemblies and also in-plant manufactured items, with the intent to require tool planners to specify attachment of proper, color-coded tags to parts removed by MCN and LDCN documents. Previously, colored tags had been attached by Production personnel based on their interpretation of information shown on the MCN and LDCN documents.

Another inter-office memorandum, dated April 29, 1970, states that quantities of C–5 purchased and subcontracted parts were found improperly tagged in scrap gondolas which supposedly contained only material which could not be reworked.

The report advised that Production Control would establish a screening crib to assure proper tagging. Flight line activities were requested to send scrap gondolas to the new crib for review.

A comprehensive Lockheed internal audit covering scrap controls in fabrication divisions was reported in October 1970 and showed that (1) controls over the scrapping of fabricated parts through the use of Discrepancy Reports and other documents were inadequate to a significant degree and (2) performance under the controls was unsatisfactory. The report showed that correction of deficiencies would require extensive revisions to manufacturing procedures regarding Discrepancy Reports and documentation. The report states that manufacturing and quality control procedures were revised and that this corrective action was satisfactory. Lack of control was evidenced by the following:

1. Practices of physically disposing of scrap were not in accordance with control procedures in that scrap yard personnel did not identify parts of supporting disposition instructions. Instead, and undocumented in-process and completed parts were received, accepted, and loaded in scrap trailers without screening. Performance with respect to control requirements was almost totally nonexistent.
2. Controls were inadequate to ensure that Discrepancy Reports and other disposition instruction forms were properly processed for replacement and statistical purposes. Accordingly, performance has been unsatisfactory.
3. Controls were unsatisfactory to ensure that scrap dispositions were properly documented and approved on prescribed forms. One form, which is not a scrap authorizing document and should have been used to submit parts to inspection for possible rework, was instead used to support scrapping actions. Controls had not been provided to assure that production and inspection supervisors' stamps and signatures were provided to show required approvals.
4. Controls were not completely satisfactory to ensure prompt and effective corrective or preventive action through analysis of Discrepancy Reports and shop disposition forms.

EXHIBIT 17

INCOMPLETE PARTS KITS SENT TO EGLIN AIR FORCE BASE

Mr. Durham testified that parts kits sent to Eglin Air Force Base, Florida, to provide for engineering changes were found to be incomplete due to omission of needed parts on related parts lists. He cited an earlier report, which he submitted in November 1969, advising the production control department that kits were incomplete due to incomplete parts lists, kits were not being controlled after receipt, and parts were scattered about.

Our review confirmed that Mr. Durham's testimony was substantially accurate. In discussing Mr. Durham's report, the Director of Manufacturing Control validated the report by giving us a copy and stating that, initially, planning papers and parts lists were incomplete because field installation was not provided for. Kits did not include miscellaneous small parts, fasteners, and other items which were available in the main plant but not at other bases. He said there were problems initially, but they have been corrected.

Because our review was limited, we could not determine the cost impact of incomplete parts kits and the lack of inventory control over parts kits. However, these factors will be considered in our continuing review.

EXHIBIT 18

NUMEROUS DISCREPANCY REPORTS WERE WRITTEN AT THE FLIGHT LINE FOR DAMAGED PARTS WHICH HAD BEEN IGNORED BY QUALITY CONTROL

Mr. Durham testified that numerous damaged parts which had been ignored by the Quality Control Department were identified at the flight line. This resulted in replacement of parts from vendors at premium prices, shipped air express, with thousands of hours of overtime. He provided a report showing that 6,746 parts were rejected on airplanes—serials 009 through 0013—after their arrival at the flight line.

Although we have not determined the adverse effect or cost impact of the problem, we believe that Mr. Durham's testimony is correct in describing the

magnitude of rejected parts identified at the flight line. This is substantiated by another Lockheed report dated February 21, 1970, which shows that about 50,000 parts were required for airplanes—serials 0009 through 0016—after their arrival at the flight line, including 8,200 parts required to replace damaged and unsuitable parts. The causes of damaged parts and resulting replacement activities will be considered in our continuing review as discussed under exhibit 4.

EXHIBIT 19

REPORT OF PARTS DELIVERED FOR AIRPLANES AFTER THEIR ARRIVAL AT FLIGHT LINE AND FLIGHT TEST AREAS

Mr. Durham provided a report showing that as of January 23, 1970, about 45,439 parts had been delivered to airplanes—serials 0009 through 0014—after they arrived at the flight line and flight test areas. The report shows that 15,291 of these were missing parts and 5,294 were replacements for rejected parts.

Additional information on missing parts and the accuracy of airplane assembly records is discussed under exhibit 1. However, we believe that this example is substantially correct and demonstrates the magnitude of parts requirements and problems at the flight line. It is supported by a report of February 21, 1970, provided by Lockheed officials which shows that almost 50,000 parts were delivered of which 18,350 were missing parts and 8,200 were replacements for damaged or unsuitable parts.

EXHIBIT 20

LACK OF CONTROL OVER THE STOCKROOM AT THE CHATTANOOGA PLANT

Mr. Durham testified that there were no controls over parts and the stockroom at the Chattanooga plant.

Our review confirmed that Mr. Durham's testimony is substantially accurate. The lack of controls is discussed under exhibits 9, 10, and 11.

EXHIBIT 21

CONTROL PROCEDURES NEEDED AT THE CHATTANOOGA PLANT

This exhibit consists of a letter which Mr. Durham wrote to the Chattanooga plant manager in May 1971 to emphasize the need to follow control procedures which he had initiated and to establish controls over standard tools. The letter also contains a summary of conditions which existed during Mr. Durham's employment at the plant.

These conditions and need for controls were discussed under exhibits 7, 8, 9, 10, and 11, which confirm that Mr. Durham's testimony was substantially accurate. We also specifically discussed the letter with the Manufacturing Services Department manager who told us that the charges were valid—although the extent of losses and waste was probably not as great as Mr. Durham indicated. In summary, the charges were as follows:

1. Raw material was purchased although quantities were available in stock.
2. Miscellaneous small parts were purchased without determining quantities on hand.
3. Raw stock, purchased parts, and miscellaneous small parts were purchased from vendors rather than ordering it from the Marietta plant stockroom at lesser cost.
4. There were no controls over the stockroom and inventories.
5. Shop orders were not assigned for production on a first-in, first-out basis.
6. Of about 4,800 line items of miscellaneous small parts on hand only 813 were needed.
7. The Planning Department would change part numbers on parts lists without notifying the Production Control Department.

8. The matching of material and parts with related shop orders was not controlled.

9. Material lost or damaged in production could be replaced easily by telephoning procurement personnel so that waste would be concealed.

10. Material and parts listings were not kept current as to part number changes.

11. Loss of control over standard tools resulted in replacement costs of $250 to $300 weekly.

12. Supervision was lax.

13. In some instances, standard hours would be credited to the cost centers before the shop orders and work could be inspected.

EXHIBIT 22

OVERDESIGN OF AEROSPACE GROUND EQUIPMENT AND USE OF AIRCRAFT SPECIFICATIONS IN ITS MANUFACTURE UNNECESSARILY INCREASED COSTS

Mr. Durham testified that the cost of aerospace ground equipment was unnecessarily increased because the parts and equipment were overdesigned and unnecessarily made to aircraft specifications. He said this was done to decrease competition and increaase profits ot Lockheed and the aerospace industry. Much of the equipment was manufactured in the Chattanooga plant wherein management did not maintain cost control procedures over purchasing—parts used were more expensive than commercial hardware because of the close tolerances and other specifications usde.

Accordingly, Mr. Durham recomended investigation of the design concept and cost of aerospace ground equipment. Although we have obtained some photographs and other preliminary information at Lockheed and the San Antonio Air Materiel Area regarding design and cost, we anticipate that a major effort will be required to resolve the charges. This matter will be included in our continuing review.

EXHIBIT 23

LOCKHEED AND AIR FORCE AUDITS WERE INEFFECTIVE

Mr. Durham testified that Lockheed's internal auditing system was obviously ineffective or restrained. He indicated that advance notices of audits provided management the opportunity to conceal problems. He stated also that Air Force personnel were negligent in allowing unsatisfactory conditions to prevail.

We believe that Lockheed internal auditors were aware of the major problems cited by Mr. Durham and reported them to management together with recommendations for corrective action. These reports were given wide distribution and were sent to corporate officers. Follow-up audits were made to evaluate corrective actions. However, we noted that audit reports generally did not identify the cost impact or the effect of deficiencies noted and therefore, in our opinion, did not adequately demonstrate the need for corrective action. In addition, we believe that Chattanooga plant operations were not audited frequently enough. We were told that only one audit was made.

In our opinion, Air Force personnel have been unable to satisfactorily demonstrate that they were aware of the problems cited by Mr. Durham or that they had reported the problems to higher commands. Both the Chief of the Contract Administration Division and the Chief of the Production Administration Division, Air Force Plant Representative's Office, told us that the Air Force had not actively participated in managing the C–5 program prior to March or April 1970. The Chief of the Contract Administration Division stated further that Mr. Durham's charges had not been reviewed. The Air Force Plant Representative told us that although the charges had not been reviewed, except for a 1-day review of the Chattanooga operations, he and his staff had been aware of the problems cited and had reported them to higher command. However, these officials were unable to provide us with meaningful information and reports on most of the charges.

CHAIRMAN DISAGREES WITH DURHAM

Chairman PROXMIRE. Thank you, Mr. Durham. You and I seem to disagree on this, which pains me, because I have great admiration and respect for your courage and the information you brought before the subcommitee and on which I think this was largely the basis for a very good constructive investigation of this whole problem by the GAO.

Now, I talked to Mr. Staats about this on Friday and Mr. Staats told me that of some 20 charges in general, he classified them as 20 charges, they found you were correct on 11 of them. They found there were others that you may or may not be correct on, but they couldn't find evidence to support your position. They found others in which they thought you were wrong.

I don't know how you can constitute this as a whitewash. After all, you can't be expected to be correct every time you go to bat.

Mr. DURHAM. No, sir.

GAO REPORT CONFIRMS SOME CHARGES

Chairman PROXMIRE. You can't expect to bat 1,000.

The report that was submitted to us this morning on the aircraft assembly records did not reflect the physical condition of the aircraft. They said you are right, parts had been removed from the aircraft without authorization. Durham is right, parts had been erroneously scrapped. Durham is right, inadequate controls over disbursement. Durham was right, high strength nuts and bolts purchased for plants, et cetera, et cetera. You were right. So I don't know how you can say that this constitutes a whitewash and at the same time, Mr. Kitchen, I don't know how you can feel that the management of Lockheed has been supported by the GAO on the basis of this report. The first was a staff study. I think that every agency head has a right to accept, reject, modify, amend the recommendations of their staff, and this is what Mr. Staats did.

Mr. DURHAM. If I may speak at this point. I will sit down with anybody in this room and show conclusively beyond the shadow of a doubt that many of the most serious charges and very definite positive findings made by GAO auditors who conducted the investigation in the field now were omitted, distorted or eliminated from the Comptroller General's report. I mean these were positive statements, concrete statements, which could not be misconstrued, and I ask everybody in this room who has a copy of it to read, the GAO report, and if they can arrive at any other conclusion, they can be my guest, I will be glad to sit down and go over it with anybody. I know that I speak the truth on this and I am positive about it.

Chairman PROXMIRE. Well, we appreciate this. The GAO has gone over these matters meticulously and carefully and they do, as I say, confirm many of your charges. Others they don't.

Mr. Kitchen, in light of all of the evidence that has been brought to light so far about the problems of the C–5A, do you consider that Lockheed, Georgia, has in the past been operating at a level of optimal efficiency or is it your opinion that none of the cost

increases are Lockheed's responsibility? You seem to put a great deal of stress, and I think to some extent with merit, on the total package procurement. Are you telling us that except for that that Lockheed operated with top efficiency?

Mr. KITCHEN. Mr. Chairman, I don't want to appear impertinent. That is like asking me when I stopped beating my wife. I don't mean it to be that way. Certainly in any endeavor where you are building a complicated system, as we did, on a compressed schedule —with the restraints you mentioned of TPP—there had to be some mistakes made. The risk you take when you go into that type of contract is doing some things that require redesigns and so forth as you run into technology problems. I won't sit here, and I would be foolish to sit here, and say we didn't make any mistakes, Mr. Chairman.

LOCKHEED ACCEPTS GAO FINDINGS

Chairman PROXMIRE. Do you accept the findings of Mr. Staats as he gave them to us this morning?

Mr. KITCHEN. Yes, sir, I do. And I wasn't sure what Mr. Durham was quoting or referring to as he made his statement. But it seemed, as I gathered it, he was referring to the staff study—I guess that is the main thrust—that he was referring to the staff study previously made, as differentiated from the last GAO report. I think that was the point he made.

The current study, as I said in my testimony, is a balanced review, Mr. Chairman. I would like to point out that we don't have anything to hide, we have made our records completely open to the GAO. The auditors have been down there. I cannot differentiate between the ones who did the field study as conscientious auditors and the ones who did the last audit. I don't know what Mr. Durham means. I think that there was an objective study made and GAO certainly pointed out that there were some airplanes moved without parts. There was no subterfuge involved in moving them. This had absolutely nothing to do with progress payments, the moving of the airplanes down to the flight line. There were known parts shortages on airplanes moved to the flight line because of compressed schedules and because of design changes on the airplanes. That is true in other programs as the GAO found out. So I can't quarrel with that. Aircraft were moved short of parts but at no time, and I would like to make this abundantly clear, at the time we delivered those airplanes to the Government for fly away—and that is when they considered progress payments, on delivery—everything missing from the airplane was thoroughly documented with the Air Force on the delivery paper before the aircraft flew over the fence—absolutely all items.

DEFICIENCIES IN C–5 DELIVERED TO AIR FORCE

Chairman PROXMIRE. How do you explain numerous deficiencies in the C–5 planes delivered to the Air Force? GAO has issued numerous reports on this and we have all been aware that two C–5's have been totally destroyed in accidents, that the life span of the C–5 is only a fraction of what was expected and the structural problem of the wings may still exist?

Mr. KITCHEN. Mr. Chairman, I would like to address each of those, if I may.

Two aircraft were destroyed, as you are aware. One was destroyed because we had a stuck valve in an air turbine unit in an airplane at Palmdale and the airplane caught on fire. The fire department was not able to put the fire out in time before the airplane was basically destroyed. The other one was destroyed at our facility in Marietta and was caused by a human error. There was a defueling process which was very complicated and required going inside of the wing to work. Employees had to drain the fuel, mop out what residue was there and then before going into the large tank, were required to dry the tank out. The process required starting a unit to blow hot air into the tank to dry it out. The mistake made was that the hose was hooked up to the tank before the unit was started. The conditions were just right that night—temperature, and humidity were such that when the unit was started the fire from the heater shot right up through the ducting into the wing. That was a human error—absolutely a human error.

Chairman PROXMIRE. Life span?

Mr. KITCHEN. I think the one you mentioned was life span and you also mentioned the ——

Chairman PROXMIRE. Structural problem.

Mr. KITCHEN. Static problems on the wing resulted when we had static failures on the wing during test. We had one, I guess the last one that failed at 126 percent, when we had a structural failure of the wing in the static test mode. We take the anticipated loads and apply them to the wing. Remember, it failed at 26 percent over what you would normally expect to experience while flying the airplane. We were testing to a 50 percent overload condition. We had already passed 150 percent tests on most modes. This was just one major test involving up-bending of the wing—and it failed.

Chairman PROXMIRE. Isn't it true that the stresses get worse sometimes in real flight conditions with storms and winds and so forth? Isn't that why they require more than 100 percent?

Mr. KITCHEN. No, sir, the 100 percent is there to take care of those known things that will happen under flying conditions, including storms, normal things that will happen to you in flight. Fifty percent is a safety factor above and beyond that. It failed at——

Chairman PROXMIRE. Why is it required then?

Mr. KITCHEN. It is just a safety factor, a safety factor for the airplane.

Chairman PROXMIRE. Redundant, unnecessary?

Mr. KITCHEN. I wouldn't say that. I like to feel when I fly that there is a margin of safety there. There could be unknowns happen, Mr. Chairman, that you could not forecast.

Chairman PROXMIRE. And the C–5 didn't have that margin, right?

Mr. KITCHEN. In this case we had the one failure at 126 percent, Mr. Chairman. That has been corrected for static test loads. Now the airplane is at 150 percent. We put in a Load Distribution Control System (LDCS) for the airplane after that static failure and we now meet the 150 percent static test margin on the airplane.

Chairman PROXMIRE. Why did Lockheed intentionally understate the cost of delivered items so as to accumulate $400 millions in excess progress payments? Didn't you know what the actual costs of the delivered items were or was your accounting system so poor that you couldn't tell what your actual costs were, or do you want $400 million from the Government without paying interest?

Mr. KITCHEN. There are three statements there. I don't agree. We did not by subterfuge underestimate costs. Secondly, the costs that are allowed as progress payments were not overpayments, they were progress payments made in accordance with terms and conditions of the contract we were operating under. That was method (C) as discussed this morning by Mr. Staats. That same condition was offered to all three contractors who quoted on this contract and for a very good reason. The actual cost method was explained by Mr. Staats[1] chart this morning. Method (A) applies if you know the actual cost —that is the way you do it. If you know the actual cost, you use A.

Method (B) is used if you can estimate the actual cost. Method (C) then is what you have referred to as understating—which I don't agree with. That was the method used from the inception of the C–5 contract.

Chairman PROXMIRE. You would concede there was an understatement of the cost, the way the costs grew, you did understate the cost.

Mr. KITCHEN. Today with the cost growth experienced in the program—I guess today I would have to say at that time it was understated.

Let me try to explain that problem. It didn't come out this morning.

Chairman PROXMIRE. My problem is this. In 1970, it was known this was an understatement, wasn't it? That is when the auditor's report of the Defense Contract Agency showed the understatement.

Mr. KITCHEN. The total report—that is the point I wanted to make—the total report also pointed out that at that time we were in dispute with the Air Force because method (B) says if you can estimate the total cost, then you can use B. There were three methods in ASPR, before Method (C) was done away with. We, nor the Air Force, could agree at that time what the estimated costs—allowable costs if you will—were at that point in time. That was the basis of our dispute, you see.

Chairman PROXMIRE. You thought you knew but they disagreed with what it was so instead——

Mr. KITCHEN. It was a question of magnitude as to what the difference was. They knew (A) was not the method. If I may make this point, because it is very crucial, they knew that Method (A), which was the actual cost, could be used as in the example of 100 used by GAO this morning—and if you go right through that simplistic calculation you can use Method (A). But in the case of Method (B), the Air Force recognized that they owed us money for abnormal economic escalation—that was known at that point in time. They knew they owed us money. They also knew at that point

in time that they owed us money for repricing. Those are the two key issues in the whole contract.

Now I am trying to make a very deliberate point here, Mr. Chairman. There were two key issues in the dispute that evolved out of TPP and our argument with the Air Force: One was in trying to get to the effect of economic escalation. The Air Force had one number, we had another. We couldn't agree on what the economic escalation——

Chairman PROXMIRE. You don't put any economic escalation in at all?

Mr. KITCHEN. If you use Method (A) that is the point, you would not have it in there. If we had used the Method in the example that was used this morning we couldn't use Method (B) estimated actuals because we couldn't agree on what the Method (B) value was.

Since we could not agree, the Air Force knew that unless we kept going the Method (C) way, someone had to bear the cost while this argument and dispute was being settled. That was the basic reason why we entered into a legal dispute on the contract, why we were willing to go to court, but did not go to court, as we well know, because of the negotiated fixed loss. The basic point is that even the way GAO used Method (A) this morning wasn't exactly the way Method (A) is in ASPR. The point is that the legal dispute caused the problem. The Air Force's position was that the only way to continue the contract while we resolved our disagreement as to who owed who what—that was the point—was to continue Method (C).

Chairman PROXMIRE. Let me ask, regardless of your dispute with the Air Force, why didn't you allocate the cost you thought ought to be charged to the delivered items rather than using the contract price of C option?

Mr. KITCHEN. Because the Air Force could not—they had no legal right—to raise the ceiling on the contract—they, the Air Force. They didn't know what the ceiling would be in making that agreement. You see they could not admit what that number was or come up with a number that would in effect cause them to raise the ceiling price.

Chairman PROXMIRE. Do you concede you did know that the C option would be lower, either actual or estimated cost?

Mr. KITCHEN. Would you mind repeating that?

Chairman PROXMIRE. Didn't you know the option C would be lower and, therefore, you would get a higher progress payment?

Mr. KITCHEN. At the time we entered into the contract, no, sir. That was in there for protection against unknowns, because at the time we were going through structuring of the contract I don't think anyone could have known that we would experience that type cost growth.

Chairman PROXMIRE. How about the CSAR, shouldn't they show that, the Cost Status Analysis Report?

Mr. KITCHEN. I don't know whether they showed it or not. I can't answer that, Mr. Chairman.

Chairman PROXMIRE. I understand they did show it.

Mr. Durham, would you like to comment?

Mr. DURHAM. Yes, sir, thank you.

Mr. Kitchen denies that Lockheed deliberately moved aircraft as scheduled regardless of condition in order to collect progress payments. That is, he denies they deliberately left parts uninstalled and moved the aircraft anyway. However, here is a C–5 audit report by Lockheed's internal auditor that says, "During our examination we were told by production flight and by flight line control management employees and our own test confirmed the fact that an unusually large number of parts were missing from C–5 aircraft delivered to the flight line although the airplane records indicated that the parts had been installed." An unusually large number.

Here is another official Lockheed report on aircraft, high serial aircraft, up in the twenties. It shows, for example, that aircraft 20 in just a month's time had a total of 893 missing parts. That was a daily average of 40.5 missing parts. That is, the aircraft record shows that the parts were installed but they were not.

Here is another aircraft, 21. The total parts missing was 1,038.

Chairman PROXMIRE. But the position Mr. Kitchen has given to us and to some extent that has been confirmed by Mr. Staats, there were missing parts, he concedes that, but this was known by the Air Force. There was no concealment here, it was public, at least knowledge between the Air Force and Lockheed, and there was no deception and, therefore, no effort to use this in order to secure funds or anything of the kind.

Mr. DURHAM. I disagree with that position and I still state that the aircraft were moved regardless of condition although the records showed the parts installed. If not, why did the report show the parts were installed if in fact they were not? That is what this is. The records showed that the parts were installed, when in fact, they were not. That is what a missing part actually is.

Mr. KITCHEN. There is one thing I would like to clear up. In a lot of these cases, and I think after the hasty GAO audit they now realize after they got in and looked deeper into the records, that what Mr. Durham called missing parts were items listed by people on the flight line on what we refer to as call sheets. We have a problem where a part is listed as missing but these are not confirmed. He is quoting raw data on items that people in the production area list as missing.

Now, Mr. Durham's job—in fact I think at that time along with other people in the production control organization—was to review those call sheets and find out what really was missing. There has been much moment made over the 30 items we said were short, but there is a statement in Mr. Durham's data which says there were 1,084 parts short. Here again it gets down to the question of proper paperwork—whether the paperwork had been stamped off. These raw data call sheets were used by our people to go verify that the parts either were there or were missing. I hastily add there were parts missing—some by human error—and some missing parts were deliberately not there because of design changes that were to be picked up and incorporated at the flight line. The flight line is nothing more than an extension of the manufacturing area, and it was a

management choice where that part was put in. I will say that I would rather install the part in the factory—going down a production line, like an automobile line. If I have interfering engineering changes it is more appropriate for me to put the changes in further down the line—out of station—even though it costs more, it does cost less than stopping the line.

Mr. DURHAM. Mr. Chairman, the auditor, Lockheed's internal auditor, didn't say anything about call sheets. He is talking about aircraft records. And he said, "Although the aircraft records indicated the parts had been installed." That was the interpretation by the General Accounting Office auditor also. I might add that.

Chairman PROXMIRE. I might say that Mr. Staats did find that, and I quote: "Our findings support the following charge made by Mr. Durham. Aircraft assembly record did not accurately reflect the physical condition of the aircraft. Parts had been removed from the aircraft without authorization," and so on.

Mr. KITCHEN. That is true.

Chairman PROXMIRE. You conceded that. Let me ask you about something else.

Mr. KITCHEN. I would like to add that the magnitude of those instances were small in comparison to the job being done and they were caught not because the numbers were raw numbers. When it got down to looking at the numbers the current GAO report shows that we took three of those airplanes that have been referenced and tracked through the records and could substantiate installation of parts.

Chairman PROXMIRE. Mr. Durham has said, didn't you say there were 800 missing, 40 a day?

Mr. DURHAM. 1,038 missing, and in one week, another case, 893 missing in one week. Another case, 1,120 missing.

Chairman PROXMIRE. It is hard to put this in perspective.

Mr. DURHAM. This is Lockheed's report.

Chairman PROXMIRE. A thousand sounds like a fantastic number. It may or may not be. How many parts are involved here, Mr. Durham? You say 890 missing.

Mr. DURHAM. Total parts? I have that information. Total missing parts on ship 20 in the 1 month was 1,356. Out of that, 893——

Chairman PROXMIRE. More than half the parts were missing.

Mr. DURHAM. In the next case, total parts requested on ship 21 was 1,533, of that, 1,038 of them were missing.

Chairman PROXMIRE. That sounds more, Mr. Kitchen, than just an oversight.

Mr. DURHAM. Ship 22. 1,492 parts requested, 1,120 were missing. This is a report from the Lockheed manager.

Chairman PROXMIRE. Apparently the report, as I understand it, the records, assembly records indicated in some cases those parts were there and they were not.

Mr. KITCHEN. Let me add that was a report from the Lockheed manager and I say we had call sheets. That is the reason we have production control people, to go out and verify or deny—it is not a case of witch hunting. The purpose is to get the parts there that are truly missing. When he says on ship 20 there were 1,356 parts

requested by the flight line, some of those could have been for engineering changes and some could have been for parts damaged by people working on the flight line installing parts. Relate that to the 420,000 on each airplane and then relate that to the amount that were actually missing of those requested. Certainly there should not have been any missing.

Chairman PROXMIRE. I think the proper relationship though is with the number requested, is it not?

Mr. KITCHEN. No, sir, because a lot of this work could be planned for the flight line.

Chairman PROXMIRE. Could you have more parts missing than were requested?

Mr. KITCHEN. I don't think I said that.

Mr. DURHAM. The missing parts problem had nothing to do with engineering changes or anything of the sort. They were parts which Lockheed records showed to be installed, they had retired those inspection records and yet the parts were missing, there were holes in the aircraft, that is all they are, and nothing more.

I would like to quote further from the audit report right at this point: Other Lockheed reports show the missing parts problem continued as follows:

> During the period from March 6, 1970, to April 6, 1970—a significant report dated April 27, 1970, shows that a daily average of 257 parts requirements were processed as a direct result of missing parts in the final assembly area alone.

Chairman PROXMIRE. Mr. Kitchen, you respond to that and then I want to go into something else.

Mr. KITCHEN. The whole purpose was to move them down to the flight line. There will be parts missing because they either were not available and were left out or the documentation was not in accordance with the parts. I get back to the point you made that one day they requested parts for ship 20—they requested 1,356 parts, as Mr. Durham said. The GAO audit report points out that only 893 of them were actually missing.

This means that out of the total number that I mentioned earlier, 420,000 parts on each airplane, the people on the line did request 1,356 parts which they had reported missing and they were not all missing. When we went back and tracked through the records we came up with a reconciled list. That is why we had our people checking—to make sure we got all of the parts on the airplane. As I said earlier—no airplane went out with parts missing that were not documented with the Air Force.

WHEEL MISHAP

Chairman PROXMIRE. I can remember very vividly watching on television when one of the first C–5As came in for review and there was a very prominent House Chairman who was there with some Air Force officers and others and the plane came in and landed and a wheel rolled off in one direction and a tire rolled off in the other. It was really very, very embarrassing. I have never seen that happen with any other plane made by any other firm. Maybe this does happen but I was astonished. Perhaps you remember that.

Mr. KITCHEN. You couldn't have been more embarrassed than we were.

Chairman PROXMIRE. I am sure of that. What was the reason for that, missing parts to keep the tire on?

Mr. KITCHEN. There were no missing parts. We had a thorough investigation of that later on and we traced all of the records and determined that a mechanic, after he changed the tire, had put the retainer on wrong. It was a human error. That is why the wheel came off. To take care of this, so we wouldn't have another human error, we made a design change that eliminated the human error possibility.

LOCKHEED'S USE OF MANPOWER

Chairman PROXMIRE. This morning I asked the Comptroller General about his report of Lockheed's use of manpower. You will recall in that report a work-sampling study of the labor force found that almost 15 percent of the production assembly employees were either idle when observed or absent from their work stations. GAO reported that Lockheed officials stated the study was representative of performance standards in the C–5A aircraft assembly area and that they expressed concern about your findings.

Are you able to estimate the effects on costs that idleness or absenteeism had on the C–5A?

Mr. KITCHEN. Let me go back to the original statement you just made. At the time they made that audit, which I think extended over a 2-week period—I don't exactly remember how the testimony came out this morning but it sounded like the whole plant was 15 percent idle. The audit was not made in the whole plant, it was made in only one area which was the final assembly area for the C–5. Final Assembly is where the airplane moves down the line, gets its landing gear attached, its wings and engines, and then goes on out to get its——

Chairman PROXMIRE. That is a very important part of the plant.

Mr. KITCHEN. Yes, sir, it is one of the most critical areas, I will agree, but let me make a point. At the time the GAO came in to make that audit, Mr. Chairman, we pointed out—and I think this is the point we made—that it was representative at that time only because the people had just come back to work. Our people had been out of the plant for 2 weeks because of a strike at one of our suppliers who provides the wings, and we had no wings to put on the airplanes. So rather than incur increased cost to the Government, we put our people on layoff for a 2-week period. At the time of the audit I had just brought those people back in to work. We were doing work around the shortages because we were still missing wings. We had enough work to do so that we could work around the missing wings and still get some productivity out of the shop. It was not the most favorable point to look at a production line. That was point No. 1.

Point No. 2—I had a union election going on in the plant. There were mitigating circumstances, Mr. Chairman, during that period and it was not a representative period for an audit. Subsequently the Air Force conducted similar audits and the productivity is very, very high.

Chairman PROXMIRE. I understand GAO made a followup audit and found the situation was still serious.

Mr. KITCHEN. My understanding from Mr. Staats this morning was that they did not make a followup audit. The Air Force has—but not GAO. Unless I misunderstood.

Chairman PROXMIRE. I think you are right, I think it was the Air Force.

Mr. KITCHEN. The Air Force has, Mr. Chairman, and let me say the tighter controls I put on are controls that are abnormal to the industry. I put them on for protection. I still go back to my point that during that period it was not a representative period to review this plant.

Chairman PROXMIRE. How about the final question in relation to this, can you estimate the effect on costs idleness or absenteeism have caused the C–5A.

Mr. KITCHEN. No, sir, I couldn't because idleness or absenteeism is something you try to take into account for the contract you are estimating and bidding on.

Chairman PROXMIRE. I am talking, of course, about extraordinary absenteeism. You always have some.

Mr. KITCHEN. I don't think we had any, Mr. Chairman.

Chairman PROXMIRE. Fifteen percent on the assembly area, I think you concede.

Mr. KITCHEN. I am submitting that was not a representative period of time.

Chairman PROXMIRE. Here is a followup audit. You say there wasn't one. I was wrong in agreeing with you, apparently. This is dated May 30, 1972. It is from the Comptroller General and it says "We reported the results of our work sampling study of Lockheed-Georgia's direct labor force assigned to C–5 aircraft assembly operations during the quarter ended December 31, 1971. We suggested to Lockheed-Georgia management that attention be directed toward reducing the amount of time spent in supporting activities necessary for the performance of craft work and that the amount of idle and unobserved time be reduced to an absolute minimum." That was on the basis of their second audit.

Mr. KITCHEN. I thought it was the recommendation of their first audit. I think what they did was to look at procedures I installed—they looked at the actual procedures I put in after their comments came out. I put on tighter control within the assembly area.

Chairman PROXMIRE. My time is up.

Mr. Blackburn.

Representative BLACKBURN. Thank you.

Mr. Kitchen, don't you feel bad about that wheel running off. We have many mouths running off up here in Washington about 90 percent of the time, and nobody puts them back on again. So don't you feel bad about one little wheel.

MISSING PARTS

Am I to understand airplanes will fly with 80 percent of the parts missing?

Mr. KITCHEN. No, sir, they will not.

Representative BLACKBURN. And so if we are going to bring this thing into a little prospective, the actual percentage of parts missing that we have had this discussion about would be miniscule as far as the operation of the airplane?

Mr. KITCHEN. They would be miniscule but even they didn't exist as everything missing from the airplane was a known missing item, agreed to by the Air Force, and for which they withheld payments—prior to conversion to a cost reimbursement contract.

EXPERIENCE WITH C–5 AIRCRAFT

Representative BLACKBURN. Have you gotten any indication from Air Force personnel that they are afraid to ride in the C–5?

Mr. KITCHEN. No, sir.

Representative BLACKBURN. What sort of report have you received from the people who use that airplane?

Mr. KITCHEN. Well, I cited in my testimony, sir, the Air Force at this point in time—the Commander of the Military Air Lift Command and others—are outspoken in their praise for what the airplane is doing right now in support of our national——

Representative BLACKBURN. Mr. Durham, have you ever designed an airplane?

Mr. DURHAM. Not one like that, no, sir.

Representative BLACKBURN. Have you ever designed an airplane?

Mr. DURHAM. No, sir, I haven't.

Representative BLACKBURN. Have you ever run a company that manufactures anything?

Mr. DURHAM. I have run responsible positions within a company that——

Representative BLACKBURN. The question I asked, have you ever run a company that manufactures anything?

Mr. DURHAM. I have not.

Representative BLACKBURN. I mean top management from the board of directors to the president.

Mr. DURHAM. No, I have not.

Representative BLACKBURN. Mr. Durham, I have a feeling sometime from reading your statements that you are like the two blind men who were trying to describe an elephant. One of them felt its trunk and said it felt like a tree and another felt its tail and said it felt like a rope. I really wonder if you are in a position to make a really competent evaluation as to the quality of those aircraft as they were being delivered?

Mr. DURHAM. Yes, sir; I was in a far better position than some of the Congressmen who made statements and didn't know what they were talking about because I was there and the Congressmen were not.

Representative BLACKBURN. When does the run of these aircraft terminate, Mr. Kitchen?

Mr. KITCHEN. All of the airplanes are out of the final assembly building now except three, and I will deliver the last one in May 1973.

LOCKHEED FINANCES

Representative BLACKBURN. Now, there was some discussion earlier today about the financial condition of Lockheed and its capability to meet its contracts, either in this respect or in respect to the L–1011 or perhaps even to survive. Had Lockheed ever had any serious financial problems until they got into this contract dispute with the Air Force?

Mr. KITCHEN. I guess I could not answer that in complete detail. I don't think we ever experienced anything like that. As you recall, with most of those contracts we suffered about $500 million in losses —like the $200 million loss settlement for the C–5—and $500 million in losses, which was greater than the Corporations net worth at that time, is pretty significant.

Representative BLACKBURN. Well the point I am trying to make is that the question was asked of the General Accounting Office, Mr. Staats, as to whether or not we could take congressional action that would prevent a company from having financial difficulties. Now, if the financial difficulties were created by reason of a contract that the company entered into, that the company itself and the other contracting party, in this instance the Department of Defense, both agreed later that the contract is a mistake, how could you have anticipated the financial problem?

Mr. KITCHEN. You could not anticipate it because the intent of each of the parties at the time we entered into the contract and the intent of the language that was in the contract for the C–5, was to prevent catastrophic loss—not a $200 million loss. That is the reason the protective language was in there for economic escalation, repricing, and so forth.

Representative BLACKBURN. Has the Department of Defense abandoned this method of procurement now?

Mr. KITCHEN. Yes, sir, they have.

Representative BLACKBURN. And they have abandoned it for their benefit the same as the contractor's benefit, as I understand.

Mr. KITCHEN. I think that is quite true, sir.

Representative BLACKBURN. Because it is certainly not to the benefit of the people of this country that the major contractor go bankrupt halfway through fulfilling a contract, is it?

Mr. KITCHEN. I wouldn't think so.

Representative BLACKBURN. Don't you have some opinion as to what it would cost the taxpayers if we went out and tried to set up another company with the same size and investment as Lockheed, just to be a competitor? What would that involve?

Mr. KITCHEN. Well, I have no idea of the magnitude in dollars but it would be significant in rotooling and retraining. We spent considerable millions of man-hours training people in our geographic area to manufacture the C–5 airplane.

Representative BLACKBURN. Isn't it better to keep an existing firm going than trying to go out and open up a brand new shop?

Mr. KITCHEN. That is true and I think the record speaks for itself. In the details I have submitted for the Committee I point out that the learning curve can go down—the learning curve reflects that each airplane we built progressively costs less.

Representative BLACKBURN. I really feel personally that we are beating a dead horse here. Frankly, I think this whole matter was decided a year or so ago when Congress voted to guarantee the loan to Lockheed and I think there have been no new facts uncovered as a result of these hearings. It has been more an opportunity to perhaps pander to some over-inflated egoes which doesn't serve any constructive purpose. We have started playing a new game on the Joint Economic Committee every time the Congress is out of session. It is called keep the Washington press corp busy while you beat a dead horse.

I appreciate your patience. I am sorry I wasn't able to be here earlier to hear all of the testimony but I have a job to do as a Congressman as well as appear on television. Thank you for your time.

TOTAL PACKAGE PROCUREMENT

Chairman PROXMIRE. Mr. Kitchen, you have criticized very seriously the total package procurement contract and I think you are right. This Committee was the first one that called this to the attention of the Defense Department. At that time they, Secretary Charles of the Air Force, said it was the best contract and best conception for a contract that the Air Force had ever come up with. We persisted in our criticism and we are glad to see we finally succeeded in disabusing the Defense Department and persuaded them to drop it, but it was this Committee that recognized the weariness of this type of contract and before that the Air Force had been very much attached to it. Nevertheless, you entered into the contract. It takes two to tango. The Federal Government didn't foist it on you, you weren't forced to do it, you did it freely. You did bid for it, you underbid, as I understand it, competitors to get the contract. A contract is a contract, bad as it may be. You are a very big firm and a firm that has I am sure excellent legal advice. Under these circumstances, how can you justify this enormous overrun and all of the problems that have been involved here by simply saying it was a bad contract. Wasn't that your mistake too?

Mr. KITCHEN. Well, sir, at the time we entered into the contract I can assure you that Lockheed would not have gone into a contract where they thought they would lose a huge sum of money. Neither would our competitors have gone into such a contract. I think the parties who thought of total package procurement in the beginning sincerely believed that the system would work. Using the words you just said, Mr. Chairman, a contract is a contract, and that is why we were willing to go to court, because we really thought a contract was a contract. There was a point I made in my statement that the intent of the C–5 contract and the contract language itself were never permitted to work. That was the dispute between the parties. And that is why TPP is bad. Outside of concurrency and all the other things you have in TPP, there were a miriad of clauses in the contract that interlaced and interlocked and were not permitted to work. There was absolutely no way we could perform.

Chairman PROXMIRE. Are you telling me that the total package procurement is bad or that the Air Force was bad in their interpretation of it?

Mr. KITCHEN. No, sir, I am saying total package procurement was bad because ambiguous clauses in the contract were open for everyone to argue and interpret—including those outside of the Air Force.

Chairman PROXMIRE. Mr. Kitchen, I would like to have both you gentlemen conclude your testimony this afternoon by answering this question, both Mr. Durham and Mr. Kitchen. Mr. Kitchen first.

You heard the discussion this morning about the problem of large defense contractors financing the costs of expensive weapon programs and the need to find some way to reconcile the Government's interest, the taxpayers' interest and the contractors' interest in defense procurement. I wonder if you would care to comment on this and make some recommendations as to how Congress can protect the interests at stake. We have the interest of the Government in providing a strong, reliable defense with weapons systems that work, that are delivered on time and do the job. We have the taxpayers' interest, of course, in trying to keep this cost as reasonably low as possible. We have the contractors' interest in trying to survive and do a profitable business so there will be some incentive for them to continue in this area, and we would like to have your overall recommendations on what you think we should do if TPP is wrong. Are we on the right track now with the milestone? Is that the answer? Or can we go farther than that? Go ahead.

Mr. KITCHEN. Mr. Chairman, as I mentioned in my opening remarks, the root cause of cost growth on a lot of the programs like the C–5—and I think you would agree and others have agreed—is that the total package procurement concept will not work for the very reasons we have talked about—the interrelationship of clauses that were open to interpretations, both by qualified and unqualified people. The contract terms became a highlighted item. If the government does go to total commitment—and what I mean by total commitment is a TPP type commitment whereby one commits for a 9-year period—a contractor must have protection as private industry cannot afford to take that type risk. Industry just does not have the assets to take a contract where the contractor could suffer a catastrophic loss. He must avoid a total commitment—unless there are protective clauses as well as protection to the Government—and not get into the position that we were in on the C–5. On the other hand another system, and that is one I think that is being pursued now, is the milestone concept which goes through a development phase to find out what you really want—can it be built—and can it be built to a cost you are willing to pay for its placement in the arsenal of the United States. If it is within that price, and it has been demonstrated that it can be built, then move forward, because then you have wrung out the technology unknowns. My recommendation to this Committee or anyone else is that the type of concurrency procurement that we had for the C–5—that was not a state of the art airplane—should never, never be done again—should never be permitted again. There must be a better way for our government to contract—a way that does not put a contractor in a position of being the recipient of all that is bad in a procurement concept—which I think we were. Witness the losses and the inordinate amount of criticism we have been subjected to in the media. I have tried to sum-

marize my position and I think quite clearly I cannot and I really do not think it appropriate sir, to sit and argue about 800 parts missing in 1 week on an airplane. I have admitted that we had missing parts on airplanes—but it was not something management did not know about and management took action—we had a compressed schedule and we had an airplane that had its technology problems and required engineering changes to be made to the airplane. Any time one makes engineering changes it is a management decision where you pick up in the line and incorporate that change in the airplane—depending on lead times and so forth. These problems did exist—they were not insurmountable—they were controlled and we knew what the problems were. That is why management had the referenced meetings and that is why management requested the very audit reports that are now being used as documentary evidence against us—for use in solving those problems. I am trying to put into context an impossible procurement concept, and an impossible contract requiring us to perform under a procurement process that should never again be allowed to put a contractor on his knees—which is almost did to us. In spite of all that, I know there was a worry by this committee and others that when this contract was changed over to a cost-reimbursement contract, the contractor would blow it. I am happy to report to you that we have continually underrun the cost estimate to complete this contract, and we have maintained schedules and we have good morale in the factory despite the criticism that keeps coming out in the paper. My job is to keep productivity up in our plant and obtain for the United States a good airplane at the least price I can turn it out for. That is my task and I need to get on with that task even though we are running out of production. We will work as hard as we can to get them all out by the end of May.

Chairman PROXMIRE. Does this mean when you say adequate protection for the contract that the Government should guarantee the survival of their contractor, guarantee them against catastrophic loss in the contract? You say you want to keep them off their knees, is that what you mean?

Mr. KITCHEN. Let me rephrase that. If one does, go to total commitment, as was done in TPP, there must be appropriate clauses in the contract that will permit government tradeoff decision points within the life of the contract—either stop and we pay you for what you have done, contractor, or continue and we will make changes to the airplane in route, reduce its sophistication and make tradeoffs to keep the cost down as we go along. Language must be in the contract that would pervent the contractor from "going to his knees" as I put it, because of expensive technology problems that could not have been foreseen over that long period of time.

Chairman PROXMIRE. You are saying they should be protected against unknown technology that come up, that you are not, or are you saying they should be protected against their own inefficiency and mistakes against loss that might conceivably destroy them.

Mr. KITCHEN. No, sir, I am saying a contractor should be protected against unknowns in the economy, because that is something he cannot control, as well as unknowns in technology. That was the

real purpose of the repricing clause that has been referred to time and again as the golden handshake.

Chairman PROXMIRE. You have inflation clauses built in.

Mr. KITCHEN. Yes, sir, but they were never allowed to work.

Chairman PROXMIRE. Why not?

Mr. KITCHEN. That was the dispute. The interrelationship of the economic clause and the repricing formula formed the dispute and debate between us and the Air Force.

Chairman PROXMIRE. That wasn't the difference. There wasn't a $2 billion inflation factor.

Mr. KITCHEN. No, it was not that large a number. It is very complicated and I am sure some of your staff know how complicated it is when you get into the application of that formula.

Chairman PROXMIRE. Mr. Durham.

Mr. DURHAM. Yes, sir, I attribute most of the problem, at least part of it to the well-known business of sweetheart contracts. In the case of the C–5 deliberately underbidding the contracts and extremely poor management, which I think has been effectively demonstrated. And I think to help matters we should expand the efforts of the Joint Economic Committee and others to attempt to install integrity in the military procurement process.

If the Social Security Department overpays an old sick widow a few dollars, they demand that the money be paid back even if the poor old woman starves. After deliberately overpaying Lockheed the Air Force converted the contract from a fixed price to cost-plus and made it retroactive so Lockheed would not be legally bound to pay it back. This overpayment continued to be hidden while the administration armtwisted the $250 million bail bill through Congress and it would still be under wraps if you, Senator Proxmire, had not revealed it in the hearing last March. In spite of all this the Government continues to award lucrative military contracts to Lockheed without demanding a purge on management or reorganization of the company or anything else. In my opinion this entire situation reveals a lack of integrity in high places and effectively demonstrates why people are rapidly losing confidence in the Federal Government.

Chairman PROXMIRE. Well, I want to thank you both very, very much. It has been a very difficult and painful kind of appearance for you gentlemen, I am sure. I think both of you did very well and stated your case clearly and helpfully.

The subcommittee will stand in recess until 10 o'clock tomorrow morning. We will reconvene in this room to hear Gordon Rule, Director, Procurement Control and Clearance Section, Navy Material Command, and Dean Girardot, coordinator for metal trades department, AFL–CIO.

[Whereupon, at 3:25 p.m., the subcommittee recessed, to reconvene at 10 a.m., Tuesday, December 19, 1972.]

THE ACQUISITION OF WEAPONS SYSTEMS

TUESDAY, DECEMBER 19, 1972

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 recess, at 10:05 a.m., in room 4221, Dirksen Senate Office Building, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire and Representative Conable.

Also present: Ross F. Hamachek and Richard F. Kaufman, economists; Jerry J. Jasinowski, research economist; George D. Krumbhaar, Jr., minority counsel; Walter B. Laessig, minority counsel; Leslie J. Bander, minority economist; and Michael J. Runde, administrative assistant.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The subcommittee will come to order.

The latest strategy to cover up the procurement mess seems to be to blame everything on something called total package procurement. Yesterday an official of Lockheed complained that the C–5 contract was impossible to perform and the total package procurement was the cause of the problems on that program.

Apparently both Grumman and Litton are following this strategy. Each seems to be saying that the total package procurement type of contract in the case of the F–14 and the LHA is the reason those programs are running into difficulties. It is not the contractor who is at fault; it is the type of contract that was signed.

This is a simplistic and superficial attempt to gloss over the deeply rooted problems of defense contracting. The irony is that it was largely the work of this subcommittee that disclosed the problems associated with the most well-known total package procurement, the C–5. We were the first to criticize this program and the contract covering it, at least the first congressional critics of it.

Unfortunately, the lesson we tried to get across about the C–5 program and the contractual problems seems to have been lost in the Pentagon and in the aerospace community.

One of the major weaknesses with total packaging has been that it has encouraged the services to put too many of their eggs in one basket. First, it locks them in with a contractor from the design and development phase to the production and provision of spare parts, theoretically through the life of the program.

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Second, it tends to concentrate more military work in a single plant or in a single contractor's organization than is healthy. When a giant like Lockheed runs into problems, it can literally threaten to halt production or go out of business if the Government does not fork over more money. And the Government, more often than not, after sinking hundreds of millions or billions into a program, has gone along with the contractor.

The problem with the C–5 contract as a legal document was not that it embodied the total packaging concept. The problem was that it contained a gigantic loophole, known as the repricing clause, or the golden handshake, which permitted Lockheed to raise the price. The contract was supposed to have a fixed ceiling on it, but as it turned out, the ceiling was fixed on hinges that allowed it to be raised.

But now that total packaging has been discredited and banned for future programs, the idea seems to be to show that your contract was a total package, claim it is impossible to perform, and ask for a Government handout or bailout.

This approach totally ignores the true problems of government mismanagement and contractor inefficiency. Yesterday we documented some of those problems with respect to the C–5 and nine Army programs.

Today we want to discuss some Navy programs. And I especially want to talk about a Government report on the Litton shipyards at Pascagoula. The reason I want to go into this report is not to single out a company or a program or two for special criticism, but because what has occurred in this shipyard illustrates the sheer waste and mismangement that infects some of the largest weapons programs.

The particular type of contract becomes a small factor in the overall picture when the contractor cannot operate his plant efficiently, when he is unproductive, when his organization is unsound, when he is guilty of poor workmanship, when he cannot even achieve good management-labor realtions. When the contractor is not properly organized and he just does a poor job, then it makes little difference whether the document he signed with the Government is a total package or a partial package.

Mr. Fred O'Green, president of Litton Industries, has declined to appear today through a letter I received last Friday from Charles B. Thornton, chairman of the board. Mr. Thornton did say that the company will be glad to appear at a later time when present negotiations with the Navy are concluded or are at a more settled stage, and he expressed his desire to cooperate fully with this subcommittee. We will try to reschedule Litton in the near future.

Our first witness this morning is Gordon Rule, director, procurement control and clearance section, Navy Materiel Command. Mr. Rule will be followed by Mr. Dean Girardot, coordinator of the metal trades department, representing most of the unions at Litton's shipyards in Pascagoul. Mr. Rule does not have a prepared statement, but will proceed to make an oral presentation about Navy procurement policies and practices, after which I will adress some questions to him.

Mr. Rule.

Mr. RULE. Good morning, Senator.

Chairman PROXMIRE. Good morning, Mr. Rule, very nice to have you here this morning. You have been a very helpful and cooperative witness and we deeply appreciate it.

Mr. RULE. Thank you.

STATEMENT OF GORDON RULE, DIRECTOR, PROCUREMENT CONTROL AND CLEARANCE SECTION, MATERIEL COMMAND, DEPARTMENT OF THE NAVY

Mr. RULE. Thank you for letting me appear without a prepared statement. The reason I do that is because, as you know, if I wrote one I would have to get it cleared in the Navy and I do not think they would clear it.

Let me make one point very clear, Senator, that everything I am going to say today is based on one fundamental point that I have in mind, and that is that I do not like to see the Navy get pushed around. There are two ways that the Navy can get pushed around. One is at sea, if we are weak, and the other is at home, by large defense contractors who rarely, if ever, give us what we pay them to give us; namely, quality, on-time delivery, and reasonable cost, and I do not want to be pushed around and I do not want to see the Navy get pushed around by those contractors, and I have a very strong feeling that they are doing that. So, everything I am saying this morning is geared to that basic premise.

F–14 PROGRAM

I would like to say a few words about the F–14, lot 5. I would like to very much congratulate Mr. Warner, Secretary of the Navy, and Admiral Kidd for the decision that they made about a week ago to exercise that option. We all know the result of their exercising that option; we know what Grumman has said, but I certainly congratulate those men for making that decision. It is a step in the right direction, and I hope they maintain that posture.

I hope that other companies who, that I know personally, have been standing in line waiting to see what we do on lot 5, I hope that they get a little bit of a message from that, and I hope that that attitude prevails on down through the Litton's and everybody else who has a contract and in some way want it reformed or want to get out of it.

GRUMMAN FULL-PAGE AD

I know you have seen this full-page ad put in the paper by Grumman. I want to congratulate them for putting that in the paper. They have for the first time—and I am very glad to see it—they have laid this whole question out right in front of the public where it ought to have been. It has been handled with so much secrecy, so has Litton, that I am delighted to see this, this full-page ad.

Chairman PROXMIRE. Without objection, that ad will be printed in full in the record at this point.

Mr. RULE. Well, if I had known that, will you get a copy because I have got some notes on this one.

Chairman PROXMIRE. I do mean that one. [Laughter.] We have copies of it.

Mr. RULE. OK.

[The full-page ad referred to follows:]

[Full-page ad from the New York Times, Dec. 12, 1972]

TO THE SHAREHOLDERS OF GRUMMAN CORPORATION

On December 11, 1972, Grumman Aerospace Corporation, a subsidiary of Grumman Corporation, received notice from the United States Navy of exercise of an option for 48 F–14 Aircraft to be procured in Fiscal Year 1973.

Under instructions from the Board of Directors, acting in your interest, Grumman Aerospace Corporation has advised the Navy that it will not proceed under the option.

The pertinent facts of the matter are:

1. *The option is invalid and unenforceable.*—Counsel has advised the Corporation that the option exercised by the Navy does not comply with the terms of the contract, or with Congressional Authorization Public Law 92–436 of 26 September 1972, and cannot be legally enforced.

2. *To continue under the option would not be in the best interests of the Government and the shareholders.*—The form of contract which the option exercise seeks to perpetuate has proven to be so contrary to the Government's own interest that its further use has been prohibited by Department of Defense Regulations. The terms of the option are such as to seriously threaten Grumman Aerospace Corporation's ability to remain a viable producer of essential defense and space hardware and to meet its responsibilities to shareholders.

3. *The causes of the contract problem are beyond the corporation's control.*—There would be no financial problem had not external, unusual, and unpredictable economic factors—namely: extreme inflation and a radical shift in Government procurement policy—come into play during the life of the program. None of these factors was accurately foreseen by Grumman or the Navy at the original contract negotiations. Data presented by the Corporation conclusively demonstrate that Grumman Aerospace is a competitive and efficient supplier of essential products, and no statement of disagreement with those data has been made by the Navy.

4. *The F–14 meets or exceeds all Navy requirements.*—Uninformed opinion to the contrary, data accumulated in over 900 flights of 20 airplanes totaling over 1,900 flight hours conclusively demonstrate that the aircraft will, in fact, fulfill the essential fleet roles originally established for it. These results have been substantiated by fleet pilots in over 300 test flight hours in the airplane, and they have been unanimous in their statements that the F–14 fighter is superior to any other known fighter in the world.

5. *There is no cheap alternative means of fulfilling the requirement.*—Studies have also been made by the Navy considering all possible means of providing the absolutely essential air superiority and fleet air defense capability represented by the F–14. They have been unanimous in concluding that no cheaper alternative exists.

6. *The corporation has made every effort to negotiate a settlement with the government.*—The Corporation has been very open with the Government and its shareholders in discussing the problems caused by the F–14 Contract. For over two years the Corporation has intensely pursued a negotiated settlement of these problems. Despite assurances given to the Corporation at the inception of the preceding Fiscal Year 1972 procurement, the Corporation has not received a single offer from the Government in settlement of the problem. In fact, Grumman Aerospace agreed to the Navy's request for an extension of the Fiscal Year 1973 procurement option date to December 15, 1972 in order to provide additional time for resolution of the contract.

7. *It is unreasonable to expect Grumman shareholders to assume the entire burden for this essential defense program.*—To date, Grumman Aerospace Corporation has contributed nearly $1,000,000 towards the cost of each F–14 ordered by the Government. The Government has not paid one cent above the original costs negotiated for Grumman's portion of the program work. Eighty-six aircraft

have been ordered thus far, and the Corporation has written off $85,000,000 in losses. These losses have been accepted even though their cause was beyond the control of the corporation. To continue under this now discredited and prohibited type of contract, which can not be enforced legally, would be to exercise extremely poor management judgment to the detriment of shareholders, and the long term interest of the Government.

In view of the foregoing, the Board of Directors has regretfully instructed that no further work be performed with respect to the Fiscal Year 1973 procurement of the F–14 aircraft, and directions to stop work have been sent to suppliers across the country. Production of other Navy aircraft will continue as will work on F–14's already on order and scheduled to be completed in mid-1974.

Grumman Aerospace views today's action by the Navy with great regret. The employees, officers, and directors of the Company have worked with unique dedication to produce for the Navy an outstanding fighter weapon system. We have accomplished this and it has been acknowledged in Navy evaluations. This effort has been carried out with the same dedication which has produced for the Navy the very successful A–6 and the E–2 series of aircraft, as well as the Orbiting Astronomical Observatory and the Apollo Lunar Module for NASA. These are and have been sound products; the F–14 is a sound product. It is unfortunate for the nation, the Navy, and Grumman Aerospace that today's action was taken.

The Corporation will continue its efforts to achieve a reasonable and equitable solution to the F–14 contract problem with the Government, and will keep its shareholders advised of important developments regarding the program.

E. CLINTON TOWL,
Chairman of the Board.
JOHN C. BIERWIRTH,
President
(For Grumman Corp.).

Mr. RULE. The reason I mention Grumman, and I have not been a participant in any of the negotiations, I am interested in the public, the taxpayer, knowing what in the hell is going on in these cases, and this gives me the opportunity to say what I know has been alluded to in some publications but I think needs to be really stressed, and that is, that when Grumman got this contract, the F–14, it was, in my opinion, and still is, the most flagrant buy-in that I have ever seen.

GRUMMAN REDUCES F–14 PROPOSAL BY $500 MILLION

On the 6th of January, 1969, when negotiations were going on between Grumman and McDonnell-Douglas, they came in right in the midst, right at the end of the negotiations and, as a result of a management decision, reduced their bid proposal by $500 million.

Now, oddly enough it is just about $500 million that they say they want now from the Government, and it is no coincidence, in my opinion. I think the taxpayers of this country have a right to know that this company made a management decision and bought in.

They say in this ad that were they to continue work on this contract it would be extremely poor management judgment. Well, they did not put out a full-page ad when they bought in, to notify their shareholders and their labor force, they did not do that, but now they want to be bailed out for that management decision.

I have been asked the question by some of my superiors, "Well, Grumman says that when they reduce that"—incidentally they reduced the figure on the 6th of January 1969, the announcement that they got the contract was the 14th of January 1969, just about a week after they came in with that $500 million reduction.

Now, the question I have been asked is, "Well, Grumman says they expected to make up that reduction by future business. They expected to get the space shuttle program, they had no idea that inflation would creep or gallop as much as it has done," and I have been asked "Well, isn't there some merit to these contentions of Grumman?" And my answer is, absolutely not. These are big boys. They are not kids, they know how to bid on contracts. I am afraid they had the philosophy, as so many other companies had, "Get the contract and then you will get bailed out," and I just am not persuaded by the fact that they are so naive that they can now expect the Government to bail them out of this contract, and I think the first thing I said about congratulating Mr. Warner and Admiral Kidd, I want to repeat again because I hope they hold the line with this company.

Now, with respect to lessons learned on Grumman, I have recommended a clause to Mr. Shillito that we put in any contract where there is reason to believe that there is a buy-in. For example, in this contract we should have put a clause in, in my opinion, which said "OK, we recognize, we think we recognize, that you are buying in to the tune of $500 million. We cannot tell you to raise your price, we cannot offer to pay you more, but we are going to put a clause in this contract, Mr. Grumman, which says if you get in financial trouble the first $500 million is on you. If you need more maybe we will talk to you but the first $500 million is on you," and that to me, is the lesson learned, and that is all I have to say about Grumman.

LHA NOT A TOTAL PACKAGE PROCUREMENT

I would like to make a couple of comments about Litton. I have had no part in the negotiations with Litton either, but the fundamental point that again, I think, the public, the taxpayer, should know about Litton, LHA in particular, and I am not talking about the 963, but with respect to the LHA, I want to make it very clear that that is not a total package procurement. The RFP that went out, that this company bid on, said specifically this is not a total package procurement, and anything that Litton says in that regard is just not so.

MODULAR CONSTRUCTION CONCEPT

But, I want to point out what is really basic in this Litton contract. I am reading, I would like to read, from a Litton piece of paper:

What is the new principle of building ships? The new principle employed by Litton is to "manufacture" rather than construct ships. Such an approach substitutes production methods of operation based on work flow through a production line for the in-place construction method heretofore applied to ships. There are no "ways" on which a keel is laid. Successive elements of the hull are built up and down which the ship is launched before final outfitting. Instead, starting from the ship design itself, which is especially adapted to the potential efficiencies of production line methods, the process resembles a giant automobile assembly line. A number of modules progress in parallel through the fabrication shops, down the assembly lines, become joined into successively larger and larger units and finally are joined together into a nearly completed ship which is then transferred on massive rails to a ground level but floating launching platform which is submerged allowing the ship to float off. This

process, developed from extensive analysis of European and Japanese shipbuilding techniques, achieves maximum efficiency in the shipbuilding by making use of capital intensive mechanization and work flow control.

That is what this company tried to do. I submit that the best thinking I have heard on this subject is that you can do that. You can modular and assembly line commercial ships but that it is not possible to use this technique to build warships, men-of-war.

If I may read once more, Senator, I would like to tell you what Admiral Rickover has testified on this subject. He was testifying before the House Appropriations Committee on the defense appropriation bill of 1973 in part 9, which is a volume directed entirely to Admiral Rickover's testimony:

Mr. Sikes, you asked me a question about modernization in shipyards. I think the idea of going to highly automated shipyards for warships is inherently wrong for several basic reasons. Finally, as in the case of nuclear submarines, modern warships are too complicated to use a high degree of automation effectively. I think if you ask anyone familiar with the complexity of building modern warships you would find a unanimous opinion that you cannot universally apply automated production techniques for this kind of work. Even the Soviets, who make great use of automated production, use the more conventional techniques when building their large combatants.

The drive for use of fully automated shipyards by the Navy is another example of inexperienced managers and Navy officials advocating something they know little about. In their eagerness to impose their interpretive pattern they gloss over evidence that does not fit. Having formulated their conclusions they go on to construct a suitably incredible machine to fit them.

The courses in industrial management teach that a good manager makes maximum use of automation to improve efficiency, and if that is what the textbook says then it is assured that that is the way warships should be built. But in reality this is just not true, and there are many problems in trying to highly automate the construction of major warships and still deliver to the fleet high performance vessels at a reasonable cost.

I am glad that there has been this publicity on the Litton situation in the last few days. I think again, as I do in the case of Grumman and the F–14, the taxpayers have a right to know, and this publicity, I think, is all to the good.

If there is any lesson to be learned here, I submit it is that the Navy got sold a bill of goods. This contract was a good contract, it was not total package procurement, and I just think that the weight of the evidence is that you cannot build these ships, men of war, warships, you cannot build them, by this technique. I think, and I hope, that Litton can do this with respect to some of these Marad ships that are coming along. I understand that it is a beautiful facility down there. I understand they brought a very good shipbuilder over from the other bank, who says he will build these LHA's but they will not be built by this modular construction technique, and what that does to our costs, I do not know.

I just will say one more thing on Litton and that is, if by the 28th of February, when they are supposed to have quite a few things done under their latest modification, if they have not done those things and made the proper progress I think they ought to be terminated for default. They are 2 years late now, and this is going to have impact on. I am sure on, the 963's and I just think we ought to stop horsing around with them.

Chairman PROXMIRE. Thank you very much, Mr. Rule. I want to welcome you to our hearings again. We invited four admirals to tes-

tify as well as yourself, and the Navy sent only you. So we are expecting quite a lot from Gordon Rule this morning. The Navy did promise to allow Admiral Zumwalt and Admiral Kidd and the others to testify at a later time, by the way.

JOB DESCRIPTION RESPONSIBILITIES

The first question I want to ask is about your job and responsibilities. Can you tell us what your job description means and what role the clearance branch plays in Navy procurements?

Mr. RULE. Well, they just changed my job sheet since I was—my job description since I was—up here the last time. I do not think it makes a hell of a lot of difference if they did. The job, when I got this job in July 1963, the job description said that whoever occupied this position was the principal agent of the Secretary of the Navy in procurement matters to advise him that we were making prudent business deals.

At that time there was in effect a so-called bilinear system in the Navy, which simply means that CNO was in charge of all operations and requirements, and CNM, the Chief of Naval Materiel, was of equal status, the two admirals that headed CNO and CNM were of equal rank.

Now, it is the unilinear system. They put CNM under CNO, and Admiral Kidd, who is CNM, is responsible to Admiral Zumwalt.

When it was the other way, when it was the bilinear system whoever was CNM could challenge CNO, and did. They were of equal rank.

Now, I see signs that this unilinear system is not good. It is not good and it should be changed, and again I can quote, and I think it is very interesting, I can quote, where Admiral Rickover testified at the same hearing that we should do away with the unilinear system and get back to the bilinear system.

Chairman PROXMIRE. Do you fit into this unilinear system in reporting to one of the admirals or do you report directly to the Secretary?

Mr. RULE. Well, I say when I got the job I was the principal agent of the Secretary. When it changed to the unilinear system, Admiral Kidd said, "Well, I think we have to change that. You are no longer the principal agent of the Secretary. You are the principal agent of me, CNM."

Chairman PROXMIRE. I see.

Mr. RULE. I agreed so long as the change had to be made but when they rewrote the job sheet they said I was the principal agent of a rear admiral by the name of Freeman, my boss, and I gagged at that and would not sign the job sheet because I thought that was diluting the function. But the job itself that I am supposed to perform, let me just read you a couple of lines.

Chairman PROXMIRE. All right.

Mr. RULE [reading]:

In his present position Mr. Rule's overriding responsibility is to insure that all major negotiated contracts or contractual changes of the Navy are subjected to an independent, penetrating, objective review of all contractual and business considerations prior to any procurement commitment by the Department of the Navy. Within the scope of procurement operations of the Navy,

Mr. Rule's duties and responsibilities constitute the most salient point of a system of checks and balances in the entire procurement organization. His is the responsibility to challenge, to question, and to disapprove when such action is necessary regardless of other considerations or consequences. In economic terms this responsibility encompasses eight to $10 billion each year in programs vital to the Navy's future.

That was written and signed by Frank Sanders, who then was Assistant Secretary of the Navy. He is now Undersecretary of the Navy. That is how he described my job. So in effect, I am getting paid by the taxpayer to challenge. That is the simple fact, and I do challenge. But this check and balance system that they talk about, which was a darned good system set up by Mr. Forrestal when he came down here as Secretary of the Navy, this is being eroded more and more.

Now the whole concept of checks and balances is becoming thought of as roadblocks. so that the function of challenge that I still get paid to do is not appreciated as much, shall I say, as it was.

Chairman PROXMIRE. We appreciate it.

ALLEGATION OF MISREPRESENTATION IN LITTON SUBMARINE CLAIMS

Can you confirm or deny the information I have received that there is a serious possibility of fraudulent misrepresentation in connection with a claim and requests for progress payments submitted by Litton: Are you aware that a three-man team was recently set up by the Commander of the Naval Ship Systems Command to investigate the possible steps to be taken with regard to false and misleading data submitted by Litton on their nuclear submarine (SSN's 680, 682, and 683) claims?

Mr. RULE. You are speaking specifically about that submarine claim?

Chairman PROXMIRE. Yes, sir.

Mr. RULE. All I know, Senator Proxmire, is a letter that I have seen signed by Admiral Rickover in which he does not categorically charge fraud but he says it almost amounts to fraud.

Now, I did not know there was any other investigation or possible suit with respect to that. I know that the claim that they put in, Admiral Rickover made a determination that it was worth considerably less than what they claimed.

Chairman PROXMIRE. Yesterday we pointed out the huge disparity between the face amount of the claim and the amount offered in settlement by the Navy. Can you tell us anything about the claim and whether you agree that there is a possibility it is based on misleading and false information?

Mr. RULE. I do not think I can in any way that would be helpful. I only have impressions and I only think—I know this thing has grown from—I had it before me once for about $6 or $7 million, and I sent it back. The next time I heard of it it was up around $40 or $50 million. Now, what happens to these things goodness knows.

Chairman PROXMIRE. As I recall one of the claims, there was a discrepancy between the amount of $40 million claim by Litton, and less than $1 million decision on the part, or allowance on the part, of the Navy or willingness on the part of the Navy to provide any of the amount. The second was, I think, something over $30 million

and I think that Navy offered only $3 million. The discrepancy was so enormous that it seemed the claim may or may not have had much merit.

You say you are not familiar with this three-man team investigating this situation?

Mr. RULE. No, Senator. We send so many teams around to so many places that I frankly, cannot keep track of them. I do not remember this one. We have—one of the things that I was going to talk about later and I might as well talk about it now, is our indecision and our inability in the Navy to make decisions and dispose of these claims.

Chairman PROXMIRE. Could you find out for us when this three-man team is likely to make its report, when it will be available?

LITTON OVERPAID ON SUBMARINE CONTRACTS

I would also like to ask you are you familiar with the fact that Litton has been overpaid during the past several years on its submarine contracts?

Mr. RULE. On its submarine contracts?

Chairman PROXMIRE. Submarine contracts. It has received excess progress payments for these contracts, and that the overpayments may have been as much as $30 million or more during this period?

Mr. RULE. No, sir; I am not familiar with that.

Chairman PROXMIRE. Are you aware that requests for progress payments have to be certified as to the physical progress upon which progress payments are based, and that Litton may have certified to false and misleading information in order to obtain more money than it was entitled to on these contracts?

Mr. RULE. Well, in the normal shipbuilding contract progress payments are based on physical completion. That is one of the big points in the present Litton controversy on the LHA. They are not getting paid on that basis. They are getting paid on the basis of costs incurred as distinguished from progress payments. That is what the whole issue, one of the principal issues, was about last September. They said "If you convert from costs incurred, where they get a hundred percent of their costs, to physical completion, that they owe us a lot of money."

Chairman PROXMIRE. Well, are you saying then that this is legal and within the contract on the basis of their claims, that there is no evidence that there is any false or misleading information involved here?

Mr. RULE. I am saying, I do not know, Senator.

Chairman PROXMIRE. You cannot tell?

Mr. RULE. I have not looked at it from that point of view and I just do not know so I cannot say.

CORRESPONDENCE BETWEEN CHAIRMAN PROXMIRE, SECRETARY WARNER AND ASSISTANT SECRETARY SANDERS

Chairman PROXMIRE. I wrote to Secretary John Warner on November 30 asking, among other things, about the overpayments to Litton. I received an answer on December 14 from Frank Sanders,

Under Secretary of the Navy, confirming the fact that Litton, operating as Ingalls Shipbuilding Division, has received overpayments on its submarine contracts. I previously released my letter and I am releasing Mr. Sanders' reply today.[1] The difficulty I have with the Navy response is that the Navy's figures show the cumulative overpayment amounted at its maximum to $7,590,000 and that it has all been recently recovered. But I have evidence that the overpayments were substantially higher than that figure. My information comes from a series of audit reports made by the Defense Contracts Audit Agency. Are you familiar with these reports?

Mr. RULE. No, sir; but I would take their word for it.

DCAA AUDIT REPORTS

Chairman PROXMIRE. Well, I obtained these reports by requesting them from the Department of Defense and I want to point out that the Pentagon has been very cooperative and responsive to my requests for information. But the letter transmitting the reports said they contain contractor proprietary data and may not be made available to the public under the law protecting this kind of information. I sharply disagree with the Pentagon's position on this. After looking at the reports I fail to see what the proprietary data subject to legal protection might be and I intend to press until it is made public or its withholding from the public is satisfactorily explained. I wonder if you have an opinion as to whether these reports ought to be released or kept secret?

Mr. RULE. I would err on the side, Senator, of making them public. I think it is public information.

Representative CONABLE. Are you familiar with what is in the reports?

Mr. RULE. No, sir; but I mean audit reports generally, I thought that is what the Senator was talking about.

Chairman PROXMIRE. That is right.

Mr. RULE. These DCAA reports, I would make those reports public. As I said a little while ago, the secrecy air that has enveloped almost all of our work is to me just ridiculous.

Chairman PROXMIRE. I want to ask you, can you—let me say before proceeding with Mr. Conable's helpful interjection, can you—imagine what might be in the report that would be damaging to our national interests or damaging to the Navy's interest if they were made public?

Mr. RULE. Well, Senator, these reports, these audit reports, are supposed to be factual reports, and I can certainly conceive, I have seen many, I have seen them within the last week, audit reports from Grumman, from the auditor at Grumman, where he says "We are denied access to records so that we cannot tell you what we think about this price."

Chairman PROXMIRE. You are talking about the Defense auditors, Defense Department's auditors?

Mr. RULE. That is right, the same group you are talking about.

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[1] The exchange of correspondence, dated Nov. 30, 1972, and Dec. 14, 1972, respectively, may be found on pp. 2479–2482.

NAVY-MARITIME ADMINISTRATION JOINT AUDIT-INTERIM REPORT

Chairman PROXMIRE. Let me ask you about the Marvin Miller report made on May 10, 1972, following a joint audit of Litton's shipyards by a team composed of auditors from the Navy and the U.S. Maritime Administration? Are you familiar with this report and its findings?

Mr. RULE. No, sir.

Chairman PROXMIRE. Well, that report contains some of the most brutally honest and disturbing disclosures of contractor mismanagement and inefficiency that I have ever seen. On the strength of this report I would conclude that the Litton shipyards were among the most poorly organized and wasteful shipyard operations in the world. Let me read some of the findings and then I am going to place selections from the report into the record, and I ask Mr. Conable if I can run over 2 or 3 minutes with his permission, so I can read this. They found a great deal and I am just going to read a few of their findings, some of the most pertinent and appropriate and, as I say, the entire findings will be placed in the record.

Lack of engineering and work packages was having a major effect on LHA production.

Lack of manpower coupled with low productivity in the shipyard was having a major impact on the production schedules for both the Farrell and LHA programs.

The company did not have an effective means for controlling schedule slippages, and for the allocation of manpower between the various ships in the yard.

Productivity in the shipyard was low. Overmanning to meet schedules was apparent in many areas, precluding efforts to improve productivity and control costs. However, due to lagging schedules, the yard resorted to inefficient overmanning in many instances.

The training program at Litton Ship Systems was primarily subsidized by Government training programs. The shipyard's training program is inadequate to support current production schedules. The company provided no on-the-job or off-the-job training during regular hours of duty for career development programs. The yard has no formal apprentice program.

The quality assurance directorate was not effective. Poor workmanship and repetitive defects were noted throughout the yard. The average defect rate being experienced was excessive and was having a serious impact on production schedules. The quality assurance directorate reported to the vice president of operations rather than through the general manager of the yard and so forth.

The company was having serious planning, scheduling, manning, and productivity problems.

The company was behind on all schedules to which it was working. There were no effective schedules to support the planned delivery dates, and no recovery plans by which planned dates could be met. Although there was much scheduling and planning activity in the shipyard, no orderly and consistent scheduling or rescheduling was available in the yard at the time of the audit.

The planned allocation of manpower was inadequate for all ships. Manpower allocations were not keyed to production schedules.

During the course of the audit, the company modified considerably its manpower plans for all ships under contract.

There was a lack of adequate fire protection for the shipyard.

The engineering directorate, largely located in California, had a number of serious problems prior to the audit which have adversely affected the LHA engineering. At the time of the audit, the engineering directorate appeared to be operating effectively with its major weakness being the split in engineering effort and production work between California and Mississippi. This problem is hopefully being resolved by the transfer of engineering to Mississippi as soon as practicable.

The management organization was large and has a very complex structure. The DD and LHA program management offices were also large resulting in a dilution of total management effort because of the time required to manage the individual offices.

The company had a complex, cumbersome management control system requiring the issuance of many documents in order to authorize and track work.

As I said, there were other elements here, and we will put the entire report in the record.

[The report referred to follows:]

INTERIM REPORT OF PRODUCTION AUDIT OF LITTON SHIP SYSTEMS, DIVISION OF LITTON INDUSTRIES, CONDUCTED DECEMBER 6, 1971 THROUGH DECEMBER 10, 1971; JANUARY 31, 1971 THROUGH FEBRUARY 18, 1972; MARCH 13, 1972 THROUGH MARCH 17, 1972; AND APRIL 24, 1972 THROUGH APRIL 28, 1972, BY A JOINT NAVAL SHIP SYSTEMS COMMAND AND U.S. MARITIME ADMINISTRATION (OFFICE OF SHIP CONSTRUCTION) PRODUCTION AUDIT TEAM

NAVSHIPS 0511,
MARAD CODE 723,
May 10, 1972.

To: Commander, Naval Ship Systems Command, Chief, Office of Ship Construction, Maritime Administration.

Subject: Interim Report of Production Audit of Litton Ship Systems Division.

1. Forwarded herewith is an interim report of the production audit and post-audit reviews conducted at the Litton Ship Systems Division, Litton Industries, Inc. by a joint NAVY/MARAD team. The audit began on 6 December 1971 with a preliminary review at the shipyard in Pascagoula, Mississippi and was completed for purposes of this report at the conclusion of a post-audit review at the shipyard on 28 April 1972. This report contains an overall analysis of the shipyard and its capabilities to build ships as well as a detailed schedule analysis of the four Farrell container ships currently under construction.

2. The report also contains a preliminary review of the status of the LHA and DD 963 Class Programs. Because of the incomplete state of planning and scheduling for these two programs by Litton, the audit team was not able to fully evaluate these two programs nor determine the reliability of the shipyard's proposed delivery dates. Litton is in the process of developing revised construction schedules. The team is reviewing these schedules as they are developed.

3. After completion of the Litton scheduling effort, followed by an evaluation by the production audit team, a detailed analysis of these two programs will be provided.

M. B. MILLER,
Team Leader.
L. D. PASSET,
Assistant Team Leader.
C. T. COOKSON,
Maritime Administration Representative.

INTRODUCTION

A preliminary production audit of Litton Ship Systems Division, Litton Systems, Incorporated, Pascagoula, Mississippi was held 6 December through 10 December 1971 and followed by a formal production audit during the period 31 January to 18 February 1972. Both of the above phases of the audit at Pascagoula were conducted by a team of NAVY/MARAD representatives. A third phase of this audit was conducted during the period 23 March through 17 March 1972 at the itton Ship Systems and Data Systems Divisions in California by a small team of Navy representatives. A post production audit review was conducted by audit team members at Pascagoula during the period 24–28 April 1972. The audit included a detailed review of the shipbuilder's engineering facilities, test facilities, production facilities, production planning, status of design, schedules, manpower planning, material planning, and related management information systems. It also covered a review of the actual physical progress being achieved on the four MARAD containerships (Farrell 1–4) and on the amphibious assault ships (general purpose), LHA 1–5, under construction at the contractor's new facility.

The contractor's personnel and management worked harmoniously with the NAVY/MARAD team and were responsive in furnishing available data requested for the production audit.

PURPOSE

The purpose of the audit was to:

(*a*) Physically inspect the MARAD/Farrell ships under construction to ascertain current progress.

(*b*) Analyze the contractor's production capability and supporting schedules to obtain assurance that delivery schedules developed for the four MARD/Farrell ships were realistic and feasible, and, if not, to develop delivery schedules which were considered attainable.

(*c*) Review status of design and planning for LHA and DD 963 programs with emphasis on facilities scheduling, manpower scheduling, production work scheduling, material ordering, and planned subcontracting of structural work to ascertain if delivery schedules for Navy programs were feasible, and, if not, to develop delivery schedules which were considered attainable.

(*d*) Determine if MARAD/Farrell program work would impact Navy work.

(*e*) Ascertain if MARD/Farrell production performance to date is indicative of future performance and can be applied as a valid base to project estimates for Navy shipbuilding programs.

(*f*) Review the shipyard's overrall production planning and control systems, manpower estimating procedures, manpower planning and control systems, material planning and control systems, and other management information systems related to ship production to ascertain if the contractor has effective management control and if management information systems are timely and adequate.

(*g*) Follow the industrial processes and paper flow through the shipyard.

(*h*) Review current employment, recruitment and training plans, and obtain data relative to attrition and absenteeism.

(*i*) Ascertain if the Navy has adequate visibility of the contractor's performance and the contractor's potential productive capacity.

BACKGROUND

At the time of the formal production audit at Pascagoula, Litton Ship Systems held two contracts with the Naval Ship Systems Command for the construction of 21 surface ships: one for five LHA's (of an original planned quantity of nine) under contract N00024–69C–0283 with LHA 1 awarded on 5/1/69, LHA 2–3 awarded on 11/15/69 and LHA 4–5 awarded on 11/6/70; and a second for 16 DD's of a planned contract total of 30 DD's under contract N00024–70–C–0275 with DD 963–965 awarded on 6/23/70. DD 966–971 awarded on 1/15/71 and DD 972–978 awarded on 1/26/72. In addition to the Navy contracts, Litton held a contract for the construction of four MARAD C6–S–85a containerships for Farrell Lines, Incorporated, contract MA–MSB–75 dated 10/3/68.

When the MARAD/Farrell contract was awarded to Litton, construction of three similar ships for the American President Lines, Ltd. were also awarded to Litton by contract MA–MSB–77 dated 10/3/68. Construction of a fourth ship

for the American President Lines was added by an addendum to contract MA–MSB–77 dated 2/2/70.

At the time of the MARAD/Farrell and MARAD/APL bid openings and contract awards, Litton Ship Systems was constructing a new shipyard at a site on the Pascagoula River across the river from the Ingalls Nuclear Shipbuilding Division of Litton Systems, Incorporated. Numerous problems were encountered during the completion and start-up of the shipyard simultaneously with the start of construction of the MARAD/Farrell ships. Consequently, schedule slippages in the MARAD programs resulted. Due to the slippages on Farrell and APL ships and considering the Navy work under contract, a decision was made by Litton on 4/16/71 to transfer construction of the four APL ships to the Ingalls Nuclear Shipbuilding Division.

The production audit was initiated as a result of delays to the original scheduled deliveries of LHA 1–6 and the potential impact which slippages in the MARAD/Farrell program would have on both the LHA and DD 963 programs. The provisional delivery schedule contained in the Memorandum of Agreement dated 4/23/71 reflected LHA 1–5 delivery dates which were later than the original contract delivery dates by 12, 13, 14, 14 and 14 months respectively. Also, MARAD reported that Farrell 1–4 had slipped 10, 9, 8 and 7 months respectively. Exhibit 1 reflects Litton's workload and the key events for the ships at the time NAVSHIPS advised Litton by NAVSHIPS ltr 0511:HP:ie, 4760, Ser 118–0511 dated 5/13/71, Exhibit 2, that a joint NAVY/MARAD audit team would be sent to Pascagoula to review the feasibility of the shipyard meeting production schedules. In reply to Exhibit 2, the shipbuilder by letter 030100/XL/1X0081 dated 6/22/71, Exhibit 3, indicated that LHA was in the preliminary stages of production, LHA schedules were being re-evaluated and the company felt the Navy would "perform a more meaningful audit if it could be accomplished at a point in time when full fabrication and production of LHA has been effected."

In June 1971, MARAD reported that the Farrell program had again slipped and that Farrell 1–4 were scheduled for delivery 14, 14, 12 and 14 months respectively later than the contract delivery dates.

At the same time the shipbuilder reported that start construction dates for LHA 2–5 were revised 7, 7, 10 and 10 months later than previously planned, but held the provisional delivery schedule delivery dates. Exhibit 4 reflects these changes in the Farrell and LHA programs.

By Naval message 220024Z July 1971, Exhibit 5, NAVSHIPS advised Litton that the production audit would be held during a two week period commencing on 8/2/71. Litton by letter dated 7/30/71, Exhibit 6, questioned the Navy's right to conduct the production audit. NAVSHIPS asserted the Navy's rights by letter 022:SK:mar, Ser 397–022 of 7/30/71, Exhibit 7, but advised the company that it would limit the production audit to the East Bank facility because planning for LHA had not been completed and requested that the Navy be advised when the necessary LHA data would be available for Navy audit. Litton, by letter 1CA100/LL/1S0070 dated 8/9/71, Exhibit 8, recommended to the Navy that the production audit be scheduled approximately six weeks before the contractor's reproposal submittal which was scheduled for early 1972.

In September 1971 NAVSHIPS was informed by the president of Litton Ship Systems that the information necessary to conduct the audit had either been developed by Litton or was very close to completion. Accordingly, by NAVSHIPS letter 0511: MBM:gs, Ser 280–0511 dated 9/16/71, Exhibit 9, NAVSHIPS advised that the production audit be held during the period 18–29 October 1971. However, Litton's Director of Contracts advised NAVSHIPS that because of a work stoppage which the company was experiencing the necessary planning would not be completed for a Navy audit in October 1971. The work stoppage ended early October 1971. A meeting was held 10/12/71 at NAVSHIPS headquarters with company representatives to discuss the rescheduling of the audit. The company agreed to preliminary production audit to be conducted during the period 6–10 December 1971 and a formal audit to be conducted in January 1972. NAVSHIPS letter 0511:MBM:gs. Ser 334–0511 dated 11/16/71, Exhibit 10, confirmed the scheduled dates.

In November 1971, MARAD reported further slippages in the Farrell program indicating that Farrell 1–4 were scheduled for delivery 19, 18, 17 and 17 months respectively later than the contract delivery dates. Exhibit 11 reflects the changes in the Farrell program.

NAVSHIPS messages 010110Z December 1971, 2002352 January 1972 and 260412Z January 1972, Exhibits 12 through 14 respectively, apply to the preliminary and formal portions of the audit at Pascagoula.

Just prior to the formal portion of the audit, Litton was awarded the seven additional DD's, DD 972–978 which comprised the third increment of that multiyear contract. Exhibit 15 reflects Litton's firm workload as of 1/31/72.

Subsequent to the production audit portion conducted at Pascagoula in January and February 1972, an additional phase of the audit was conducted at Litton's related division in California. NAVSHIPS msg 031855Z March 1972, Exhibit 16, established the agenda for the audit at Litton's Advance Marine Technology Division (AMTD) and Date Systems Division (DSD) sites.

AUDIT TEAM COMPOSITION

The production audit team consisted of 14 representatives from the Naval Ship Systems Command, one from the Naval Material Command, two from the U.S. Maritime Administration, four from the Navy Shipbuilding Scheduling Office, one from the Office of the Supervisor of Shipbuilding, Conversion and Repair (SUPSHIP) Bath, Maine, two from SUPSHIP Newport News, Virginia, one from SUPSHIP Quincy, Massachusetts and was assisted by representatives from SUPSHIP Pascagoula and RESSUPSHIP Culver City. Two consultants under contract to NAVSHIPS were present at the audit in Pascagoula on a part time basis. The team members, SUPSHIP Pascagoula and RESSUPSHIP Culver City personnel are lists on Exhibits 17 through 19 respectively. Support from Defense Contract Area Audit (DCCA) personnel was obtained when necessary.

DISCUSSION

General

The team began the preliminary production audit at Pascagoula, Mississippi on 6 December 1971. Orientation meetings were held with SUPSHIP Pascagoula personnel and Litton Ship Systems representatives. The contractor's staff was advised of the purpose of the production audit, the scope of information desired and that, data obtained during this phase of the audit would serve as the basis for the formal portion of the audit would be continued in January 1972. The contractor was further advised that during the audit no direction would be given by the government, and nothing offered should be construed as such. Also, that commitments, if any, could be made only by a duly authorized Navy contracting officer in writing.

The preliminary audit encompassed a review of the shipyard's production planning and control systems, material planning and control systems, manpower estimating procedures, manpower planning and control systems and other management information systems related to ship production. The status of planning for LHA and DD 963 programs was reviewed with emphasis on facilities scheduling, manpower scheduling, production work scheduling, status of material ordering and planned subcontracting of structural work.

Presentations on the following shipyard operations and systems were given to the audit team: master program scheduling (FAMSCO), manpower forecasting system, production work schedule system, cost accounting system, production software flow, production control system, material planning and control, facilities scheduling and quality control system. In addition, the team was taken on a tour of Litton Ship Systems' shipyard facility.

Individual groups of the audit team were organized to conduct preliminary reviews on the current status of the following: manpower estimating, planning and scheduling, facilities planning, structural work schedules (farmout), subcontracting, material procurement, personnel planning (including hiring and training plans), and design.

The preliminary portion of the audit was concluded on 10 December 1971.

On 31 January 1972, the production audit was resumed at Pascagoula, Mississippi. The contractor apprised the audit team of changes implemented since the preliminary audit, provided an updated status of significant management information systems, and discussed the current shipyard organizational structure.

The audit team was organized into basic review groups to conduct detail reviews of the MARAD/Farrell, LHA and DD 963 programs and the overall shipyard, together with an overall shipyard schedule and manpower evaluation. The

contractor assigned team coordinators to each group. Contractor team coordinators and personnel conferred with in Pascagoula during the audit are listed in Exhibit 20. Miscellaneous persons conferred with in Pascagoula are listed in Exhibit 21.

An independent visual inspection of the four Farrell ships under construction was started by members of the team to ascertain current status of completion. Visual inspection of the LHA ships, although construction was minimal, was also conducted. Construction had not started on the DD 963 program.

Other team members reviewed and analyzed the shipyard's facilities, organizational structure, status of design, available major events schedules, material ordering and delivery schedules, planned manning schedules, manufacturing and erection schedules, compartment completion schedules, test schedules, material and production control systems, quality control systems, and other pertinent data required to determine if the contractor has effective management control, if management information systems are timely and adequate, and, in conjunction with the audit team's evaluation of ship progress, if delivery schedules developed for all ships were realistic and feasible.

The contractor's available and projected manpower by trades was compared to planned manning and the Navy's estimated manpower required to complete the ships under construction and planned future ship construction. Leave and absentee rates were reviewed; hiring plans were discussed and overtime usage was reviewed.

The formal portion of the production audit at Pascagoula, Mississippi was concluded on 18 February 1972.

The third phase of the production audit resumed on 13 March 1972 in California and was conducted by a small number of Navy representatives from the audit team. This portion of the audit involved Litton's Advanced Marine Technology Division (AMTD), Culver City, which is a segment of Litton Ship Systems (LSS) and Litton's Data Systems Division (DSD), Canoga Park and Culver City, which is supporting LSS in the electronics and test areas for Navy shipbuilding contracts.

During this phase of the audit, the team ascertained the organizational relationships and administrative aspects of AMTD, DSD and LSS Mississippi and their functions, interfaces and responsibilities relative to LHA and DD 963 programs, and conducted a review of Litton's engineering and test facilities.

Planning and status of engineering, government furnished information requirements, software farmout, software problem areas, advance planning effort, material procurement problem areas, vendor furnished information requirements, and other pertinent data relative to the LHA and DD 963 programs were reviewed Data relative to Litton's AMTD planned phase out and transfer of functions to LSS Mississippi was obtained.

In general, software inputs by AMTD and DSD were reviewed and evaluated to ascertain if planning and schedules developed were realistic and feasible to ship production and delivery schedules.

The production audit in California was completed on 17 March 1972. Litton AMTD and DSD team coordinators and personnel conferred with in California are listed in Exhibits 22 and 23 respectively.

A post production audit review was conducted by members of the production audit team at Pascagoula during the period 24–28 April 1972, for the purpose of obtaining the latest available information on manpower and schedules for the Farrell, LHA and DD programs. During this review the team inspected the Farrells 1 and 2 and reviewed the status of construction and progress attained on those ships.

No formal exit briefings were presented to either the Supervisor of Shipbuilding or Litton Ship Systems. However, during the course of the production audit and post audit review, the audit team director met with the SUPSHIP and Litton's top management on several occasions to discuss preliminary findings, observations, or problems being encountered in obtaining data required to complete the audit.

This report is an interim report of the findings of the audit team and the resulting conclusions therefrom.

The shipyard is still in the process of reviewing the Farrell scheduling and preparing revised schedules for both the LHA and DD 963 programs. Until these revised schedules are completed and evaluated, the audit team cannot

submit final conclusions and recommendations nor can it predict delivery schedules for LHA and DD 963 class ships with any degree of certainty. Follow up reviews and reports are planned at appropriate intervals during the continuing evaluation of the shipyard and the three on-going programs.

The ensuing sections of this report will briefly discuss the shipyard, the specific programs now under contract, and provide a summary of findings and conclusions to date. Recommendations of the production audit team have not been included in this report as they were considered premature. The recommendations of the team are dependent on the continued cooperation of Litton Ship Systems, the development of schedules to which the shipyard will work, organizational changes being made and the development and implementation of plans to hire and train the requisite work force.

Summary of findings and conclusions

The findings and conclusions of the team based on the production audit to date are summarized below. Detailed discussions of the finding and conclusions are contained in the appropriate sections of the report.

Findings

1. Litton Ship Systems Division was essentially composed of two major operating divisions with the shipyard in Mississippi and the major supporting divisions in California. Senior management was based in both places and its effectiveness diluted because of the large amount of commuting required between the two.

2. The management organization was large and has a very complex structure. The DD and LHA program management offices were also large resulting in a dilution of total management effort because of the time required to manage the individual offices.

3. The company had a complex, cumbersome management control system requiring the issuance of many documents in order to authorize and track work.

4. During the course of the audit, the company underwent several reorganizations and a large number of management personnel changes, apparently in an effort to obtain an effective organization.

5. The shipyard's physical plant clearly contains modern and highly automated equipment. It is a more capital intensive plant than most other United States shipyards. The facility is generally adequate for immediate contractural requirements with several notable exceptions. The shipyard requires an expanded platen area for the construction of structural assemblies, including curved shell assemblies; an aluminum superstructure assembly area; additional cranes in both the platen and module assembly areas; and, expansion of the integration area by extension of transverse tracks to permit the DD–963 class ships to bypass the LHAs for launching purposes.

6. There is a lack of adequate fire protection for the shipyard.

7. The hurricane and heavy storm standard procedure outlines a reasonably adequate hurricane and heavy weather plan.

8. The material directorate, primarily located in California, has excellent procedures, and is an effective organization.

9. The engineering directorate, largely located in California, had a number of serious problems prior to the audit which have adversely affected the LHA engineering. At the time of the audit, the engineering directorate appeared to be operating effectively with its major weakness being the split in engineering effort and production work between California and Mississippi. This problem is hopefully being resolved by the transfer of engineering to Mississippi as soon as practicable.

10. The Quality Assurance Directorate was not effective. Poor workmanship and repetitive defects were noted throughout the yard. The average defect rate being experienced was excessive and was having a serious impact on production schedules. The Quality Assurance Directorate reported to the vice-president of Operations rather than through the general manager of the yard, thus, in the opinion of the audit team, compromising the effectiveness of the organization. Subsequent to the audit, the organization was modified and the Director of Quality Assurance now reports to the general manager organizationally.

11. The company was having serious planning, scheduling, manning and productivity problems.

12. The company was behind on all schedules to which it was working. There were no effective schedules to support the planned delivery dates, and no recovery plans by which planned dates could be met. Although there was much scheduling and planning activity in the shipyard, no orderly and consistent scheduling or rescheduling was available in the yard at the time of the audit.

13. The planned allocation of manpower was inadequate for all ships. Manpower allocations were not keyed to production schedules. During the course of the audit, the company modified considerably its manpower plans for all ships under contract. The planned manning is still considered inadequate for the Farrell ships. The company was unable to provide actual manpower requirements for LHA and DD programs.

14. The company did not have an effective means for controlling schedules slippages, and for the allocation of manpower between the various ships in the yard.

15. Productivity in the shipyard was low. Overmanning to meet schedules was apparent in many areas, precluding efforts to improve productivity and control costs. However, due to lagging schedules, the yard resorted to inefficient overmanning in many instances.

16. The training program at Litton Ship Systems was primarily subsidized by Government training programs. The shipyard's training program is inadequate to support current production schedules. The company provided no on-the-job or off-the-job training during regular hours of duty for career development programs. The yard has no formal apprentice program.

17. Although the shipyard was placed in an economically viable area, the immediate Pascagoula area cannot presently satisfy the needs of a large inmigration of employees necessary to support the Litton production schedules.

18. Contractor furnished material did not appear to be a problem on any program.

19. There were no major items of Government Furnished Material adversely affecting ship delivery.

20. Engineering for the Farrell ships was essentially complete.

21. Lack of engineering and work packages was having a major effect on LHA production.

22. Lack of manpower coupled with low productivity in the shipyard was having a major impact on the production schedules for both the Farrell and LHA programs.

23. The president and vice-president/general manager of Litton Ship Systems were aware of most of the problems besetting the division and expressed a total dedication to solving these problems and to developing an efficient, viable shipyard.

Conclusions

As a result of the findings of the production audit, it was concluded that:

1. The shipyard is an excellent facility, taking advantage of modern automated machinery and the capability of handling heavy weights. The shipyard can ultimately become an efficient, highly productive facility when an experienced management and work force are developed.

2. The shipyard was unable to predict the delivery dates of any ships in the yard with any degree of confidence.

3. The four ships being constructed for Farrell Lines will be delayed beyond the company's promised delivery dates. The delivery dates of Farrell ships predicted by the production audit team are as follows:

	Earliest date	Most probable date	Latest date
Farrell 1	July 15, 1972	Sept. 1, 1972	Oct. 15, 1972.
Farrell 2	Dec. 15, 1972	Jan. 15, 1973	Feb. 15, 1973.
Farrell 3	Apr. 15, 1973	May 15, 1973	July 15, 1973.
Farrell 4	June 30, 1973	Aug. 15, 1973	Sept. 30, 1973

4. Until completion of the rescheduling effort now underway at Litton, the audit team cannot predict delivery schedules for the LHA and DD 963 programs.

5. There has been significant manufacturing improvements noted through the

transfer of management and hard task employees from INS to LSS. The continuing influx of experienced employees should increase the quality of work in the assembly and erection areas.

ORGANIZATION

At the start of the production audit in December, the Litton Ship Systems Division was organized as shown in Exhibit 24. Since that time there have been a number of reorganizations with the organizational structure shown in Exhibit 25 in effect at the completion of the post audit review on April 28, 1972. Although not shown in the organizational charts there are two major operating organizations in Litton Ship Systems, one located in Pascagoula, Mississippi and the other located in Culver City, Calif. At the time of the audit only management of the Farrell program was physically located in Mississippi. The president of the Company is located in California and the general manager divides his time between both Mississippi and California. The LHA and DD 963 Program Management Offices had groups in both Calif. and Mississippi, with the program managers stationed in Calif. and commuting to Mississippi on a regular basis. Material Procurement was split between Mississippi and Calif. with senior management of the directorate located in California and commuting to Mississippi as necessary. Major components were procured in California, with the minor components and the many parts needed to build the ships being procured in Mississippi.

Material Control was located in Mississippi. Engineering was located primarily in California, with a small group located at the shipyard in Mississippi. The Contracts, Industrial Relations, and Operations Directorates were located in Mississippi as was the Comptroller with representatives of each of these Directorates also located in California. The Data Systems Division of Litton, which has a sub-contract from Litton Ship Systems for the software development and test and checkout of the Command Control and Weapon Systems of both the LHA and DD 963, is also located in California, with a small group located in Mississippi serving as liaison between the two operations. This Division also ties into each of the programs through the Program Management Offices of Litton Ship Systems located in Culver City, California. The Operations Directorate in Mississippi is the largest Directorate in the Division. The organization of this Directorate is shown on Exhibit 26. This Directorate, in essence, is responsible for producing and delivering the ships at the Mississippi shipyard. In addition to the Production Departments, it also includes the Quality Assurance Department, Operations Planning and Control, which includes Planning and Scheduling, and Manufacturing Service which includes Production Control.

Prior to, during and subsequent to the audit, there has been considerable turn-over in management personnel throughout the entire Division with ensuing reorganizations to accommodate these changes in an effort to gain better control over the Division's operations. As a result of the review of the organizations and management of Litton Ship Systems, it was concluded by the team that the split between California and Mississippi diluted management's effort, was ineffective, and seriously complicated the lines of communication and responsibility between the various Directorates. This situation was discussed with the president of the Division, who stated that he recognized this problem and further stated that it was his intent to consolidate the Division's operations in Mississippi at the earliest practical time. Subsequent to the audit, the team was advised that all Program Management, Engineering and Material Procurement functions for the LHA Program heretofore being performed in California would be transferred to Mississippi by 1 May 1972, and that these functions for the DD 963 Program would be transferred by the end of the summer of 1972. The planned transfer for the LHA Program was accomplished by 1 May 1972.

The team further concluded that the Operations Department was too large, had too many varied responsibilities and was organized in such a way that planning, scheduling and scheduled control were performed by a number of organizations. Is was considered by the team that Quality Assurance should be removed from this Directorate and transferred directly to the staff of the general manager, if it were to be effective. It was further concluded that Planning, Production Planning, Scheduling and Manpower Planning should be concentrated in one Directorate also reporting directly to the general manager. Subsequent to the audit the Quality Assurance organization was removed from the Operations Directorate and placed on the staff of the general manager.

During the course of the audit a new Master Scheduling organization was established, reporting to the general manager, which was responsible for the coordination of all scheduling effort in the shipyard. However, this organization did not carry with it the personnel or the functions of the Operations, Planning and Control Department of the Operations Directorate, and it was subsequently placed under the vice-president for Program Management. The team did not consider this to be an effective organization.

As the result of the large, complex organization of Litton Ship Systems and the large Program Management Offices used to manage the programs, the Company developed a complex, cumbersome management control system requiring the issuance of many documents in order to get the work done. These documents in many instances were erroneous, out of date and in conflict with one another by the time they were issued to the organization responsible for doing the work. The Company recognized this problem and during the course of the audit established several groups to review the simplification of the paper flow and to submit recommendations to the general manager. As a result of this effort, a considerable amount of management paper was deleted or modified. In addition, much of the paper used to manage the various programs has been made common to all of the programs which was previously not the case. The audit team is of the opinion that this effort should continue and be intensified with a view towards eliminating as much of the redundant and unnecessary paper as possible.

It was also the conclusion of the production audit team that the LHA and DD 963 Program Management Offices were considerably larger than necessary to effectively carry out their assigned functions. Because of the size of these offices, much of the time and effort of the management people in the program offices was spent in the internal management of the offices rather than in vigorously prosecuting their programs. During the course of the audit, there were changes in a number of key management slots, among those were Director of Industrial Relations (with three incumbents during the course of the Audit), managers of LHA Project Office, DD Project Office, Farrell Program Office, Director of Contracts, Comptroller and Director of Advance Programs. In addition, a number of changes were also made in middle management. These many changes have had a significant disrupting effect on the operations of the shipyard, as well as a serious impact on morale.

FACILITIES

Structural shops and areas

The Litton Ship Systems Shipyard has been built on a 611 acre almost rectangular peninsula at the mouth of the Pascagoula River emptying into the Gulf of Mexico. This shipbuilding facility was designed and constructed for series production. Ships are to be manufactured by assembly of modules or sections fabricated from smaller sub-assemblies. Sub-assemblies move through the facility from one fixed working station or bay to the next.

Steel plates and shapes are received by barge, rail or truck and offloaded into the raw material storage area by a 20-ton overhead magnetic crane. A conveyor and a 40 ton collocator car move the shapes or plates to designated spots in the storage area. The collocator car is also used for sorting material in proper sequence.

The fabricating facility includes a fabrication shop, a panel shop, a shell assembly shop, a shot blast building and a paint shop. After leaving the raw steel storage area, all plates and shapes are transferred by an integrated materials handling system to the fabrication shop for processing. The steel enters the fabrication shop on either of two conveyors which carry individual plates or shapes through an automatic cleaning and descaling station.

The fabricated steel leaving the fabrication shop is delivered to the panel and shell assembly shops for assembly into basic flat and curved panels and then transferred to the shot blast and paint shops for cleaning and painting. The steel plates traveling through the panel shop pass through various stations which take care of alignment for tack welding, butt welding, forming of up to 56′ square panels, fillet welding of stiffeners, etc. In the shell assembly shop, curved plates are placed on jigs, adjusted by jacks, then longitudinals, web frames, transverse frames, intercostals, etc., are welded in place.

After passing through the panel and shell assembly shops, panels are transferred through the staging and kitting area to the platen area where panels are joined to form complete inner bottoms, decks, bulkheads, wing tanks, etc. In the platen and sub-assembly areas, nonstructural outfitting kits (electrical, piping,

machinery, boilers) are received from the combined shops and the boiler erection area and are physically installed in the sub-assemblies. Two-hundred ton capacity cranes running north and south move these sub-assemblies through various work stations into the modular assembly area where they are joined together and further outfitted to form a complete section or module of the ship. As the assembly work progresses the sections or modules are moved south in their respective bays, toward the integration area.

In the ship integration area the rails run at right angles to the bay rails. Cranes are equipped with hydraulic jack units that lift the entire crane from one set of rails serving a bay to another set, at right angles, in the integration area. Two cranes can operate in tandem to handle loads up to 400 tons during superstructure work.

After the modules are assembled in the integration area, the entire ship is moved onto the launch pontoon which is firmly anchored to the shore and rests on a submerged concrete platform (grid foundation). To launch the ship, the pontoon is floated off its mooring by discharging its ballast and is then towed into the ship channel. When it reaches the launching area, the pontoon takes on ballast and sinks under the ship which is then towed free and moved to the final outfitting docks.

A plan view and flow chart of Litton's facility is attached as Exhibit 27.

Pipe Shop

The Pipe Shop occupies 91,056 square feet in the combined shops building. An adjoining area of 7216 sq. ft. adjacent to the machine shop is used for pipe storage. The east end of the building, in addition to the pipe storage area, contains receiving areas for ferrous and non-ferrous pipe, a metal cut off saw, an abrasive saw and an area for holding in-process cut pipe. This area is served by a 7-½ ton capacity monorail hoist for carrying pipe from outside the building into the receiving area. As it is processed, the pipe travels westward through the building.

The first operation in the pipe shop takes place in an area adjoining the receiving area where pipe is cut ot required lengths and stored until needed for processing. When needed, pipe is transported to various areas depending upon the operation to be performed. These include pipe bending, end beveling, drilling, threading, welding, brazing, fabrication, inspection and kitting. There is no assembly line, as such, but each pipe assembly is carried through the necessary process areas while bypassing other unneeded process areas.

Pipe bending may be accomplished on the following pipe sizes:

Pipe type and pipe size	Clockwise bends	C-clockwise bends	O.D. C/L radius of bend
I.P.S. Sch. 40, 80, and 120; ½", ¾", 1"	X	X	5X.
O.D. type K: ½", ⅝", ¾", ⅞", 1", 1⅛"	X	X	3X.
I.P.S. Sch. 40 and 80: 1", 1¼", 1½", 2"	X	X	3X, 5X.
O.D. type K: 1⅜", 1⅝", 2⅛", 2⅝"	X	X	3X.
I.P.S. Sch. 40 and 80: 2½", 3", 3½", 4"	X	X	5X.
O.D. type K: 3⅛", 4⅛"	X	X	3X.
I.P.S. Sch. 40 and 80: 5", 6"		X	3X, 5X.
I.P.S. Sch. 80:			
⌐ 1¼"	X	X	(Min.) 7½" C/X rad.
⌐ 1½"	X	X	(Min.) 7½" C/X rad.
⌐ 2"	X	X	(Min.) 10" C/X rad.
I.P.S. steel: 2", 2½"	X	X	2X dia.
Copper			
Copper-nickel: 3", 3½"			

End beveling of pipe is accomplished by a portable pipe-end preparation lathe which machine faces, bevels or bores ferrous or non-ferrous pipe ends for pipe sizes 2" through 12". Torch cutting or beveling of pipe ends is done on steel pipe sizes 4" through 12".

Holes to be cut in copper-nickel pipe for pipe branches can be accomplished for pipe sizes from 2" through 8" with a hole cutting saw.

Tapered pipe threads are cut on ends of pipe sizes from ½" through 4" on two pipe threading machines.

Other facilities for miscellaneous operations includes a copper cleaning machine for deburring, reamining, face off and cleaning copper pipe or fitting from

½" through 6" diameter and a pipe expander to make bell joints in copper, copper-nickel and steel (schedule 40) I.P.S. pipe for 2½", 3", 3½", 4", 5", 6", 8", 10" and 12" sizes.

An abrasive belt grinder is used for cleaning copper and copper-nickel pipe prior to welding or brazing.

A steam cleaning machine cleans ferrous or non-ferrous pipe or shapes with steam, hot water or cold water as required with a maximum temperature of 325° F. for steam.

Joining of pipe assemblies in the pipe shop is accomplished by ovyacetylene torch welding for ferrous pipe and by silver brazing for non-ferrous pipe.

Welding fixtures include a pipe turning power roll which turns all sizes of pipe up to 2000 pounds weight capacity while the pipe is being welded or brazed. There is also a pipe welding positioner and gripper which holds and turns all sizes of pipe or fittings up to 1000 pounds weight capacity while they are being welded or brazed.

Annealing of welded pipe joints to relieve residual stresses is accomplished by a press reliever with controlled temperatures up to 1500° F. This device will accommodate pipe up to 12" diameter and is equipped with a recording rack for record charts.

An X-ray machine is used for inspection of welded pipe and fitting joints as required.

Material handling facilities in the pipe shop include a 7½ ton capacity bridge crane and two 2-ton bridge cranes. Also provided are a number of floor mounted jib cranes of one ton capacity.

Average monthly production of pipe assemblies in the shop, working three shifts, is 103,000 linear feet.

The final process area in the west end of the building is a fabrication inspection and kitting area. Here, after inspection, appropriate assemblies are gathered into work packages and sent to assembly areas or held in a storage area until they are needed.

Machine Shop

The machine shop is located in the southwest corner of the combined shops building, occupies a space of 10,240 square feet adjacent to the pipe shop, and is equipped as follows:

(*a*) Lathes. Two lathes in this area will accommodate maximums of 15" swing on 54" centers and 19" swing on 102" centers and a gap bed lathe has a 24" swing on 96" centers with gap closed or 56" swing on 156" centers with gap open.

(*b*) Milling Machines. Two vertical milling machines in this area has a 42" table with a 12" cross feed by 30" longitudinal feed and a 94" by 20" table with a 50" longitudinal feed respectively. One universal milling machine has a 68" by 15" table.

(*c*) Shaper. One universal shaper in the shop has a table travel of 13" vertical and 24" horizonal with a 25" long stroke.

(*d*) Surface Grinder. The shop has a small surface grinder with a 6" × 8" table and a travel of 7½" × 22". Maximum height under the wheel is 10".

(*e*) Radial Drill. This machine has a 6' arm on a 17" column and can take up to a 4" diameter drill. There is a maximum height of 78" from the base to the spindle.

(*f*) Band Saw. This device has a 24" × 28" table, a throat capacity of 23½" and will cut a thickness of 13".

(*g*) Miscellaneous Tools. A floor mounted drill having a ½" diameter drill capacity, a 2,000-pound maximum load horizontal band saw used to cut stock, a 50-ton hydraulic press with 36" between uprights, an assortment of tool grinders and a layout table complete the inventory in the Machine Shop.

(*h*) Crane service in this area is furnished by a 5-ton bridge crane.

Sheet metal shop

The shop, located in the combined shops building, occupies approximately 5,500 square feet of area and produces various forms of ductwork. The machine tools are arranged in two lines each approximately 500 feet long. One line is arranged to produce ductwork with thicknesses up to and including #16 guage galvanized steel. The second line, parallel to the first, produces ductwork with thicknesses above #16 guage to a maximum of .250 inch black iron.

Sheet and plate stock enter the east end of the building by monorail hoist and are placed in a storage area prior to processing. The entire shop is serviced by two bridge cranes of 2-ton and 7½-ton capacity. The machines are arranged in a logical sequence to permit the work to flow in an orderly manner from shearing and punching to forming, joining and final finishing.

Shot blast shop

The shot blast facility is housed in a prefabricated steel building having 11,500 square feet of area. A seel grill floor supports the work to be cleaned and allows the steel shot, used in the cleaning process, to fall through the floor where it is recovered and cleaned for re-use.

The facility can accommodate a weldment 60′×60′×20′ maximum. Compressed air driven steel shot automatically blasts sub-assembly surfaces to remove scale and corrosion. This unit cleans about 90% of the surface to white metal. Shadowed areas and corners must be cleaned by a manually operated blast unit. The floor is limited to a 100-ton maximum weldment. Accordingly, a generous safety factor is necessary due to the buildup of a considerable amount and weight of shot accumulating in corners and on horizontal surfaces.

A spin blaster is used for the internal cleaning of pipe from 6½″ to 36″ I.D.

A heavy duty 100-ton capacity rotation and positioning crane, having a 90-foot lift, services the area in the building.

A number of tractor drawn trailers of 10-ton, 30-ton, 70-ton and 100-ton capacity are used to transport assemblies to the shot blast and other shops.

Paint Shop

This facility is housed in a prefabricated steel building with an area of 29,900 square feet. The paint shop's function is principally the application of primer coatings to bare steel sub-assemblies prior to their transfer to assembly or storage areas.

Sub-assemblies up to 100 tons maximum can be handled in this building by the use of hydraulic tripod jacks for supporting the work.

Paint is applied with a portable siphon airless spray assembly using fluid pressures of approximately 2000 psi. The unit is capable of pumping epoxy, stabilized, self cure inorganic zincs and conventional paints. It can also apply paint with air pressure.

Spray paint application is also accomplished by using 5 gallon pressure pots either with or without air agitators.

Boiler Erection Shop (Assembly Area)

The boiler erection and assembly area is for assembling components of boilers and gas turbines. It occupies approximately 13,900 square feet and is located adjacent to the modular assembly and ship integration areas.

The boiler shop has two 6-ton bridge cranes and the following equipment:

hydrostatic test pump
abrasive cut-off saw
double grinder
drill press
hydraulic power lift
masonry cut-off saw

Completed boilers are removed through the removable sections of the roof by 200-ton cranes and then covered and stored in an area opposite the boiler shop until moved for installation in the required module.

Machinery assembly shop

The machinery assembly shop is housed in a building with an area of 47,000 square feet. This shop is used to assemble shipboard machinery which arrives in an unassembled condition and to provide non-complex bases or foundations for equipment as required aboard ship.

The shop can perform minor machine operations such as sawing, drilling, shearing and welding.

Crane facilities include units from 1½ ton capacity jib cranes to 15 ton bridge cranes.

Warehousing and stores

An on-site survey was made of all Litton warehousing, both inside and outside storage areas. Approximately 150 persons are employed in general warehousing and auxiliary warehousing. General warehousing occupies some 244,000 square

feet of covered space such as that in building No. 301, that in the Port Authority warehouse (leased) located at the Port Authority Terminal, the multi-purpose warehouse and the land based test facility. Auxiliary warehousing occupies approximately 72,000 square feet principally located in the paint warehouse, pipe storage, portable building and boiler materials, and classified storage areas.

General warehousing

The main warehouse, building No. 301, is located adjacent to the combined shop building and occupies some 70,000 square feet of space. It currently provides office space for the Material Processing Department, Inventory Control, and Quality Assurance Inspection. It houses general Farrell material, receiving and shipping, and all materials from kitting activities. The receiving and shipping functions will be transferred to the new multi-purpose warehouse facility. Practically 100% of the main warehouse is used for Farrell contract. As the Farrell contract phases out, this warehouse will be used to supplement the multi-purpose warehouse for storing LHA material.

The Port Authority warehouse houses all cable, cable cutting facilities, major Farrell equipment and major equipment loose parts. It occupies some 64,000 square feet, and contains two temporary de-humified rooms which will be retained due to deletion of environmental storage from the multi-purpose warehouse FY–72 requirements. The de-humified space consists of a housing made of plastic sheeting with two small de-humidifiers and is used to house generators, etc. The warehouse has a sprinkler system and a secure area for pilferable items. A rail spur is available for incoming shipments, however, all material is now brought in by truck.

The multipurpose warehouse is complete and has approximately 100,000 sq. ft. of space. All wiring and sprinkler systems have been installed. This facility will warehouse LHA general materials. It was originally intended that this facility house the receiving/packaging/shipping areas, however, due to curtailment of funds, all first floor office space, caging and environmental storage was deleted from the FY 72 budget. These areas are considered necessary and are expected to be included in the FY 73 budget. It is felt that the land-based test facility can accommodate the FY 72 environmental storage as needed. A warehouse with approximately 200,000 square feeet of space will be built adjacent to the multi-purpose warehouse in the future.

The land based test facility is a facility for testing electronic equipments for the LHA and DD ships. Located within the land based test facility is approximately 10,000 square feet of environmental storage space completed in March 1972. This area will be utilized to store LHA program DSD and GFE materials which require systems integration in that facility. A 13,000 square feet addition to the LBTF is under construction and will be used to store and test electronic equipments for the DD 963 program.

In summary, LSS has approximately 244,000 square feet of general warehousing and stores area, 13,000 square feet under construction and plans to construct a building with an additional 200,000 square feet of area.

Auxiliary warehousing

Approximately 72,000 square feet of area for auxiliary warehousing is available at the shipyard as follows: (a) paint warehouse, 3,600 square feet, (b) pipe storage, 50,000 square feet, (c) twenty-two portable buildings totaling 11,000 square feet, (d) boiler materials storage, 4,800 square feet and (e) classified storage. 2,500 square feet. An additional 3,600 square feet area for warehousing paint had been requested in the Litton capital budget, but had not been approved at the time of the audit.

Adequacy of facilities

The team found that the facilities as designed and constructed are adequate for the immediate contractual requirements except in the following areas:

(*a*) Panel shop—the manual welding and torch cutting of web frames and flame cutting of lightening holes, penetrations, limber holes and other miscellaneous openings downstream from the automatic butt welding machines slows or stops the normal flow of plates entering the shop.

(*b*) Panel shop turntable, which rotates panels 90° prior to the layout marking, suffers from a design deficiency. Panels with large perforations, when rotated on the turntable fall below the level of the rollers and prevent completion of the turning cycle.

(*c*) Shell assembly shop area is inadequate for anticipated destroyer contractual requirements. Only a limited number of structures can be worked at any one time.

(*d*) Most of the equipment in the shops are of foreign make, thus the unavailability of spare parts, particularly long lead time items, may cause delay and disruption.

(*e*) Considerable delays are experienced by welders working in unprotected outdoor areas due to the wind adversely affecting the welding torch flame.

(*f*) Parts and sub-assemblies, when made up in advance of their intended date of utilization are primed and stored outdoors. During lengthy storage periods these parts accumulate corrosion which must be removed before the part is used.

(*g*) The machine shop area is lacking in larger machine tools such as lathes, vertical and horizontal mills and planers. Some of this capability will have to be obtaned by sub-contracting work to other sources.

(*h*) Aluminum fabrication currently performed in temporary quarters until the new aluminum fabrication shop is completed, is hampered by crowded working conditions, poor lighting in the work area, inadequate ventilation to dispel welding fumes, etc.

(*i*) Approximately 200,000 additional square feet of warehousing will be required at peak of LHA and DD programs.

(*j*) The 200-ton level luffer cranes servicing the assembly and integration areas are slow. When the crane is traveling it cannot at the same time rotate or lift. Conversely, when it is lifting or rotating it cannot travel.

(*k*) Tracks in Bay #1 and #2 will need to be extended and additional transverse tracks installed in the integration area in order to launch a DD while an LHA is in the integration area.

(*l*) Other shop areas such as the pipe shop, sheet metal shop, shot blast shop, paint shop, boiler erection shop and machinery assembly shop appeared to have adequate capacity for the contractor's immediate contractual requirements.

(*m*) It was apparent, throughout all the shops, that much of the equipment was standing idle for the three-week period of the on-site survey.

(*n*) Housekeeping throughout the plant was judged to be good. Material was neatly stacked and scrap and trash were disposed of in conveniently placed containers.

(*o*) The hardware flow-through from raw steel storage to final ship integration permits the work to be moved to the worker and is conducive to series production.

(*p*) The Litton facility can accomodate the required steel through-put of approximately 4,000 tons a month based on a peak production figure obtained from Litton and certified as having been reached during a maximum production period.

(*q*) If Litton is to achieve their scheduled ship delivery dates, certain facility additions and modifications must be made to Bays #1 and #2 and the integration area.

Litton's LHA and DD schedules are extremely tight and allow for no slippage in the module assembly area or the integration area. The analysis of module assembly procedures show that with the exception of a few modules on the first LHA, all modules for LHA 2 through 5 can be constructed in bays #3, #4 and #5 leaving bays #1 and #2 for DDs and LHA superstructures.

Extension of tracks in bays No. 1 and No. 2 approximately 100 feet south and installation of new transverse tracks running east and west are required in order to by-pass LHA already in the integration area when necessary for the launching of DD 963 and subsequent destroyers. These additions and modifications must be complete prior to 7 November 1973 for the launching of DD 963.

Facilities expansion plans

Litton has forecast a capital expenditure of approximately 20 million dollars for fiscal years 1972 and 1973. Twelve of the 20 million dollars expenditure has been previously approved.

A listing of major items included in the Litton capital forecast for FY 72–3 is as follows:

Portable boring equipment	$200,000
Sheetmetal equipment. (25-ton fabricator, band saw, duplicator, lift tables, etc.)	198,500
Platen gantry crane. (Required to give area 400 additional crane service)	900,000

Aluminum superstructure assembly area. (Required to construct LHA and DD superstructures)	$798,800
Expand multi-purpose warehouse West. (Manufacturing schedules dictate that additional warehousing space will be required by July 1972)	900,000
Litton administration and Navy Building. (This building is to provide office area for the forecasted increase in Litton office personnel and necessary areas for the Navy.)	2,520,000
Wet dock building. (Construction of a two-story building in the vicinity of Wet Dock for office areas. Building will replace 13 portable buildings in dock area.)	825,000
12' X 60' Portable buildings. (These are trailers which will be used to provide interim office space required for projected headcount growth in FY-72)	201,000
Mobile crane 50-ton capacity. (Required for unloading of heavy equipment and material from barges when Krupp Crane is otherwise occupied.)	125,000

FIRE PROTECTION

Fire protection requirements for the DD 963 and LHA procurements are identical. The contractor is required to submit written procedures for complying with fire protection, fire prevention and fire fighting requirements of the contracts to the SUPSHIP for review and comments. At the time of the audit, official submission had not been made, but a preliminary copy of the fire protection manual was provided to the SUPSHIP on 15 December 1971.

The following inadequacies were noted during the production review:

1. Inadequate staffing

(*a*) Staffing of the fire protection department consist of 1 fire chief, 1 fire inspector and 2 firemen per shift. These are the only full-time employees on the staff; they are supplemented by a volunteer fire brigade. Each of these part-time firemen is given approximately one hour training per month, which is not nearly enough to prepare them to properly support the full-time firemen in case of fire. Because of the personnel shortage, (i) security guards are used at "key fire stations" in unoccupied areas and on ships (this is not a satisfactory arrangement), and (ii) fire regulations on board ships under construction cannot be enforced. For example, we noted fire hazard related deficiencies on a Farrell ship under construction such as welding machine grounds badly deteriorated, fire equipment boxes inaccessible due to doors being blocked by tools and material, and general poor housekeeping. The department has one fire truck that is manned by the two firemen. The fire chief advised that to effectively utilize the truck for fire fighting, five trained firemen are required.

2. Inadequate water pressure system

The water pressure of 100 pounds presently available for fighting fire at yard elevation is not adequate to reach LHA construction elevations with sufficient pressure. Additionally, since the low pressure equipment is not equipped with automatic trip-in pumping devices, maintaining adequate pressure is a manual operation.

3. Lack of fire protection in the administration building

The administration building houses all eexcutive offices and a large percentage of the software for the Navy programs. The building has no fire escapes from the second floor to the outside, the fire alarm does not sound at the fire station, and doors on the side and back of the building are for exit only, meaning that in the case of fire, firemen can enter through them only after someone opens the doors from the inside or by breaking through the doors. Destruction of the building by fire would greatly impact Navy contract schedules.

The lack of adequate fire protection is a serious problem that could be calamitous to the entire program and should be resolved at once.

Hurricane and heavy weather plans

Litton Ship Systems has compiled and distributed a manual to implement the LSS Hurricane and Heavy Storm Standard Procedure. This manual sets forth the Storm Preparatory Action that will be taken in each specific area. LSS has established a Hurricane Control Center under the vice-president of Operations.

This manual has been reviewed and appears satisfactory for the protection of lives and property at the Litton plant. Since the manual itself is only a tool, all procedures and directions must be implemented and a condition of readiness maintained throughout the hurricane season, June through November.

Procurement procedures and systems

The Materiel directorate is responsible for the procurement of all material and equipment in support of Litton Ship Systems programs and operations. This department is split between Mississippi and California as reflected in Exhibit 28 which is the organizational chart of the Materiel directorate. The LHA Materiel Program office is being relocated to Mississippi.

The responsibility for procurement activities in support of the LHA and the DD 963 programs is divided as follows:

A. Advanced Marine Technology Division (AMTD), Culver City, California:

1. The LHA and DD 963 Materiel Program offices are responsible for procurement of items in the following categories:

(*a*) All items identified by a Litton specification.

(*b*) All items requiring design interface between AMTD Design Engineering and supplies.

(*c*) Any other critical or key items as determined by the Materiel Program Office Director.

2. The AMTD purchasing section is responsible for all miscellaneous supplies and services required for use at AMTD.

B. Litton Ship Systems Mississippi (LSSM):

The LSSM procurement department is responsible for procurement of standard marine items all bulk, and raw material items. and all other ships material not purchased at AMTD.

The company provided the audit team with a copy of the key procurement procedures which were reviewed. A list of these procedures is attached as Exhibit 29. The procedures appear to be in full conformance with ASPR and the contractual terms of the LHA and DD 963 contracts. The procedures are concise and well written and spell out in detail the various aspects of the procurement procedures.

The contractor's pre-award survey procedures are very similar to those required by ASPR and are conducted on major subcontracts in order to determine the capability and capacity of a vendor to produce and deliver the material or equipment in question.

The procurement procedures and systems per se were considered to be satisfactory by the team.

ENGINEERING

The Engineering Directorate is organized as shown on Exhibits 30 and 31. In March 1972 the Engineering Directorate had of an equivalent head count of 1,431 people of which 1,170 were permanent employees. The Engineering Directorate is located primarily in Culver City, California where the Litton Ship Systems vice-president for Engineering is headquartered and where 846 of the 1,170 permanent employees at the time of the audit were located. The remaining 324 were located in Mississippi.

The Engineering Directorate is responsile for preparation of systems drawings, detailed work drawings for use by production, preparation of test procedures, preparation of material procurement specifications and other engineering services required to support the ship construction effort, including Integrated Logistics Support. The responsibility for the electronic systems design, however, has been subcontracted to the Data Systems Division of Litton.

At the present time, the in-house engineering organization is inadequate to satisfy the engineering requirements necessary to support production. As a result, the Company has subcontracted engineering work to Gibbs & Cox, Rosenblatt, Rust Engineering and Ingalls Nuclear Shipbuilding. The engineering requirements will begin to phase down as the DD 963 drawings are released. The LHA engineering organization was scheduled to be transferred to Pascagoula on 1 May 1972 and DD 963 class engineering effort is scheduled to be transferred by the end of the summer of 1972.

Although the engineering organization has had problems in the past, which are reflected in the LHA drawings, the engineering organization appeared to be operating effectively at the time of the audit. However, as a result of the earlier

problems in engineering there are still a considerable number of problems in the LHA drawings needing resolution and the Company is faced with an extremely tight and compressed DD 963 drawing effort. Although it is considered necessary that the engineering effort be transferred from California to Mississippi this impending transfer has caused a morale problem among many of the engineers located in California who do not wish to move. As a result, productivity appears to be suffering and many will undoubtedly look for other jobs rather than move to Mississippi. This will tend to negate some of the benefits which should be derived from the transfer. The status of engineering, together with a discussion of the current problems being encountered, is contained in the LHA and DD 963 portions of this report.

Quality assurance

A fundamental principle of every industry, including shipuiblding, is that quality is everybody's job. A paraphrase of this concept is—quality cannot be inspected into an item, it must be built in. The audit team did not find this philosophy implemented but did find the contrary. There were several indications of attempts to inspect good workmanship and specification compliance into the ships rather than follow the "producers doctrine" of building them in. There is substantial evidence that substandard quality is a significant contributing factor to the failure of LSS to meet production schedules. Hence, the effort of their quality assurance organization is not effective.

Since the review was primarily directed toward the identification of problems related to the assessment of the shipyard's production capability, an in-depth investigation of the quality assurance operation was neither planned nor performed. However, the team did find some deficient areas of Q.A. operation that are related to the product quality problem. These are discussed in the following paragraphs.

During the February 72 visit the Litton Ship Systems Q.A. Director reported to a vice-president who also has the responsibility for manufacturing. This organizational placement of the Quality Assurance Directorate might explain the lack of emphasis on quality problems that require a manufacturing/QA interface for effective corrective action. For example, the Defect Status Report for the Farrell ships revealed several outstanding defect reports dating as far back as October 1971. No apparent special attention was being given this serious situation at a level higher than the QA and manufacturing directorates. There were indications that production schedules were given first priority to the detriment of quality.

The Quality Assurance Directorate should be in the overall organization where it will not be subordinated to another functional area such as manufacturing, engineering, etc. that restricts its proper performance. LSS advised on April 26, 1972 that the QA director now reports directly to the president.

The Quality Assurance Directorate consisted of three groups, two departments, 1 staff administrator and a manager for each of the major programs—DD 963, LHA and Farrell. Review of the Quality Assurance Directorate functional statements and discussions with the director disclosed that, in the opinion of the team, the functions performed by the managers of the individual programs are not managerial in nature, since they have no personnel assigned to them. Their responsibilities include such functions as submitting the QA budget to the respective LSS program managers for approval and advising the program managers on quality assurance matters. The budgets are prepared by the Quality Systems and Planning Group and concurred in by the QA director who also assists in negotiating the budget, if necessary. QA planning and development of instructions and plans are functions of other personnel subordinate to the QA Director. The team therefore concluded that these jobs are really staff assistants for quality to the program managers who serve principally as liaison between QA and the program offices. It was concluded that their managerial expertise could be utilized much more advantageously from both the economical and quality improvement points of view. A recent proposed QA organization structure change showed the reassignment of the Farrell QA manager. The team knows of no action taken to this date regarding the other two managers.

The Quality Assurance Directorate had 352 people assigned with an aggregate of 2,583 man years of shipbuilding experience and 946 man years of aircraft/aerospace experience. The distribution of these experiences by category is shown in the chart which follows. The team did make a manpower study to determine

the quantitative adequacy of personnel for the work to be accomplished since performance/efficiency indicators are not used by LSS. The team did make a cursory review of the assignments of managers and staff personnel (not including inspectors) to determine the shipbuilding/aerospace intermix. It was concluded that the 1 to 3 ratio of aircraft/aerospace to shipbuilding experience had been intermingled in an adequate manner, except in one case. The manager of the Inspection Control Group's experience is total aircraft/aerospace. It is understood that this position has now been filled by a manager with 25+ years of shipbuilding experience. The former manager of the group has been transferred to LSSC.

Since the percent of shipbuilding experience among the 240 inspectors is high at 80% we did not develop a profile for analysis purposes.

QUALITY ASSURANCE DIRECTORATE EXPERIENCE MATRIX

[Man-years]

Personnel by categroy	Number	Shipbuilding	Aircraft/ aerospace	Total	Percent shipbuilding
Director and staff	7	88.5	44	132.5	67.0
Group/department managers	12	138.0	81	219.0	64.0
Section managers	8	71.5	57	128.5	56.0
Supervisors	20	286.0	20	306.0	93.5
Engineers	28	353.0	113	466.0	75.0
Analysts	37	256.9	283	539.5	47.5
Inspectors	240	1,389.5	348	1,737.5	80.0
Total	352	2,583.0	946	3,829.0	73.0

LSS has experienced some serious problems in the control of dimensions and alignment of assemblies. It appears that two of the major contributing factors are the "neat" (exact size) cut technique used in steel cutting and the nondetection of dimensional and alignment deficiencies at the subassembly stage.

The exact size cutting method has been replaced by the use of tolerances that allow for temperature and welding thermal variations. The responsibilities for dimensional requirements and determination of conformance to same have been clearly defined and assigned to engineering and quality control, respectively.

In the opinion of the team, LSS has properly evaluated the dimension and alignment control problems encountered on the Farrell ships and determined the extent of rework, scrap and schedules missed because of these problems. They subsequently developed a control plan that is being implemented on the LHA and DD 963 programs. The plan appears to be adequate but should be comprehensively evaluated by the SUPSHIP as soon as possible to determine how effectively it is implemented.

The team found that 21.1% of submissions made by manufacturing during the period 28 October 71–3 February 72 were rejected by quality control. The weekly rejection rate varied from 42.5% the second week of the period to 18.0% the last week. During the same period the owner/MARAD rejected 6.2% of requests for acceptance made by quality control.

Records maintained on the Farrell contract further revealed a significant amount of repetitiveness among certain categories of defects responsible for the high rejection rates. For example, a report of outstanding deficiency reports (DRs) against manufacturing dated 2 Feb. 72 covered 393 DRs. The nonconformances included 66 defective installations, 74 improper storage, 56 defective welding and 55 dimensions/configuration defects. Some of the DRs date as far back as September 1971. The lack of immediate diagnostic attention to the causes of defects and development of effective corective action by manufacturing and quality control are contributing factors to the high rate of recurring defects and to the inability of LSS to get the average defect rate below 21% with a serious schedule impact.

Some structural work has been subcontracted to other shipyards. Upon receipt of these farmed out structures, LSS did not normally conduct physical inspection for specification conformance and workmanship. On several occasions these structures have been assembled into major sections of the ship and presented to the owner for acceptance without deficiencies being detected either by

the LSS Quality Source Control Department, Incoming Inspection Department, Manufacturing Department or Ship Manufacturing Inspection Department. They were subsequently rejected by MARAD. Rejections of this nature result in the back-outs of the nonconforming material and time consuming rework and re-inspection that adversely impact production schedules.

Although the team found procedures for the preparation of work instructions flow charts by QC, it did not find the QC/Manufacturing interface that should be stressed by top management to assure the combined efforts of the two groups in identifying causes of deficiencies and developing revisions to manufacturing and QC methods and processes for product quality improvement purposes. It is imperative that the manufacturing line supervisors and managers have a clear understanding of their responsibility for adherence to specification requirements and work instructions. However, a situation was found where a special "consent to move" procedure was necessary and subsequently established to prevent material and structures from proceeding to the next higher assembly before completion. The move consent is given by QC; their decision time limit is 24 hours. Seldom do they require more than 24 hours to make the necessary decisions. But in the team's opinion this 24 hours is a production delay that would not be necessary if each of the two directorates carried out its individual and combined obligations in an effective manner.

PLANNING AND SCHEDULING

At the start of the audit, the Operations Planning Control Department of the Operations Directorate was responsible for the preparation of production schedules, planning, manpower planning, and the preparation of all work packages required for issuance to the production department. In addition to this organization each program manager had a planning and scheduling organization within his program office responsible for the preparation of production schedules. The program office was expected to control the scheduling effort in operations planning and control. In addition, schedules were also prepared by production control for the use of production controllers to progress subassemblies, assemblies, and modules and controlling the work for which each was responsible.

In most instances the various schedules in existence in the shipyard for the same program were not synchronized with each other, and at the time of the production audit most were out of date. It was extremely difficult for the production audit team to relate the work in process to schedules which were in force.

In an effort to alleviate this problem, a master scheduling organization reporting to the general manager was established during the course of the audit. Subsequently, the organization was placed under the vice-president for program management who was also appointed during the course of the audit.

The Master Scheduling Organization includes the director, located in Culver City, Calif., with deputy directors located in Mississippi and Culver City. The organization will ultimately be responsible for all formal scheduling activities within Litton Ship Systems, and will be located in Mississippi.

The above organization is still in its infancy and has not been fully implemented, but will develop, publish, and maintain all formal schedules utilized in-house by the shipbuilder; and will prepare for the program manager's approval all contractual schedules for the customer. The Master Scheduling Organization is responsible to the program and functional managers for providing required support and to the vice-president for program management for the composite scheduling function.

Prior to completion of the production audit, the deputy director of master scheduling at Mississippi was transferred to another directorate.

This organization had not yet become fully operational or effective at the time of completion of the post audit review on 28 April 1972.

In an effort to solve the scheduling problems with which the company is faced, a new ship scheduling effort was initiated in November 1971, prior to the time of the beginning of the production audit. This effort was known as First Article Master Scheduling Committee or FAMSCO. This was an effort to finalize all scheduling effort relating to the delivery of the lead ship, and to obtain the concurrence of the various directorates as to their ability to meet the needs of this scheduling.

The directorates involved were Operations, Engineering, Material Procurement, and the Project Manager office. The initial effort was for the LHA Program, and the FAMSCO for LHA was completed in February 1972. The LHA

schedule developed by FAMSCO was out of date and not feasible when completed. The FAMSCO effort for DD 963 Program was started in February 1972 in Culver City, Calif. and transferred to Mississippi in April 1972. The initial FAMSCO effort for DD was also not feasible and a FAMSCO to a revised schedule was being prosecuted at the time of a post audit review in April 1972.

At the time of the post audit review, revised Farrell schedules and revised LHA schedules were also being developed and an attempt was being made to coordinate these schedules with each other to balance the shipyard workload. At no time during the audit was manpower planning and production scheduling synchronized, and the manpoyer planning that had taken place could not support the production schedules which had been developed.

The shipyard, at the time of completion of the post audit review on April 28, 1972, was revising all of its manpower scheduling in an effort to relate it to the production schedules which were then being developed. This effort has not yet been completed and is being monitored and reviewed by the production audit team and will be evaluated after completion.

PRODUCTION CONTROL

Production Control is made up of four (4) Production Control Departments which are in the Manufacturing Services Directorate. These departments are: a) Production Control Planning, b) Production Control Ship Fabrication, c) Production Control Ship Manufacturing and d) Production Control Ship Completion. Each department reports, via the overall manager of Production Control, to the director of Manufacturing Services whose directorate includes the Transportation Department, the Heavy Lift and Rigging Department, and Paint and Cleaning Department and the Welding Services Department.

The Production Control Planning Department develops short, medium and long range plans for providing production control support to manufacturing activities; developing and implementing procedural requirements for total production control operations; reviewing, evaluating and supporting the development of master ship program schedules; providing production control interface and liaison with other directorate organizations.

The Production Control Planning Department is subdivided into two (2) functionally oriented sections, which are:

(*a*) The Project and Status Control Section, whose promary function is to insure that all requirements associated with the reporting of work status is invoked.

(*b*) The Production Control Planning Section, whose primary function is to establish baselines for all production control activities.

The Production Control Ship Fabrication Department is responsibile for providing production control support for productive work activities assigned to the fabrication, panel, shell assembly, electrical, machine, pipe, sheetmetal, machinery assembly and boiler erection shops. In addition, this department is responsible for marshalling, staging, kitting and routing of shop-manufactured items.

The Production Control Ship Fabrication Department is subdivided into three (3) sections which are:

(*a*) The Fabrication Complex Section, whose functions are aligned to the processing of work accomplished within the fabrication, panel and shell assembly shops as well as the work assigned to the platen area located along the southeast site of the panel shop.

(*b*) The Combined Shop Section, whose functions are aligned to the processing of work accomplished within the electric, sheetmetal, pipe, machine, machinery assembly and boiler erection shops.

(*c*) The Fabrication Parts, Kitting and Expediting Section, whose primary functions are kitting, staging and expediting parts and material.

The Production Control Ship Manufacturing Department is responsible for providing production control support for productive work activities involving the subassembly of major elements of the total ship configurations; the assembly of subassemblies, machinery, electrical, piping, sheetmetal, joiner, electronics and general outfitting items into ship modules; the integration of modules to form the total ship configuration including completion of hull and extension of systems; the testing (preliminary) of systems, subsystems and units of structure.

The Production Control Ship Manufacturing Department is subdivided into two (2) sections, which are:

(*a*) The Ship Subassembly Area Section, whose functions are aligned to the processing of work accomplished within bays 1 through 5 of the ship subassembly area.

b. The Ship Module Assembly and Integration Section, whose functions are aligned to the processing of work accomplished within bays 1 through 5 of the ship module assembly area and also that work accomplished within the ship integration area.

The Production Control Ship Completion Department is responsible for providing production control support for productive work activities associated with the final outfitting of ships; the tests and trials scheduled before ship deliveries; the provisioning of ships to the extent outlined within specific ship program requirements.

Since there was only one ship (Farrell 1) in the wet dock at the time of the audit, the Production Control Ship Completion Department was concentrating all efforts on this ship. However, as the number of ships in the wet dock area increases, this department will be subdivided into separate ship completion sections to carry out all production control functions for each ship located in the ship completion wharf areas undergoing nal outfitting, test and trials.

COST REPORTING

Litton Ship Systems (LSS) has about 29 different Management Information System (MIS) cost system reports presenting many combinations of cost returns on a daily, weekly, monthly, or annual report basis. These reports appeared to be adequate. However, the system did not satisfactorily collect return costs, such as expended man hours, to permit adequate planning and control by top management. Also, there were no readily available summary reports showing planned expenditures against actual expenditures by departments or systems broken down into the detail necessary for management control of the overall operation. LSS recognized these problems and was in the process of revising its cost reporting systems to satisfy the needs of top management. Some changes had been completed at the time of the post audit review in April, with all changes scheduled for completion by August 1972. The contemplated changes appeared to satisfy the needs of management for planning and controlling the operations of the company.

Overall shipyard manpower

The manpower required by Litton Ship Systems is broken into three basic categories. They are direct hard task, direct soft task, and indirect labor.

Direct hard task labor is made up of actual production workers engaged in the manufacture, fabrication and erection of the ship and is composed of the various skills and trades required for shipbuilding.

Direct soft task labor is composed of labor which is directly charged to the contract but which is not directly engaged in the actual fabrication of the ship. Included in this category are program office personnel, operations planning and production control personnel, quality assurance personnel and several other similar categories.

The indirect labor force is made up of management, supervision, contract administration, and other personnel performing functions which cannot be directly charged to the end product, but are required for the operation of the company.

The company has apparently not experienced any difficulty in obtaining either indirect or direct soft task personnel. The major concern is the company's ability to obtain sufficient numbers and types of hard task labor to satisfy the requirements of the production schedules. The company reported that, as of 15 October 1971, there were 2,701 hard task employees onboard: as of 1/30/72 there were 4,131 onboard and as of 3/26/72 there were 4,658 onboard. This represented an increase of 1.357 hard task employees over this 5½ month period for an average increase of 247 per month. Absenteeism has been averaging approximately 20%, and on occasion has been considerably higher.

It is estimated that the shipyard will require a hard task work force of approximately 12,500 people by mid 1974 to meet production schedules and to deliver the LHAs and DDs on their current planned delivery dates. This required workforce is without absenteeism and does not consider the use of overtime. If

the shipyard absentee rate continues to run at 20%, an additional 2,500 employees could be required to satisfy the shipyard workload needs. However, with the judicious use of overtime, the required increase could be reduced by about 1,250 hard task employees. In order to achieve the required manpower level, it will be necessary for the shipyard to average an approximate 375 hard task workforce monthly increase between now and 1974. The company felt that a 313 man monthly increase was necessary. The company's planning was based on actual manpower requirements without considering absenteeism.

The attrition rate at the shipyard has been running abnormally high. For example, during the three month period, October-December 1971, there were 2,233 hires and 1,318 severances for a net increase of 915.

The ratio of skilled to unskilled workmen in the shipyard was approximately 1:1. In order to operate efficiently, the skill level should be at least 3:1.

It was not possible for the team to conduct a complete analysis of hiring, attrition, absenteeism and overtime trends because of the sketchy information provided by the Industrial Relations Directorate in the shipyard. Very little information seemed to exist for the period prior to 1 October 1971, and much of the data that did exist was not in usable form.

During the course of the audit, there were a number of transfers from the Ingalls Nuclear Shipbuilding Division to Litton Ship Systems primarily in the structural trades. The INS Division workload begins to fall off in September 1972, and the production audit team was advised that, as this INS workload dropped the workforce thus made available would be transferred to Litton Ship Systems and would provide a nucleus of approximately 2,600 additional skilled workers by the end of 1972.

This INS workforce will satisfy the Litton Ship Systems Division's short term workforce requirements and tend to moderate the shipyard's personnel problems. It may also be possible to transfer additional people from INS to LSS by the peak workload period in mid 1974, depending on the extent of additional work obtained by the INS shipyard. However, it was the conclusion of the production audit team, pending the completion of the Litton scheduling effort, that obtaining the necessary workforce in the time required will be a major problem.

Labor relations

The shipyard workforce is represented by the Metal Trades Department, AFL–CIO, Pascagoula Metal Trades Council, and the International Brotherhood of Electrical Workers, Local No. 733.

The shipyard suffered a major strike starting in late August 1971. An interim agreement was reached in late September 1971, and production was resumed in early October 1971. A new labor agreement was negotiated with the unions and became effective in November 1971, and runs to November 17, 1974.

In February 1972, discussions with the labor relations advisor of Litton Ship Systems and with the President of the Pascagoula Metal Trades Council indicated that both the company and union considered the labor agreements satisfactory and that the labor/management relationships were harmonious, with only minor problems. In fact, at that time, the union felt that the most serious problem facing the work force was the lack of adequate paved parking facilities, which the company was working diligently to provide and had provided by the time of the post audit review.

Training

The majority of the formal training conducted by Litton Ship Systems (LSS) is through the "Jobs 70" program which is funded by the federal Government and administered by a Mississippi state operated training system. For FY 1972, the total training budget is $2.300,400, primarily in federal funds. As of 1 February 72, LSS had training contracts for 270 shipfitters, 80 outside machinists, 80 sheetmetal workers and 80 pipefitters.

The first 7 weeks of this 25–27 weeks training program is devoted to "vestibule training" which is conducted in the classroom. The remaining 18–20 weeks training is conducted through half day each day in the classroom and half day on the job training (OJT). At completion of the "Jobs 70" training the graduates are assigned to the 2nd step of a 6,000 hour (3 year) journeymen training program. This is really a continuation of OJT on a full time basis. The "Jobs 70" program is too young to evaluate its results in terms of proficiency of the graduates, however, records show a rate of retention of more than 65%. This means

that about 35% of the people who enroll do not finish the 25–27 weeks of training.

LSS provides no on-the-job or off-the-job training during regular tours of duty for career development purposes for employees below or at the managerial level.

The team was unable to conduct an in-depth review of the total training program due to the limited amount of time available. However, it did conclude that based on available records, classroom visits and observing the trainees and and journeymen working in the yard that the training program is not adequate to support current production schedules.

COMMUNITY IMPACT

The Litton Shipyard is located in the City of Pascagoula in Jackson County, Mississippi. The shipbuilding business is not new to the city. The Ingalls Nuclear Shipbuilding Division (INS) has been located there since the 1930's.

Pascagoula is a small urban area which is largely dependent on manufacturing and other kinds of commercial enterprises. Pascagoula has experienced a substantial population growth over the past twenty years. The 1950, 1960, and 1970 population figures were 10,805, 17,155, and 27,264, respectively. The rate of population growth within the city's corporate limits is likely to slow down due to the constraint of land available for residences. In a recent study for the City's Planning Commission and sponsored by the Department of Housing and Urban Development, it was noted that only approximately 20,000 additional persons could be accommodated within the city by 1990. Considerable attention must be directed at the availability and needs for social infrastructure.

The Pascagoula Planning Area covers the current corporate limits of the city and the city's Municipal School District when extends into the rural county. The current population of this Planning Area is slightly over 30,000.

Population projections for this area range from about 60,000 to 80,000 persons by 1990. There is an urgent need for rezoning to permit more multi-family dwellings and a possible immediate requirement for annexation of the School District.

While housing in the city is a major problem area, there are other problems which require attention to sustain the needs of the new shipyard and the introduction of other firms in the area. One is the school system. The current percent of population under 19 years of age in the city is slightly over 42%, and the percent from 20–44 years of age is almost 35%. On a national basis, about 38% of the population is under 19, and about 32% are between the ages 20 and 44. People moving into the area are young and this has an important influence on the current and future needs of the school system, since the young population will contribute to large rates of natural growth in population. Similar observations may be made with respect to the needs for a health care delivery system and other social and cultural requirements including public transportation and recreation.

Exhibit 32 reflects data which was received from Litton Ship Systems (LSS), and provides some specific information concerning the availability of community resources. It should be noted that the "community" referred to in this illustration includes an area larger than the City of Pascagoula, and even this larger area could not accommodate the needed in migration of population for the new yard. This assumes that in-migration is necessary to provide the needed additional work force in the new yard, i.e., individuals needed over and above current work force levels in the two shipyards and other establishments. Of course, the problem is of less magnitude to the degree the work force requirements in the new yard are satisfied by a redistribution of the current labor force in the area.

The assessment of community impact cannot be restricted to the City of Pascagoula. Obviously the labor market area for the shipyard goes beyond the city limits. In fact, if determined by the possible commuting area, it includes all of Jackson County, almost all of Harrison County, and significant portions of Stone County, George County, and Mobile County. Mobile County is in Alabama and the remaining counties are in the state of Mississippi. Selected data for these counties appear in Exhibit 33 from which it is clear that there are considerable variations among these counties with respect to size and structure.

It should be noted that equivalent data from the recent 1970 Census are not yet available. However, while the data portrayed are out of date, they are instructive as indicators. For example, Jackson County in 1960 had important indi-

cators to suggest growth which did, in fact, occur. In 1970 the County had a population of approximately 90,000 persons.

Relating to Exhibit 33, Jackson County, which includes the City of Pascagoula, has been experiencing considerable inmigration which by itself is an excellent factor for economic growth. Forty-one percent of the labor force was in manufacturing and the median family income, while less than that for the nation as a whole, was not markedly low. The level of education, as measured by median school years for population over 25 years of age, is fairly good. Relative to its nearby counties, it seems to have about the highest potential for economic growth and could approximately be considered as a growth center. Similar to the City of Pascagoula, there is some question as to whether the county has the necessary social infrastructure to accommodate the apparent economic growth.

Stone and George Counties are rural areas with very small population sizes. Based particularly on the apparent significant out-migration of population from these counties and their very low family income levels, these may properly be considered as depressed areas. Depending on Federal, state and local government policies, the population in these counties may be viewed as an important source for the shipyard's labor force provided, of course, that appropriate incentives and training programs are supplied.

Harrison County would appear to be an excellent source for labor supply. It is a county with relatively low manufacturing employment but does include large proportions of labor in commercial and clerical (including government) occupations; also the level of education is quite high. Mobile County in Alabama provides another excellent source of supply, particularly in the Mobile metropolitan area. However, in terms of some major local problems, employment of residents from Mobile would not have the same impact on the state of Mississippi.

In conclusion, the new shipyard was placed in an economically viable area and this location could have very desirable social and economic benefits for the entire labor market area. However, there appears to be some significant obstacles in attaining these goals due to deficiencies in infrastructure. There does not appear to be any particularly designed package of government programs to overcome these obstacles, at least in the near future. This would include programs for investment in social and human capital in addition to economic capital.

Of more particular consequence, it is difficult to ascertain that, in fact, the necessary size and structure of the shipyard labor force can be accommodated in any immediate period.

The current total employment in the new yard is approximately 8,400. To complete the current backlog of work a work force of approximately 18,000–20,000 will be required in 1974. As indicated earlier, if the necessary increment is to be supplied largely by in-migration to the area, there are severe constraints present, particularly in terms of social capital. To the extent the increment is to be supplied by a redistribution of current labor force in the area, such as the diversion of labor from INS to LSS, the constraint is relaxed.

MARAD/Farrell Program

GENERAL

The MARAD/Farrell/APL Program was initiated under the contract entered into as of October 3, 1968, among the United States of America, Farrell Lines, Incorporated, American President Lines, Ltd., and Litton Systems, Incorporated for the construction of seven single screw container and unitized cargo ships, MA designs C6–S–85a and C6–S–85b. An additional ship was included in the contract for APL by an addendum entered into as of February 2, 1970.

These ships are approximately 18,700 gross tons, 668 feet 6 inches in length overall, having a 90 ft. beam and 29 ft. draft. Contract delivery dates were as follows:

Farrell 1, 12/22/70; Farrell 2, 3/22/71; Farrell 3, 6/20/71; and Farrell 4, 9/3/71.

APL 1, 11/17/71; APL 2, 1/31/72; APL 3, 4/15/72; and APL 4, 11/1/72.

On April 16, 1971, Maritime Administration, Office of Ship Construction, at Litton Ship Systems request, approved the transfer for construction of the four APL ships to Ingalls Nuclear Shipbuilding Division. This decision by Litton was primarily due to the numerous start-up problems encountered by the new shipyard.

The delivery schedules for the four Farrell ships at the time of the joint Navy/MARAD audit starting on December 6–10, 1971 and continuing on January 31, 1972 through February 18, 1972 were as follows:

1st ship, 7/15/72; 2nd ship, 9/15/72; 3rd ship, 11/15/72; and 4th ship, 2/15/73.

These revised dates represented delays from the contract delivery date of 19 months, 18 months, 17 months, and 17 months for the Farrell's one to four respectively.

At the time of the production audit, engineering was essentially complete and there were no significant outstanding engineering problems. All material had been procured and was available, and there were no major problems which would impact the scheduled ship delivery dates.

A post audit review of the Farrell program was conducted during the period 24–28 April 1972. The narrative which follows for each of the ships describes their status at the time of the production audit in February with updates, as appropriate, based on the post audit review.

A summary of the anticipated delivery schedules for the four Farrells will follow the narratives of the individual ships.

FARRELL 1

Status of Ship Construction

The Farrell 1 contract delivery date was 12/22/70. The February review of the production status of Farrell 1 found an internal shipyard schedules geared to a 5/13/72 delivery date, with a promised ship delivery date of 7/15/72. The ship was launched on 6/26/71 and was being outfitted at the wet dock in the 900 area. In April 1972, revised internal shipyard schedules had been issued reflecting the 7/15/72 delivery date, and the shipyard was working to this same date.

Hull Status

The hull was completely erected. However, due to numerous discrepancies that occurred in the assembly and erection of the ship prior to launch, major structural rework was required. Considerable structural work remained to be done in April, and was controlling for ship delivery.

Ventilation

The installation of ventilation work appeared to be satisfactory. However, there were definite areas where the depth of ducts have reduced available deck heights and where the ventilation ducts will have to be altered in order to avoid interferences. This was very noticeable in the superstructure areas and the No. 9 cargo holds. In addition, there were interferences resulting from a lack of coordination between the piping, electrical and ventilation installations in the superstructure. As a result of these interferences, rip-out or modification of some of the already installed ventilation duct work will be required. Reconstructed flat, rectangular duct in lieu of the more square type presently installed will be required to alleviate the deck height problem. The amount of ventilation work completed in mid-February was considered inadequate to support either a 5/13/72 or a 7/15/72 delivery date. The ventilation installation was considerably advanced in April 1972, and, barring unforeseen problems, could support a 7/15/72 ship delivery (1936 linear feet of ventilation ducting remained to be installed as of 24 April 1972).

Joiner work in superstructure

Joiner work was subcontracted to Jamestown Metals and was in the start-up stage at the time of the audit. Furring strips had been installed in many areas of the superstructure and the subcontractor was in the process of structurally aligning bulkheads. However, due to interferences in the overhead areas, as well as distortion of decks, considerable rework will be required for satisfactory installation of joiner bulkheads.

Airports and windows

The headers that are required around the windows at the forward end of the superstructure were being installed in the ship during the audit period. These headers should have been installed during the sub-assembly of the superstructure. Some of the airports and windows had been installed; however, they were misaligned and, therefore, required removal and rework. By April 1972 the airports and windows installations had progressed satisfactorily.

Foundations

Many of the foundations supporting the main engines and main auxiliaries were improperly installed and required an excessive amount of rework due

to discontinuity in alignment of structural members. The foundations were not installed in line with the main support members below. In addition, many of these foundations were installed on decks which had not been faired. The majority of the above foundation problems had been corrected at the time of the April review.

Cargo Reefer Insulation

According to the major events schedule based on the 5/13/72 ship delivery, completion of the cargo reefer holds were scheduled for 1/24/72 by the subcontractor, Eastern Cold Storage. However, these cargo holds (Nos. 5, 6 and 7) were not released to Eastern Cold Storage until several weeks after the scheduled completion date. Consequently, the subcontractor was just beginning the insulation work during the February phase of the audit. There was considerable rework in these cargo holds such as pick-up welding, realignment of transverse bulkheads, and cleaning of the steel which had only a thin coat of primer and had become oxidized due to the length of time it had been exposed to the elements. After turnover of these cargo holds to the subcontractor it takes approximately 60 to 70 days for their completion, thus completion of the cargo holds could not support the 5/13/72 ship delivery target and was extremely tight for the promised ship delivery date of 7/15/72.

Because of extensive structural rework required in the cargo holds, and because of a fire in one of the cargo holds which caused considerable damage to already installed insulation, the reefer installation was seriously lagging at the time of the April 1972 review, and is one of the main items controlling ship delivery.

Machinery status

In February, the audit team estimated that the machinery installation was approximately 75% complete. Boiler work was nearly complete, and boiler cookout was scheduled for 9 May 1972. It actually occurred in early March. Number 1 reduction gear was chocked and bolted down with fitted bolts. Number 2 reduction gear was chocked and bolted down with temporary bolts; permanent bolts were being fitted. Number 1 and 2 reduction gear couplings were made up. The LP turbine chocks were in and bolt holes were being aligned. Chocks were being fitted under the HP turbine. The main thrust bearing chocks were complete and bolts were being fitted. All main shaft couplings were made up. The ship service air compressor installation was complete. The starboard steering gear machinery was completely installed and the port side installation was well along.

The turbine generator was installed, the turbine flushing had to be done, and pipe to the turbine was not complete. The refrigeration machinery was installed, but electric hookup and piping was not complete.

The machinery installation was approximately 92% complete at the time of the post audit review in April and could support 7/15/72 ship delivery.

Piping system status

A great deal of pipe had been installed, throughout the ship, but no piping systems were complete in February 1972. There was essentially no piping in the superstructure in February. The overall piping installed was estimated at approximately 65% complete in February. Piping systems were about 90% complete in April although most of the piping systems remained to be tested. Approximately 11,000 feet of a total of 106,000 feet of piping remained to be installed.

Electric system status

The electrical installations were approximately 60% completed in February. The turbine generator had not been hooked up electrically. The main ship service switchboard was completed, and shore power was applied. The status of main run cable in February was as follows:

[Note.—All main run cables for Farrell 1 had been cut]

Total footage of main run cables	200,000
Total footage of main run cables pulled less footage coiled on ends	173,802
Total footage of main run cables coiled	6,500
Percentage of main run cables aboard ship	87
Percentage of main run cable aboard ship less cables which are coiled	84

Many cables were coiled throughout the ship waiting to be cut in and hooked up. The main propulsion control console had not been completely wired although some testing was in progress. Approximately 30,000 feet of a total 165,000 feet of local cable had been pulled in mid-February. Reported hookup of all electrical cable was 54%.

In April, approximately 12,000 of the 200,000 feet of main cable and 32,000 feet of the 165,000 feet of local cable remained to be pulled. Hookup was approximately 80% complete and testing was approximately 22% complete. There appeared to be some significant re-work required in the cabling area. The main propulsion control console was still being tested. Because of the work remaning, completion of the electrical installation is also controlling ship delivery.

Labor progress

The contractor's labor progress, including engineering, submitted to MARAD and the owner as of the end of January 1972 was 79.7%. The production audit team had independently progressed the ship on the basis of factors developed from Ingalls Nuclear Shipbuilding Division, East Bank, estimates of work involved in the various systems for the APL ships. Using these developed factors, the production audit team estimated that the ship was approvimately 74.5% complete, not including engineering. This figure was revised downward by 2% to reflect the re-work required to already completed work.

The audit team developed a probable labor progress curve based on the analysis of construction rates attained on approximately 35 merchant type ships. Based on the estimated 72.5% labor progress attained on this ship in February and an analysis of the probable labor progress curve, it was estimated that the Farrell 1 could not deliver before 15 September 1972.

The audit team progressed this ship again in April and estimated that Farrell 1 was approximately 82% complete at that time. Although the shipbuilder attained approximately 10% labor progress in the 2½ month period between the production audit and post audit review, it still appeared to the team that delivery of the ship could not occur before early to mid-September, unless the ship was inordinately named to the detriment of the follow ships in the yard coupled with a concomitant degradation in productivity on Farrell 1.

Status compared to schedules:

A. Design status-shipyard drawings

Status of drawings as of 1–31–72 was as follows:

Total number of drawings required	618
Number of drawings scheduled to be submitted for approval	613
Number of drawings submitted for approval	613
Number of drawings scheduled to be issued to product engineering	597
Number of drawings issued to product engineering and the yard	597

Status of drawings on 3–31–72 was the same as reported above.

B. Hull and machinery erection schedules

At the time of the audit the hull was fully erected. Forty-six of the forty-eight machinery assemblies required and scheduled to land on ship had been landed. Eighteen machinery assemblies had been installed.

C. Major events schedule

At the time of the audit all schedules for Farrell 1 were either outdated or completely unrealistic. The schedules all reflected a delivery completion date of May 13, 1972. All of the key milestones were missed or in jeopardy. During the early part of the audit MARAD and the Farrell Lines were advised by the company that the ship would not be delivered until July 15, 1972. In February, during the third week of the audit, the company produced a new major events schedule reflecting the July 15, 1972 delivery date. The schedule covering Farrell 1 listed 36 vents remaining to be completed before delivery.

A full comparison of the new major events schedule is not possible since the new schedule did not follow the same format as the earlier key events schedule dated 1–4–72. Another revised schedule for Farrell 1 was provided the audit team during the post audit review in April. The following is a comparison of those events that were common to all three schedules.

Major event description	Scheduled date based on schedule issued (1972)		
	January 4	February 10	April
Standby diesel lube oil flush	Feb. 9	May 19	Mar. 7.[1]
Operate standby diesel	Feb. 16	May 22	Do.[1]
Main engine lube oil system flush	Do	May 1	Apr. 21.
Start SSTG test	Do	June 7	May 5
Main engine 1st run	Mar. 8	Do	May 19.
Dock trials	Mar. 22	June 12	Do.
Complete testing of navigation equipment	Mar. 20	July 7	May 26.
Complete testing hatch covers	Mar. 25	June 9	June 2
Inclining experiment	Mar. 26	June 13	June 7
Builder's sea trials	Apr. 4	June 15	Do.
Dry docking	Apr. 6	June 19	June 11.
Official sea trials	Apr. 25	June 30	July 6.
Delivery	May 13	July 15	July 15.

[1] Actual date.

D. Material Ordering Schedule

As of January 31, 1972, all major vendor furnished material was either delivered or on schedule. No problems were apparent on material receipts.

E. Status of Work Packages

All of the 15,934 work packages scheduled for release to production as of 2–4–72 were released. 11,743 of 14,660 work packages scheduled to be completed had been completed on 2–4–72.

As of 4–16–72 16,351 work packages had been released to production and 12,994 work packages had been completed. Data relative to work packages scheduled for release and completion was not available.

F. Compartment Completion Schedule

The compartment completion schedule issued January 1972 for Farrell 1 was based on the 5/13/72 ship delivery date which existed at the beginning of the audit. When the revised major events schedule issued in February reflected a 7/15/72 ship delivery, this compartment completion schedule became obsolete. A new schedule was being prepared and was made available to the audit team subsequent to the February audit.

Reported status of compartmenet completions was as follows:

	Feb. 4, 1972	Apr. 16, 1972
Total number of compartments	388	390
Number of compartments scheduled for completion	15	158
Number of compartments completed	29	39

G. Test Schedule and Inspection

The test schedule issued December 1971 for Farrell 1 was geared to a 5–13–72 ship delivery date. When the revised major events schedule referenced a 7/15/72 ship delivery date, the previous test schedule was no longer valid. A new test schedule was prepared. Reported status of tests and inspection at the time of the audit and the April review was as follows:

	Feb. 4, 1972	Apr. 16, 1972
Number of test items required	826	826
Number of test items scheduled	122	554
Number of test items complete	105	460

The ability of the shipyard to complete the remaining tests will ultimately determine the delivery date of the ship.

Manning

Litton provided the audit team a FY 72–3 projected manning plan which included a contingency reserve for completing Farrell 1 by 7–15–72. A revised manning plan was provided the audit team in April. The revised plan was based on

manpower expenditures through March 1972. Neither plan was considered adequate by the audit team to permit delivery of the ship by 7–15–72. If the ship is to meet the 7–15–72 delivery date, manning will have to be significantly increased over that now planned. Available planned and actual manning for hard task labor from August 1971 to the scheduled ship delivery follows:

Month	Projected manning plan— February 1972	Projected manning plan— April 1972	Actual
August 1971			759
September			[1] 53
October			591
November			907
December			1,107
January 1972			1,034
February	588		1,043
March	588		1,128
April	580	950	
May	300	750	
June	300	600	
July	300	297	

[1] Shipbuilder experienced a work stoppage in September 1971.

Quality of work in process

At the time of the audit, the general appearance of the hull, decks, superstructure, container cargo holds, etc., revealed a definite pattern of inferior quality workmanship. There was incorrect alignment and discontinuity with regard to waterline, frame lines, buttock lines and molded lines which necessitated areas having to be cut loose, realigned and rewelded. The disregard of established and/or lack of welding procedures had caused extreme distortion in decks and bulkheads. The fabrication and erection of assemblies and installation of equipment in the pre-outfitting period without regard to dimensional control also caused distortion. These, and the omission of certain vital structural members prior to launch have compounded the contractor's problems. These improper procedures have necessitated thousands of hours of costly rework and caused considerable delay in ship delivery.

At the time of the post audit review in April, many of the deficiencies observed in February had been corrected, but many still remained to be corrected.

The status of ship construction compared to scheduled ship delivery date

At the time of the production audit in February, all production schedules for Farrell 1 were geared to a 5–13–72 delivery date. The shipyard was behind all schedules and had no current schedules to which they were working. The shipyard had advised the owners that the ship would probably be delivered on 7–15–72. Revised schedules to this delivery date were in the process of being developed.

At the time of the post audit review in April, the shipbuilder was working to revised schedules geared to the 7–15–72 delivery date, but was already behind these schedules. The shipbuilder's labor progress in mid-February was estimated to be 72.5%, about two months behind schedule for meeting the 7–15–72 delivery.

In April, it was estimated that labor progress was 82% and about 1½ months behind the schedule necessary for meeting the 7–15–72 delivery. The schedule which the shipbuilder was working to was not considered feasible without significantly increased manning. This manning would have to come from other ships in the yard with a resultant delaying effect on these follow ships.

Although a 7–15–72 delivery is conceivably possible, the audit team considers it very unlikely and estimates that the ship will deliver during the first two weeks in September. Unless the current manning level is sustained the ship could slip beyond the audit team's estimated delivery.

FARRELL 2

Status of ship construction

The Farrell 2 contract delivery date was 3/22/71. The February review of the production status of Farrell 2 found the shipyard geared to a schedule based upon ship delivery on 9/15/72. The ship was scheduled for launch on 6/1/72. In April 1972, the shipyard was still working to the 9/15/72 delivery date. The

current scheduled launch date was 6/10/72, but the shipbuilder was targeting to a 6/3/72 launch.

Hull status

Modules 2 and 3 were in the process of being welded together and module 1 had been moved into the integration area for joining with module 2. However, all scheduled assemblies were not erected in module 1 when it was moved to the integration area on 2/5/72. The superstructure had been assembled and was moved into the integration area for erection on the ship. The superstructure was landed in March. In April, all but one of the 181 hull assemblies had been erected.

Machinery status

In February, the audit team estimated that the machinery installation was approximately 25% complete. The main propulsion turbine and gears were on board, but were not bolted down. The boilers had been erected and placed on board and the main condenser had been installed. The main thrust bearings and shaft steady bearing were aboard but not installed. There was no shafting on board. The steering gear hydraulic unit was sitting in place, but the holes had not been reamed nor the bolts fitted. Refrigeration machinery and air compressor machinery were installed and piping for these systems was being worked on. Most of the major pumps had been installed. In April, the machinery installation was approximately 30% complete.

Piping system status

In February 1972, the piping system installation was approximately 40% complete. Approximately 42,000 feet of a total 106,000 feet of piping had been installed. In April Litton reported 47,609 feet of piping had been installed, which equated to 44.9% completion of the piping system.

Electrical system status

The electrical system installation was approximately 10% complete in February. The ship service turbine generator and the emergency diesel generator were aboard, but had not been placed on their foundations. No cables for the equipment had been installed. The main ships service switchboard was in place, but not secured to its foundation and no cables had been attached. The Group Control switchboards were at their location, but had not been placed on foundations. The refrigeration control console was also on board, but not on its foundation. The main engine control console was not yet on board.

Reported status of electrical cable, wireways and collars in February and April was as follows:

	Feb. 11, 1972	Apr. 23, 1972
Total footage of local cable	165,000	165,000
Local cable pulled		24,500
Total footage of main cable	200,000	200,000
Main cable pulled		
Total footage of main wireways	4,416	4,416
Footage of main wireways installed	3,472	4,183
Total number of collars	355	355
Number of collars installed	262	334

Electrical installation was approximately 16% complete in April 1972.

Ventilation installation status

In February, 3,743 feet of a total of 15,419 feet of ventilation duct had been installed and the system was approximately 24% complete.

In April, 4,805 feet of ventilation duct had been installed and the system was approximately 30% complete.

Labor progress

The contractor's labor progress, including engineering, submitted to MARAD and the Owner as of the end of January 1972, was 54.9%.

The production audit team independently progressed the ship on the basis of factors developed from INS estimates of work involved in the various systems for the APL ships. Using these factors, the production audit team estimated that the ship was approximately 48% complete, not including engineering. Using the audit team's merchant ship labor progress curve and the estimated 48% progress

attained on this ship in February, it was estimated that Farrell 2 could not deliver before mid-December 1972.

The Audit Team progress Farrell 2 again in April and estimated that it was approximately 55% complete at that time. The shipbuilder had attained an estimated seven percent labor progress since February, but the Audit Team was still of the opinion that delivery of the ship could not occur prior to mid-December 1972 without disrupting production on other ships in the yard, and that the ship could deliver as late as early February 1973 depending on the productivity obtained throughout the remainder of construction.

STATUS COMPARED TO SCHEDULES

A. Design

Status of design drawings for the Farrell Program has been reported under Farrell 1.

B. Hull erection

There are a total of 181 hull assemblies on the Farrell ships. At the time of the February review fabrication of all material for Farrell 2 had been completed, and 158 of 165 scheduled sub-assemblies were completed. All sub-assemblies had been completed for Farrell 2 by April 1972.

Status of erection in February and April was as follows:

	Feb. 4, 1972	Apr. 16, 1972
Number of assemblies required to be erected	181	181
Number of assemblies scheduled for erection	139	181
Number of assemblies erected	150	180

C. Major events schedule

The item numbers and item description of the events contained in the Farrell 2 Major Events Schedule provided to the team in April were identical to those contained in the Farrell 2 Major Events Schedule dated 2/7/72. Both schedules were geared to a 9/15/72 ship delivery date. However, the following date changes are of significance:

Item No.	Description	Feb. 7, 1972 schedule date	Actual date	April 1972 schedule date
15	Complete module 3 tank hydro	March 10, 1972		May 15, 1972.
16	Complete weldout module 1	do	April 21, 1972	
20	Complete butt tank hydro modules 2 and 3	March 24, 1972	April 14, 1972	
21	Complete butt tank hydro modules 1 and 2	March 30, 1972	April 19, 1972	
34	Tail shaft made up and secured	May 19, 1972		May 26, 1972.
39	Launch	May 27, 1972		June 10, 1972.[1]

[1] At the time of the post audit review the shipbuilder was targeting to a June 3, 1972, launch date.

With the exception of major event item Nos. 15, 16, 20 and 21, all major events scheduled for accomplishment prior to the April issuance of the Major Event Schedule actually occurred, either on or near the scheduled date. Additionally, with the exception of items 34 and 39 as noted above, all remaining major events were scheduled for accomplishment on the same dates in the April schedule as they were in the 2/7/72 schedule.

D. Material Ordering

All major vendor furnished material was either delivered or on schedule.

E. Status of Work Packages

Reported status of work packages for Farrell 2 was:

	Feb. 4, 1972	Apr. 16, 1972
Number of work packages scheduled for release to production	11,042	11,500
Number of work packages released to production	12,098	12,543
Number of work packages scheduled for completion by manufacturing	10,284	10,284
Number of work packages completed by manufacturing	7,120	7,978

F. Machinery assemblies

Status of machinery assemblies for Farrell 2 in February and April was:

	Feb. 4, 1972	Apr. 16, 1972
Number of machinery assemblies required	48	48
Number of machinery assemblies completed on ground	40	41
Number of machinery assemblies landed on ship	32	35
Number of machinery assemblies installed on ship	6	17

G. Compartment completion schedule

There are a total of 390 compartments. None were scheduled for completion at the time of the audit and none had been completed.

H. Test schedule and inspection

Reported status of tests and inspection for Farrell 2 was:

	Feb. 4, 1972	Apr. 16, 1972
Number of test items required	826	[1] 177
Number of test items scheduled	74	154
Number of test items completed	58	98

[1] Only the number of required prelaunch tests reported in April.

Manning

In February, Litton provided the team with a projected manning plan which included a contingency reserve for completing Farrell 2 by 9/15/72. A revised manning plan was provided the audit team in April. The April manning plan was based on an October 1972 ship delivery, although the company maintained that it was still committed to a 9/15/72 ship delivery. Neither plan was considered adequate by the team.

A comparison of Litton's two manning plans and actual hard task labor expenditures since August 1971 follows:

	Projected		
	February 1972 manning plan	April 1972 manning plan	Actual
1971:			
August			1,016
September			[1] 66
October			816
November			1,230
December			1,049
1972:			
January			875
February	850		716
March	952		614
April	862	936	
May	850	1,053	
June	501	1,053	
July	349	1,141	
August	[2] 245	1,112	
September	[2] 245	819	
October		415	

[1] Shipbuilder experienced a work stoppage in September 1971.
[2] 2-month average.

Quality of work in process

In comparison to the workmanship on Farrell 1, the workmanship on Farrell 2 showed considerable improvement. The pattern of poor workmanship was still evident in many areas, but not to the extent observed on Farrell 1. Although many hours of rework have been expended and many more will be required, the

number of rework hours required on Farrell 2 will not be as extensive as those required on Farrell 1. Attentiveness to proper alignment of structural members and use of proper welding procedures were some of the factors which reduced rework on Farrell 2.

FARRELL 3

Status of ship construction

The Farrell 3 contract delivery date was 6–20–71. The production audit in February 1972 found the shipyard geared to a 11–15–72 delivery date for Farrell 3. The Major Events Schedule for this ship was dated 2–11–72 and reflected a scheduled launch date of 7–29–72. A Major Events Schedule provided by Litton at the post audit review in April 1972 was also geared to an 11–15–72 delivery date and a 7–29–72 launch date.

Hull status

In February the audit team estimated the hull to be approximately 30% complete. There are a total of 181 hull assemblies required for the ship.

The steel required for 128 of the 181 hull assemblies had been fabricated. The steel for 56 assemblies was provided to subcontractors who were assembling these 56 assemblies. Thirty-six of these 56 subcontracted hull structural assemblies had been completed and were in the shipyard. A total of 58 assemblies had been structurally completed for Farrell 3. Twenty-two of the completed assemblies had been erected.

At the time of the post audit review in April 1972, the number of assemblies which had been fabricated increased to 176. Of these, 88 had been assembled and 81 had been erected. Many of the assemblies on the ground were being pre-outfitted.

Machinery status

In February the Farrell 3 boilers were erected. Of the required 48 machinery assemblies, 28 had been completed on the ground and one landed in the ship. By April 1972, 9 additional machinery assemblies had been completed on the ground and a total of four had been landed in the ship.

Piping system status

Approximately 106,000 feet of pipe are required for the ship. In February, pipe installation was reported 8% complete. In April installation of pipe was reported 15% complete.

Electric system status

A total of 165,000 feet of local cable and 200,000 feet of main cable are required for the ship. No cable had been installed in Farrell 3 at the time of the post audit review in April. This ship also has a total of 4,416 feet of main wireways and 355 collars to be installed for the electric cable. None of the wireways had been installed but 185 collars were completed in April 1972.

Ventilation installation status

A total of 15,419 feet of ventilation duct is required. Installation was 5% complete in February and 14% complete in April.

Labor progress

The contractor's labor progress, including engineering, submitted to MARAD and the owners as of the end of January 1972 was 26.1%. The Production Audit Team independently progressed the ship on the basis of factors developed from INS estimates of work involved in the various systems for the APL ships. Using these developed factors, the production audit team estimated that the ship was approximately 19% complete, not including engineering. Using the audit team's merchant ship labor progress curve and the estimated 19% progress attained on this ship in February, it was estimated that Farrell 3 would not deliver before mid-April 1973, and could deliver as late as July 1973, depending on the productivity obtained throughout the remainder of construction. The audit team considered delivery about mid-May 1973 as the most probable delivery date.

The audit team did not progress, by visual inspection, Farrell 3 during the post audit review in April. However, based on information supplied by the company, the audit team estimated the ship to be 28% complete at that time. Review of Farrell 3 data in April confirmed the audit team's assessment of the probable delivery schedule as discussed above.

Status of work packages

Status of work packages for Farrell 3 in February and April were as follows:

	Feb. 4, 1972	April 16, 1972
Work packages scheduled for release to production	11,293	12,784
Work packages released to production	7,572	7,629
Work packages scheduled to be completed by manufacturing	4,721	4,721
Work packages completed by manufacturing	2,380	3,819

Compartment completion schedule

There are a total of 390 compartments. None were scheduled for completion at the time of the audit and none had been completed.

Test and inspection schedule

As of 2/4/72, none of the 177 required pre-launch tests and inspections were scheduled to complete.

As of 4/16/72, twenty-two pre-launch tests and inspections were scheduled to complete, but none were completed.

Manning

In February, Litton provided the team with a projected manning plan which included a contingency reserve for completing Farrell 3 by 11/15/72. A revised manning plan was furnished to the audit team in April. The April manning plan was based on a January 1973 ship delivery, although the company maintained that it was still committed to a 11/15/72 ship delivery. Neither plan was considered adequate by the audit team.

A comparison of Litton's two manning plans and actual hard task labor expenditures on Farrell 3 since August 1971 follows:

	Projected manning plan—		
	February 1972	April 1972	Actual
1971:			
August			357
September			[1] 23
October			207
November			246
December			313
1972:			
January			506
February	1,359		683
March	1,007		882
April	1,100	900	
May	1,100	900	
June	1,100	923	
July	1,100	1,035	
August	[2] 270	1,118	
September	[2] 270	1,200	
October	[2] 270	1,200	
November	110	1,150	
December		750	
1973: January		367	

[1] Shipbuilder experienced a work stoppage in September 1971.
[2] 3-month average.

FARRELL 4

Status of ship construction

The Farrell 4 contract delivery date was 9/3/71. The production audit in February 1972 found the shipyard geared to a schedule based upon a 2/15/73 delivery date for Farrell 4. The Farrell 4 Major Events Schedule, dated 2/11/72, reflected a scheduled launch date of 9/30/72. The Major Events Schedule provided to the audit team by Litton in April 1972 was also geared to a 2/15/72 ship delivery and a 9/30/72 launch date.

Hull status

In February the audit team estimated the hull to be approximately 26% complete. There are a total of 181 hull assemblies required for the ship.

The steel required for 128 of the 181 hull assemblies had been fabricated. The steel for 56 assemblies was provided to subcontractors who were assembling

these 56 assemblies. Twenty-five of these 56 subcontracted hull structural assemblies had been completed and were in the shipyard. A total of 37 assemblies had been structurally completed for Farrell 4. Seven of the completed assemblies had been erected.

In April, the number of assemblies which had been fabricated had increased to 171. Of these, 59 had been assembled and 56 had been erected. Many of the assemblies on the ground were being pre-outfitted.

Machinery status

In February the Farrell 4 boilers were erected. Of 48 required machinery assemblies, 24 were completed on the ground and one was landed in the ship. By April, no additional machinery assemblies had been completed and no others had been landed in the ship.

Piping system status

Approximately 106,000 feet of pipe are required on the ship. In February, pipe installation was 4% complete. In April, installation of pipe was reported 7% complete.

Electric system status

At the time of the post audit review, 88 of the total 355 collars were completed for Farrell 4; no local cable, main cable or wireways had been installed in the ship.

Ventilation installation status

A total of 15,419 feet of ventilation duct is required. Installation had just been started in February and was 8% complete in April.

Labor progress

The contractor's labor progress, including engineering, submitted to MARAD and the owners as of the end of January 1972 was 21.9%. The production audit team independently progressed the ship on the basis of factors developed from INS estimates of work involved in the various systems for the APL ships. Using these developed factors, the production audit team estimated that the ship was approximately 15% complete, not including engineering. Using the audit team's merchant ship labor progress curve and the estimated 15% progress attained on this ship in February, it was estimated that Farrell 4 would not deliver before the end of June 1973 and could deliver as late as September 1973, depending on the productivity obtained throughout the remainder of construction. The audit team considered delivery about mid-August 1973 as the most probable delivery date.

The audit team did not progress, by visual inspection, Farrell 4 during the post audit review in April. However, based on information supplied by the company, the audit team estimated the ship to be 21% complete at that time. Review of Farrell 4 data in April confirmed the audit team's assessment of the probable delivery schedule as discussed above.

Status of work packages

Status of work packages for Farrell 4 in February and April were as follows:

	Feb. 4, 1972	Apr. 16, 1972
Work packages scheduled for release to production	11,293	12,784
Work packages released to production	7,476	7,484
Work packages scheduled to be completed by manufacturing	4,500	4,500
Work packages completed by manufacturing	2,298	3,590

Compartment completion schedule

There are a total of 390 compartments. None were scheduled for completion at the time of the audit and none had been completed.

Test and inspection schedule

Of the 177 required pre-launch tests and inspections for this ship none were scheduled for completion at the time of the audit.

Manning

In February, Litton provided the team with a projected manning plan which included a contingency reserve for completing Farrell 4 by 2/15/73. A revised manning plan was furnished to the audit team in April. The April manning plan

was based on a March 1973 ship delivery, although the company maintained that it was still committed to a 2/15/73 ship delivery. Neither manning plan was considered adequate by the audit team.

A comparison of Litton's two manning plans and actual hard task labor expenditures on Farrell 4 since August 1971 follows:

	Projected manning plan—		
	February 1972	April 1972	Actual
1971:			
August			293
September			[1] 19
October			136
November			187
December			258
1972:			
January			392
February	398		460
March	787		534
April	1,055	700	
May	1,270	750	
June	1,184	870	
July	1,308	950	
August	[2] 940	1,050	
September	[2] 940	1,050	
October	[2] 940	1,050	
November	[2] 173	947	
December	[2] 173	803	
1973:			
January	[2] 173	641	
February	NA	500	
March		300	

[1] Shipbuilder experienced a work stoppage in September 1971.
[2] 3-month average.
NA—not available.

Summary of Status of the Farrell Program

This summary is to permit a concise focus of the delivery status of the Farrell Program as the audit team has analyzed it.

At the time of the production audit in February, the contractor's planned delivery dates were as follows:

Farrell 1, 7/15/72; *Farrell 2*, 9/15/72; *Farrell 3*, 11/15/72; and *Farrell 4*, 2/15/73.

At the time of the post audit review, the official schedules provided by the company were the same as the February schedule. However, the company provided unofficial delivery schedules which they were then reviewing. These delivery dates were as follows:

Farrell 1, 7/15/72; *Farrell 2*, 10/30/72; *Farrell 3*, 1/31/73; and *Farrell 4*, 3/30/73.

The audit team estimated that, based on the status of completion of the ships, the amount of work remaining, and the time spans allowed to completion, the above schedules were not feasible. The team considered that if sufficient manpower of the right skills and proper experience were applied and scheduled in an efficient manner, Farrell 1 could be delivered by mid-July. This assumes that the entire test program for the ship can be completed with no undue problems and that the sea trials will be successful and not have to be rerun. However, the manning required to deliver Farrell 1 by 7/15/72 was such that significant production inefficiencies would result and it would further have a major impact on the yard's ability to deliver the three follow ships. In summary, because of the inability to predict either the degree or speed of improvement in the shipyard's productivity and efficiency, the audit team developed a range of probable delivery dates for each ship together with a most probable delivery date. These dates are shown as follows:

	Earliest date	Most probable date	Latest date
Farrell 1	July 15, 1972	Sept. 1, 1972	Oct. 15, 1972
Farrell 2	Dec. 15, 1972	Jan. 15, 1973	Feb. 15, 1973
Farrell 3	Apr. 14, 1973	May 15, 1973	July 15, 1973
Farrell 4	June 30, 1973	Aug. 15, 1973	Sept. 30, 1973

The most probable delivery dates shown above were based on an assumption that there would be some degree of improvement in productivity throughout the rest of this program, and that the quality of workmanship would continue to improve, thus reducing the amount of rework which would be necessary.

LHA PROGRAM

General

A multi-year contract for the construction of nine (9) amphibious assault ships (LHA) was awarded to Litton Ship Systems on 5/1/69, with only the first ship contractually funded. Construction of LHA–2 and LHA–3 was contractually authorized on 11/15/69, and LHA 4 and LHA 5 on 11/6/70. By "Memorandum of Agreement" dated 4/23/71, LHA 6 through 9 were deleted from the program and the delivery dates of LHA 1–5 were revised.

The original contract delivery dates for LHA 1 through LHA 5 follow as do the revised delivery dates contained in the "Memorandum of Agreement":

Ship	Contract delivery dates	Memorandum of agreement dates
LHA 1	Mar. 30, 1973	Apr. 1, 1974
LHA 2	June 29, 1972	July 29, 1974
LHA 3	Oct. 1, 1973	Dec. 2, 1974
LHA 4	Dec. 31, 1973	Feb. 28, 1975
LHA 5	Apr. 1, 1974	June 2, 1975

At the time of the production audit in February, the shipyard was working to the "Memorandum of Agreement" delivery dates and all LHA schedules then in use were geared to these dates.

During the course of the production audit, the company advised that new delivery dates were being developed for inclusion in the "reset proposal". The revised delivery dates that were proposed and subsequently included in the "reset proposal" submitted to the Navy on 31 March 1972 are as follows:

LHA 1, 11/15/74; LHA 2, 4/11/75; LHA 3, 8/15/75; LHA 4, 1/16/76; and LHA 5, 5/28/76.

These dates represent additional delays in delivery of the LHA 1 through LHA 5 of 7.5, 8.5, 8.5, 10.5, and 12 months respectively from the delivery dates contained in the "Memorandum of Agreement".

Engineering

Engineering responsibilities for the LHA Program are divided among Litton Ship Systems California (LSS/C), Litton Ship Systems Mississippi (LSS/M), and Data Systems Division (DSD).

Development and preparation of system and detail design drawings for the electronics installation was subcontracted to DSD. LSS/C is responsible for preparation of the design drawings and test procedures required for ship production with the exception of the electronics systems. All system design drawings were essentially completed by March 1971, however, changes continued to be made as the need arose.

Integrated Logistics Support functions are being accomplished by both LSS/C and DSD. Additionally, DSD has responsibility for acquisition or manufacture of certain selected electronics system components, and for computer programming operations at the Canoga Park Integration Center (CPIC).

LSS/M performs engineering processing services whereby the detail drawings and parts lists received from LSS/C and DSD are adapted for use by production for ship construction. These services include detail drawing scoping and the development of engineering aids. The scoping operation consists of marking up the detail drawing with planning annotations for production use. However, in order to reduce the time of the planning software cycle (receipt of drawings from LSS/C or DSD to work package release), the Contractor is now accomplishing the detail drawing scoping operation at LSS/C or DSD for all disciplines except hull. Advance Production Planning personnel of Operations Planning are located at LSS/C and DSD to provide manufacturing knowledge for scoping the detail drawings. The scoping at LSS/C and DSD is preliminary in nature and is

reviewed at LSS/M with revisions made as necessary. Additionally, LSS/M engineering has responsibility for the upkeep of all vellum drawings received from LSS/C and DSD. The contractor planned to transfer all engineering drawing functions, including assigned personnel, to LSS/M by May 1972.

The contractor's initial Engineering Drawing Index, Schedule and Report (EDI) established 12/30/70 as the target date for issuing all detail design drawings by Litton Ship Systems Calif. (LSS/C) and Data Systems Division (DSD).

In May 1970 after the contractor failed to issue any of the 360 hull drawings scheduled for issue, a revised drawing schedule was issued which eliminated the hull drawing delinquencies and set 4/30/71 for completion of all detail drawings.

The contractor was unable to meet the scheduled requirements. Only 12 of 54 scheduled drawings were issued by 31 July 1970 and by November 1970 only 120 of the 880 drawings scheduled for issue were actually issued.

In December 1970 the contractor again revised the drawing schedule; all delinquencies were eliminated and the completion date for all detail drawings was extended to 12/31/71.

In March 1971 the Contractor again submitted a revised drawing schedule. A review of this revised drawing schedule disclosed the following:

(*a*) All detail drawings (2635) were scheduled for issue during the period of March to December 1971, including the 293 detail drawings already issued.

(*b*) An average of 263 drawings were required to be issued monthly; the contractor had averaged 38 drawings a month between October 1970 and January 1971.

Of 99 drawings scheduled for issue between 1 March and 14 April the contractor was able to issue only 66 drawings: however, 29 of the 66 drawings were part of the 293 drawings issued prior to development of the revised schedule. 28 of the 33 delinquent drawings were piping system drawings. Additionally, production scheduling data received indicated that the drawing schedule was not compatible with manufacturing requirements.

In June 1971 the contractor started preparation of the first engineering/manufacturing correlation schedule.

In July 1971, 124 drawings were delinquent, most of which were piping drawings.

Based on the preliminary engineering/manufacturing correlation, the contractor recognized deficiencies and concentrated on meeting manufacturing requirements for the first six months of construction (August 71 through January 1972). Development of a new drawing schedule was delayed pending finalization of the engineering/manufacturing correlation.

In November 1971, the contractor established a First Article Master Scheduling Committee (FAMSCO) for the purpose of establishing a fully coordinated engineering/planning/manufacturing schedule. At the time FAMSCO was initiated, the contractor was approximately 3 months behind schedule on detail drawing issues.

The status of engineering at the time of the audit was:

LITTON SHIP SYSTEMS, CALIFORNIA (LSS/C)—DETAIL DRAWING STATUS (MAR. 3, 1972)

Hull	Total required	Total released	Schedule for release	Release to schedule	Delinquent
Structural	220	214	216	214	2
Arrangements	21	15	5	5	0
Outfit and furnishings	170	152	28	27	1
Foundations	204	121	178	107	71
Miscellaneous	2	2	2	2	0
Marine Engineering:					
Propulsion systems	100	77	73	66	7
Fluid systems	455	424	331	311	20
Environmental control	222	120	177	120	57
Mechanical/hull	262	170	134	110	24
Weapons systems	41	41	40	40	0
Electrical engineering:					
Control systems	248	214	18	16	2
Electrical systems	325	290	54	54	0
Electrical installation	165	151	40	40	0
Total [1]	2,435	1,991	1,296	1,112	184

[1] Includes farmout drawings but does not include 51 DSD command and control (C. & C.) drawings which are completed.

Delinquencies:

Foundations	71
Ventilation	54
Piping	47
Propulsion	7
Structural	2
Electrical	2
Outfit and furnishings	1
Total	184

LSS/C has transferred 556 vellum drawings to LSS/M.

Drawing farmount

The contractor subcontracted the preparation of 20 ventilation systems and 19 foundation drawings to Rosenblatt & Co. Eighteen foundations, 23 piping, 10 ventilation, 3 propulsion, 4 mechanical drawings and all electrical label plate booklets have been subcontracted to Ingalls Nuclear Shipbuilding.

Shock status (February 29, 1972):

Table Testing:	
No. required	66
No. conducted	46
No. submitted to Navy	21
No. approved	8
Barge Testing	
No. required	32
No. conducted	17
No. submitted to Navy	14
No. approved	3
Shock Test Extensions	
No. required	31
No. received by Litton	28
No. submitted to Navy	25
No. approved	22

Analysis	Number requested	Number submitted to Navy
Static "G"	13	11
Math model	17	11
DDAM	17	2

Foundation Design (Shock):

No. requested	2,400
No. certified	1,216

Delinquent Dynamic Design Analysis Method (DDAM) Reports:

Boiler.
Main condenser.
Reduction gears.
L.P. turbine.

Vendors have been authorized to proceed with DDAM reports prior to Math Model approval.

At the end of February 1972, 1390 drawings contained a total of 2772 reservations; 1175 of these reservations were for weight data to be added to the drawings. The contractor stated that the weights had been calculated for most drawings but had not been added to the drawings.

Development of Standard Drawings are late for production requirements. All standard drawings are planned to be completed by 1 June 1972.

Engineering changes had not been incorporated on the drawings as rapidly as necessary. Delay was affecting engineering services at LSS/M and was impacting ship manufacture. Unincorporated changes on electrical detail drawings were holding up development of local cable drawings.

Sizing errors for the ventilation system necessitated almost complete redesign of the system.

Data Systems Divisions (DSD)

Design.

All (51) Command and Control detail drawings required for ship construction are completed. Approximately 250 open ECRs are being processed.

Computer Programming

CPIC and Overall Computer Programming is slightly ahead of schedule. CPIC is 67% complete and Overall Computer Status is 54% complete.

Equipment Acquisition

DSD Build Equipment

Total No. of items	20
No. of items completed	4
Outstanding items on schedule	13
Outstanding items late	[1] 3

[1] CMCS/MPS Enclosure, Comm. Control Mux and Message Mux are presently four weeks behind schedule due to ECOC (design errors and pre-integration/1st Art. Acceptance Tests). This delay will impact LBTF date of June 1972 but will not affect ship construction.

Electronics Subcontracts

Expected availability dates for all equipment indicate 2 to 11 months of positive slack as related to LHA 1 in yard need dates. Minor deficiencies exist on AN/SPS-52 Radar, Exterior Communication System, Interior Voice Communication System, Antennas, Switching Matrix and Man on the Move equipment; corrective action is being taken.

Litton ship systems Mississippi (LSS/M)

Receipt and storage of all engineering data is controlled by the Engineering Department. The plan vault and files are being rearranged and reorganized to provide faster retrieval and better control.

Detail drawings and parts lists received from LSS/C and DSD are reviewed by the various design discipline codes who incorporate all approved changes not already on the drawings. Engineering, in conjunction with Operations Planning, reviews the preliminary scoping accomplished at LSS/C and makes whatever changes are required. Following the scoping of the detail drawing the engineering department prepares the following engineering aids:

Hull.—Numerical control tapes, templates, roll sets and flame planer sketches.

Piping.—LZ booklets for shop fabrication of piping assemblies; booklets identify fabrication points and material requirements.

Ventilation.—LZ booklets for shop fabrication of ventilation sections. Also included in the package are computer produced tapes for the Werdimann Machine.

Elcctrical.—LK Booklet for runs of all local electrical cabling.

Upon completion of preparation of all engineering aids, the detail drawings, parts lists and engineering aids are forwarded to Operations Planning for issuing work instructions to production.

Engineering status

Detail drawings: *February 29, 1972*

No. received at LSS/M	1,859
No required LSS/M Engineering action	1,672
No. released for manufactuing software cycle	636

Detail drawing scoping	Feb. 10, 1972	Feb. 29, 1972	Mar. 31, 1972
Number drawings requiring scoping	1,080	1,080	1,080
Number drawings scheduled	308	434	519
Number completed to schedule	306	364	484
Number delinquent	2	70	35

ENGINEERING AID BOOKLETS (HULL, PIPE, VENT ONLY)

	Feb. 10, 1972	Feb. 29, 1972
Number of engineering aids required	4,369	4,369
Number scheduled for issue	1,104	1,208
Number issued to schedule	783	939
Number delinquent	228	269

NUMERICAL TAPES AND TEMPLATES

	Feb. 10, 1972	Feb. 29, 1972	Mar. 31, 1972
Number of N/C tapes required	1,355	1,355	1,355
Number scheduled for issue	610	676	871
Number issued to schedule	568	643	803
Number delinquent	42	33	68

Piping was severely behind schedule in the preparation of LZ Booklets. Delay was attributed to lack of firm information from LSS/C caused by significant revisions to the drawings and parts lists. The contractor was attempting to alleviate problem by transferring vellums and change paper to Mississippi so that revisions and development of LZ Booklets can be accomplished concurrently.

Ventilation was similarly behind schedule. This was attributed to redesign of the ventilation system due to sizing errors and late receipt of firm information.

Electrical was behind schedule because of reservations on drawings related to unissued standard parts drawings. This was delaying preparation of LK drawings.

The time span for preparation of engineering aids had been reduced from nine to five weeks. A significant portion of the time is required to revise and/or correct the drawings and parts lists received from LSS/C.

Total detail drawing status as of 4/7/72

Total No. drawings required	2465
Total No. drawings issued	2191
No. of drawings scheduled for issue	1676
No. of drawings issued to schedule	1518
No. of drawings delinquent	158

Initial issue of detail drawings was approximately 85% complete. Estimated completion date for initial issue of all detail drawings is July 1972.

The number of revisions to detail drawings has grown considerably. Delay in incorporating these changes on the drawings is inhibiting use of detail drawings by LSS/M for developing LZ and LK engineering aids and impacting planning software releases.

LSS/M Engineering late release of engineering aids was delaying Operations Planning in issuing work instructions to production. As of 4/26/72, a total of 106 assemblies and six areas were affected by engineering/planning/manufacturing interface problems.

Material

The shipbuilder's procurements are categorized by the following levels:

Level and description:	Approx. number of items
I. Major components	130
II. Major O/F subcontracts	18
III. Minor O/F subcontracts	163
IV. Key items	2,000
V. Raw material and stock items	

The status of material procurement at the time of the audit is discussed below.

Major components level I

Purchase orders had been placed for all of the 130 major components. Purchase orders were for five ship sets of components.

All vendor contracts have been modified to include a "build and hold" clause; necessitated by slippage in ship construction and delivery.

Forty-two of the major components for LHA 1 are manufactured and in storage at various vendor plants awaiting shipping instructions. Multiship sets of some components such as steering gears, waste treatment plants and main propulsion units are in storage.

Enclosed Operating Station (EOS) consoles, degaussing control equipment and main ballast valves have expected delivery dates which are later than the required in-yard dates.

EOS consoles

The expected delivery date for the LHA 1 forward EOS console is 11/15/72. The late delivery of the forward console for LHA 1 will not permit the required shock testing prior to installation. The first unit to be shock tested is the console for the second ship and this console is scheduled for barge shock testing in March 1973.

Degaussing control equipment

Delivery of the degaussing control power supply units for LHA 1 was being delayed to correct the excessive emission of electro-magnetic interferences. The expected delivery date is 11/1/72.

Main ballast valves

The originally designed main ballast sea valves provided insufficient flow through the port of the valves to satisfy ballast/deballasting time requirements. The design of the valves presently under procurement was modified to meet flow requirements. The contractor reported an expected delivery date of May 1972.

Other major components

The final vendor design, manufacture of shock testing of many major components had not been completed. Potential problems exist on the hydraulic power packs, control center switchboard, damage control console, bowthruster, heat exchangers and aqueous film fire proportioners. There could be some impact on ship construction if problems do develop.

The contractor has a material monitoring system for tracking progress at the vendor level for manufacturing major components. It includes all milestones in the manufacturing cycle from delivery of vendor drawings through component delivery to Litton. Visits by the contractor to the vendor's plant are part of the monitoring system.

The Procurement Department issues a weekly department newsletter which identifies major procurement actual or potential problems including corrective action being taken to minimize the impact on ship construction.

A current Material Ordering and Delivery Schedule, reflecting the effect of FAMSCO rescheduling was not available.

Major and outfit and furnishing (O/F) subcontracts level II

Exhibit 34 contains a list of procurement items in this category. Purchase orders had been placed for six of the 18 required items; an additional five were in the procurement cycle. Reefer spaces, hull insulation, piping and ventilation insulation and deck covering awards include both material and installation services. The shipbuilder had not yet made "make or buy" decisions on installation services for commissary, furnitures, storeroom stowages and lockers, metal joiner bulkheads and doors, expanded metal bulkheads and doors, work benches and well deck sheathing and planking.

Delay had been incurred in processing procurement of expanded metal bulkheads because of a lack of engineering drawings.

Minor O/F subcontracts level III

This category of procurement includes the shop and utility space equipments such as serving machines, waste extractors, barber chairs, hoists, printing press, lathes and grinders. Awards had been made for 106 of the 163 items required; no known delivery problems exist.

Key items level IV

Key items are procured by either LSSC or LSSM depending on the amount of design interface and data requirements imposed. Typical items in this category

are main steam valves, heaters, filters, electrical panels, demineralizers, compasses, etc.

Of the estimated 2,000 items, a total of 1467 key items had been identified, 1303 requirements were released, 540 were in the procurement pre-award cycle and 760 items had been awarded. 125 of the awarded items were issued prior to establishing requirements for vibration, thus requiring some modifications to the contracts.

Raw material & stock items level V

At the time of the audit the shipbuilder had the following raw material inventory:

	Tons
Steel plates	33,159
Aluminum plates	275
Steel shapes	8,137
Aluminum shapes	137

Actual and potential farm out items

Forty-four (44) structural assemblies making up module #1 and 6 assemblies in module #3 were farmed out to the Ingalls Nuclear Shipbuilding Division. The contractor anticipated farming out approximately 100,000 manhours of additional work per ship for major piece parts, including the following items:

1. Fixed walkway, port and starboard.
2. Hinged walkway, starboard.
3. Aluminum stacks.
4. Upper and lower stern gate.
5. Water barrier gate.
6. Hinged platform assembly.
7. Stern closure support structure.
8. Ramp assembly sideport.
9. Main boiler uptakes.
10. Eng. Rm. operating sta., fwd. & aft, mod. #3.
11. Inclined ladders.
12. Deck edge elevator platform assembly.
13. Aft elevator platform.
14. Missile person platforms.
15. Expanded metal bulkheads.
16. Metal and expanded metal doors.
17. Portable bulkheads Mod. #2 and #4.

Labor progress

The audit team did not attempt to determine labor progress for the LHAs since the minimal amount of work which had been accomplished would not permit a meaningful determination of labor progress.

Status of construction

In February 1972 construction had been started on LHA 1–3. The keel for LHA 1 had been layed on 11/15/71 and was made up of innerbottom sections #301 and #302. From that date to February very little additional work had been accomplished on LHA 1. By the end of February approximately 2,000 tons of an estimated required 17,000 tons of steel for LHA 1 had been processed through the fabrication shop. No additional structural assemblies had been erected to add to the 2 of the 6 structural assemblies which comprise the innerbottom of module #3. The 4 remaining module #3 innerbottom assemblies were in process in the 400 (sub-assembly) area and ranged from approximately 45%–90% complete structurally. There was no piping or bottom shell plating installed.

The 6 innerbottom assemblies for module #2 (#201–206) were in process. Four were in the "cut and fabrication" stage, two were complete in fabrication and one of these (#201) had started sub-assembly on the recently built platens in the 400 area. The first 6 assemblies for module #4 were in process in the fabrication shop. In addition the first non-innerbottom assemblies for module #3 (bulkheads and 1st platform) had recently started through the fabrication shop.

The following is a more detailed status of performance to schedule:

MODULE NO. 3

[Key: S—Schedule; A—Actual]

Assembly No.	Start date	Interval (weeks)	Completion date	Remarks
301, 302				Completed and erected (keel laying) prior to audit.
303	(S) Nov. 15, 1971 (A) Nov. 29, 1971	3 18	(S) Dec. 6, 1971 (A)	On Feb. 8 estimated completion was Feb. 21, 1972. On Feb. 15 estimated completion was Feb. 23, 1972 (60 percent). On Mar. 8 estimated completion was Apr. 10, 1972.
304	(S) Nov. 15, 1971 (A) Nov. 29, 1971	3 16	(S) Dec. 6, 1971 (A) Mar. 31, 1971	On Feb. 8 estimated completion was Feb. 21, 1972. On Feb. 15 estimated completion was Feb. 12, 1972 (65 percent). On Mar. 8 estimated completion was Mar. 10, 1972.
305	(S) Nov. 15, 1971 (A) Nov. 29, 1971	5 +17	(S) Dec. 20, 1971 (A)	On Feb. 8 estimated completion was Mar. 6, 1972. On Feb. 15 there was no estimated completion date; estimated progress was 35 percent and assembly was delayed by late sea chest. On Mar. 8 estimated completion was Apr. 17, 1972.
306	(S) Nov. 15, 1971 (A) Nov. 29, 1971	5 +17	(S) Dec. 20, 1971 (A)	On Feb. 8 estimated completion was Mar. 6, 1972. On Feb. 15 there was no estimated completion date, estimated progress was 35 percent and assembly was delayed by late sea chest and scoop. On Mar. 8 estimated completion was Apr. 17, 1972.

The production control department noted the following items delaying assemblies #305 and #306:

Sea chests were "on hold" (work stopped pending fix of design problem).

Plans were not being issued with work packages (e.g. LD 603007 for innerbottom ladders).

On 2/11/72, the audit team observed #303 in wheelabrator area with manual touch-up blast cleaning in process; #304 was in the Module Erection (500) area with touch-up painting in process. Piping and bottom shell plating were not yet installed.

The eight non-innerbottom assemblies did not have an estimated start date for sub-assembly as of 2/14/72 (six were only about 5% complete in the fabrication phase and two (#311 and 312) had not started fabrication).

The FAMSCO schedule indicated that six innerbottom assemblies (#201–206 incl.) should have started sub-assembly on 1/24/72. Assembly #201 actually started on 2/7/72, two weeks late, the other five had not started. Assembly #201 was estimated to be complete on 2/14/72 by Litton. The estimated start date for #202 and #203 by the Production Control Dept. was 2/21/72.

Four non-innerbottom assemblies (208, 209, 211 and 213) were scheduled to start on 2/14/72. None had actually started.

The six bottom assemblies were scheduled to have started sub-assembly; #401–404 inclusive on 1/31/72 and #410–411 on 2/14/72. None had started assembly and on 2/14/72 fabrication was only 20%–40% complete. These four assemblies all started structural fabrication on schedule, on 1/3/72.

The 2/17/72 weekly report from the Production Control Dept. noted the inability to estimate the start dates for assembly because of:

Non-receipt of structural material.

No pipe work packages issued as drawings were not available.

The aluminum for the superstructure (module #6) was completely fabricated and stored in various places throughout the yard. Assembly of assemblies #601 and 602 were in process.

The skeg (assembly #525) and both rudders (#526 and 527) were complete.

Other than the pipe installed in assemblies #301 and 302, piping system fabrication in process was limited to assemblies 303–306 inclusive and 201, 205 and 206.

No ventilation work, sheet metal work or preparatory work for electrical systems was in process.

Both boilers had been erected.

The structural work of Module #3 wing tank assemblies #322–327 inclusive and all of Module #1 was farmed out to Ingalls Nuclear Shipbuilding Division. Fabrication of all six #3 assemblies for Module #3 started in February 1972 and assemblies 322 through 325 were being assembled at Ingalls. (Structural assembly was approximately 50 to 75% complete for #322 through #325.

The work accomplished on LHA 2 and LHA 3 by February was essentially limited to processing steel through the fabrication shop. 1,200 tons of steel has been processed for each of LHA 2 and LHA 3. In addition approximately 1,000 tons of steel total for both LHA 4 and LHA 5 had been processed.

The status of construction for LHA 1 at the time of the post audit review, April 24–28, 1972, in the terms of assembly completion follows:

Fabrication, 30; Erection, 7; Ventilation, 0; Piping, 6.

The shipyard was behind the schedules in use in all of the above areas. The schedules in use were preliminary schedules based on the delivery dates proposed in the "reset proposal".

At the post audit review, the company supplied data on weekly tons processed (throughput) for a seven (7) week period from 2/27/72 to 4/9/72. The actual throughputs for the latest four (4) week period available (3/12/72 to 4/9/72) compared to original planned monthly throughput and the planned monthly peak throughput follows:

[In tons]

Shop	LHA 1 actual, Mar. 12 to Apr. 9	Actual, Mar. 12 to Apr. 9	LHA 1–5 planned March 1972	Peak planned monthly
Fabricated	723	2,451	2,544	3,606
Panel	80	325	1,020	1,020
Shell	115	115	193	346
400 area	87	87	1,400	4,000
500 area	0	0		4,000

The slow completion rate of innerbottom assemblies in the 400 (sub-assembly) area was the primary cause of the disparity between assemblies complete in fabrication and assemblies complete in erection. As it was during the February audit, the delay in software (work packages, plans, etc.) for piping was still a major delaying factor.

Status of planning and scheduling

At the time of the production audit, the company provided the team with copies of the LHA 1 ground assembly schedule, erection sequence visibility charts, ship manufacturing schedule, and ship production schedule networks. Detailed schedules for the follow ships had not been developed. In addition to the above, the company provided a key events schedule for all five ships.

The company also provided the team with a preliminary manning plan for LHA 1 by skills and a total manning plan by skills for the five ship program. These manning plans were based on their planning estimate of 32 million hard task production manhours to construct the five ships.

The company had established a First Article Master Scheduling Committee (FAMSCO) in November 1971 to develop integrated schedules with the objective of realistically coordinating all the affected departments within the shipyard. This FAMSCO effort was originally scheduled to be completed in January 1972. It was essentially complete at the time of the production audit in February 1972, although additional "work-around" rescheduling actions were continuing.

The February FAMSCO schedule was developed for LHA 1. Follow ship schedules had not been updated at the time of the production audit.

The February FAMSCO schedule was based on delivery of LHA 1 on 4/1/74, "The Memorandum of Agreement," delivery date. The time spans for assembly construction and erection into the modules were deferred and shortened to permit the major key event dates contained in the prior schedules to be held except for launch, which was advanced.

By the time the FAMSCO effort was completed, the construction effort on LHA 1 was three months behind that assumed in the FAMSCO schedule because of the lack of engineering, and lack of software for foundations, ventilation, cabling, and piping, and the preemptive effect of manning for the Farrell ships.

Many of the detailed schedules provided the team, such as the ship manufacturing schedule, were not current and had not been brought into consonance with the February FAMSCO schedule.

The manning plan provided the team had not been coordinated with the FAMSCO schedule although the company stated that this was in the process of being done.

Analysis of the LHA 1 manning plan and a comparison with the schedules provided the team revealed the following:

(*a*) The planned manning for each skill in each cost center was a constant percent of the total manning for the cost center without regard to the amount of work actually scheduled.

(*b*) Manning in the sheetmetal, pipe, electrical and machine shops was not in consonance with the schedules provided the team. Planned manning for work in the shops was shown subsequent to scheduled completion of the work and in many instances after completion of the scheduled installation work on the ship. In fact, planned manpower expenditures for shop work, in some instances, continued after the expiration of planned manpower for ship installation work.

(*c*) LHA 1 manning rose rapidly to a peak of 2850 six months prior to launch, and dropped sharply to 1000 men two months later.

(*d*) LHA 1 manning planned for the sub-assembly area (400 area) did not support the scheduled completions of the assemblies. A plot of manning in the 400 area compared to the scheduled completion of assemblies (both by tons and number of assemblies) showed that scheduled manning was later than the scheduled completions.

After preliminary review of the schedules provided the team, the manning plan and the status of LHA 1 construction, the audit team concluded that the schedules and manning plan were not realistic.

During ensuing discussions with the company, Litton stated that it was recognized that the schedules and manning plans provided the team were unrealistic and could not be met.

The company further stated that a revised delivery schedule was being prepared for the five ships and would be included in the reset proposal scheduled for submission to the Navy on March 31, and that a revised manning plan was being prepared based on their new estimate of 42.6 million hard task production manhours to build the five LHAs.

At the time of the post audit review in April, the company provided the team with revised preliminary production schedules for the first ship together with a revised preliminary manning plan for each of the five ships. A review of these plans and schedules by the team indicates that a number of inconsistencies and conflicts still exist and that the preliminary manning plans provided were still not in agreement with the construction schedules. Furthermore, reports of actual manning for March and April 1972, continue to show actual manning much lower than the new hard task plan for LHA 1 and the new total hard task for LHA 1–5, particularly for shipfitters and pipefitters.

The company recognizes the above and is still in the process of developing feasible schedules and manning plans for the construction of the ships. It was not possible for the team to fully evaluate the LHA program and to develop with any degree of assurance the delivery dates the company might attain. This cannot be done until the company completes its manpower analysis and scheduling effort for all five LHAs with inconsistencies and conflicts eliminated.

Based on the preliminary review of the LHA program, the status of LHA 1 construction and the shipyard's performance on the Farrell program, it is considered that delivery of the LHA 1 to 5 by the dates contained in the "reset proposal" is optimistic. Moreover, programs achieved in the last four months by the shipyard on the LHA program was not sufficient to support these dates. The ability of the shipyard to deliver these ships will, in large measure, depend on its ability to obtain the required skilled workforce, and to obtain significant improvements in productivity over that achieved thus far.

The audit team is reviewing the revised schedules as they are developed and will provide a detailed evaluation of the reset dates at the conclusion of the current Litton scheduling effort.

DD 963 CLASS PROGRAM

General

On June 23, 1970 Litton Ship Systems was awarded a multi-year contract for the construction of 30 Destroyers (DD) designated DD 963 Class with increments of 3 in fiscal year 1970, 6 in fiscal year 1971, 7 in fiscal year 1972, 7 in fiscal year

1973 and 7 in fiscal year 1974. The first 3 fiscal year awards have been made as follows:

Fiscal year	Number of DD's	Award date
1970	3	June 23, 1970
1971	6	Jan. 15, 1971
1972	7	Jan. 26, 1972

The DD 963 is 563 feet long, 55 feet in beam with a full load displacement of 7600 tons.

The contract delivery dates at the time of the audit are as follows for the 16 DD 963 class ships awarded to date:

Ship:	*Contract delivery date*	Ship—Continued	*Contract delivery date*
DD-963	Oct. 31, 1974	DD-971	July 30, 1976
DD-964	Apr. 30, 1975	DD-972	Sept. 30, 1976
DD-965	June 30, 1975	DD-973	Oct. 29, 1976
DD-966	July 31, 1975	DD-974	Nov. 30, 1976
DD-967	Oct. 31, 1975	DD-975	Dec. 31, 1976
DD-968	Feb. 27, 1976	DD-976	Jan. 31, 1977
DD-969	Apr. 30, 1976	DD-977	Feb. 28, 1977
DD-970	June 30, 1976	DD-978	Mar. 31, 1977

Production work had not yet started in February 1972 but was scheduled to start 1 January 1973. In March 1972 the scheduled start of DD 963 construction was advanced to 1 August 1972.

No material has been delivered to the yard, however, long lead time material has been ordered.

Status of design

The Engineering Release Review of the DD Design Baseline was completed on 15 December 1971. System design is complete. Based on the Detail Drawing Schedule and on actual starts vs. scheduled starts geared to a 1 January 1973 start of ship construction date, detail design was 9–10 weeks behind schedule in February. The shipbuilder has sub-contracted the design of Module 4 (superstructure) to Gibbs & Cox, Inc. and was negotiating with Rosenblatt & Sons, Inc. and Ingalls Nuclear Shipbuilding Division for design of foundations in Modules 1, 2 and 3. There were 600 additional foundation drawings which still need to be identified. The contractor's scheduled drawing completions and scheduled drawing starts vs. time curve indicated that in the last half of calendar year 1972, 450 drawings would have to be completed each month with all detailed drawings essentially completed by March 1973. As of 1/31/72 there was no outstanding Government Furnished Information (GFI) which was delaying the shipbuilder's Engineering effort.

At the time of the audit review in California in March, critical structural drawings had been identified and were being expedited. The company was in the process of analyzing all drawing requirements and developing a new drawing schedule.

Subsequent to the audit, the shipyard rescheduled start of construction for DD 963 from 1 January 1973 to 1 August 1972. The design schedule reviewed by the audit team will not support this early start.

A revised schedule supporting the early start has not been received by the audit team and can therefore, not be evaluated.

Status of material

The status of material ordering was reviewed in February and again in March. Most of the major components had been ordered, and there appeared to be no material delivery problems which would adversely impact the 1 January 1973 start of construction for DD construction 1973.

The company had initiated action to determine which components required to support a 1 August 1972 start of construction for DD 963 could be obtained in time to make this revised target feasible.

The company ascertained that the majority of the required components could be obtained when needed to support the early start. There were three major items which could not be obtained in time to support a normal erection sequence, but could be installed at a later date even with the early start. Work-around planning was being done to support those components. The affected components were: The fuel oil transfer purifier, the high pressure air compressor and the ship service air compressor.

In summary, the status of material ordering and delivery could support a schedule acceleration to a 1 August 1972 start of construction for the DD 963 Class.

The majority of the contractor furnished electronics equipment was being procured by the Data Systems Division. With the exception of several items, the major items of equipment have been ordered and some equipment actually has been delivered to the shore based test site in Culver City, California. At the time of the review, delivery of this equipment did not appear to be controlling ship schedules. The major electronics component which was not ordered by DSD was the AN/SQS-26C Sonar. The Sonar has been ordered by Litton Ship Systems.

A review of the promised delivery dates for Government Furnished Material indicated that the dates were currently in accordance with the contract requirements, and that there were no anticipated Government Furnished Material problems.

Status of planning and scheduling

At the time of the production audit, the company provided the team with copies of the DD 963 ground assembly schedule, erection sequence visibility charts, ship manufacturing schedules, ship production schedule networks, as well as the manning plans for DD 963 and DD 964 together with total program manning plans. The schedules provided were for DD 963 only. Detailed schedules for follow ships had not been developed. In addition to the above, the company provided a key event schedule for all thirty ships.

The team conducted a review of the DD 963 schedules which were based on start of construction of 1/1/73 with delivery scheduled for 9/27/74, one month in advance of the 10/31/74 contract delivery date. The shipbuilder's planned construction time for DD 963 was 21 months.

The manning plan provided to the audit team was not keyed to the production schedules. The manning plan was not considered feasible, in that it called for a peak manpower requirement of 1750 approximately five months after start of construction. The manning plan also indicated peak manning for eleven of thirteen trades in the same month. This peak manning requirement was considered excessive for this type of ship, and occurred too early in the building period to permit orderly construction of the ship.

In addition, the planned manpower for the first ship was considered inadequate to construct the ship. The manning plan was discussed with company representatives who stated that it would have to be revised, and that they were in the process of doing this.

The time spans allowed in the production schedules for completion of specific tasks were considered too short and were not supported by the shipyard's performance to date.

The company stated that they recognized that schedule conflicts exists and that a FAMSCO effort similar to that for LHA was planned to be started by the end of February with completion of a detailed FAMSCO schedule for the first ship by 6/30/72.

In early March, after a schedule analysis, the company recognized that the time span allowed for construction of the DD 963 was too short and that planned manpower for the early ships was inadequate. The company began to review the feasibility of starting construction by 8/1/72 to allow twenty-seven months for construction of the lead ship.

The FAMSCO effort had been initiated in California and was well along at the time of the team's review, 13–17 March 1972. The FAMSCO effort was based on start of construction for the first ship on 1/1/73, and was holding to the basic

schedules previously developed for construction of that ship. The primary purpose of the FAMSCO effort at that time was to eliminate bottlenecks and schedule irregularities and to assist in the development of a firm drawing schedule necessary to support production.

On March 16, 1972, while members of the team were in California, a firm decision was made by Litton to advance the start of construction for DD 963 to 8/1/72 and to reorient the FAMSCO effort to that date.

Subsequent to that time, a decision was made by the company to start construction of Module 4, the superstructure, in June 1972, to insure adequate time for testing and checkout of the command and control systems.

At the time of the post audit review in April, the company provided the team with revised preliminary production schedules for the first ship together with revised manning plans for all of the ships. Review of these plans and schedules shows a number of inconsistencies and conflicts and the manning plan still not in consonance with the construction schedules.

The company recognized this situation and is in the process of developing feasible schedules and manning plans for construction of the ships. It was not possible for the team to fully evaluate the DD 963 program and to develop with any degree of assurance the delivery dates that the company might attain. This cannot be done until the company completes its manpower analysis and scheduling effort for all of the ships in the program.

The audit team is reviewing the revised schedules as they are developed and will provide a detailed evaluation of the DD program at the conclusion of the current Litton scheduling effort.

LIST OF EXHIBITS

1. Litton Ship Systems Workload Plan as of 1 May 1971.
2. NAVSHIPS letter 0511:HP:ie, 4760, Ser 118–0511 dated 13 May 1971.
3. Litton Ship Systems letter 030100/XL/1X0081 dated 22 June 1971.
4. Litton Ship Systems Workload Plan as of 1 July 1971.
5. NAVSHIPS msg 220024Z July 1971.
6. Litton Ship Systems letter 030100/XL/1X0096 dated 30 July 1971.
7. NAVSHIPS letter 022:SK:mar, Ser 397–022 dated 30 July 1971.
8. Litton Ship Systems ltr 1CA100/LL/1S0070 dated 9 August 1971.
9. NAVSHIPS letter 0511:MBM:gs, Ser 280–0511 dated 16 September 1971.
10. NAVSHIPS letter 0511:MBM:gs, Ser 334–0511 dated 16 November 1971.
11. Litton Ship Systems Workload plan as of 1 December 1971.
12. NASHIPS msg 010110Z December 1971.
13. NAVSHIPS msg 200235Z January 1972.
14. NAVSHIPS msg 260412Z January 1972.
15. Litton Ship Systems Workload Plan as of 1 February 1972.
16. NAVSHIPS msg 031855Z March 1972.
17. Navy/MARAD Production Audit Team.
18. SUPSHIP Pascagoula personnel and team members.
19. RESSUPSHIP Culver City personnel.
20. Litton Ship Systems, Mississippi personnel and team members.
21. Miscellaneous persons contracted at Litton Ship Systems, Mississippi.
22. Litton Ship Systems, California personnel and team interfaces.
23. Litton Industries Data System Division personnel.
24. Litton Ship Systems Organization Chart 11/23/71.
25. Litton Ship Systems Organization Chart 3/16/72.
26. Litton Ship Systems Operations Organization Chart Jan. 1972.
27. Plan view and Flow Chart of Litton Industries' automated ship production facility.
28. Litton Ship Systems Material Directorate Organization Chart.
29. Litton Ship Systems Key procurement procedures.
30. Litton Ship Systems engineering organization chart.
31. Litton Ship Systems engineering organization chart (Pascagoula).
32. Community resources of the Pascagoula area.
33. Statistics relative to population of the surrounding counties in the Pascagoula area.
34. Major LHA Outfitting and Furnishings (O/F) Subcontracts.

EXHIBIT 1

MAY 1, 1971

Farrell:								
1	Oct. 3, 1968	—	Mar. 12, 1970	June 19, 1971	Dec. 22, 1970	—	Oct. 31, 1971	
2	do	—	Aug. 25, 1970	Sept. 4, 1971	Mar. 22, 1971	—	Dec. 31, 1971	
3	do	—	Feb. 9, 1971	Oct. 9, 1971	June 20, 1971	—	Feb. 10, 1972	
4	do	—	do	Dec. 18, 1971	Sept. 3, 1971	—	Apr. 25, 1972	
LHA-1	May 1, 1969	Jan. 12, 1971	Nov. 15, 1971	May 31, 1973	Mar. 30, 1973	Apr. 1, 1974	Apr. 1, 1974	
LHA-2	Nov. 15, 1969	June 1, 1971	May 15, 1972	Sept. 30, 1973	June 29, 1973	July 29, 1974	July 29, 1974	
LHA-3	do	do	Sept. 30, 1972	Jan. 31, 1974	Sept. 1, 1973	Dec. 2, 1974	Dec. 2, 1974	
LHA-4	Nov. 6, 1970	Jan. 3, 1972	Feb. 28, 1973	Apr. 30, 1973	Dec. 31, 1973	Feb. 28, 1975	Feb. 28, 1975	
LHA-5	do	do	July 31, 1973	July 31, 1974	Apr. 1, 1974	June 2, 1975	June 2, 1975	
DD 963	June 23, 1970	Jan. 2, 1973	Feb. 5, 1973	Jan. 12, 1974	Oct. 31, 1974	—	Oct. 31, 1974	
DD 964	do	June 25, 1973	Aug. 6, 1973	July 13, 1974	Apr. 30, 1975	—	Apr. 30, 1975	
DD 965	do	Oct. 8, 1973	Nov. 19, 1973	Oct. 12, 1974	June 30, 1975	—	June 30, 1975	
DD 966	Jan. 15, 1971	Jan. 7, 1974	Feb. 18, 1974	Dec. 14, 1974	July 31, 1975	—	July 31, 1975	
DD 967	do	May 20, 1974	July 1, 1974	Mar. 22, 1975	Oct. 31, 1975	—	Oct. 31, 1975	
DD 968	do	Sept. 3, 1974	Nov. 4, 1974	July 19, 1975	Feb. 27, 1975	—	Feb. 27, 1976	
DD 969	do	Dec. 9, 1974	Jan. 20, 1975	Sept. 20, 1975	Apr. 30, 1976	—	Apr. 30, 1976	
DD 970	do	Feb. 10, 1975	Mar. 24, 1975	Nov. 12, 1975	June 30, 1976	—	June 30, 1976	
DD 971	do	Mar. 17, 1975	Apr. 28, 1975	Dec. 20, 1975	July 30, 1976	—	July 30, 1976	

Note: Legend: S/C—start construction (start of fabrication); K—keel (start erection of 1st module); L—launch; OCD—original contract delivery date; M/AD—provisional delivery dates contained in the "Memorandum of Agreement" dated Apr. 23, 1971; CED—current estimated delivery date.

Source: NAVSHIPS 250-574 Naval Ship Systems Command monthly progress report for shipbuilding and conversion dated May 1, 1974 and Maritime Administration Office of Ship Construction Report No. MAR-800-3 issued No. 268 dated Apr. 30, 1971.

EXHIBIT 2

DEPARTMENT OF THE NAVY,
NAVAL SHIP SYSTEMS COMMAND,
Washington, D.C., May 13, 1971.

From: Commander, Naval Ship Systems Command.
To: Litton Systems, Inc., (Attention Mr. E. B. Gardner, Senior Vice President).
Via: Supervisor of Shipbuilding, Conversion and Repair, USN, Pascagoula, Miss.
Subject: Ship Delivery Schedules, Review of.

1. Litton currently holds Navy contracts for the construction of AE 32–35, SSN 680, 682, 683, LHA 1–5, and DD 963 Class and for the overhaul of several nuclear submarines. In addition, the company holds contracts for the construction of a number of commercial ships.

2. There has been considerable delay in the scheduled delivery of these ships. The AE 32–35 have been delayed 3, 5, 7 and 8 months respectively. Additional delays of unknown magnitude are also impending. The proposed delivery dates for SSN 680, 682 and 683 are significantly later than current contract delivery schedules, and the ships are lagging behind even these extended schedules. Despite protracted negotiations, no agreement has yet been reached between the Navy and Litton on delivery schedules for these ships. The LHA 1–5 have been delayed 12, 13, 14, 14 and 14 months respectively. These schedule problems are of continuing concern to the Navy. In addition, Litton has submitted large claims to the Navy for delay and disruption plus other causes on some of these ships.

3. Litton has recently advised of its intention to move the four APL ships from the West Bank Yard to the East Bank Yard for construction. The effect of this move on the Navy work in the East Bank Yard is also cause for serious concern. To date, the Navy has not been successful in obtaining detailed production and manning schedules for these ships or for either shipyard as a whole.

4. In view of the foregoing, and in order to obtain assurance that the delivery schedules being developed for these ships, to which the Navy must adjust its planning, are feasible and realistic, it is intended to conduct a production audit of both the East and West Bank Shipyards. In view of the interference between the Navy ships and the MARAD ships in both yards this production audit will be a joint Navy/MARAD audit.

5. Accordingly, it is requested, that NAVSHIPS be provided with full substantiating documentation relating to the delivery schedules of all work in each shipyard. This documentation shall include erection schedules, compartment completion schedules, test schedules, individual ship manning schedules (both total and by trade including engineering), overall shipyard manning schedules

(by trade and total yard), design schedules, contractor furnished material ordering and delivery schedules, monthly manhours expended to date by total ship, ship system and trade, monthly manhours estimated to complete ship, by total ship and trade, and all other pertinent production schedules for the ships under construction at Litton.

6. In addition, it is intended to review the factors used to determine progress for the AE and SSN to insure their continuing validity. Supporting data for these factors should, therefore, also be provided.

7. It is requested that this data be furnished to the Naval Ship Systems Command, Attention: Code 0511, via the Supervisor of Shipbuilding by 28 May 1971. After receipt of this data, NAVSHIPS and MARAD will schedule the sending of a Production Audit Team to Pascagoula to jointly review with the company the production outlook of the shipyards and the feasibility of meeting the yards' production schedules.

N. SONENSHEIN.

EXHIBIT 3

LITTON SYSTEMS, INC.,
Pascagoula, Miss., June 22, 1971.

COMMANDER, NAVAL SHIP SYSTEMS COMMAND,
Department of the Navy,
Washington, D.C.

Attention: RADM Nathan Sonenshein.
Via: Supervisor of Shipbuilding, Conversion and Repair, U.S. Navy, Pascagoula, Miss.
Subject: Ship Delivery Schedules, Review of
Reference: (a) NayShips letter Ser 118–0511 dated 13 May 1971
Enclosure: (1) Tabulation of Information being Supplied. (2) Tabulation of Additional Information Supplied.

GENTLEMEN: The Reference (a) letter requested certain schedule and manpower data for Litton Ship Systems' Maritime and Navy contracts. Enclosure (1) lists the information being provided in response to your individual reqeusts. As shown in Enclosure (1), much of the information requested for the LHA and DD963 contracts is already being furnished to the navy via contract CDRL submittals.

Attachments (1) through (10) to Enclosure (1) are copies of some of the more applicable data submittals specifically addressing the key elements of the Reference (a) letter. Enclosure (2) is a listing of all of the applicable information currently provided to the Navy by our contract CDRL submittals.

Issues raised in litigation on the MarAd/Farrell Lines contract involve matters covered by your request; therefore, on advice of counsel we must respectfully decline to submit this data. However, we would be pleased to meet with you personally to review this matter. Further, please note that the information submitted herewith and that information, analyses, and reports developed in connection with the production audit could relate to matters in litigation and is confidential information within the meaning of Title 18, Section 1905, USCA. We respectfully request that we be given an opportunity to review the information, analyses, and reports developed by NavShips as a result of this audit and comment thereon prior to finalization of the audit report.

As you are aware, the LHA is in the preliminary stages of production with full fabrication scheduled to commence August 1, 1971. We are also in the process of revising many of our LHA detail schedules to reflect a five ship program on the basis of the "provisional delivery schedule" contained in the Memorandum of Agreement dated 23 April 1971. In addition, we are currently reevaluating the LHA fabrication schedules, manpower, and material required for a five ship program to determine the most economical delivery schedule in accordance with the Memorandum of Agreement. DD963 fabrication is not scheduled to commence until early 1973. While we are pleased to cooperate with the Navy in a further review of our LHA and DD963 production planning, we believe, based on the above comments, that the Navy will obtain more visibility and could perform a more meaningful audit if it could be accomplished at a point in time when full fabrication and production of the LHA has been effected.

We sincerely hope that we have complied with the intent of your request, and restate our offer to meet with you at your convenience to amplify our position.

Yours very truly,

R. L. RODERICK, *President.*

Enclosures.

ENCLOSURE (1)

SCHEDULE INFORMATION

1. Erection Schedules

DD963.—Attachment (1) contains the DD963 Ship Rate and Delivery Schedule as well as the DD963 Key Event Schedule. Also, CDRL M001AE Network Update Report contains applicable information.

LHA.—Attachment (2) contains the LHA Master Material Erection Schedule. In accordance with the LHA Memorandum of Agreement, dated April 23, 1971, we are adjusting our planning from 9 to 5 ships. In conjunction with that, we are developing 140 Key Events that represent the major events in the total erection sequence. This data will be available in July and will be forwarded to you at that time.

2. Compartment Completion Schedules

Litton Ship Systems primarily schedules its manufacturing process by work packages, assemblies and modules. Schedule visibility to this level of detail is provided in Item 1 above.

3. Test Schedules

DD963.—Attachment 3 supplies CDRL T001AG, Test Schedules.

LHA.—As indicated above, we are in the process of preparing test schedules for the five-ship program.

4. Individual Ship Manning Schedules

DD963.—Attachment 4 contains CDRL P001BA, Master Manpower Schedule.

LHA.—Attachment 5 contains CDRL M001AA, Manloading Charts.

5. Overall Shipyard Manning Schedules

Overall Shipyard Manning Schedules are not being furnished for the reasons explained in the cover letter relating to the Farrell contract.

6. Design Schedules

DD963.—Attachments 6 and 7 provide CDRL E001AC, Drawing Schedule Update Report and CDRL E001CA, Drawing Schedule—Combat System.

LHA.—Attachment 8 provides CDRL E001AC, Engineering Drawing Index, Schedule and Report.

7. Contractor Furnished Material Ordering and Delivery Schedule

DD963.—Attachment 9 contains CDRL P001AF, Master Material Ordering and Delivery Schedule.

LHA.—Attachment 10 contains CDRL P001AB, Material Ordering and Delivery Schedule.

8. & 9. Monthly Manhour Data

This information is provided as part of several of the cost CDRL submittals. Attachments 4 and 5 represent summaries of the manhour data.

DD963

APPLICABLE CDRL's

A001AA—Cost/Schedule Report
A001AB—Contract Funds Status Report
A001AC—Hot Line Reports
A001AG—Life Cycle Cost/Analysis Refinement and Update Report
E001AA—Drawing Schedule
E001AC—Drawing Schedule Update Report
E001CA—Drawing Schedule—Combat System
M001AB—Organizations Changes Report

M001AD—Monthly Progress Report
M001AE—Networks and Revised Network
M001AG—Problem Analysis Report
M001AK—Management Information Center Displays
P001AA—Consolidated Ship Production Schedule
P001AF—Master Material Ordering and Delivery Schedules
P001BA—Master Manpower Schedule
P001BD—Manpower Training and Recruitment Report
S001BB—Shock Design Analysis Schedule
T001AA—Builders Trial Agenda
T001AD—Acceptance Trial Agenda
T001AE—Final Contract Trial Agenda
T001AG—Test Schedule
T001AK—Development Test Schedule
T001AL—T & E Interdependency Network
T001AS—Special Test Agenda
T001AT—Mission Demonstration Agenda
V001AJ—Cosal Production Schedule
V001AU—Equipment/Component Index Development Schedule
A001AA—Cumulative Cost Chart
A001AB—Ship Production Cost Trend
A001AH—Contract Funds Status (DD1586)
A001AJ—Contract Cost Data (DD1558)
M001AF—Work Breakdown Structure
M001AC—Milestone Charts
M001AD—Summary & Activity Networks
M001AE—Slack Report
P001AA—Still Photo Report
P001AC—Master Erection Schedule
M001AA—Manloading Charts
P001AB—Material Ordering & Delivery Schedule
V001AM—Index of Purchase Orders
V001AN—Copies of Purchase Orders
M001AB—Management Summary Report

EXHIBIT 4

JULY 1, 1971

Ship	Award	S/C	K	L	OCD	M/AD	CED
Farrell:							
1	Oct. 3, 1968		Mar. 12, 1970	June 26, 1971	Dec. 22, 1970		Mar. 1, 1972
2	do		Aug. 25, 1970	Feb. 5, 1972	Mar. 22, 1971		May 31, 1972
3	do		Feb 9, 1971	Apr. 15, 1972	June 20, 1971		Aug. 15, 1972
4	do	do	do	July 1, 1972	Sept. 3, 1971		Oct. 31, 1972
LHA-1	May 1, 1969	Jan. 12, 1971	Nov. 15, 1971	May 31, 1973	Mar. 30, 1973	Apr. 1, 1974	Apr. 1, 1974
LHA-2	Nov. 15, 1969	Jan. 3, 1972	May 15, 1972	Sept. 30, 1973	June 29, 1973	July 29, 1974	July 29, 1974
LHA-3	do	do	Sept. 30, 1972	Jan. 31, 1974	Oct. 1, 1973	Dec. 2, 1974	Dec. 2, 1974
LHA-4	Nov. 6, 1970	Oct. 30, 1972	Feb. 28, 1973	Apr. 30, 1973	Dec. 31, 1973	Feb. 28, 1975	Feb. 28, 1975
LHA-5	do	do	July 31, 1973	July 31, 1974	Apr. 1, 1974	June 2, 1975	June 2, 1975
DD 963	June 23, 1970	Jan. 2, 1973	Feb. 5, 1973	Jan. 12, 1974	Oct. 31, 1974		Oct. 31, 1974
DD 964	do	June 25, 1973	Aug. 6, 1973	July 13, 1974	Apr. 30, 1975		Apr. 30, 1975
DD 965	do	Oct. 8, 1973	Nov. 19, 1973	Oct. 12, 1974	June 30, 1975		June 30, 1975
DD 966	Jan. 15, 1971	Jan. 7, 1974	Feb. 18, 1974	Dec. 14, 1974	July 31, 1975		July 31, 1975
DD 967	do	May 20, 1974	July 1, 1974	Mar. 22, 1975	Oct. 31, 1975		Oct. 31, 1975
DD 968	do	Sept. 23, 1974	Nov. 4, 1974	July 19, 1975	Feb. 27, 1975		Feb. 27, 1976
DD 969	do	Dec. 9, 1974	Jan. 20, 1975	Sept. 20, 1975	Apr. 30, 1976		Apr. 30, 1976
DD 970	do	Feb. 10, 1975	Mar. 24, 1975	Nov. 22, 1975	June 30, 1976		June 30, 1976
DD 971	do	Mar. 17, 1975	Apr. 28, 1975	Dec. 20, 1975	July 30, 1976		July 30, 1976

Note: Legend: S/C—start construction (start of fabrication); K—Keel (start erection of 1st module); L—Launch; OCD—original contract delivery date; M/AD—provisional delivery dates contained in the "Memorandum of Agreement" dated Apr. 23, 1971; CED—current estimated.
Source: NAVSHIPS 250-574 dated July 1, 1971 and MARAD Report No. MAR-800-3 issue No. 270 dated June 30, 1971.

EXHIBIT 5

July 1971.

NAVSHIPS SOUND; Subship Pascagoula.
Info: MARAD (ship construction)
Subship Newport News
Subship Oroion
Subship Quincy
HAVEAT (02)
Production audit.

Ref A NAVSHIPS LTR 0511:HP:IE 4760 STR 11S–0511 DTD 13 May 1971. Ref B Ingalls Nuclear Shipbuilding LTR of 30 Jun 1971 with Subship Pasca end Ser 103–31 DTD Jul 1971.

Ref C conference between Mr. R. B. Schensen and NAVSHIPS Code 0511 of 21 Jul 1971.

Ref A requested production rate on Navy and MARAD ships under constr at both Ingalls Nuclear Shipbuilding and Litton Ship Systems and advised that after receipt of requested info a joint Navy-MARAD production audit would be scheduled. Ref B asked for specific info relating to production audit which was provided during ref C. This MSO confirms abjc info. Promotion audit is hereby scheduled for period 2 Aug thru 15 Aug 1971. Production audit team will consist of approx 25 Navy and MARAD personnel. Rates and security clearances are being fwd separately.

The team will be broken into five sub-teams as fols:
As; SSN (including overrids); IHA/DD–913; MARAD/commercial.
Total:———

The AF and SSN subships will be divided into progressive and schedule and manpower evaluation groups. Evaluation of programs will cover period from date of contract claims and current estimated delivery dates. Appropriate subship members should be assigned to each sub-team. It is desirable to have appropriate contractor personnel assigned to work with each sub-team. The approved audit agenda which is flexible and can be modified to satisfy conveniences of group and company follow:

03 01

2 Aug.	
Orientation meeting with Supship	9–10:30
Orientation meeting with Ingalls	10–12:00
Nuclear shipbuilding division lunch	12–1:00
Orientation meeting with Litton Ships System Division	1–2:30
Navy/Marad groups meet with contractor counterparts to formulate detailed schedule and procedures	2:30–4
Team meeting	4–6
Aug. 3–6/–12	
Groups to conduct detail review of production planning schedules manpower application, and analysis of ship progress	9–4
Team meeting	4–6
03 Aug.	
Conference regarding findings with Supship	8–9
Conference regarding findings with Supship and Ingals nuclear shipbuilding	9–11
Conference regarding findings with Supship and Litton Ship Systems	11–1:00

Detailed discussions of contractors production, planning and control and processing systems is desired. Schedule for work will be developed in Pascagoula after discussions with contractor. Detailed discussions of Supship Pascagoula progressing is also desired and will be scheduled after arrival of team.

EXHIBIT 6

LITTON SYSTEMS, INC.,
Pascagoula, Miss., July 30, 1971.

COMMANDER, NAVAL SHIP SYSTEMS COMMAND,
Department of the Navy,
Washington, D.C.

Attention: Mr. S. C. Kzirian.
Via: Supervisor of Shipbuilding, Conversion and Repair, U.S. Navy, Pascagoula, Miss.
Subject: Navy Scheduled Production Audit.

Reference:
(a) NavShip ltr Ser. 118–0511 of 13 May 1971.
(b) LSS ltr 030100/XL/IX0081 of 22 June 1971.
(c) Clarification of the Engagement Concept, Naval Material Command Headquarters, dated April 1971.
(d) Meeting between LSS and Navy on July 27, 1971.

GENTLEMEN: Reference (a) advised that the Navy with MarAd intended to conduct a joint production audit and requested that details of manpower and production planning and schedules be furnished to the Navy for the APL/Farrell, LHA and DD963 programs. Reference (b) suggested that the audit be deferred until LHA fabrication and production was further in process and pointed out that no Farrell data was being provided in that such data was pertinent to an appeal now pending before the Maritime Subsidy Board.

We are concerned about the Navy's policy of "Engagement" vs. the "Disengagement" expressed in the LHA and DD963 contracts and have requested clarification.

In the Reference (d) meeting the above items were again discussed and Litton Ship Systems was advised that the production audit would commence on August 2, 1971, by a team of approximately 25 people. It was stated that Litton Ship Systems is expected to make available all of its latest manpower data and production planning and schedules and that we were expected to have those people available to explain and answer questions concerning such data.

Litton Ship Systems questions the contractual basis for such a production audit. We, therefore, advise that we consider this audit or such audits to be direction by the Contracting Officer to implement a contract change. On the basis we will assist the audit team to perform the audit within the constraints indicated within our June 22, 1971 letter. Upon completion of the audit we will forward our proposed equitable adjustment to the contract including price and schedule.

Very truly yours,

E. B. ROBBINS,
Director, Contract Administration.

EXHIBIT 7

JULY 30, 1971.

From: Commander, Naval Ship Systems Command,
To: Litton Systems, Inc. (Attention Mr. E. B. Robbins.)
Via: Supervisor of Shipbuilding, Conversion and Repair, USN, Pascagoula, Miss.
Subject: Ship Delivery Schedule, Review of
References: (a) Litton letter of July 30, 1971, (Advance Copy)
(b) Meeting in Washington, D.C. on July 27, 1971, between Mr. E. Robbins of Litton and various representatives of the Navy.
(c) Litton letter 030100/X/1X0081 of June 22, 1971.
(d) NAVSHIPS letter Ser. 118–0511 of May 13, 1971.

1. Reference (a) in part confirms the suggestion proposed during reference (b) meeting that the Navy scheduled "Production Audit" be deferred until LHA fabrication and production was further in process. Further, reference (a) questions the contractual basis for such a production audit and considers that the audit is directed by the Contracting Officer as a contract change.

2. You are hereby informed that this Command does not consider the proposed Production Audit to be a directed change under any NAVSHIPS contract held by Ingalls or its successor corporate entities. The Navy's rights to inspect the progress or lack of progress in its shipbuilding contracts does not require a change to the contract.

3. However, in view of the fact that your LHA production planning has not been completed in July as was indicated in reference (c) and in consideration of your request, we shall limit the Production Audit to the East Bank Facility, at this time. Since the need for audit of both exists, it is requested that you advise this Command by 6 August 1971 when the necessary LHA data will be available for Navy audit.

N. SONENSHIEN.

EXHIBIT 8

AUGUST 9, 1971.

COMMANDER, NAVAL SHIP SYSTEMS COMMAND,
Department of the Navy,
Washington, D.C.

Attention: RADM Nathan Sonenshein.
Via: Supervisor of Shipbuilding, Conversion and Repair, U.S. Navy, Pascagoula, Miss.
Subject: Navy production audit.
References: (a) NAVSHIPS TWX Ser. 397–022, dated July 30, 1971.
(b) Litton letter 030100/EL/1X0081, dated June 22, 1971.
(c) Litton letter to RADM Sonenshein from R. L. Roderick subject: LHA Memorandum of Agreement, dated April 23, 1971, Contract N00024–69–C–0283, dated July 22, 1971.

GENTLEMEN: Reference (a) advised that the subject audit would be limited to the East Bank facility at this time and inquired when LHA data would be available for Navy audit.

As indicated in reference (b), the contractor believes that the Navy will obtain more visibility and could conduct a meaningful audit if it is performed when full fabrication and production of LHA is underway. The contractor also understands that this audit is desired by the Navy as a basis for evaluating our reproposal. Reference (c) informed the Navy that the reproposal would be submitted in early 1972.

It is therefore recommended that the production audit be scheduled approximately six weeks before the contractor's reproposal submittal. The contractor will notify the Navy at least six weeks in advance of the recommended production audit date so that detailed arrangements for the audit can be properly coordinated.

We trust that this recommendation meets with your approval. If additional information is desired, please contact the undersigned.

Sincerely,

E. B. ROBBINS,
Director, Contract Administration,
Litton Ship Systems; Litton Systems, Inc.

EXHIBIT 9

DEPARTMENT OF THE NAVY,
NAVAL SHIP SYSTEMS COMMAND.
Washington, D.C., September 16, 1971.

From: Commander, Naval Ship Systems Command.
To: Litton Ship Systems Division,
Litton Systems, Inc.,
(Attn: Dr. R. L. Roderick, President)
Via: Supervisor Shipbuilding, Conversion and Repair, USN, Pascagoula, Miss.
Subject: Ship Delivery Schedule, Review of
Reference: (a) Litton Ship Systems Division letter 1CA 100/LL/1S0070 of Aug. 9, 1971.
(b) NAVSHIPS 1tr Ser 397–022 of July 30, 1971.
(c) NAVSHIPS 1tr Ser 1508–PMS–377 of Aug. 18, 1971.

1. Reference (a) replied to reference (b) and recommended that the Navy Production Audit of Litton's West Bank facility originally scheduled for August 1971 be rescheduled to approximately six weeks prior to the contractor's LHA reproposal submittal which was scheduled for early 1972. Reference (c) advised that the reproposal submittal date by the contractor requires Navy concurrence and requested that a meeting be held by 15 September 1971 during which time a new submission date may be agreed upon.

2. The Naval Ship Systems Command does not desire to tie the planned production audit to the contractor's reproposal submission. In view of the Navy's interest in the progress of its shipbuilding contracts with Litton, it is desired to conduct this audit at the earliest practicable time. It is the understanding of this Command that the information necessary to conduct this audit has now either been developed by Litton or is very close to completion. It is therefore proposed that the production audit be scheduled for the period 18 through 29 October 1971.

3. In order to permit the team to prepare for this audit it is requested that all detail design, material and production schedules together with all manpower planning schedules and detail manpower estimates to construct the ships be pro-

vided to NAVSHIPS, Attn: Code 0511 by not later than 24 Sep 1971. This data should be provided for Farrell ships, LHA, and DD–963 class to the extent available.

4. An audit agenda and a list of the audit team personnel will be provided after receipt of the information requested in paragraph 3 above.

5. Your early attention to this matter will be appreciated.

N. SONENSHEIN.

EXHIBIT 10

DEPARTMENT OF THE NAVY,
NAVAL SHIP SYSTEMS COMMAND,
Washington, D.C., November 16, 1971.

From: Commander, Naval Ship Systems Command.
To: Litton Ship Systems Division,
Litton Systems, Inc.
Via: Supervisor of Shipbuilding, Conversion and Repair, USN, Pascagoula, Miss.
Subject: Production Audit; Conduct of
Reference: (a) NAVSHIPS 1tr $511:MBM:gs Ser 280–$511 of Sep. 16, 1971.

1. Reference (a) advised Litton that the Naval Ship Systems Command desired to conduct a production audit of that shipyard during the period 18–29 October 1971.

2. Subsequent to reference (a) Naval Ship Systems Command was advised by Mr. E. B. Robbins that the shipyard could not be ready for the production audit at that time, nor could it provide the information requested by that time, as the result of the labor work stoppage and the necessity of revising the shipyard's planning. A meeting was held at Naval Ship Systems Command on 12 Oct 1971 between Mr. J. Herron and Mr. Robbins of Litton and Mr. M. B. Miller of Naval Ship Systems Command to discuss the rescheduling of the audit. During the course of this meeting, the Litton representatives advised what information was then available and the information which had yet to be developed and provided a time schedule for the development of this information. Based on the time schedule provided it was agreed that a preliminary production audit would be conducted during the period 6–10 December and that the formal production audit would be conducted during the period 10–21 January 1972. The Litton representatives agreed to provide the scheduling and manning information that was then available. To date this information has not been received by Naval Ship Systems Command.

3. This letter is to confirm the scheduled dates for the production audit and to again request that the information promised be provided at the earliest practicable date. Details of the agenda and the composition of the audit teams will be provided by separate correspondence.

R. E. HENNING,
Deputy Commander for Production.

EXHIBIT 11

DEC. 1, 1971

Ship	Award	S/C	K	L	OCD	MAD	CED
Farrell:							
1	Oct. 3, 1968		Mar. 12, 1970	June 26, 1971	Dec. 22, 1970	July 15, 1972	
2	do		Aug. 25, 1970	Apr. 15, 1972	Mar. 22, 1971	Sept. 15, 1972	
3	do		Feb. 9, 1971	June 17, 1972	June 20, 1971	Nov. 15, 1972	
4	do	do		Aug. 19, 1972	Sept. 3, 1971	Feb. 15, 1973	
LHA–1	May 1, 1969	Jan. 12, 1971	Nov. 15, 1971	May 31, 1973	Mar. 30, 1973	Apr. 1, 1974	Apr. 1, 1974
LHA–2	Nov. 15, 1969	Jan. 3, 1972	May 15, 1972	Sept. 30, 1973	June 29, 1973	July 29, 1974	July 29, 1974
LHA–3	do	do	Sept. 30, 1972	Jan. 31, 1974	Oct. 1, 9173	Dec. 2, 1974	Dec. 2, 1974
LHA–3	Nov. 6, 1970	Oct. 30, 1972	Feb. 28, 1973	Apr. 30, 1973	Dec. 31, 1973	Feb. 28, 1975	Feb. 28, 1975
LHA 5	do	do	July 31, 1973	July 31, 1974	Apr. 1, 1974	June 2, 1975	June 2, 1975
DD 963	June 23, 1970	Jan. 2, 1973	Feb. 5, 1973	Jan. 12, 1974	Oct. 31, 1974		Oct. 31, 1974
DD 964	do	June 25, 1973	Aug. 6, 1973	July 13, 1974	Apr. 30, 1975		Apr. 30, 1975
DD 965	do	June 25, 1973	Aug. 6, 1973	July 13, 1974	Apr. 30, 1975		Apr. 30, 1975
DD 965	do	Oct. 8, 1973	Nov. 19, 1973	Oct. 12, 1974	June 30, 1975		June 30, 1975
DD 966	Jan. 15, 1971	Jan. 7, 1974	Feb. 18, 1974	Dec. 14, 1974	July 31, 1975		July 31, 1975
DD 967	do	May 20, 1974	July 1, 1974	Mar. 22, 1975	Oct. 10, 1975		Oct. 31, 1975
DD 968	do	Sept. 23, 1974	Nov. 4, 1974	July 19, 1975	Feb. 27, 1975		Feb. 27, 1976
DD 969	do	Dec. 9, 1974	Jan. 20, 1975	Sept. 20, 1975	Apr. 30, 1976		Apr. 30, 1976
DD 970	do	Feb. 10 1975	Mar. 24, 1975	N9v. 22, 1975	June 30, 1976		June 30, 1976
DD 971	do	Mar. 17, 1975	Apr. 28, 1975	Dec. 20, 1975	July 30, 1976		July 30, 1976

Note: Legend: S/C—start construction (start of fabrication); K—keel (start erection of 1 module); L—launch; OCD—original contract delivery date; MAD—provisional delivery dates contained in the "Memorandum of Agreement" dated Apr. 23, 1971; CED—current estimated delivery date.

Source: NAVSHIPS 250-574 dated Dec. 1, 1971 and MARAD Report No. MAR-800-3 issue No. 275 dated Nov. 30, 1971.

EXHIBIT 12

NAVSHIPSYSCOMH.
SUPSHIP Pascagoula.

Info: NAVMAT.
MARAD.

Production audit.

Ref a Navships letter D511:MSM:GS ser 334–0511 dtd Nov. 16, 1971, ref a requested production data on Navy and MARAD ships under contract at Litton Ship Systems and advised that a preliminary production audit is scheduled for the period Dec. 6 through Dec. 10, 1973.

The team composition and security clearances will be fwd separately. The purpose of the preliminary production audit is to review the shipyard's production planning and control systems, manpower estimating procedures, manpower planning and control systems, material planning and control systems and other management information systems related to ship production. In addition the current status of planning for LHA and DD963 programs will be reviewed with emphasis on facilities scheduling, manpower scheduling, production work scheduling, status of material ordering and planned subcontracting of structural work. It is also desired to follow the industrial processes and paper flow through the shipyard.

The proposed agenda which is flexible and can be modified to satisfy the convenience of the supship and the company follows:

December 6

Orientation meeting with SUPSHIP	9–10:30
Orientation meeting with Litton	10:30–12:00
Lunch	12:00–1:00
Presentation by Litton on above systems	1:00–4:00
Team meeting	4:00–6:00

December 7

Tour of shipyard	4:00–12:00
Lunch	12:00–1:00
Completion of presentation by Litton	1:00–4:00
Assignment of team members into groups:	
Group team meeting	4:00–6:00

December 8–10

Preliminary previews by individual teams on current status of following	4:00–4:00
(a) Manpower estimating	
(b) Manpower planning	
(c) Facilities planning	
(d) Structural work schedules	
(e) Outfit work schedules	
(f) Integrated ship schedules	
(g) Sub-contracting	
(h) Material Procurement	
(i) Personnel planning including hiring and training plans	
(j) Design Status	
Team Meeting	4:00–6:00

December 10

Discussions with Litton and SUPSHIP on plans for final audit scheduled for January 1972	2:00–4:00

It is desired to review the above for LHA, DD 963, Farrel ships and total shipyard to the extent of available information.

Additionally, it is desired to discuss with SUPSHIP plans for developing progressing procedures for LHA. A schedule for this will be developed after arival of team. A schedule for meetings with contractor personnel at Ingalls nuclear shipbuilding for purpose of completing the report of the production audit held in August will also be developed after arrival of team.

It is requested that the SUPSHIP make arrangements for the provision of working spaces and secretarial assistance to the team.

EXHIBIT 13

JANUARY, 1972.

NAVSHIPSYSCOMHQ.
SUPSHIP Pascagoula.
Info: NAMVAT.
MARAD (SHIP CONSTR).
Production audit.

Confirming discussions by Mr. M. B. Miller NAVSHIPS 0511 with RADM. C. N. Payne, SUPSHIP Pascagoula and Mr. E. B. Robbins, Litton Ship Systems. Production audit of Litton Ship Systems at Pascagoula, Miss., will resume January 31, 1972, and continue for 2–3 weeks.

Reviews will be conducted as previously discussed with Litton Ship Systems and SUPSHIP Pascagoula representatives.

Basic review teams will be Farrel, LHA, DD 963 and total yard.

Request SUPSHIP Pascagoula representatives be assigned each group except Farrell.

EXHIBIT 14

JANUARY, 1972.

NAVSHIPSYSCOMHQ.
SUPSHIP Pascagoula.
INFO: SUPSHIP Quincy.
SUPSHIP Newport News.
MARAD.
NAVSHIPSO.
NAVMAT.
SUPSHIP Bath.
Production audit team.

The team of the production audit scheduled at Litton Ship Systems for Jan 31-Feb 18, 1972, will consist of the following personnel:

Mr. B. Miller, team leader; L. D. Passet, assistant team leader; G. Spitz; V. Stepp; H. Paul; S. Gamble; J. Gallagher; T. Grossman; G. Grotos; G. Kirchgassner; H. Waterman; C. McCauley; H. Rust; A. Potashnick; J. Greco; J. Fee; C. Englehardt; T. Petry; C. Cookson; R. Payne; C. Parker; G. Massey; D. Whiting; Dr. H. Solomon; Dr. J. Bennett; and S. Hutchens.

EXHIBIT 15

FEB. 1, 1972

Ship	Award	S/C	K	L	OCD	M/AD	CED
Farrell:							
1	Oct. 3, 1968		Mar. 12, 1970	June 26, 1971	Dec. 22, 1970	July 15, 1972	
2	do		Aug. 25, 1970	Apr. 15, 1972	Mar. 22, 1971	Sept. 15, 1972	
3	do		Feb. 9, 1971	June 17, 1972	June 20, 1971	Nov. 15, 1972	
4	do		do	Aug. 19, 1972	Sept. 3, 1971	Feb. 15, 1973	
LHA-1	May 1, 1969	Jan. 12, 1971	Nov. 15, 1971	May 31, 1973	Mar. 30, 1973	Apr. 1, 1974	Apr. 1, 1974
LHA-2	Nov. 15, 1969	Jan. 3, 1972	May 15, 1972	Sept. 30, 1973	June 29, 1973	July 29, 1974	July 29, 1974
LHA-3	do	do	Sept. 30, 1972	Jan. 31, 1974	Oct. 1, 1973	Dec. 2, 1974	Dec. 2, 1974
LHA-4	Nov. 6, 1970	Oct. 30, 1972	Feb. 28, 1973	Apr. 30, 1973	Dec. 31, 1973	Feb. 23, 1975	Feb. 28, 1975
LHA-5	do	do	July 31, 1973	July 31, 1974	Apr. 1, 1974	June 2, 1975	June 2, 1975
DD 963	June 23, 1970	Jan. 2, 1973	Feb. 5, 1973	Jan. 12, 1974	Oct. 31, 1974		Oct. 31, 1974
DD 964	do	June 25, 1973	Aug. 6, 1973	July 13, 1974	Apr. 30, 1975		Apr. 30, 1975
DD 965	do	Oct. 8, 1973	Nov. 19, 1973	Oct. 12, 1974	June 30, 1975		June 30, 1975
DD 966	Jan. 15, 1971	Jan. 7, 1974	Feb. 18, 1974	Dec. 14, 1974	July 31, 1975		July 31, 1975
DD 967	do	May 20, 1974	July 1, 1974	Mar. 22, 1975	Oct. 31, 1975		Oct. 31, 1975
DD 968	do	Sept. 23, 1974	Nov. 4, 1974	July 19, 1975	Feb. 27, 1975		Feb. 27, 1976
DD 969	do	Dec. 9, 1974	Jan. 20, 1975	Sept. 20, 1975	Apr. 30, 1976		Apr. 30, 1976
DD 970	do	Feb. 10, 1975	Mar. 24, 1975	Nov. 22, 1975	June 30, 1976		June 30, 1976
DD 971	do	Mar. 17, 1975	Apr. 28, 1975	Dec. 20, 1975	July 30, 1976		July 30, 1976
DD 972	Jan. 26, 1972	May 26, 1975			Sept. 30, 1976		Sept. 30, 1976
DD 973	do	June 23, 1975			Oct. 29, 1976		Oct. 29, 1976
DD 974	do	July 28, 1975			Nov. 30, 1976		Nov. 30, 1976
DD 975	do	Aug. 25, 1975			Dec. 31, 1976		Dec. 31, 1976
DD 976	do	Sept. 22, 1975			Jan. 31, 1977		Jan. 31, 1977
DD 977	do	Oct. 27, 1975			Feb. 28, 1977		Feb. 28, 1977
DD 978	do	Nov. 24, 1975			Mar. 31, 1977		Mar. 31, 1977

Note: Legend: S/C—start construction (start of fabrication); K—keel (start erection of 1st module); L—launch; OCD—original contract delivery date; M/AD—provisional delivery dates contained in the "Memorandum of Agreement" dated Apr. 23, 1971; CED—current estimated delivery date.

Source: NAVSHIPS 250-574 dated Feb. 1, 1972 and MARAD Report MAR-800-3 issue No. 277 dated Jan. 31, 1972.

EXHIBIT 16

MARCH 1972.

NAVSHIPSYSCOMHQ.
SUPSHIP Pascagoula.
RESUPSHIP Culver City.
Production audit, Litton Ship Systems.

A. Discussions between Mr. M. B. Miller/NAVSHIPS and SUPSHIP PASCA and company personnel.

B. Fonecon between Mr. M B. Miller/NAVSHIPS and Mr. A. Hilley/Litton ship systems.

1. CFM ref a continuation of the production audit of Litton Ship systems—amtd/DSD site will be conducted March 13–17, 1972. Team will consist of approximately seven members. Names and security clearances will be forwarded September.

2. Agenda as discussed ref B follows:

A. Orientation meeting with RESUPSHIP.

B. Orientation meeting with Litton.

C. Amtd.

1. Staffing, relationships with other elements of corporation, functions and responsibilities relative to LHA and DD 963 project offices.

2. Organizational relationships and administrative aspects of amtd with LSS/M. Planned phaseout and transfer of functions to LSS/M.

3. Manpower required to meet LHA and DD 963 schedules, current manning and types, planning to meet required manning and contemplated farmouts of portions of LHA and DD 963 design work.

4. Planning and status of engineering for LHA and DD 963—system design, reservations on system design drawings, detail designs, scoping, GFI requirements, dimensional control, quality control, incorporation of welding symbols, problem areas and advance planning organization as applies to design.

5. Material procurement for LHA and DD 963—procurement system, status of procurements, vendor information and shock tested equipments and problem areas.

6. Interface of engineering schedules with material and manufacturing schedules. System implemented to integrate design changes in schedules—problems encountered.

7. Internal control reports.

D. DSD.

1. Staffing, relationships with other elements of corporation functions and responsibilities relative to LHA and DD 963 project offices.

2. Organizational relationships and administrative aspects of DSD with amtd and LSS/M.

3. Current and projected manpower.

E. Master scheduling organization.

1. Staffing, functions, responsibilities, interface with amtd/LSSM.

3. Request RESUPSHIP make hotel reservations for single rooms.

EXHIBIT 17

NAVY/MARAD PRODUCTION AUDIT TEAM

NAVSHIPS

M. B. Miller, 0511, team director.
L. D. Passet, 0511, assistant team director.
G. Spitz, 0511, LHA team leader.
V. Stepp, 0511, LHA review.
C. E. McCauley, 0161, LHA review.
H. W. Rust, PMS 377, LHA review.
H. Paul, 0511, DD 963 team leader.
J. P. Gallagher, 0511, DD 963 review.
A. Potashnick, PMS 389, DD 963 review.
T. Grossman, 0511, Farrell review.
S. E. Gamble, 0511, total yard review.
G. E. Grotos, 0511, total yard review.
G. Kirchgassner, 0511, total yard review.
H. L. Waterman, 0513, total yard review.
I. L. Emmert, staff assistant.

NAVMAT

S. Hutchens, Jr., total yard review.

NAVSHIPSO

J. R. Greco, total yard team leader.
J. J. Fee, LHA review.
T. M. Petry, DD 963 review.
C. Engelhardt, DD 963 review.

SUPSHIP BATH

D. Whiting, DD 963 review.

SUPSHIP NEWPORT NEWS

R. Payne, Farrell review.
H. Parker, Farrell review.

SUPSHIP QUINCY

G. Massey, Farrell review.

MARAD

C. Cookson, Farrell team leader.
J. MacInnes, Farrell review.

TEAM CONSULTANTS

Dr. H. Solomon, total yard review.
Dr. J. Bennett, total yard review.

EXHIBIT 18

SUPSHIP PASCAGOULA PERSONNEL AND TEAM MEMBERS

Radm. C. N. Payne, Jr., SUPSHIP.
Capt. J. W. Lisanby, Deputy SUPSHIP.
Cdr. R. G. Langrind, LHA review.
Cdr. T. C. Goslin, Jr., contract officer.
Lcdr. F. B. Lash, DD 963 review.
Lt. H. Boardman, Code 140.
G. O. Broussard, chief engineer.
C. B. Schnadelbach, LHA project officer.
R. K. Cooke, LHA review/total yard review.
R. Parish, quality assurance review.
E. J. Nunenmacher, LHA review/total yard review.
A. F. Sislak, DD 963 review/total yard review.
J. K. Pittman, total yard review.
D. T. Lanquist, LHA review.
P. M. Foerster, LHI review.
G. Martin.
L. Rainey.
G. Howard.

EXHIBIT 19

RESSUPSHIP CULVER CITY PERSONNEL

Capt. E. C. Hill, RESSUPSHIP.
Cdr. L. Shafer, LHA project officer.
Lcdr. U. C. Parnell, DD project officer.
Lcdr. P. H. Shultz, LHA Assistant project officer/DSD.
Lcdr. E. G. Schweitzer, assistant DD project officer.
B. G. Patterson, contract administrator.

EXHIBIT 20

LITTON SHIP SYSTEMS, MISSISSIPPI PERSONNEL AND TEAM INTERFACES

F. W. O'Green, president.
C. A. Krause, vice president and general manager.
N. Milakovich, vice president and director of operations.
R. A. Muller, assistant to vice president of operations.
R. J. Dankanyin, vice president of program management.
C. J. Brewer, director of quality assurance.

E. B. Robbins, director of contracts and Farrell program manager.
T. L. Byers, controller.
B. W. Borne, director of industrial relations (resigned during audit).
M. L. Mosier, director of labor-relations (appointed director of industrial relations during audit).
R. Munyan, director of master scheduling.
C. V. Hazeltine, director of operations planning and control—team interface.
A. W. Snodgrass, director of planning, team interface.
J. L. Siniard, industrial engineering.
L. Blackwell, operations scheduling and program control.
W. A. Roemer, operations administration.
C. C. Whitney, structural planning.
O. D. Wood, advance process planning.
R. J. Brandenburg, planning data management.
C. Burke, test/trials planning.
A. Murdock, pipe/machinery planning.
W. L. Buckingham, ventilation/O&F planning.
W. F. Fairley, estimating and make/buy.
E. F. Lagonegro, director LHA material program office.
D. A. Logan, director ship fabrication.
L. W. Massey, industrial relations, team interface.
J. Dresner, director DD 963 project management, team interface.
T. F. King, project manager DD 963.
F. J. Nadalich, machinery assembly, boiler erection and aluminum fabrication.
A. B. Hilley, deputy director, master scheduling, overall Litton interface.
W. W. Rody, director ship systems.
W. C. Johnson, ship completion.
R. L. Bodden, electronics and weapons systems.
J. W. Donegan, electronics and weapons systems.
B. C. Martino, director ship manufacturing.
G. A. Meehleis, director manufacturing services, team interface.
W. A. Jacobson, production control planning.
J. Pierce, manager production control for ship fabrication.
G. A. Stoddard, production control ship completion.
E. D. Albertsen, manager production control for ship manufacturing.
E. L. Ryan, manager facilities, team interface.
S. R. Stapleton, facilities engineering.
T. G. Rakish, quality systems group.
W. D. Stinnett, quality engineering group.
R. V. Palmer, inspection control group.
J. R. Herron, LHA program, team interface.
H. C. Cox, Farrell program, team interface.
R. H. Horton Material, team interface.
D. Fleming, Finance, team interface.
R. G. Dunston, Quality Control, team interface.
J. Fulcher, Design Engineering, team interface.
S. L. Kinsolving, status and control.
J. Reeves, pipe shop.
B. Ainsworth, superintendent Farrell 2.
G. L. Akins, Jr., design engineering.
F. Aldrich, Farrell control room.
H. A. Moody, Jr., planning and administration.
J. E. Baker, ship manufacturing.
P. Barrelleaum, operations scheduling.
V. Barton, quality control.
H. Bettis, Jr., equipment engineering.
C. Brendley, industrial engineering.
H. W. Brumat, data management.
S. A. Calogero, operations control.
L. J. Compton, equipment engineering.
C. A. Culnepper, community services.
D. L. Crelia, LHA material.
C. P. Daly, LHA program.
S. E. Davies, resources planning and control.
D. F. Davis, LHA program.
C. D. Davis, design engineering.
B. Diamond, ship manufacturing.
D. J. Dubois, operations planning and control.
J. Drewry, project manager, LAMP.

V. H. Dyer, planning operations, scoping.
C. E. Evens, ship manufacturing.
W. S. Embry, design engineering.
C. East, material, piping.
J. Gest, industrial engineering.
C. George, fire chief.
W. B. Gaines, ship fabrication.
J. O. Garvin, ship manufacturing.
M. E. Hines, quality planning and analysis.
J. S. Henry, steel and conservation yard.
T. J. Hilley, guaranty survey.
W. N. Henefelt, ship manufacturing.
W. M. Hipp, manufacturing services.
J. J. Hirtel, LHA material.
W. H. Hooper, cost accounting.
D. Howard, quality control.
J. B. Harwood, data management.
G. Irvine, LHA program.
C. D. Ivy, LHA change administration.
J. Jackson, operations scheduling.
R. R. Kraft, Jr., design engineering.
J. C. Langham, mechanical.
J. Little, planning operations and scoping.
H. H. MacLean, industrial laboratory.
D. B. Massengale, industrial relations, manpower.
C. C. Martin, quality audits and training.
R. H. Owens, material.
R. L. Payne, ship manufacturing.
J. L. Pressley, ship manufacturing.
C. C. Price, LHA program.
W. R. Fortas, design engineering.
E. Polgar, design engineering.
R. O. Peiper, data management.
W. G. Randolph, operations planning and control.
J. Renny, design engineering.
J. Roe, planning operations, scoping.
M. Robertson, hull material.
W. Stennis, quality control.
R. Schwab, material office.
R. P. Schneider, operations planning and control.
S. T. Speaks, ship manufacturing.
L. F. Spagnola, Farrell control room.
E. Snyder, electrical supervisor Farrell 1.
D. Schwerdtfeger, ship manufacturing.
M. O. Scheunemann, safety, medical and fire.
B. Turner, DD 963 material ordering.
J. E. Veland, material program office.
G. Vountain, planning operations, scoping.
M. Widock, planning operations, scoping.
J. J. Walkuw, operations scheduling.
H. Yawn, electrical shop.
R. E. Zitner, LHA FAMSCO, assistant director project engineering.
J. Pakis, manpower control center.
H. O'Dell, manpower control center.
E. Pease, manpower control center.
And others.

EXHIBIT 21

MISCELLANEOUS PERSONS CONTACTED AT LITTON SHIP SYSTEMS, MISSISSIPPI

INGALLS NUCLEAR SHIPBUILDING

Z. Hayman, LHA farmout.
R. Wikstrand, MARAD representative.

FARRELL LINES INC.

R. Anderson, Farrell Lines representative.

MARITIME ADMINISTRATION

LOCAL TRADE UNION

E. Lowe, president, Metal Trades Council.

EXHIBIT 22

LITTON SHIP SYSTEMS CULVER CITY, CALIF., PERSONNEL AND TEAM INTERFACES

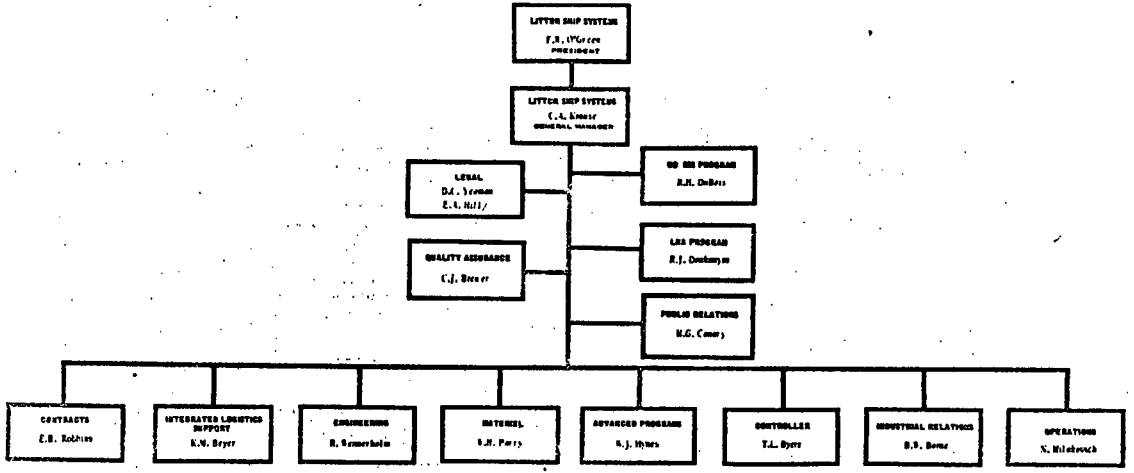
C. A. Krause, vice president and general manager.
R. J. Dankanyin, vice president, program management.
J. J. Williams, vice president, program manager DD 963.
W. J. Hynes, vice president, program manager LHA.
W. Parry, vice president material.
R. Wennerholm, vice president engineering.
R. A. Munyan, director master scheduling.
P. Madden, manager LHA subsystems, overall Litton interface.
J. Dresner, director DD 963 project management, DD interface.
A. G. Grushkin, director project engineering, engineering interface.
R. E. Kesler, controller LSSC and finance interface.
R. F. Melville, deputy director master scheduling LSSC, master scheduling interface.
E. F. Lagonegro, director LHA material program office.
J. Vasta, Naval architecture technical staff.
F. Hunt, advance material planning.
R. Schwab, material office LSSM.
R. Curtin, configuration control board chairman LSSC.
A. McCulloch, manager configuration and data management LHA.
K. M. Beyer, director integrated logistics engineering.
J. Templeton, manager logistics engineering, ILS interface.
J. Frey, quality assurance LHA.
K. Benson, DD change control.
J. E. Veland, material program office, material interface.
C. Evans, manager program finance.
T. F. King, project manager DD 963, LSSM.
R. Poole, task management engineering, LHA.
D. Logan, manager naval architecture, hull.
M. Farnum, director program planning and control DD 963.
J. Nielsen, manager DD 963 MIS.
A. B. Hilley, deputy director master scheduling LSSM.
G. M. Stauffer, director DD material program office.
R. Owens, DD material office.
D. Galvin, DD material office.
P. Laxner, manager technical publications, ILS.
T. Gurley, weight control.
Mr. Biederman, weight control.
L. Hertzberg, farmout.
T. Brydon, hull structure design.
M. Burnett, advance planning.
B. Turner, DD advance planning.
V. H. Dyer, LHA advance planning.
And others.

EXHIBIT 23

LITTON INDUSTRIES, DATA SYSTEMS DIVISION

PERSONNEL

N. A. Begovich, president DSD.
D. L. Dudas, vice president ship electronic systems.
B. Levine, director LHA program.
J. L. Owsley, vendor management, program controls and administration.
L. Broccoli.
J. Powell.
S. Dressin, LHA DSD IDWA.
R. D. Fleck, director DD program.
F. O'Neill, DSD DD 963 project manager.
W. C. Knight, test and evaluation.
N. E. Tamm, DD 963 scheduling.

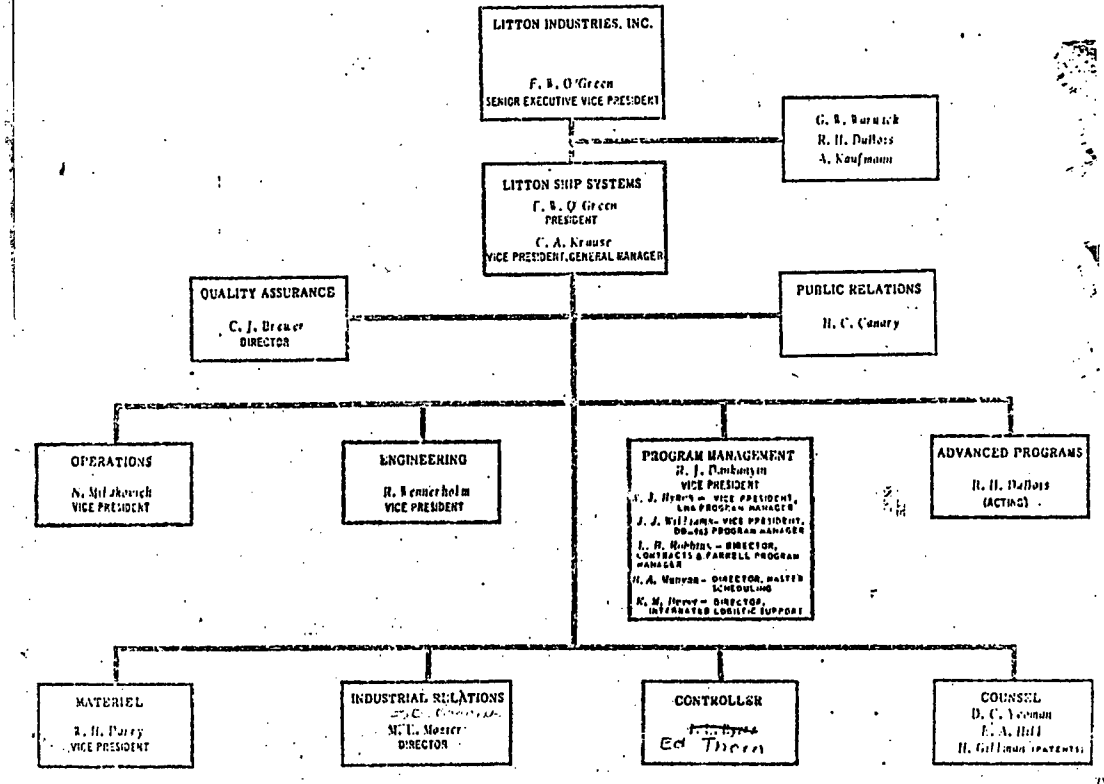


PREPARED BY:
INDUSTRIAL RELATIONS
NOVEMBER 23, 1971

LITTON SHIP SYSTEMS

Exhibit 25
LSS ORGANIZATIO...

APPROVED C.A. Krause



PREPARED BY
INDUSTRIAL RELATIONS
MARCH 16, 1971

1898

LITTON SHIP SYSTEMS

Exhibit 26

APPROVED

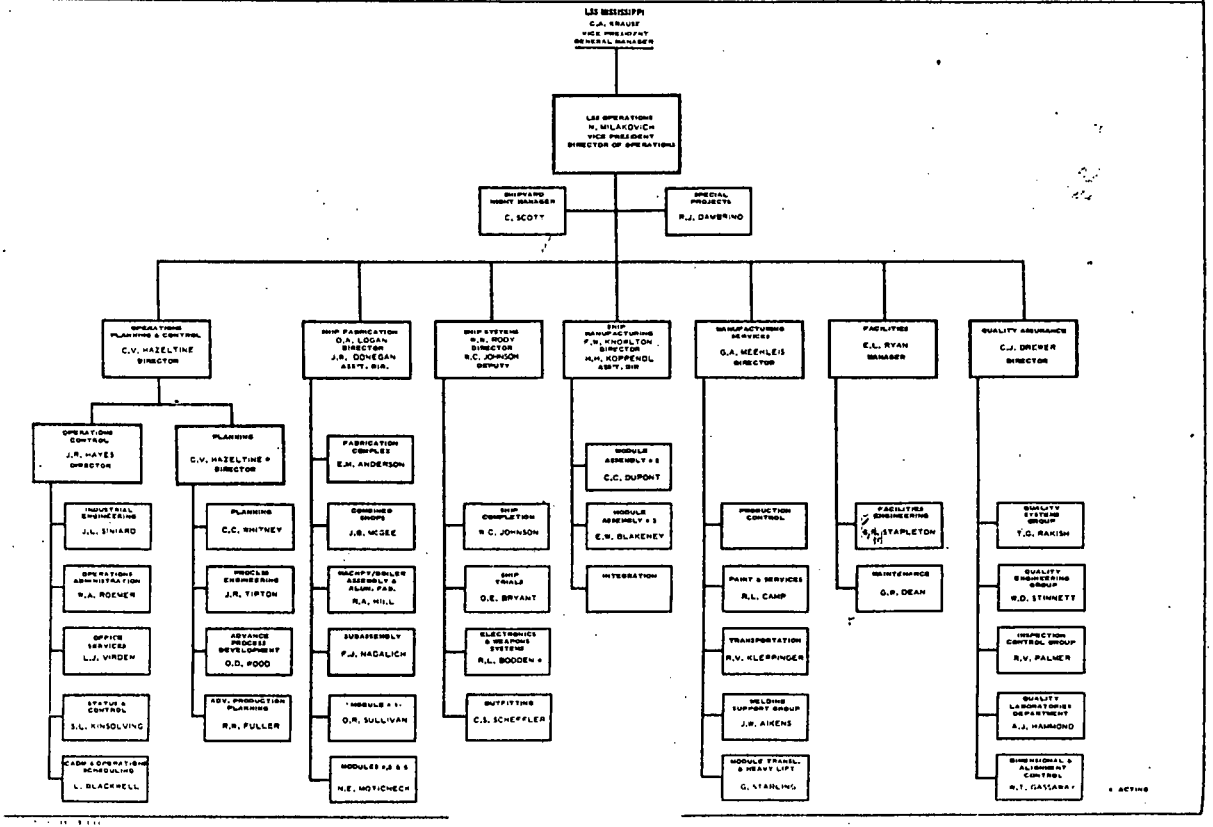


Exhibit 27

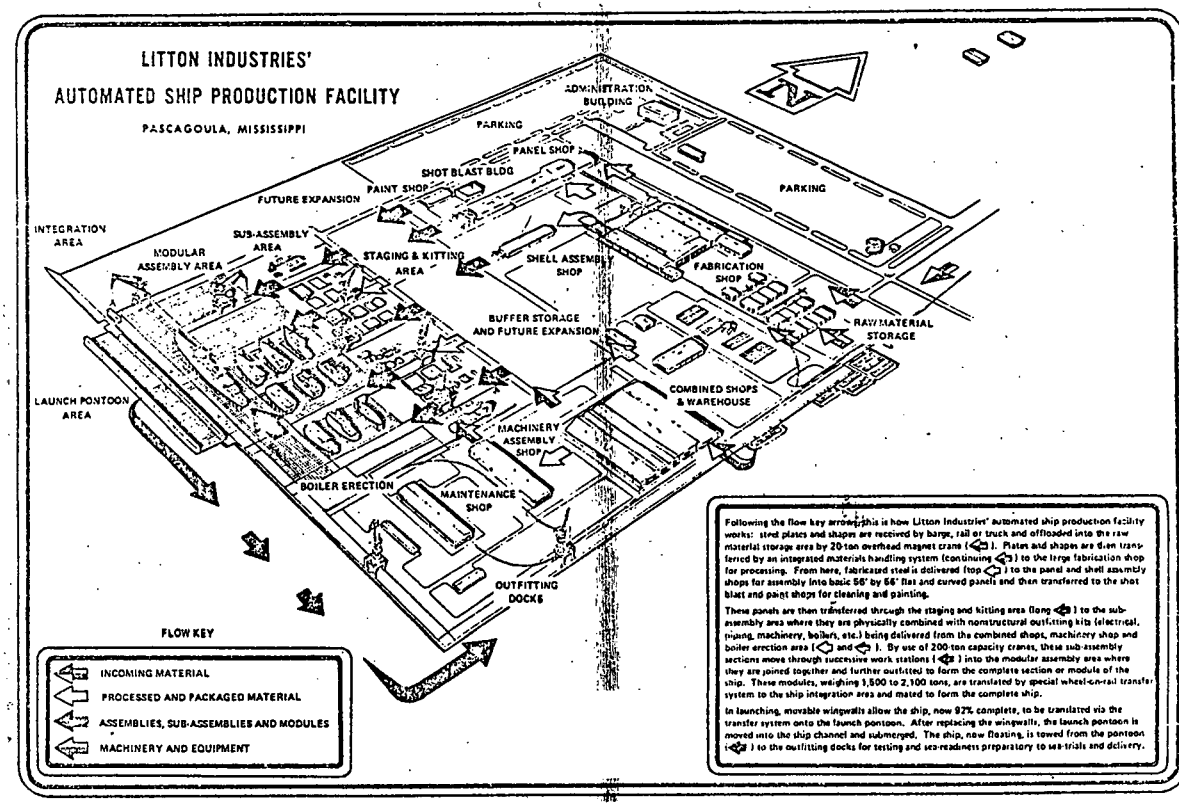
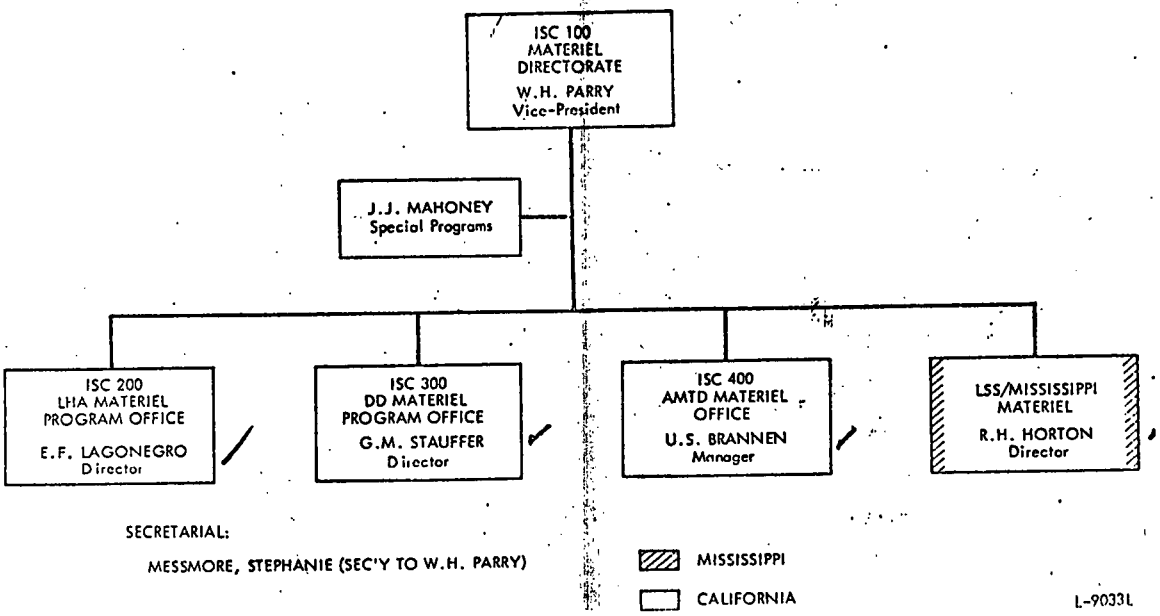


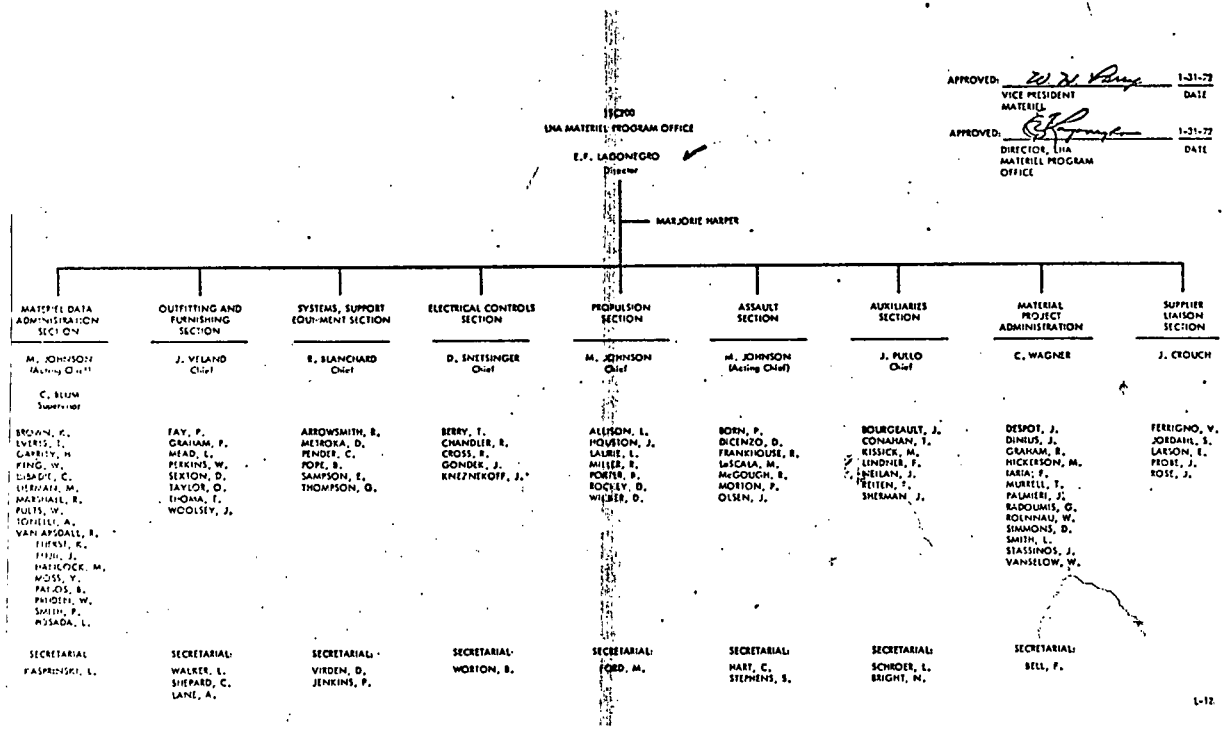
Exhibit 28

LITTON SHIP SYSTEMS

APPROVED W. H. Parry 1-31-72
VICE-PRESIDENT, MATERIEL — DATE



1901


APPROVED: W. H. Bruce 1-31-72
VICE PRESIDENT MATERIEL DATE
APPROVED: E.F. Lagonegro 1-31-72
DIRECTOR, LHA MATERIEL PROGRAM OFFICE DATE
15000
LHA MATERIEL PROGRAM OFFICE
E.F. LAGONEGRO
Director
MARJORIE HARPER
MATERIEL DATA ADMINISTRATION SECTION
M. JOHNSON (Acting Chief)
C. BLUM Supervisor
BROWN, K.
EVERIS, T.
GARVEY, H.
KING, W.
LISANTI, C.
LIEBMAN, M.
MARSHALL, R.
PULTS, W.
SOFFIETTI, A.
VAN ARSDALL, R.
FURST, K.
FUSH, J.
HANCOCK, M.
MOSS, Y.
PAPAS, B.
PHIDEAS, W.
SMITH, P.
ROSADA, L.
SECRETARIAL
KASPRZYNSKI, L.
OUTFITTING AND FURNISHING SECTION
J. VELAND
Chief
FAY, P.
GRAHAM, P.
MEAD, L.
PERKINS, W.
SEXTON, D.
TAYLOR, O.
THOMA, T.
WOOLSEY, J.
SECRETARIAL:
WALKER, L.
SHEPARD, C.
LANE, A.
SYSTEMS, SUPPORT EQUIPMENT SECTION
R. BLANCHARD
Chief
ARROWSMITH, B.
METROKA, D.
PENDER, C.
POPE, B.
SAMPSON, E.
THOMPSON, O.
SECRETARIAL:
VIRDEN, D.
JENKINS, P.
ELECTRICAL CONTROLS SECTION
D. SNETSINGER
Chief
BERRY, T.
CHANDLER, R.
CROSS, R.
GONDEK, J.
KNEZNEKOFF, J.
SECRETARIAL:
WORTON, B.
PROPULSION SECTION
M. JOHNSON
Chief
ALLISON, L.
HOUSTON, J.
LAURIE, L.
MILLER, R.
PORTER, P.
ROCKEY, D.
WILBER, D.
SECRETARIAL:
FORD, M.
ASSAULT SECTION
M. JOHNSON
(Acting Chief)
BORN, P.
BICENZO, D.
FRANKHOUSE, R.
SaSCARA, M.
McGOUGH, R.
MORTON, P.
OLSEN, J.
SECRETARIAL:
HART, C.
STEPHENS, S.
AUXILIARIES SECTION
J. PULLO
Chief
BOURGEAULT, J.
CONAHAN, T.
KISSICK, M.
LINDNER, F.
SHEILAN, J.
REITEN, T.
SHERMAN, J.
SECRETARIAL:
SCHROER, L.
BRIGHT, N.
MATERIAL PROJECT ADMINISTRATION
C. WAGNER
DESPOT, J.
DINIUS, J.
GRAHAM, R.
HICKERSON, M.
IARIA, F.
MURRELL, T.
PALMIERI, J.
RADOUNIS, G.
ROENNAU, W.
SIMMONS, D.
SMITH, L.
STASSINOS, J.
VANSELOW, W.
SECRETARIAL:
BELL, F.
SUPPLIER LIAISON SECTION
J. CROUCH
FERRIGNO, V.
JORDAHL, S.
LARSON, T.
PROBE, J.
ROSE, J.
1-12

LITTON SHIP SYSTEMS

APPROVED: W. N. Rupp
VICE PRESIDENT, MATERIEL

APPROVED:
DIRECTOR, DD MATERIAL PROGRAM OFFICE

MATERIEL DIRECTORATE

ISC200
DD MATERIEL PROGRAM OFFICE
G.M. STAUFFER
Director

VANHEE, B.

ASW SUBSYSTEM AND ARMAMENT SECTION
W. HILL
Chief
BLEDSOE, G.
SMITH, C.
VAUGHN, E.

SECRETARIAL:
JACOBSEN, J.

IDWA ADMIN. SECTION
D. GALVAN
Chief
CLINE, R.
CLOTHIER, J.
DICKSON, A.
KIBBE, J.
KOFRON, R.
LONGDEN, R.
MELLISON, R.
OTT, W.
WEBB, H.

SECRETARIAL:
LUTHER, P.
BALLAS, E.
CODDINGTON, P.

PROPULSION SECTION
P. WEINER
Chief
DANZL, F.
JOHNSON, R.
KING, N.
LA FLEUR, A.
LERMAN, T.
McENIRY, F.
MORGAN, M.
PUORTO, J.
TOWNSEND, J.
ZALA, J.

SECRETARIAL:
WOGENSEN, D.
SHEPARD, R.
NUNES, A.

ELECTRICAL AND COMMAND AND CONTROL SUBSYSTEM SECTION
D. POWELL
Chief
ADAMS, R.
AXELROD, M.
FINLEY, J.
LAFFERTY, J.
MERYN, S.
MYERS, C.
OURAND, J.
STOVER, H.
TROBAUGH, G.
WALLACE, P.

SECRETARIAL:
TESSIER, L.
MARSHALL, J.

AUXILIARIES SECTION
D. WECKER
Chief
BARRON, F.
COBB, C.
GRIFFITH, W.
HAEGGSTROM, I.
HUDSON, W.
KAPLAN, M.
MARTELL, D.
MICHEL, J.
BAGGETT, J.

SECRETARIAL:
FAULK, J.
MANALAD, L.

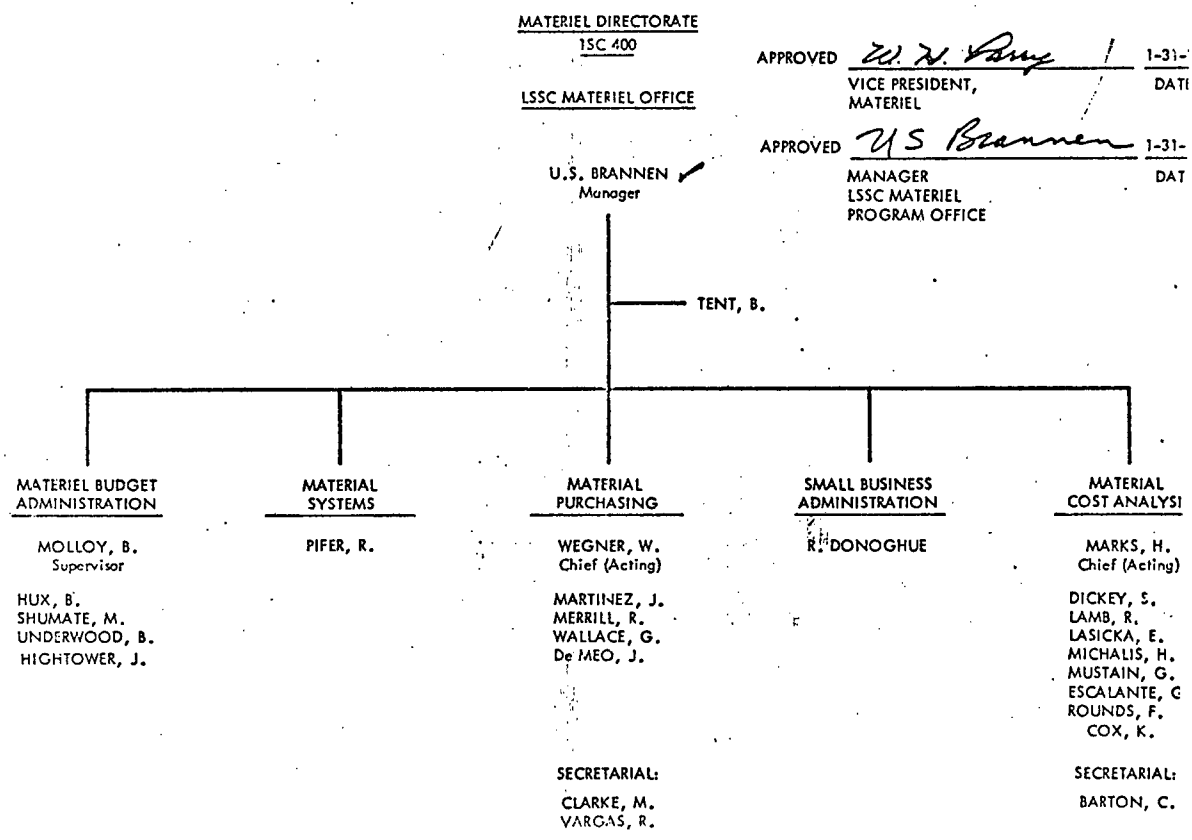
OUTFIT AND FURNISHING SECTION
D. POWELL
(Acting Chief)

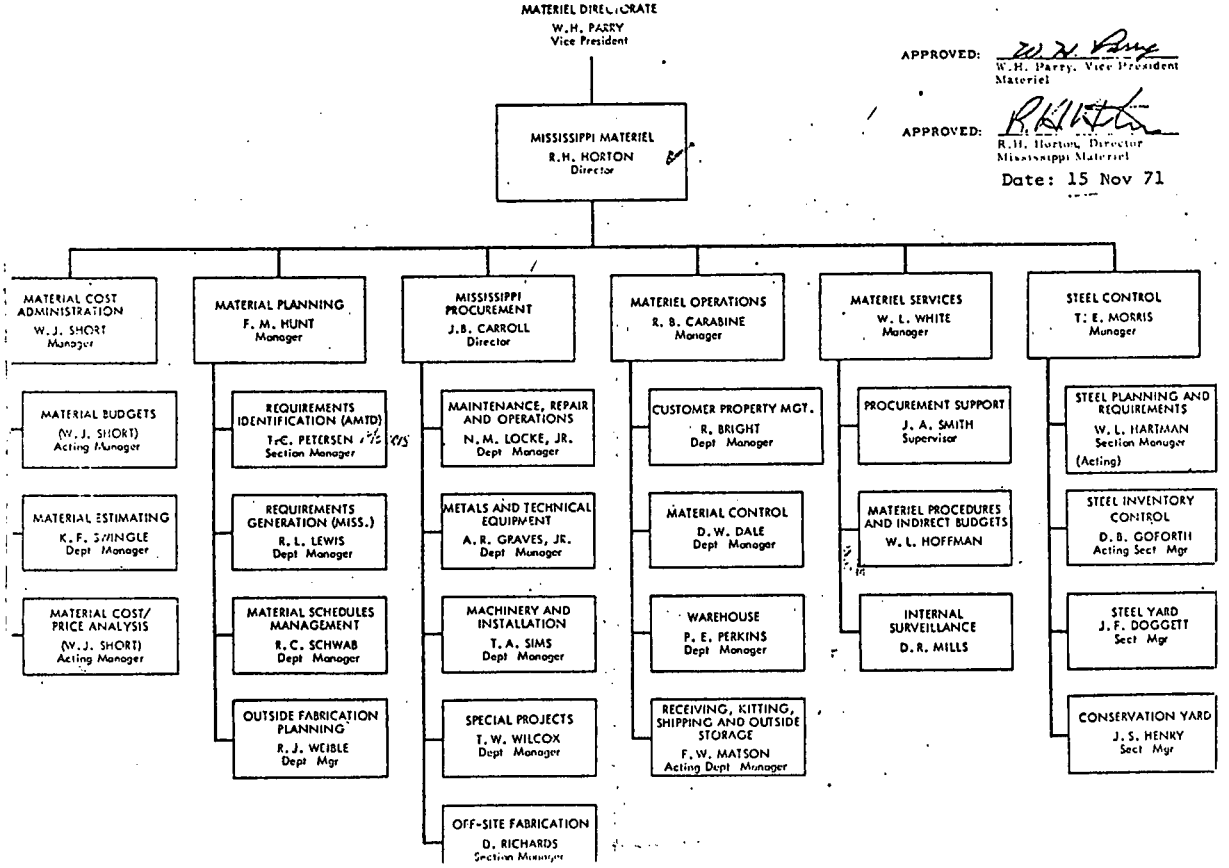
GAS TURBINE AND AIR SYSTEMS SECTION
P. WEINER
(Actg. Chief)
BELLIS, M.
SLAPER, R.
YECK, R.

MATERIAL PE ADMINISTR SECTIO
R.H. OWI
Chief
BIRD, R.
BRUCE, D.
CRANE, I.
DAVIDSO
ESSLINGE
GUENTHE
MANN, A
McBRIDE,
RUSH, W.
SCHESTAG
SEARCY, V
WELCH, B
WING, L.
GRAVE

SECRETARI
MAC PHEE

L-9


MATERIEL DIRECTORATE
1SC 400
LSSC MATERIEL OFFICE
APPROVED
VICE PRESIDENT, MATERIEL
1-31-
DATE
APPROVED
MANAGER LSSC MATERIEL PROGRAM OFFICE
1-31-
DATE
U.S. BRANNEN
Manager
TENT, B.
MATERIEL BUDGET ADMINISTRATION
MOLLOY, B.
Supervisor
HUX, B.
SHUMATE, M.
UNDERWOOD, B.
HIGHTOWER, J.
MATERIAL SYSTEMS
PIFER, R.
MATERIAL PURCHASING
WEGNER, W.
Chief (Acting)
MARTINEZ, J.
MERRILL, R.
WALLACE, G.
De MEO, J.
SECRETARIAL:
CLARKE, M.
VARGAS, R.
SMALL BUSINESS ADMINISTRATION
R. DONOGHUE
MATERIAL COST ANALYSI
MARKS, H.
Chief (Acting)
DICKEY, S.
LAMB, R.
LASICKA, E.
MICHALIS, H.
MUSTAIN, G.
ESCALANTE, C
ROUNDS, F.
COX, K.
SECRETARIAL:
BARTON, C.



APPROVED: W. H. Parry
W.H. Parry, Vice President
Materiel

APPROVED: R.H. Horton
R.H. Horton, Director
Mississippi Materiel

Date: 15 Nov 71

1903

EXHIBIT 29

JANUARY 31, 1972.

Key procurement procedures

Title	*Procedure number*
Requirements change control	1101–6
Nonprocurable parts	1101–9
Delivery adjustment notice (DAN)	1101–10
Buyers' routine and buyers' check sheets	1102–1
Procurement case file documentation	1102–2
Preaward supplier surveys	1102–4
Deferred delivery and payment provisions	1102–5
Case file memoranda	1102–8
Subcontract status work book	1102–9
Buyer directed delay in delivery schedule ("Build & Hold")	1102–10
Accountability for supplier special tooling and special test	1103–4
Bidders list	1106–1
Procurement review committee	1106–4
Formal solicitation of competitive bids	1108–1
Manufacturing releases	1109–1
Outside receiving report processing	1110–4
Subcontractor nonconforming material	1112–2
Obtaining contracting officer consent to procurements	1113–9
Cost/price analysis	1114–1
Bid control	1115–2
Progress payments	1120–1
Preaward subcontract management requirements	1129–1
Postaward subcontract management requirements	1129–2

Exhibit 30

LV-12418E

LSS ENGINEERING ORGANIZATION

Litton Ship Systems

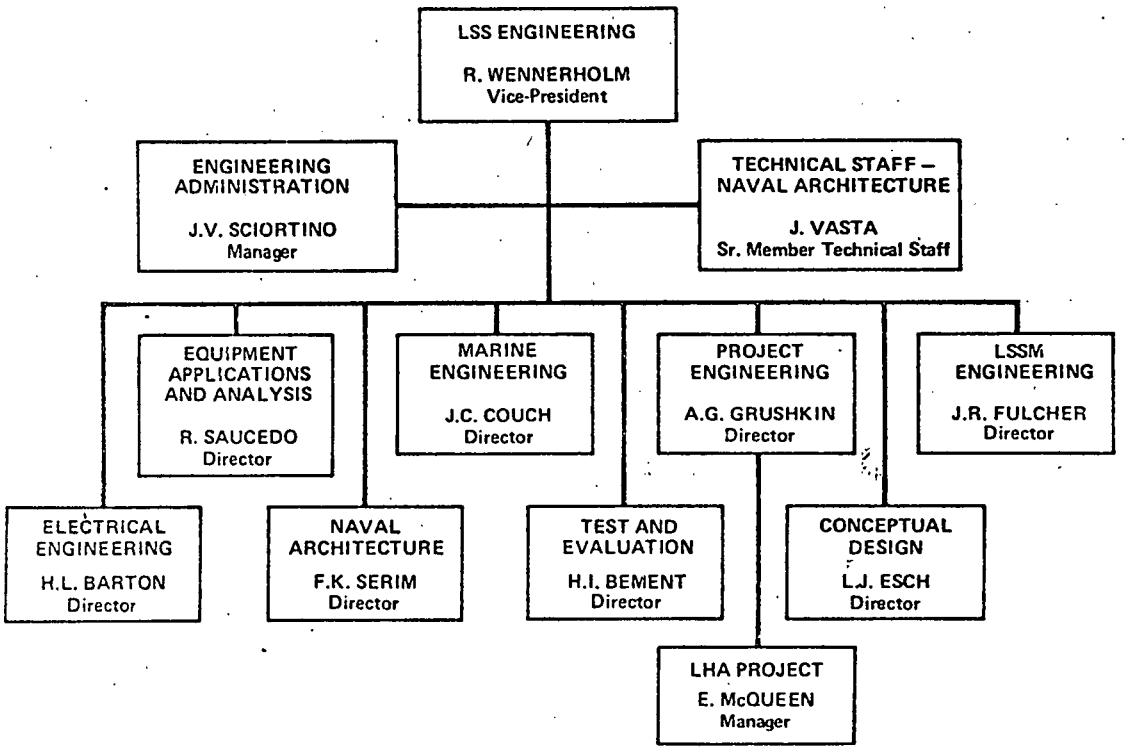
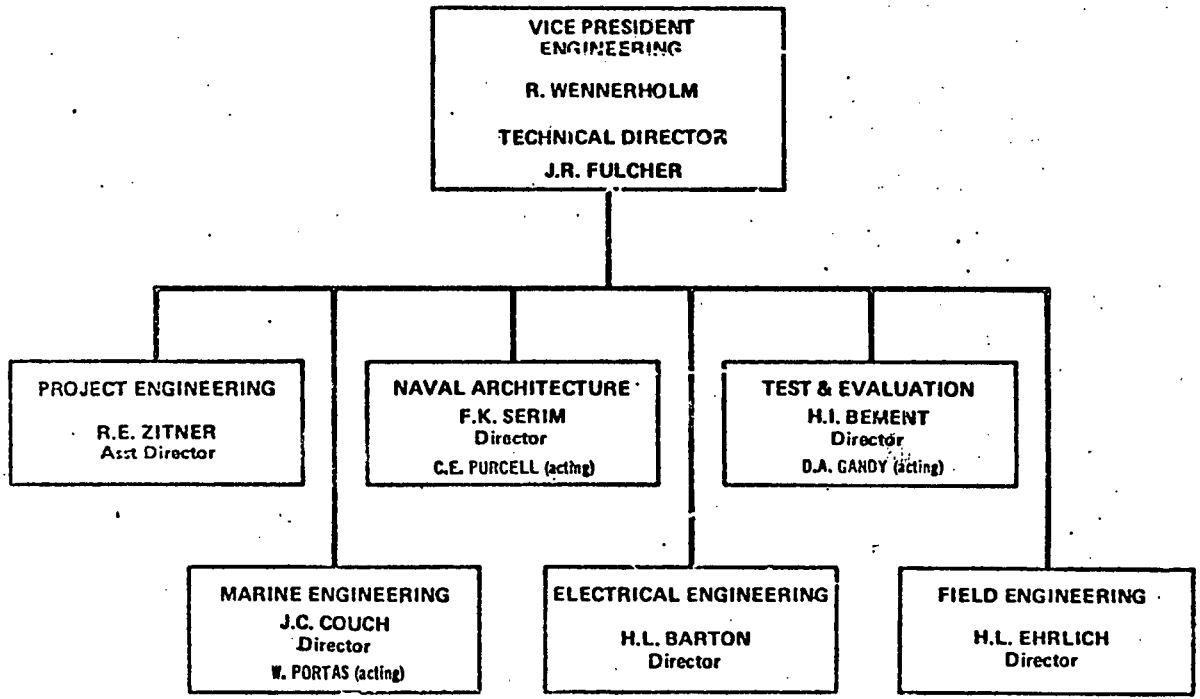


Exhibit 31

LV-13211A

LSS ENGINEERING (PASCAGOULA)

Litton Ship Systems



1908

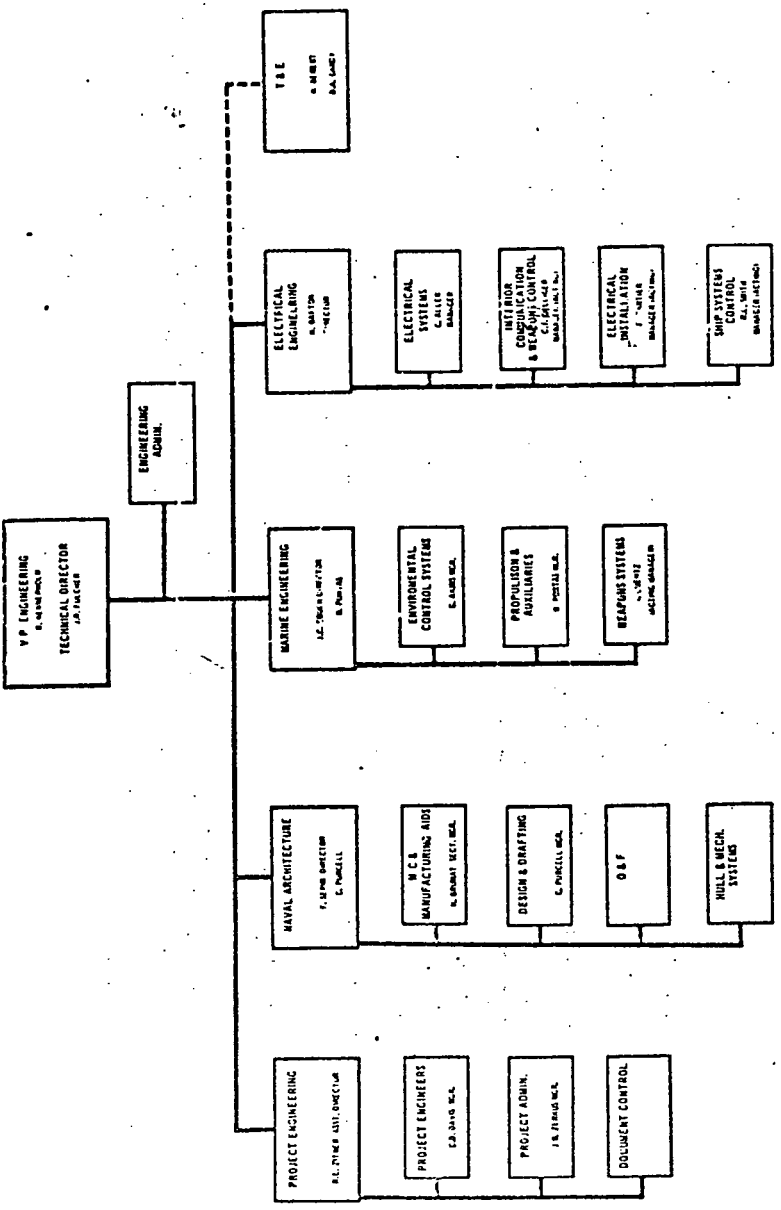

V P ENGINEERING
TECHNICAL DIRECTOR
ENGINEERING ADMIN.
T & E
ELECTRICAL ENGINEERING
ELECTRICAL SYSTEMS
INTERIOR COMMUNICATION & WEAPON CONTROL
ELECTRICAL INSTALLATION
SHIP SYSTEMS CONTROL
MARINE ENGINEERING
ENVIRONMENTAL CONTROL SYSTEMS
PROPULSION & AUXILIARIES
WEAPONS SYSTEMS
NAVAL ARCHITECTURE
N C & MANUFACTURING AIDS
DESIGN & DRAFTING
O & F
HULL & MECH. SYSTEMS
PROJECT ENGINEERING
PROJECT ENGINEERS
PROJECT ADMIN.
DOCUMENT CONTROL

EXHIBIT 32

Current	Jan. 1, 1972–Jan. 1, 1973	Jan. 1, 1973–Jan. 1, 1975	Remarks
Housing: Single units, 820 for sale.	1,948 permits issued; 1,200 July completion; 748 September completion; 1,150 new permits (pending).	7,000 units programed, St. Andrews, Vancleave, Westgate Estates.	Adequate single units housing.
Multiple units/apartments, 220 for rent.	1,622 permits issued; 1,000 July completion; 642 September completion; 542 new permits (pending).	2,700 236-funds requesting 1,000 apartments in planning stage. 2,500 low to middle income required.	Developers and financial agencies are encouraged to provide middle income 2, 3 and 4 apartments.
Multiple units/mobile home spaces, 125 for rent.	782 permits issued; 584 July completion; 198 September completion.	2,500 in planning stage	Zoning and financing major problem. Old "Fort Village Pilot Project."
Schools: 1 junior college, 4 high schools, 7 junior high schools, 22 elementary schools.	Facilities for 1,500 additional students.	Under study major problem.	A crash program is underway, final report underway.
Hospitals: 367 beds	40 beds, Pascagoula, June completion; 36 beds, Ocean Springs, October completion.	150 additional beds required.	$4,000,000 in funds requested.
Public transportation: None	Employees and small operators plan, limited service.	Mississippi coast transportation authority to implement coastal transportation system.	Grant from urban mass transportation requested for coastal system.
Recreation: Limited	Several projects in planning stage.	YMCA recreation areas; bowling, golf and tennis facilities required.	LSS to sponsor recreationa projects.

EXHIBIT 33

POPULATION STATISTICS

	County				
	Jackson	Harrison	Stone	George	Mobile
Population 1960	55,522	119,489	7,013	11,098	314,301
Land area	736	585	448	481	1,240
Population per square mile	76	204	16	23	254
Percent population change, 1950–60	76.8	42.1	12.0	10.8	36.0
Percent net migration	46.2	12.5	−6.1	−10.8	10.2
Percent Nat. increases	30.7	27.6	18.0	21.6	25.8
Percent urban	61.3	77.4		0	86.1
Percent 65 years and over	5.3	5.9	9.4	7.1	5.7
Median school years	10.3	11.5	9.9	9.3	10.3
Employment	17,735	30,070	2,088	3,192	106,211
Percent manufacturing employment	41.4	11.4	28.0	26.9	17.2
Median fmaily income	$5,120	$4,272	$3,058	$3,401	$5,132

Note: Median income, United States—$5,660.

Source: 1967 County and City Data Book, U.S. Department of Commerce.

EXHIBIT 34

MAJOR LHA OUTFITTING AND FURNISHINGS (O/F) SUBCONTRACTS

NOMENCLATURE

1. Commissary.[1]
2. Furniture.[1]
3. Module 6 furniture.
4. Storerooms/stowages/lockers.[1]
5. Metal joiner bulkheads and door. Expanded metal bulkheads and doors.
6. Honeycomb nonstructural.
7. Well deck sheathing and planking.
8. Work benches.
9. Reefer spaces.[1 2]
10. Hull insulation.[2]
11. Deck covering.[2]
12. Machine, pipe, and vent insulation.[2]
13. Protective coating (paint).[1]

See footnotes on p. 1911.

14. Windows and wipers.
15. Accommodation ladders.
16. Labels and nameplates.
17. Cathodic protection.[1]
18. Ballistic-non ballistic doors, hatches, scuttles, and manhole covers.

[1] Awarded.
[2] Subcontractor installation.

Chairman PROXMIRE. I would like your evaluations as an expert in this area, Mr. Rule. You said you were not familiar with that report but I have read you some of the criticisms. Will you tell us the —to place this in perspective, how it would compare with other ship producing operations, and so forth?

Mr. RULE. I am sure the short answer is that that is all the fault of total package procurement. [Laughter.]

Senator, let us be fair. I do not know when that study was made.

Chairman PROXMIRE. May 10 it was issued, May 10 of this year.

Mr. RULE. Of this year.

Chairman PROXMIRE. Yes.

Mr. RULE. When was the study made?

Chairman PROXMIRE. Fall of 1971 through April 1972.

Mr. RULE. In all fairness, this is a new yard, it is a new concept. They are going to try to manufacture ships. I am told that, from people who have been down there, that it is a well laid out yard.

Chairman PROXMIRE. I like the concept, I like it very much. I think we have not been applying new techniques to ship manufacturing, the same problem you have to some extent in housing, and there is nothing wrong with innovation. But this report constitutes an indictment which goes far beyond difficulty with new techniques, it seems to me, with respect to the training program, with respect to the management organization, and so forth.

Mr. RULE. Well, I grant that, but certainly part of their problem was getting going on a new concept. I think a great deal of their problem was that they did not have experienced shipbuilders. They were trying to run it with the aerospace philosophy and techniques, and Mr. Packard has criticized that, and rightly so. They have had a lot of problems.

As I said earlier, I do hope that they get this mechanized yard working because for commercial work, Marad ships, I think it will be good but not for warships.

It is the worst indictment I have ever heard of any shipyard, but I think they will work out of it insofar as commercial work is concerned.

Chairman PROXMIRE. So you say it is bad, it is the worse indictment you have heard of a shipyard. At the same time, we have to put it in the perspective of a new technological operation which is bound to have a lot of bugs and a lot of difficulties, to begin with. But it seems to me, having said that, you still have a very serious indictment of inefficiency?

Mr. RULE. I think so, too, and I think the company did not take the proper action that they should have taken in a timely manner to overcome a lot of those things.

There was a report, I do not know whether you have it, from a Maritime Commission examiner who issued his report on, the issue was, how far Litton was behind schedule on building some Maritime Commission ships, those Farrell Line ships that you mentioned.

They finally ended up having to pay these companies, I think, $5½ million. But on issue after issue this Maritime examiner just said about the same things you read, how inefficient, how they underestimated what the problem was, how they just did not hack it.

Chairman PROXMIRE. My time is long up and I want to thank Mr. Conable for permitting me to proceed. Go ahead, Mr. Conable.

Representative CONABLE. Thank you, Mr. Chairman.

You said the short answer is, this is the fault of total package procurement. Is that an accurate answer?

Mr. RULE. Please forgive me, I was trying to be facetious.

Representative CONABLE. You believe in total package procurement, is that what you are saying?

Mr. RULE. No, I have already said, I think it was before you came in——

Representative CONABLE. Yes.

Mr. RULE [continuing]. That the LHA contract is not a total package procurement. The RFP that went out for the shipyards to bid on specifically said, "This is not total package procurement so for them to try to say it is, is not accurate.

Representative CONABLE. I see. Well, was there what columnist Jack Anderson calls a "golden handshake" on this shipbuilding contract at some point?

Mr. RULE. On the LHA contracts?

Representative CONABLE. Yes.

Mr. RULE. Let us see, what did he say that "golden handshake" was, that they would get bailed out?

Representative CONABLE. If I can summarize, he said that they were encouraged to put in low bids which were announced as savings, that at some point in the process a "golden handshake" took place whereby the manufacturer was assured that if there were problems that developed they would be taken care of by cost overruns somewhere later in the process.

LHA CONTRACT AWARDED COMPETITIVELY

Mr. RULE. I am as sure as I sit here, Mr. Conable, that there was no such "golden handshake." They got that contract, the LHA contract, in competition. We made a mistake when we gave them the contract, and we learned that lesson and we have never made it since. They got this contract coming out of what is called contract definition. They were evaluated with other contractors and in May of, I think it was, 1968, it was announced that Litton had won this LHA contract. But the mistake we made was, we did not have a signed contract. Now, whenever we come out of source selection with two or three competitors, we have signed contracts by all of the companies competing, so that when the announcement is made the contract is signed and they cannot raise their prices.

PRICE RAISED AFTER CONTRACT AWARDED

Now in the Litton case on LHA we announced that they had won the contract. It took about 9 months to actually get the contract signed because they increased their price 26 percent. They kept put-

ting in proposals, and that is why we learned a lesson that when you announce a winner, you have a signed contract.

Representative CONABLE. It sounds like the Vietnam negotiations, does it not? [Laughter.]

PROGRESS PAYMENTS

I would like to explore your statement that Litton would owe the government money if they were to be paid on a progress report basis rather than a cost incurred basis. Was there some sort of a "golden handshake" in connection with this or was that an option that was provided in the contract, that they could be paid either on a cost-incurred or progress report payment basis?

Mr. RULE. No, sir. When a contract, when we make a contract, of that magnitude, it was I think a billion, two. This is a great financial drain on a company right at the outset of that contract.

Representative CONABLE. Sure.

Mr. RULE. So we made, and I think quite properly so, the arrangement with Litton that rather than start right off on a percentage of completion basis because there would not be any percentage complete for some months, in order to be fair to the contractor, we put in on this cost incurred basis where he would get all his costs, but we said, "We will do this only for a certain length of time", I think 20 months, it was until September last year—this year, it was until September this year; then we said, "Your initial financial problems should be such that you can now switch over to the traditional payment system of physical percentage of completion."

Representative CONABLE. And has the 20-month period been extended; is that what you are saying?

Mr. RULE. It had been extended 6 months to 28 March—28 February, 1973.

Representative CONABLE. It cannot be that there is no detectable progress still, can it? That was the original justification for the cost-incurred type of payment?

Mr. RULE. That is right.

Representative CONABLE. But is the progress so slight that the extension of the option is necessary?

Mr. RULE. Well, the company maintained that if we switched them over in September to physical completion versus costs incurred that they could not stand the financial impact.

Representative CONABLE. So, whatever the progress is, it is not adequate to absorb the difference between costs incurred and normal progress payments; is that correct?

Mr. RULE. That is correct.

POSSIBILITY OF FRAUD IN CLAIMS

Representative CONABLE. I would like to go back now to refer to the statement that this might almost amount to fraud, with respect to some of the contracts you were talking about. You were referring to the filing of claims that were far above what the government felt was due. What is the process of filing a claim? Certainly, if you are certifying to something that is incorrect, swearing that a certain

milestone in the contract has been achieved, it would be fraudulent if that had not happened.

I am wondering, however, in all these contested contracts to what extent these claims are simply bargaining positions and to what extent the government also assumes a bargaining position realizing that there is going to have to be some compromise, some give and take on both sides.

As a man who used to practice law, I am aware of the fact that frequently the truth is not halfway between two incorrectly stated versions. But I am wondering to what extent this business does get into a bargaining position quite apart from questions of fraud because of the litigious nature of the relationship between the government and the contractor. Do you get what I am saying? Is there ground for give and take here of a negotiating nature in these contracts or are they set up in such a way that it ought to be all cut and dried?

Mr. RULE. This is an interesting question. You ought to bear one thing in mind and that is that the only time we get into these hassles with contractors, I should say most of the time, is as a result of competition. Sole source contractors do not get into this position. They do not have to cutthroat compete like companies that we make compete. This is one reason why I think one of the—I think competition is really hurting us more than helping us in some areas.

But on the question of a company that has bid to get a contract and they know they have had to bid low to get it, they are going to start right at the outset, the day they sign that contract, to find ways and means of getting more money, we know that.

Now, when a contractor comes in with a claim that he unilaterally has prepared, this is going to your question of negotiation, there are different schools of thought on this, but I happen to believe that if you file a unilateral claim against me I ought to sit down with you and see if it has any merit, and I ought to talk to you and see what facts you have got to justify your claim. But rather than, after having gone through this fact finding exercise, rather than, then starting to negotiate with you I ought to tell you, "OK, you have said I owe you a $100. Now, all the facts in this case tell me that I owe you $15," and that ought to be it. This is, I might say, the philosophy that Admiral Rickover believes in, that is what he did in that submarine contract with Litton. He determined how much we owed them and he said, "I will pay you that," and no negotiation. That is the way I think claims should be handled. That is not the way they are being handled. We then sit down and negotiate.

Representative CONABLE. So people are taking bargaining positions on both sides?

Mr. RULE. Sure, that is right.

Representative CONABLE. And, of course, on both sides there is a constituency that has to be dealt with. If it is hoped to get $50 million out of the contract the company is very likely to say, "We are owed a $100 million," the Government is very likely to say "We owe you $25 million," and then when they settle at $50 million each one can point to the result with some satisfaction in dealing with the Joint Economic Committee, in dealing with the stockholders, and in dealing with the taxpayers. Every constituency is happy.

Mr. RULE. And dealing with the politicians.

Representative CONABLE. Well, in talking about the Joint Economic Committee I intended to include a few politicians. [Laughter.]

Chairman PROXMIRE. Never.

Representative CONABLE. Speak for yourself, Senator. [Laughter.]

Well, I am just wondering how much these things then get into the realm of the negotiated settlement. I must say I admire the Rickover approach because we know a lot more where we stand with such an approach. But when you are talking about fraud, it is important to know what you are talking about. If people are falsifying sworn statements that is one thing. If, on the other hand, they are simply inflating their view of the amount that is owed them for the purpose of ultimately satisfying a constituency in the negotiating process, that is a different matter.

Mr. RULE. But I think I have to point out these are not sworn statements.

Representative CONABLE. That is what I am asking you.

Mr. RULE. These claims are not sworn statements. It might be helpful if they were, it just might be helpful for some of these accounting firms and some of these lawyers who prepare these things, and corporation executives, it might just be well if they would have to certify the accuracy, but they do not.

Representative CONABLE. Well, thank you very much. That helps clear up some things in my mind.

Chairman PROXMIRE. Request for progress payments have to be certified, do they not, when they have excess progress payments?

Mr. RULE. Yes, sir.

Chairman PROXMIRE. Mr. Rule. in a minute, I want to ask Mr. Girardot to join you and read his statement, and then I want to question both of you gentlemen. Before I do that I want to ask you one question. I read this Miller report which I said was a brutal finding in my view, of the weaknesses of this yard, including mismanagement, disorganization, lack of training, lack of engineering, low productivity, no control of ship schedules, poor workmanship, repetitive defects, planned allocation of manpower on all ships was inadequate, no adequate fire protection, and I think you indicated that this was as bad or worse in terms of inefficiency as any shipyard you are familiar with.

APPOINTMENT OF ROY ASH

Now, as you know, Mr. Roy Ash, the former president of Litton, and he was the chief executive officer of this company at the time that this situation had developed, he is the man who has been designated by the President of the United States as the new head of the Office of Management and Budget. Do you have any views on that appointment? [Laughter.]

Mr. RULE. I sure do.

Chairman PROXMIRE. We would sure like to hear them.

Mr. RULE. Well, I think, first, that old General Eisenhower must be twitching in his grave. He was the one who first called attention to the so-called military-industrial complex, and I frankly think we

have added a new dimension to the military-industrial complex. I think it is a military, this may not be the proper order, but I think it is almost a military-industrial-executive department complex. I think it is a mistake for the President to nominate Mr. Ash, whom I have never met. I think it is a worse mistake for him to accept the job. I just—that is the way I feel about it.

Chairman PROXMIRE. Why is it a mistake? Why is it a mistake, first, for him to be nominated?

Mr. RULE. I am saying this strictly from his background and his efforts on behalf of Litton during the negotiations that have been going on.

Chairman PROXMIRE. It is a mistake, on the basis of his record as a business manager, to bring a man with this kind of a record in as head of the Budget Bureau.

Mr. RULE. Insofar as the LHA is concerned, yes; and, of course, Senator, his job is probably——

ROLE OF ROY ASH IN LHA NEGOTIATIONS

Chairman PROXMIRE. Let me ask you what Ash did in the negotiations on the LHA contract?

Mr. RULE. Well, let me just finish what I was going to say.

Chairman PROXMIRE. Yes, sir.

Mr. RULE. And I forgot it, you interrupted me.

Well, there was an article in the paper the other day by Orr Kelly which quoted, he was quoting from, some minutes of a meeting, and these minutes, according to the article, said that Mr. Ash had talked to Mr. Connally about a program of the magnitude of $1–$2 billion dollars to help companies like his and other shipyards, and the statement was made by Mr. Connally apparently, "Well, if you are going to present that to Congress make it bigger than the Congress." Now he has that background.

All I say is that from where I sit now I have to think it is a mistake. But I think my thoughts on whether it is a mistake could easily be or could be overcome if he was subject to confirmation and going before a committee to be confirmed where he could be questioned about, I do not know, any number of things. But he has probably the most important job in this Government, next to the President, but he is not subject to confirmation, he is not subject to questioning, and he enjoys the same executive privilege, I guess, that Mr. Kissinger does. He does not have to go up to any committee and be questioned throughout the year, and I just think this is wrong.

Chairman PROXMIRE. Well, he does come before committees, certainly previous budget directors have, in their capacity, but I agree he certainly does not need any confirmation.

Will you give me your interpretation, I read that column by Mr. Kelly, too, and I was a little puzzled by that reference in the conversation with Mr. Ash and Mr. Connally, in which he said "Make it bigger than the Congress." What was your interpretation of that? You would go to the President for——

Mr. RULE. Well, he wrote two columns. In one column he said that Mr. Ash had told, in this meeting that he was quoting the minutes, that he was quoting from, he had told the people in that meet-

ing that he was going next to see Mr. Warner, Mr. Sanders and then to the White House with his problem. Now, that was in one column.

Then in the second column he talked about this program of $1 billion to $2 billion to be presented to Congress and, so far as I am concerned, sitting here right now, I think you will see that program presented to Congress. I think you will see it presented to Congress with the aid of the Grummans and the Lockheeds and others, I think you will see it.

Chairman PROXMIRE. You mean a program simply to wipe out all of the claims by paying them in full?

Mr. RULE. I do not know how ingenious the program will be, I do not know what it will try to do, but it will try to get $1 billion or $2 billion to help out some companies in trouble.

Chairman PROXMIRE. Help out Litton, Lockheed, Grumman, and so forth.

In view of the fact that we have discussed these articles by Mr. Kelly in the Star, without objection, they will be printed in full in the record.

[The articles referred to follow:]

[From The Washington Star-News, Dec. 15, 1972]

PRESSURE FROM ASH ON NAVY PACT CITED

(By Orr Kelly)

Roy L. Ash, at the time president of Litton Industries and a close adviser to President Nixon, last summer warned senior Navy officials that he would carry his firm's half-billion dollar contract dispute over their heads to the White House, according to minutes of a meeting obtained by The Star-News.

Ash, who left as Litton's top executive this month after Nixon named him to head the powerful Office of Management and Budget, denies he purposely gave the impression that he intended to take Litton's case to the White House to try to sway the decision.

"I did not, in fact, exert any such influence," he said last night.

But high Navy officials who took part in a June 6 meeting over a severely delayed ship construction program clearly thought Ash was cautioning them not to lean too hard on Litton. Ash told them the company was in a serious financial crunch at the time, aggravated by disputes over costs on Navy Contracts.

The minutes of the June meeting—an unclassified report by one of the admirals present—were made available by Navy sources troubled by the continuing dispute now that Ash will be a top official in the Executive Branch.

As it turned out, Litton in late summer was given a six-month reprieve—until February—from enforcement of a contract clause that would have seriously jeopardized payments to Litton and which could have put the 11th-ranking defense contractor in debt to the Navy for uncompleted work already paid for.

The extension was announced by Navy Secretary John W. Warner, who had participated in a series of unpublicized "summit" meetings between Navy officials and Litton representatives.

Ash's comments about going to the White House came at the June meeting, according to the minutes.

"Mr. Ashe (his name is mispelled in the minutes) indicated that it appears that some in the Navy have a built-in sense of self-righteousness concerning Litton's performance and that the Navy would have to relax this view if Litton is expected to proceed with the contract," the report said.

"Mr. Ashe indicated that he intended to meet with Secretaries Sanders (Undersecretary Frank Sanders) and Warner and then on to the White House to explain the problem," continued the admiral's report of the June meeting.

A Litton spokesman said the firm's chief negotiator with the Navy has been Fred W. O'Green, who succeeded Ash as company president, but Navy sources said Ash did the talking for Litton in the numerous meetings he attended.

And despite objections from some lower-echelon Navy officials who argue that such "summit" meetings can lead to bad decisions, Warner—first as undersecretary and later as secretary—dealt personally with Ash and other high company officials over the expensive disagreement.

As of now, the half-billion-dollar dispute is at various stages of negotiation and adjudication.

OVERSEES NAVY FUNDS

Ash, a confidant of Nixon since he headed a major governmental reorganization study in 1968, will be in a position as head of the OMB to review and influence the Navy budget, although most decisions on 1974 spending will have been made by the time he takes office. His appointment at OMB does not require Senate confirmation.

The half-billion dollar dispute goes back at least a year and a half. Trouble came up in construction of a fleet of LHA—landing, helicopter assault ships—being built at Litton's new automated shipyard in Pascagoula, Miss.

Litton has had severe problems at the new shipyard, built with the aid of a $130 million Mississippi bond issue. The original contracts for the LHA's has been cut from nine ships to five and construction now is running more than two years behind schedule.

RAISES OTHER QUESTIONS

This has raised questions both about the assault ships and the cost of 30 destroyers to be built at the same shipyard. In addition, Litton also has contracts for construction of three nuclear submarines and an ammunition ship.

Litton claims the Navy owes it $547.1 million—$379.7 million in connection with the $1.2 billion LHA contract and $168 million in connection with other programs.

Basically, Litton says costs grew because the Navy failed to deliver necessary equipment on time and made expensive design changes.

The Navy says Litton's claims are grossly overstated. It also says the landing ship program is so badly behind schedule that a case could be made to cancel it for default by Litton.

With those issues at hand, the first meeting was held. Minutes of the third session—in November 1971 at Litton's Beverly Hills headquarters—said two earlier meetings had already been held.

CRITICAL TIME

By the time of the June 1972 meeting, it was a critical time for the huge firm. That meeting was held just below "summit" level.

Present, in addition to Ash, were Adm. Isaac C. Kidd Jr., chief of Naval Materiel; Charles L. Ill, assistant Navy secretary for installations and logistics, and Rear Adm. Kenneth L. Woodfin, director for contracts of the Naval Ship Systems Command.

The session came a little more than three weeks before the end of the company's fiscal year. Ash warned the Navy officials, the minutes show, that the firm's cash flow position was so tenuous that Litton might not be able to continue working on the LHAs unless the Navy changed the contract.

Particularly troublesome to Litton was a contract clause that would require a shift in the method of paying for the ships, effective Sept. 1.

Until that date, Litton was to be paid on the basis of costs incurred by the shipyard. But on Sept. 2, the Navy was supposed to begin paying Litton only for work actually completed.

SHIFT POSTPONED

With the ship construction lagging so badly, this would have put Litton into debt for work already paid for by the government but not finished.

But on Aug. 31, the day before the payment shift was due, Warner announced the old system would continue until Feb. 28, 1973, assuring continued payments to Litton for the time.

Navy sources said Ash had been assured at least two months before Warner's announcement that the extension would be granted—even though the public announcement was not made until Aug. 31.

Litton's annual report for the year ending June 30 makes no mention of the critical cash flow problem Ash predicted if the change wasn't made.

Navy officials also fear future problems that could run prices up on other outstanding contracts, hinging on Ash's actions as head of OMB.

Litton was one of a number of companies that signed "total package procurement contracts" with the government in the late 1960s and early 1970s. These contracts placed far greater responsibility on contractors, sometimes spanning design, construction, and even maintenance.

The total package contracts were thought at the time to be the answer to many of the big procurement headaches at the Pentagon. But instead the contracts created new problems.

For example, earlier this week the Navy ordered a new batch of 48 fighter planes from Gruman Aerospace Corp. under such a contract.

REFUSED TO BUILD

The firm promptly refused to build the planes. It said it would suffer unacceptable losses if it did. Gruman said the contract would have to be renegotiated at an increased cost.

The signing of new total-package contracts now has been halted by the Pentagon, but some Navy officials are worried about growing pressure from industry to make that ruling retroactive. That could reopen contracts, such as those held by Litton and Gruman, to renegotiation at higher costs to the government.

Litton's half-billion-dollar dispute continues unresolved, with various aspects of it being handled at different levels of government. The basic figure has changed—upward—over the months, with Litton asking for an additional sum, bringing the total to the $547 million figure.

Ash said yesterday he does not intend to divorce himself from budget decisions affecting the Navy. The apprehension of some Navy officials, he said, "is not warranted."

WILL SELL SHARES

Ash said he has arranged to sell not only his 200,000 shares in Litton, which he helped build into one of the top conglomerates, but all other stock holdings as well.

He moved into an office in the Old Executive Building on Monday, and will take over OME from Casper Weinberger as soon as Weinberger is confirmed as the new Secretary of Health, Education and Welfare.

"I can and will be very objective and will serve the best interests of the country," he said.

[From the Washington Star-News, Dec. 17, 1972]

PROPOSAL BY ASH FOR $2 BILLION AID PUSHED BY LITTON

(By Orr Kelly)

Litton Industries is now pushing a big-money solution to its shipbuilding problems first proposed to the Navy last June by White House adviser Roy L. Ash when he was president of the corporation.

The key to the solution is for Congress to provide a large amount of money—up to $2 billion, according to Ash—to settle claims against the Navy by Litton and a number of other shipbuilders.

Ash, who resigned as Lotton's top official and moved into an office in the Old Executive Office Building last week, will take over as head of the Office of Management and Budget next month. He made his proposal in a meeting with top Navy officials on June 6, according to minutes of that meeting made available to the Star-News by Navy sources.

The minutes said Ash described the company's serious cash flow problems as resulting from a $1.2 billion contract to build five landing helicopter assault (LHA) ships.

'GRAND PROGRAM SCALE'

"Mr. Ashe (the minutes mispelled his name) also recommended that the Navy consider presenting this type contract problem along with other similar shipyard problems to Congress," the minutes said.

"This presentation would be in the form of a procurement policy change and would perhaps require $1 billion to $2 billion. Mr. Ashe indicated that he had discussed such an approach with Mr. Connally. Mr. Connally was quoted as saying

such a program should be positively presented, on a grand program scale—make it bigger than Congress."

Ash, in a telephone interview, identified the "Mr. Connally" as former Treasury Secretary John B. Connally, who served as a member of a task force on governmental reorganization headed by Ash in 1969 and 1970.

In a five-page statement handed to newsmen late last week, Litton bitterly condemned the Navy for its problems on the LHA contract.

NO PLAN IN MIND

"The proper approach is to admit to rising costs, to ask Congress for the money that will be needed, and then to administer the contract properly," the company statement said.

"Instead it is worked after the fact, with the contractor not only taking the brunt of the criticism but ending up wasting additional money to prepare the claims and to fight the legal battles and waiting years to recover costs. It amounts to private industry financing the government."

Ash said he had no program or plan in mind in his new role as the government's top budget expert to propose to Congress to settle the shipbuilding claims problem. He described the problem as essentially "Navy business," but he did not rule out the possibility that he might propose some solution to the problem later.

"I did say, to the Navy and to Mr. Connally, that it seems in the government interest if we can resolve, in one way or another, these $1 billion to $2 billion in claims the Navy has. It is just prudent and in the government interest to resolve these claims . . . It is not prudent business to run with a big backlog of unresolved issues. . . .

"I have no program of what can be done . . . This is as much in the interest of the government as it is in the interest of Litton."

DISPUTED FUNDS EXTRA

A Navy spokesman said the total amount of shipbuilding claims pending against the Navy as of Nov. 1 was $659 million. Another $225 million in such claims are pending before the Armed Services Board of Contract Appeals.

This total of $914 million does not include several hundred millions of dollars in disputed funds which have not yet reached the stage of becoming formal claims by the shipyards against the Navy.

Most of the nation's major shipbuilders have large claims against the Navy.

Many of them stem from changes in the construction of submarines ordered after the loss of the USS Thresher in the North Atlantic.

Another large batch of the claims is related to a program to build 48 destroyer-escort ships. The Navy has acknowledged that poor planning on its part caused problems for the yards but the amount of liability is in dispute.

HALF-BILLION OWED

In Litton's case, the company says the Navy owes it $547.7 million. Of that, $379.7 million is related to the LHA program and the remainder to a variety of other programs.

The minutes of the June 6 meeting also showed that Ash warned senior Navy officials that he would carry his firm's contract dispute over their heads to the White House. Litton has denied he purposely gave the impression that he intended to take Litton's case to the White House to try to sway the decision.

Litton in late summer was given a six-month reprieve—until February—from enforcement of a contract clause that would have seriously jeopardized payments to Litton and which could have put the 11th ranking defense contractor in debt to the Navy for uncompleted work already paid for.

Chairman PROXMIRE. Mr. Girardot, will you come up here and you may proceed as soon as he finishes his answer to the question.

Mr. RULE. I have one thing further I would like to say.

Chairman PROXMIRE. We will have more questions for you, Mr. Rule. We do not want you to leave.

Mr. RULE. No, but I want to make this affirmative——

Chairman PROXMIRE. Very good.

GET-THE-CONTRACT SYNDROME

Mr. RULE. As I see sitting where I sit in Navy procurement today, and I read you what somebody else said my function was, I think we have to do somthing to get away from this get-the-contract syndrome. There are these companies that take the attitude, and thankfully most companies in industry, the defense industry, do not take this attitude, but there are some, and they are pretty obvious who they are, that take this attitude that it is a way of life, "get the contract and Uncle Sugar somehow will bail us out."

BAILOUT LAW

Now, I want to make two, I want to put forward two thoughts on that. You may not remember, but Congress passed a law entitled Public Law 85–804, which provides a means for the Government, for want of a better term, bailing out or assisting defense contractors who get into trouble financially. It is an outgrowth of the old War Powers Act. If a contractor, and he is certified to be necessary to the national defense—take Grumman, for example, if Grumman is certified essential to the national defense for those F–14 planes—and it certainly is—if they need money to continue operation, to give the Government its contracted for hardware, 85–804 has the mechanism which Congress has provided where they come in and they ask for an amendment without consideration, and this is handled by the Navy Contract Adjustments Board, and we do this rather frequently, mostly for small companies, but that is a mechanism that Congress itself has provided. These companies don't like to go that route because they have got to lay open every bit of their financial records. They have to show they can't get the money anywhere else, but if they have a case, and we need their hardware, we will give them relief under that act.

Now that is——

Chairman PROXMIRE. We referred to that act yesterday, it has to be a finding that it is in the national defense interest, and as you say, the guts of it is that the company has to lay open their financial records and make a full justification.

Mr. RULE. That is right.

Chairman PROXMIRE. I can't see how we can possibly justify escaping that if we are going to provide this enormous amount of taxpayers' largesse under these circumstances. We certainly have to have full justification.

Mr. RULE. I think you will find that the C–5A contract, when it was reformed, was handled under that procedure. It had to be, and I just want to point it out again because you don't hear these companies going that route, they don't want to, but I think they should be required to.

Chairman PROXMIRE. All right, sir.

Mr. RULE. Now the second point I want to make is rather than permit the Government to continue to be soft on favorite contractors, I suggest we admit failure of our free enterprise system and proceed to nationalize or socialize certain industry segments. Certain contractors, in my opinion, are in effect asking for this. We ought to

make up our mind, do we want free enterprise with its success and its failures, and by "failures," I mean bankruptcies. Do we want that kind of system or do we want something else.

Do we want a special privileged group of defense contractors who by their size and/or influence can get bailed out, which is most unfair to the majority of contractors in this country. As I see it, we have already moved to a quasi-welfare industry, certainly without having guts enough to tell the taxpayer free enterprise is out, and socialism is in. And I think we ought to give consideration to taking that route with some of those contractors.

Chairman PROXMIRE. I congratulate you warmly—in that statement you put it exactly right. If we want free enterprise and if we want to have it we are going to have to pay the price with some bankruptcies.

Mr. RULE. That is right. In the commercial market, if a company can't hack it, they go bankrupt.

Chairman PROXMIRE. That is right.

Mr. RULE. Now, I say we ought not to favor certain contractors or if they need to be bailed out, 85–804 is the mechanism that Congress has provided for doing it. If they are essential to the national defense, and we need the hardware that only they can supply, the mechanism is there, and if they don't take advantage of it, well, I think we are going to have to take some drastic steps.

Chairman PROXMIRE. I want you to stay there, and Mr. Conable has some more questions to ask you and then we want to go to Mr. Girardot and we want you to stay.

Representative CONABLE. I am not sure we have time to go into further exploration of your views about how to convert the military-industrial complex into the military complex here but it does seem to me——

Mr. RULE. I sure do mean to infer that.

Representative CONABLE. Well, you are suggesting the Government takeover apparently any company that can't hack it; is that right?

NEED FOR PLANNING MOBILIZATION BASE

Mr. RULE. What I am suggesting more specifically is that we start planning, we have not planned this way. I think in these essential segments of our industry, we ought to start with getting together a very good mobilization base, a base that is required for our national defense, and then having decided the mobilization base rather than having these companies compete, buying in and then have all these consequent problems, allocate our work, allocate our work to the contractors who give us what we want, namely quality, ontime delivery, and reasonable costs.

Representative CONABLE. I was somewhat bemused by your position, sir, because earlier you said that you are one of the few witnesses who has appeared before this subcommitee who has said that in some circumstances sole source procurment is justified, and it seems to me that one of the protections we have had against the development of a military-industrial complex has been competition for bids. Is there any inconsistency there?

Mr. RULE. It is very ironical, it certainly is, no doubt about it.

Representative CONABLE. I don't want to extend this unnecessarily, Mr. Chairman, but it does seem to me that we have a lot of paradoxes in this field.

Chairman PROXMIRE. I just want to break in here to say when I approved of that statement, and I do very warmly, I thought you were implying that we ought to preserve the free enterprise system, including the free enterprise system with respect to defense contracting with all its weaknesses and shortcomings, and Heaven knows there have been plenty of them, and nevertheless, I think it is still a better system than having the Government get into this. We would have far more problems than we do. But if we are going to have the free enterprise system, then we have to recognize when you have an inefficient, incompetent operation that can't hack it, can't cut it, can't meet a contract, theyshave got to pay the price. If bankruptcy is the price that is it. If the price is to come in under the regulation that you referred to and lay bare all their financial problems and get relief and the Government decides it is necessary for the national defense to keep them alive, then they should be required to do that. That was, I thought was, your position.

Mr. RULE. That is right.

Chairman PROXMIRE. Not that we ought to move to a socialized system of procurement, which I would oppose.

Representative CONABLE. Mr. Chairman, I don't quarrel with that point of view. I do think we ought to avoid the sweeping generalization about defense contracting generally. You are still going to have to look at individual situations and decide what the equities require. There is a great tendency in these hearings and otherwise to talk about the Pentagon as though it existed in a vacuum, and there were no accountability, for instance, to the administration controlling the Pentagon at any given point.

Now these single source procurement contracts, the total package concept, all these things were creatures of an earlier era. We are having a lot of crash landings now as a result of takeoffs that were apparently conceptually faulty, and we have a lot of hard decisions to make. We are going to have to do them pretty much on an individual basis in each case—hard decisions, because we still need the hardware.

It isn't enough just to say it is an outrage that we have these cost overruns. We have got to decide what the realistic answer is, faced with the circumstances we find ourselves in.

I am not quarreling with your general statement, sir, I am not quarreling even with what you may be saying about the specific contracts you are talking about here today, but I do think we have to avoid making the kind of inflexible rules in this area as in other areas of government that can get us into bad trouble and change the whole concept of our free enterprise system in the process.

Mr. RULE. Mr. Conable, I think the record will show that when I made those comments I said certain segments of our defense industry. I also said that it was very unfair to the majority of the defense industry to carve out and treat a few of the large corporations differently, and free enterpise to me means just what I said, either succeed or hack it, and if you don't hack it you go bankrupt.

Representative CONABLE. No quarrel with that.

Mr. RULE. That is not what happens because the Government won't let these big companies go bankrupt. They will let small business go bankrupt by the dozens everyday, but they won't let that, so the system isn't working the way it should.

Chairman PROXMIRE. I want to thank you again, Mr. Rule.

Mr. Girardot, my apologies for keeping you waiting so long. I want you to go ahead with your statement. It is a fine, short statement. We are happy to hear it and then we will proceed with questions.

STATEMENT OF DEAN L. GIRARDOT, COORDINATOR FOR METAL TRADES DEPARTMENT, AFL–CIO, PASCAGOULA, MISS., ACCOMPANIED BY PATRICK C. O'DONOGHUE, GENERAL COUNSEL

Mr. GIRARDOT. Before I proceed I would like to introduce Mr. Patrick O'Donoghue, who is the general counsel of the Metal Trades Department here in Washington.

My name is Dean Girardot. From early 1970 I have been coordinator for the Metal Trades Department, AFL–CIO in Pascagoula, Miss. The Metal Trades Department is made up of about 20 international unions which have come together to bargain on a unified basis with industries, such as shipyards and the like. The department, along with several of its affiliated internationals, has had the bargaining rights for years in the Pascagoula shipyards.

As spokesman for the unions, I would like to make it very clear that we have no interest in seeing the contracts on the LHA and DD963 moved from Pascagoula, Miss. We do, however, have an interest in setting the record straight on the history of Litton labor relations in Pascagoula.

Certainly, Litton management has had a great many problems in the past but we are confident they have now turned the corner and production has vastly improved. It would be hard to deny that the starting up of this great shipyard was poorly handled in many respects. Evidently management read too many of their own press releases about the "Shipyard of the Future."

LITTON PROMISES JOB SECURITY

Our experience with Litton and the new shipyard began as early as 1967. At that time, we were the bargaining agent at Ingalls Shipbuilding—owned by Litton. At a series of widely publicized meetings, the unions were told that Litton had the shipyard of the future on the drawing boards. If it were built in Florida, as was threatened, Litton foresaw a steady drop in employment in Pascagoula. However, if the new yard were built in Pascagoula, Litton promised job security and financial prosperity for all. But the cost of insuring the new yard would be built in Pascagoula was high indeed for the journeyman shipbuilder. As the price of admission, so to speak, Litton demanded a 5-year instead of a 3-year union contract at practically no wage increase to the workers. If the unions accepted, as they had to, Litton promised the new yard and the old would be

"one big happy family." This promise was incorporated into the 5-year contract by the following language:

> In the event the company constructs a shipbuilding facility on the West Bank of the Pascagoula River as contemplated by the parties during negotiations of the basic agreement, such facility shall be covered by the basic agreement.

LABOR-MANAGEMENT PROBLEMS

As soon as the new shipyard neared construction completion, Litton gave signs of reneging on its promise. In 1969, management on the West Bank of the river (the new yard) began to grumble that, while they would recognize the bargaining authority of the unions, they could not agree that all the provisions of the basic agreement applied. When I arrived on the scene in early 1970, I was told by the first in a series of directors of labor relations that the Shipyard of the Future did not need any of the skilled workers of the old yard. He said the West Bank could and would build ships with 80 percent trainees. Litton then unilaterally declared that no employee of the East Bank (old yard) could move to the West Bank unless transferred by Litton and that cross-river seniority couldn't be retained. We all wondered what had happened to the promise of job security and prosperity. Now if an East Bank employee wanted to work on the West Bank, he could do so only by quitting his East Bank job, losing all his vested rights, wait for 30 days, and hope the new yard would hire him as a new employee. The unions met several times with management to try to reach a solution to these and other problems but it came to such a point of futility that we could not even meet with the two yards together. In order to talk out a problem, we were required to make an appointment with the West Bank, then call and make an appointment with the East Bank on the other side of the river.

Finally, in desperation we decided to arbitrate under the basic agreement a case dealing with seniority. The arbitrator ruled in our favor and held the contract applied to both sides of the river. Litton was so upset that a director of labor relations told me the company had allocated $1 million to fight us on the question of cross-river bumping, and fight they did!

The next year was spent in so much litigation it boggled our minds. Unfair labor practice charges were filed and withdrawn; a State court suit was filed to set aside the arbitrator's award. A main piece of litigation was a petition filed with the National Labor Relations Board to declare the Pascagoula facilities two separate shipyards. The second prong of the attack was a lawsuit in the Federal courts to declare that most portions of the basic agreement were not applicable to the new yard. According to Litton, nonapplicable provisions were wages, job classifications, seniority, work jurisdiction, and so forth, while the no-strike clause remained in effect.

MORALE DECLINES

During all of this litigation, morale at the West Bank was hitting an alltime low. The frustration and uncertainty finally led to a 4-day work stoppage. Litton retaliated with a 20-day lockout. The

company refused to reopen the new shipyard until the unions agreed to do away with the historical and traditional craft lines of work jurisdiction, as was guaranteed in the basic agreement.

We felt at that time, and still do, that Litton's work jurisdiction demands were just an excuse to shut down the yard for a time. Perhaps an incident might illustrate my point. A mediation session was called by J. Curtis Counts of the Federal Mediation and Conciliation Service. Litton stated their conditions for reopening the shipyard. They demanded we agree to do away with traditional craft lines at the new shipyard. The unions felt strongly that the new yard could neither operate nor build ships efficiently with a "jack-of-all-trades" mechanic and that, if Litton had such contract language, practically speaking, we were confident that such a concept could not work, either with or without the unions' cooperation. We knew that, in order to build ships, Litton would have to use craftsmen. Therefore, hoping to get the gates reopened, the unions agreed to give Litton the language it wanted over work jurisdiction.

Litton refused; it took our proposal and said "no dice." So, although we gave Litton what it requested, California management still saw fit to keep the shipyard closed.

20-DAY LOCKOUT

Only late in September, after a 20-day lockout, were we finally successful in reaching an agreement with Litton to reopen the shipyard. We agreed to have two separate contracts and that there would be two separate shipyards, but we kept the right to dovetail seniority so, if a person was laid off in either shipyard, he could exercise his seniority rights at either the East Bank or West Bank. The unions have all along maintained that complete separation of East Bank and West Bank is not efficient and Litton cannot produce ships with a dual system. But Litton wanted to try—and try they did.

From the time the unions signed the contract recognizing two separate yards, production on the West Bank went from bad to worse. Finally, business agents of most of the local unions in Pascagoula asked me to contact company officials and let them know of the deplorable conditions in the new shipyard. I did this.

REORGANIZATION OF SHIPYARD

I met with Mr. Fred O'Green, who is now President of Litton in Pascagoula, Mississippi, and told him I felt the company must do something very soon or the shipyard would be completely destroyed by mismanagement. Mr. O'Green seemed to agree. About two weeks after our meeting, Litton decided to no longer have two shipyards; they put Mr. Ned Marindino in charge of both the East Bank and West Bank yards. The unions have applauded this decision. We feel the "Shipyard of the Future" cannot possibly work without having experienced ship builders—not only running the yard but working in it to produce ships.

Mr. Marindino is the past president of the old shipyard and his record was outstanding. He took over the shipyard when it was losing money; he put it in the black and delivered ships on time. In doing so, he has earned the confidence and respect of most of the union leadership in Pascagoula, Mississippi. He is truthful and, when he tells you he intends to do something, you know it will happen. I am not saying all of our problems are solved in Pascagoula —we will surely have many problems down the road—but I do say to this Committee I feel under the leadership of Mr. Marindino the new shipyard has turned the corner and will be able to produce the DDs on schedule. I firmly believe from the conversations I have had with the workers in the yard and with union representatives in Pascagoula that the new yard will produce the LHA on the revised timetable they have with the Navy.

The new yard has some of the finest facilities I have ever seen and, with their decision to let people with shipbuilding experience "do their thing," they will surely be able to produce on time all of these ships.

With the proper management at the Pascagoula shipyards, Pascagoula can truly be the "Shipbuilding Capital of This Country."

Thank you.

MANAGEMENT INSISTED ON TWO SEPARATE YARDS

Chairman PROXMIRE. Thank you very much, Mr. Girardot. You might, if you want to, refer to the chart you placed up there which, I understand, you might want to use in responding to questions.

I get the feeling listening to your testimony there was a great deal of practical knowledge which the shipworkers had and which they wanted very much to impart to the management but which the management was very reluctant to accept or to consider. When finally they did, as you tell us, on one very important decision, that is to merge the two shipyards, the East and the West yards, it has turned out to be a good decision, one that the workers have been urging, the union has been urging for some time.

Why, in your view, was the management so reluctant to listen to the advice of the union and why did they resist this, what appears to be now an obvious and good move?

Mr. GIRARDOT. Well, Senator, in the very beginning, of course, you understand, that the company talked the unions into a 5-year contract with practically no money by saying that if we didn't sign this contract then they would not build this yard in Pascagoula, that this yard would have been built somewhere in Florida—I think it was Tampa they indicated.

Chairman PROXMIRE. Let me just get back to, you say a 5-year contract, practically no increase. Can you tell us how much of an increase was it arithmetically?

Mr. GIRARDOT. Right off the bat I can't.

Chairman PROXMIRE. Was it three, four percent a year? Less than that?

Mr. O'DONOGHUE. It was less than that; I think it was eleven, ten, eight—seven and eight cents.

Chairman PROXMIRE. An hour, is that it?

Mr. O'DONOGHUE. It was in that area.

Chairman PROXMIRE. It would amount to a one or two percent increase.

Mr. GIRARDOT. We have a copy of those contracts here and if you want them, we will be glad to submit them to put them into the record.

But getting back to the problem of not wanting East Bank people, when they first started up the shipyard we had conversation with management which, by the way, was totally new management —you understand, they completely separated these shipyards, they no longer decided it would be feasible to do as they told the unions in the beginning; that is, to keep it as one big happy family. Therefore, they had people who were not familiar with our organization, and I guess they didn't want to be familiar with our organization nor the people on the East Bank, because their comments to us were, well, they needed people who did not have the old ideas entrenched in their minds. In other words, they were not brainwashed with the old system of building ships. They needed new people so they could train them in this new theory of module construction.

Chairman PROXMIRE. I see.

Do you believe the existence of the two separate yards did result in higher costs and delays?

Mr. GIRARDOT. Oh, there is no question about it. Had they used the skills they have on the East Side of the river they certainly would have had some problems. There is no question about it, because it is new concept, and a concept that we like; they just simply didn't have the people who had the skill and knowledge of how to build a ship.

ORDERS TO CUT SHIP IN HALF

Chairman PROXMIRE. Aside from the independence of the two yards and the obvious lack of competence on the part of the people in the new West Bank, what were some of the other management, poor management examples?

Mr. GIRARDOT. Well, I think to illustrate one, it is sort of sad, pathetic, but yet rather funny, as you can see on this drawing—by the way, this is a picture of a LHA, the last one down here. Let me point to it. This is what they called the integration area in this shipyard. This is the module assembly area where they supposedly put these things together in pieces.

During all of the litigation we had with the company, they had started to build their first ship which was a containerized ship for the Farrell Line and they had a number of problems with this ship, and the fellow who was over the whole yard was a chap by the name of Barney LeBlanc, who was the works manager or the production manager of this shipyard. He was in charge of this whole thing, and he was so upset and, by the way, he is an old shipbuilder; he came from National Steel and—I think at San Diego, California, and—knew his business but he was so upset with this whole new system because he just couldn't seem to get the bugs out of it and get it to work, that he decided to build one ship in one

piece just like the one we called Farrell II. I think it is called 1181, Hull 1181, which is a Farrell containerized ship. So instead of starting it up here and start building it, moving it down on these rails, he put it together here all in one piece, and we found out during testimony during one of these unfair labor hearings the company did not know what he was doing. Therefore, when they found out about it, that is, when the California management found out about it, they came down and actually made him cut the ship in two so they would have the module construction, and——

Chairman PROXMIRE. Wait, you say that he constructed the ship in one piece.

Mr. GIRARDOT. Yes, they started——

Chairman PROXMIRE. And then in order to say it was modular construction they actually sawed it in half?

Mr. GIRARDOT. Yes, sir, they started, it had all the inner bottom, the keel, and the inner bottom is, I suppose, as high as this room, but where they cut it in two it was not this high, it was probably as high as the seal up there, and they actually took the torch and cut it in two and moved it from about this table up there.

Chairman PROXMIRE. Then they had to put it back together again.

Mr. GIRARDOT. Yes, but it was module construction at that point. [Laughter.]

Chairman PROXMIRE. One thing about this, I am sure it would fit back together again.

Mr. GIRARDOT. No question about that.

PROBLEMS WITH MODULAR CONSTRUCTION

Chairman PROXMIRE. I understand you had some trouble with some of the others where they wouldn't.

Mr. GIRARDOT. They had some difficulties, yes.

Chairman PROXMIRE. Well, I think that illustrates the problems that have been experienced with the modular construction concept. But the idea seems to work in other countries, as Mr. Rule indicated, and it works here in other industries, and it has been, it seems like, a good new idea. It has a great deal of appeal for all of us.

Mr. RULE. May I comment on that, Senator?

Chairman PROXMIRE. I will come to you in just a minute. I just want to ask Mr. Girardot, what is there about the new procedure that makes it hard to implement so far as the west bank is concerned? But did you want to correct my reference—I thought you did say this had worked in Japan and other countries.

Mr. RULE. Yes, but I did not say, Senator, why it is pretty well agreed that this modular type construction will not work in warships.

Chairman PROXMIRE. Warships?

Mr. RULE. Warships.

Chairman PROXMIRE. I see. Does it work in other countries in warships or does it work on——

Mr. RULE. No, sir.

Chairman PROXMIRE [continuing]. Primarily containerized ships.

Mr. RULE. Commercial vessels.

Chairman PROXMIRE. Commercial vessels.

Mr. RULE. Where the specification is almost 100 percent frozen. In warships we are constantly making changes in what goes into that ship.

Chairman PROXMIRE. And they are immensely complex, are they not?

Mr. RULE. Sir.

Chairman PROXMIRE. They are far more complex, by and large?

Mr. RULE. Yes.

Chairman PROXMIRE. Wiring systems and so forth.

Mr. RULE. Yes, sir, because we are making changes. You see, you have to remember one thing in a warship. Unless you are going to prototype a complete whole ship and see how the whole things works, unless you do that, there is always concurrent engineering development and production in building ships, warships.

Chairman PROXMIRE. Is this because it takes a number of years and the technology is improving all the time?

Mr. RULE. And it is, and we want to grind these changes in as we go along, and there is nothing that will screw up a modular construction type of operation more than changes, which we bore them in. That is the difference between modular construction of commercial ships where the specification is frozen.

Chairman PROXMIRE. Do you concur in that, Mr. Girardot?

Mr. GIRARDOT. No, I don't, Senator. I think the basic concept of the yard is an excellent concept. I think the problem that Litton ran into is they tried to produce much too soon. They should have taken their time and worked the problems out. You have to understand this is very complex. For example——

Chairman PROXMIRE. Mr. Rule raises the fundamental point that because of the changes, because the technology is changing all the time, and the whole concept of a modular ship is that you get the component parts and that is it, you can't very well change the parts; you can't send them back to the factory and exchange them, and then you put them together.

On the other hand, if you are building a ship in one piece, it would be possible to make the changes, to adapt to the new technology as it develops.

Mr. GIRARDOT. Well, of course, you see I have no idea what the Navy has in plans or has planned for the 30 destroyers, but I would assume they would be just about the same ship. They wouldn't be changing the concept of this ship from one destroyer to the other.

When you start talking about 30 ships all the same, without these changes, and that is, the same ship rolling down at all times, there is no reason why that yard can't produce and produce efficiently for the Navy and this country.

Chairman PROXMIRE. Then I don't see any difference. If you are talking about 30 ships all the same. Mr. Rule is not talking about—he was talking about ships that change constantly.

Mr. GIRARDOT. Well, I agree you couldn't——

Chairman PROXMIRE. You could use both of these, the east and west banks, they both have their function. The east bank I take it for the warships and the west bank perhaps for commercial ships and possibly some ships that the Government might want if they are

sufficiently standard and not subject to constant technological improvement as we go along.

Mr. GIRARDOT. Well, I think the original concept would be the east bank, which is the old shipyard, would be a nuclear yard. It would build nuclear submarines or whatever else nuclear, and the west bank would be nonnuclear.

Now, the way it was explained to me, the new yard must build at least five of one type ship or more before it can be efficient. I guess the reason for this is, you have five as the learning curve, and then you go, once it gets beyond that number. Then supposedly they have all these bugs worked out and are supposed to move it right on through even if it is a Navy destroyer or a containerized ship or whatever.

Chairman PROXMIRE. So when you get five or below, which is the number we are concerned with here, it is a problem.

Mr. RULE. These changes that I speak of, Senator, they don't result in the 963 case, they won't result in 30 different ships. If we decide on a change we retrofit the ships that are already gone so we try to standardize these things. But there are changes.

We had a contract with National Steel to build 17 LHT's, I think, and they came up with this modular construction idea. They thought it was a relatively simple ship and they had the Navy out there and the Navy went out and was just overjoyed at this new concept, and National Steel, and I am sure Litton, the same way, if you could ever do this you could cut costs.

National Steel proposed and got this contract hoping to save the Government money and hoping to make money.

Well, the fact was that when they started down this line we put in over 200 changes, and it just wrecked the whole modular construction concept. They had to scrap it and go back to what they call plate type.

Chairman PROXMIRE. Two hundred changes is not a great many, is it? I mean it is typical that you have that many changes, sometimes more; is that right?

Mr. RULE. I cannot tell you the number of changes that are standard.

Chairman PROXMIRE. At any rate they are a sufficient number so you think it would be ill-advised to proceed with modular construction on warships. You still stand by your original generalization; is that correct?

Mr. RULE. That is right. And in submarines, for example, it is set right out in a book. They extend whatever the contract price is, that price will be 16 percent more for changes, they recognize this historically. They know there are going to be changes that will amount to X number of dollars over and above the contract price.

Chairman PROXMIRE. My time is up.

SHIPBUILDING LABOR COSTS

Representative CONABLE. I have only one question. I don't know much about shipbuilding, Mr. Girardot, but what percentage of the cost of a ship is labor generally? If you look at the operation of a school, for instance, 75 percent of the cost of that is personnel cost.

Obviously it is going to be a lower percentage in shipbuilding because there you are not providing a service, you are creating something in which the materials are very significant in cost.

Does your union have any figures about how much of the cost of shipbuilding is labor?

Mr. GIRARDOT. Percentagewise, no, sir; I just wouldn't be competent to say on that. I can say, of course, one of the problems down there is the low rates, and the average, taking all into consideration, of course, there are some higher and lower, but the average rate for a shipyard worker in that area is in the neighborhood of $3.70 an hour.

Representative CONABLE. And that is lower than it is in other parts of the country.

Mr. GIRARDOT. Yes, sir.

Representative CONABLE. So that was presumably something that was counted on in the bid they gave. Well, your labor costs have stayed pretty constant, haven't they? You mentioned some modest increases.

Mr. GIRARDOT. Well, we, when we finally separated the two shipyards, we were finally successful in breaking the 5-year agreement. I say "breaking," the company agreed to do away, after we had all of the trouble on the West Bank, and at that point, we negotiated increases, fairly decent increases, for the workers but it still left them a long way behind. As an example, they say a journeyman machinist prior to our negotiations was making $3.62 an hour, which is a little ridiculous for a journeyman machinist. We have been able to bring that person now up to $4—as of this date $4.30 an hour—but that is still a great deal behind.

You have to understand in a shipyard you are competing with construction type people. It can't be classed necessarily as industry. This is construction, craft type folks. So in a ship construction, you have to compete with a pipefitter, for example, who can be making $6.50 to $7 an hour on the outside and on the inside he would be making $4.30 an hour.

Representative CONABLE. That is all, Mr. Chairman.

Mr. RULE. I think, Congressman, one interesting comparison of figures I have been given between commercial ships and warships, in the erection of the hull, the steel of a warship amounts to 20 percent of the total cost, and 80 percent is inside, what goes inside that hull.

Now, the commercial vessels are exactly the opposite. Eighty percent of the cost of a tanker or something like that is in the steel in the hull, and only 20 percent inside. It is just the reverse.

Representative CONABLE. I suspect that is true for airplanes, too, isn't it, to a substantial extent nowadays? Certainly the F–111 has the most remarkable electronics system and so forth.

Mr. RULE. Not the F–111B.

Representative CONABLE. You know more about that than I do, sir.

Chairman PROXMIRE. I understand that wage rates for workers at Litton's shipyards are lower than the rates that prevail in nearby yards and in other yards around the country. Give us some examples of wage rates and comparisons with other yards, and tell us whether

the low rates at Litton have contributed to more turnover and ultimately higher costs in spite of savings on wages.

Mr. GIRARDOT. Yes. Of course, one of your problems down there are your rates and again you have to go back to the 1967 negotiations.

Chairman PROXMIRE. Let me say what I am getting at. As I understand it, what happens is the Government comes in with the training programs, like many other yards, the Government has training programs, they train these fellows, the rates are low, and once they get trained, they go somewhere else. Why should they work for a lot less at Pascagoula when they can go to some other place and get more, and there are many shipyards in this area. They don't have to go that far.

LABOR TURNOVER

Mr. GIRARDOT. Well, it doesn't even have to be a shipyard. Once you get the skills necessary to build a ship, you can go anywhere, because some of your best craftsmen in the world work in shipyards, they have to. You take welders. A nuclear welder, he has certifications as long as this table and he can get a job anywhere. So it is not just the other shipyards in the area they have to compete with, which they do. And, for example, in Mobile, Ala., there is Alabama Dry Dock, but it is basically a repair yard. In New Orleans, which is not far from there, is Avondale shipyard which is a rather large shipyard, and they always manage to pay a few cents an hour more than what Litton does. But it is so deep, the problem of turnover there—for example, the transportation. Pascagoula is a little sleepy seaport town that suddenly grew like from 20,000 to probably 40,000 already because there are an additional 12,000 new employees alone. That is just employees in the new shipyard, so you have one main highway down there and it takes 45 minutes to get out of the shipyard at times.

Housing is a tremendous problem that causes a turnover. Doctors, if you move into Pascagoula and you get sick you had better not try to find yourself a doctor because they are so full they are not about to take you. You either have to go to the hospital as an emergency patient or go to Mobile or Gulfport, one of the two.

Of course, in the training programs we have always tried to insist with Litton they should have an indentured apprentice program down there. We even have set up in the Pascagoula area——

Chairman PROXMIRE. That would greatly reduce turnover, would it not?

Mr. GIRARDOT. It certainly should reduce turnover because you would have a constant program. But Litton has always said no to this program. We have tried on many occasions to help them in their recruiting. As a matter of fact, we have set up what we call HRDI, Human Resource and Development Institute in Pascagoula, and also a joint apprenticeship council in Pascagoula to try to help recruit people for these programs that would stay in the area.

If I may give you somewhat of an indication, the company in the beginning was going to be like California, Washington, and various places trying to recruit shipyard workers to come to Pascagoula at

the ridiculous rates they were paying there compared to the West Coast rates, which were some 50 cents an hour below at that point and they would spend, for example, on one weekend with the Los Angeles Times $10,000, just one weekend, for help wanted ads, which to me was a little ridiculous. They could take that money and spend it in the yards and up their rates and they wouldn't have to be trying to recruit in California, where they couldn't get anybody anyhow.

STRIKES AT LITTON

Chairman PROXMIRE. You mentioned in your statement a 4-day work stoppage followed by a 20-day lockout. We heard something about it being responsible for the big delay in the shipbuilding. I think the delays are almost 2 or 3 years now, at least the estimates of the Navy, Litton claims there won't be that delay, but all you talk about here is a 4-day work stoppage and a 20-day lockout. What are the facts? In the first place was that the strike that has been talked about?

Mr. GIRARDOT. Yes, it was the 4 days.

Chairman PROXMIRE. Have there been other strikes that have been longer than that or slowdowns?

Mr. GIRARDOT. There have not been any slowdowns. There was a wildcat strike, that was mentioned in the Maritime report a year or so before this lockout that we are talking about, by the operating engineers.

Chairman PROXMIRE. How long did the wildcat strike last?

Mr. GIRARDOT. It was less than a week and it was on the East Bank shipyard and it did impact the new yard, too; it was down for a period of time.

Chairman PROXMIRE. What are the facts surrounding the 4-day work stoppage, and why do you believe that Litton sought an excuse to shut the yard down at that time?

Mr. GIRARDOT. This was at a time when Litton was hiring everybody they could get and just filling the yard with numbers, don't ask me why, but they had people standing around there. It was unbelievable, and the relationship with the unions at this point——

Chairman PROXMIRE. You mean standing around idle with nothing to do?

Mr. GIRARDOT. Oh, yes, that was no real secret. In fact, the report that was read earlier is part of that.

Chairman PROXMIRE. What possible benefit could they get from that?

Mr. GIRARDOT. Well, their claim to us was that they needed people, and they were hiring them, no matter whether they had a job for them to do or not, but they needed people. But I suspect most of it was because of material control and the coordination of that yard. They had just started up and they just really didn't have their coordination together. And to go on and answer your question further, this is at a time when we were having all this litigation, when the company was trying to renege on the contract that they had with us, and our attorneys had indicated to us that we stood a very good chance of losing the shipyard, we would stand a chance of losing

representing the employees, because of the contract the company signed with us. At the time the company signed this contract they said it was an accretion, and then when they decided to separate the yards they said no, it wasn't an accretion. So the people were very, very confused in the new shipyard as to whether they had a contract or whether they didn't.

Now you have to understand during all this litigation just prior to this work stoppage, the company, the official record of the NLRB was telling us that they only had a partial contract, and that partial contract amounted to a no-strike clause and a checkoff and few other meaningless items, but they did not have a contract which had seniority provisions nor had work jurisdiction provisions, and this sort of thing. And even though the company had been living up to that contract, up to this point, on most cases, even on the matter of work assignments where we could file grievances and win them, they suddenly took a very hard position that they no longer were going to live up to any of that contract.

Chairman PROXMIRE. Why did they do that?

Mr. GIRARDOT. Well, I can only give you my opinion, and my opinion is they wanted the yard closed for a length of time, a period of time, so they could get themselves straightened out, they could get production control straightened out, they could get some of the people out of the yard and start back up, like starting new again.

Chairman PROXMIRE. I see.

Mr. GIRARDOT. And try to get their production straightened out.

LABOR-MANAGEMENT PROBLEMS

Chairman PROXMIRE. Have labor-mangement relations improved? are they better now?

Mr. GIRARDOT. Well, I say on the everyday handling of problems in the yard with Mr. Marindino things have improved somewhat. But the handling of labor relations as such with the current labor relations director has not improved. As a matter of fact, these yards, the merger of these yards happened in July, as I recall, and to this date, although the union has been pressing the company to sit down and get an agreement signed, taking care of the mergers, and getting the apprentice programs taken care of, to this date we still do not have any signed agreement, and that was six months ago that these yards were merged. So in that respect I have to say they have not changed.

Chairman PROXMIRE. Do you think a signed agreement would not only benefit the workers and the union but would be of benefit in providing a lower turnover, more stability, better workmanship and would be therefore in the interests of both the company and the government, is that right?

Mr. GIRARDOT. I certainly do. I think it would let everybody again know where they are because now you start hearing rumbling again, "Well, are we going to be in the same position as we were prior to the separation of these yards? Is the company pretty soon going to take their pick." You see we have two separate contracts, now the yard is all one, same management, where people transfer back and

forth. so the concern of the workers now is the company going to take the pick of what they like out of the contract and say, "This is what we are going to have to live by." So it certainly would be to the advantage of everybody to get it in black and white, sit down and understand what we——

LACK OF PROGRESS ON LHA CONTRACT

Chairman PROXMIRE. Mr. Rule, there has been talk about whether Litton is in default of its contract. What I am concerned about in Litton's argument is that the Navy has made a lot of changes in the program that justifies their position.

Mr. RULE. Well, I have read that, I think, Mr. O'Green or somebody was quoted as saying we made a hundred changes. As I say, changes are normal in any shipbuilding contract. Whether they should have been defaulted, of course, basic to that question is how badly does the Navy need the ships. This is also basic in the Grumman contract. This is the basic point we have to think about, how badly do we need the planes. I guess we need them badly enough that we are going to help Grumman. But I sincerely hope if we do it is under 85–804 and not just a bail out.

Chairman PROXMIRE. If they are going to help Grumman, and you just congratulated the Navy, which I did, too, because I thought their decision on Grumman was very courageous and a difficult decision to make and imperative if we are going to hold down costs in the future and avoid a precedent which is going to cost millions, but now you are telling me they are apparently going to help them. What does that mean?

Mr. RULE. I am saying if we need some more F–14's after lot 5, it does appear we are going to have to do something. They are essential to the national defense, but I should hope that we would go down the road that Congress has provided for us, 85–804, and lay everything out on the table.

Chairman PROXMIRE. I see.

Mr. RULE. Now, with respect specifically to your question on Litton and default, I personally think they should have been defaulted a long time ago; that is my personal opinion. But that wouldn't have gotten us the LHA's, you see.

Chairman PROXMIRE. You think they should have been defaulted anyway and the LHA simply was not worth it, is that correct?

Mr. RULE. Well, there is a great deal of pressure by the Marine Corps to get the LHA. They want some LHA's.

Chairman PROXMIRE. You said they should have been defaulted and that wouldn't get us the LHA and you are saying now then the decision should have been made to sacrifice the LHA at least for the time being, if necessary.

Mr. RULE. I am saying the position that Litton was in so far in default on progress on that contract, I think they could have been and should have been defaulted. But that would not have gotten the Marines their LHA's, you see.

Chairman PROXMIRE. I see.

Mr. RULE. And it is not the sort of thing that you can take to another yard and get finished.

Chairman PROXMIRE. I understand that the DD 963 and F–14 contracts are the only two large contracts not to have been sent to your office for clearance in a long time.

Mr. RULE. Say that again.

DD 963 AND F–14 NOT SENT TO RULE FOR CLEARANCE

Chairman PROXMIRE. That the DD 963 and the F–14 contracts are the only two large contracts not to have been sent to your office for clearance in a long time. Would these contracts, would they have received clearance if they were sent to you, and if not, why not?

Mr. RULE. Well, I would hope we would have been smart enough had they been sent to my office for clearance, as they should have been, I would have hoped that we would have been smart enough in the case of the F–14 to recognize this buyin at $500 million, and put such a clause in the contract that "if you get in financial trouble the first $500 million is on you." I think we would have insisted upon that.

With respect to the 963, I don't know what we would have done. We were very much opposed to putting 30 ships in one yard, very much opposed to it. Where we would have refused to approve that contract on that ground I can only speculate, Senator.

Chairman PROXMIRE. Can you give me a general picture now of the status of shipbuilding claims now pending against the Navy? You have testified about this matter before, but that was some time ago. Can you bring us up to date on the status of some of the larger claims, such as the Avondale and Lockheed claims, and the efforts in the Navy to improve its procedures?

Mr. RULE. I cannot give you an up to date picture on Navy shipbuilding claims because again the secrecy that surrounds the handling of those claims now certainly does not penetrate to where I sit.

LARGE CLAIMS STILL UNSETTLED

I would like to say that I am very unhappy with the fact that the Lockheed claim that was negotiated for $62.5 million and the Avondale claim which was negotiated for $73.5 million, I think, it is pretty silly that the Navy hasn't made up its mind what to do with those claims yet. The Avondale claim, as you know, was rejected by the group that I headed in July 1971, and we are still sending teams down to Avondale to try to get more information. We have allowed the contractor to go back and resubmit a claim on a totally new theory.

Now I just think there comes a time when we ought to make up our mind whether the claim as presented by the contractor, and amended many times, I just think there comes a time when the contracting officer ought to say precisely what Admiral Rickover would say. If he was handling the Lockheed claim and the Avondale claim, he would have disposed of those a long time ago. He would have made a decision, how much those claims were worth, paid the contractors and let them go to the Armed Services Board of Contract Appeals or to the court, he would have done it.

Now for some reason or other, the Navy is not doing it. The Navy sent teams back out to Lockheed to try to get more information.

Now, I just think that we are subject to criticism. I think we have two ways of settling claims, the Rickover way. He settles them if they have anything to do with nuclear, and then there is the other way, the way they are being handled now and I do not think it is right.

Chairman PROXMIRE. Do you think the claims board is getting adequate legal advice as to how to proceed on these claims?

Mr. RULE. Well, the Deputy General Counsel of the Navy Department, Mr. Albert Stein, died a week ago, and Mr. Stein was counsel for the group that I headed and he was then counsel to the new group that has been set up, and Mr. Stein, God bless his soul, and I want to pay public tribute to him, he has been fighting with this claims group now because they have been trying to railroad some of these claims through, not asking his legal opinion, telling him not to write his legal opinion and, finally, Mr. Stein wrote his legal opinion in one of these cases and criticized the handling of these cases by the present board. And I think the present board ought to be changed. I think the present handling of claims by the Navy ought to be changed.

Chairman PROXMIRE. Is that legal opinion by Mr. Stein available. I wonder if we can get a copy of it to put into the record.

Mr. RULE. He has written three of them, as a natter of fact.

Chairman PROXMIRE. Let's get that.

Mr. RULE. They are unclassified documents.

Chairman PROXMIRE. All right.

S–3A PROGRAM

Are you familiar with the S–3A contract. I understand the S–3A is an aircraft, carrier based antisubmarine, being produced by Lockheed, and it has been severely criticized by the House Appropriations Committee. Mr. Mahon expressed concern that Lockheed may seek a bail out on that contract. Are you familiar with it?

Mr. RULE. I did not know that Mr. Mahon's committee had criticized that program. That was a contract for, as you say, the S–3A, and I distinctly remember, Senator Proxmire, that the GAO made a thorough study of that contract and they issued a report in which they said that the contract price and the terms of the contract, that it was a tight price, but that they thought it was a good contract.

Now, Litton or rather Lockheed, I know, for a fact, is trying to fall in line behind Grumman and they were waiting to see what we would do on lot 5, and I am sure that they want some of these option maximum prices, I think they want those changed, not because they are losing money but because they just want them changed on the theory that it is total package procurement or something like that.

Chairman PROXMIRE. As I understand it, Chairman Mahon, his defense appropriations subcommittee, stated earlier this year that they had already experienced a loss of confidence, is the way they put it, in the S–3A program. They noted the cost of the S–3A pro-

gram jumped $225 million in its projected cost during the past year and it is already being funded at ceiling despite the fact that development is not complete.

He noted that Lockheed has already requested an increase in S–3A progress payments from the 80 percent rate provided in the contract to a rate of 90 percent.

I wonder how serious the Lockheed cash flow problem is under this program and whether the Navy has made any changes in the progress payment situation to alleviate its cash flow problem.

Mr. RULE. I didn't know that, but I don't see anything particularly wrong with the requesting progress payments being increased from 80 to 90 if that would help a contractor's cash flow.

Chairman PROXMIRE. Mr. Mahon also expressed the belief that the Navy was hiding the real extent of cost increases on this program by understating the projected cost of spares and support items that will be required. Do you know whether this is true?

Mr. RULE. I have not heard that and I have no knowledge whether it is true or not. I thought the S–3A program was in good shape.

Chairman PROXMIRE. At any rate, if we bail out Grumman and Litton on the F–14 and LHA, do you see any way that we could refuse such a bailout to Lockheed on the S–3A?

Mr. RULE. No; I sure don't.

TOTAL PACKAGE PROCUREMENT

Chairman PROXMIRE. I would like to ask you something more specific about the total package procurement contract and how many such contracts we still have outstanding at this point, because it seems to me that this is something that can come to haunt us in a big way unless we nail it down as to just what it amounts to. You are an expert on procurement problems, exactly what is a total package procurement contract? How many such contracts do we still have outstanding at this point, and apart from the F–14 and LHA?

Mr. RULE. That was the only question I hoped to hell you wouldn't ask me.

You know the Navy has always contended, and I can show you testimony by admirals——

Chairman PROXMIRE. Let me just ask on this before you go ahead——

Mr. RULE. They testified the Navy has never had a total package procurement really. Now I know that the FDL contract was killed by Congress, that was to be total package procurement.

Chairman PROXMIRE. FDL is what?

Mr. RULE. That was the program for the ships that would be stationed all over the world.

Chairman PROXMIRE. It stands for fast deployment logistics.

Mr. RULE. That is right. It was that contract that was supposed to go to Litton too, but you remember Senator Russell killed it in the Senate. But that was total package procurement.

Chairman PROXMIRE. Let me say what I understand and then maybe you can tell me whether you have anything that will fit this

definition. I always though the basic concept was a contract which set an overall ceiling price for both the development and production phases of a program.

Mr. RULE. And maintenance.

Chairman PROXMIRE. Maintenance.

Mr. RULE. Maintenance and maintainability throughout the life.

Chairman PROXMIRE. That would apply to the F–14 and LHA program, would it not?

Mr. RULE. No; I don't think so.

Chairman PROXMIRE. Why not?

Mr. RULE. No, sir. I do not believe that we have asked Grumman to give us a price that maintains these F–14's, all maintenance including training for the life of those planes. I do not believe that that is total package procurement.

Chairman PROXMIRE. Well then, you are saying that you have to have the maintenance and the spares as part of the ceiling price.

Mr. RULE. Yes, sir.

Chairman PROXMIRE. In order to make it a total package procurement program.

Mr. RULE. That is exactly right. What they don't like about the F–14 contract is these out year priced options as distinguished from total package procurement. DOD Directive 5000.1 says that you don't get priced options in a contract where you are developing something.

Representative CONABLE. Excuse me, may I interrupt here. Aren't you unnecessarily limiting the nature of total package procurement when you say that the concept has been generally, I thought, that you made a contract for research, development and production.

Mr. RULE. That is right, plus.

Representative CONABLE. There are other things necessary?

Mr. RULE. Plus.

Representative CONABLE. But haven't we used that concept to one degree or another in the past in the interests of trying to shorten the time span, and the big problem was that we really didn't know what bugs we were going to run into in the course of the research before we went into the development. We didn't know about the problems we would run into in development before we went into construction and, therefore, we found difficulties developing in the course of the contract. Now isn't that concept one that was used to one degree or another in a wide number of ways, and wouldn't you be unnecessarily limiting the idea of its applicability if you said it was not a total package concept unless it included maintenance as well?

Mr. RULE. I was thinking in terms, Mr. Conable of a pure total package, what you describe as development and production that is certainly a form of total package.

Representative CONABLE. Yes.

Mr. RULE. And I personally am not too opposed to it.

Representative CONABLE. Are we still doing that to any degree?

Mr. RULE. Well, no, 5000.1 says don't do that. 5000.1 says you don't now make a contract with a man to develop something and at that same time make his contract price or a contract price include production options. It seems to me that when you have two or three

of these companies in this country in a competitive situation bidding for the development, that that is—I don't see anything wrong with asking them at that time to give us maximum prices for 1 or 2 or 3 years of production.

Now, I am opposed to the seven or eight options running out 7 or 8 years, because I just don't think it is fair to the contractors. We can make it fairer by giving them escalation in those out years, but while they are in competition, to have them give us maximum price options for 1 or 2 or 3 years of production, I personally see nothing wrong with it.

Chairman PROXMIRE. You see what concerns me is that you may not call it total package procurement, and it is not, it is not, but we do have fixed ceiling targets and prices on production and perhaps maintenance but not on parts or on production, at least.

When we have that we have that on the S–3A, I guess, do we not?

Mr. RULE. Yes, and we just——

Chairman PROXMIRE. And that is under the Packard program, that is a new procurement, is it not? You see what I am driving at——

Mr. RULE. No, sir, that predated the Packard.

Chairman PROXMIRE. Did it predate Packard?

BAILOUTS MAY ESTABLISH PRECEDENT

Mr. RULE. Yes, sir. We just settled in our office the price of option No. 3 on the S–3A, and the price that was negotiated was less than the maximum price that they proposed when they got the contract.

Chairman PROXMIRE. Well, what I am getting at is this: If we blithely rewrite the F–14 and the Litton contracts, LHA and F–14, aren't we setting a bad precedent in spite of the fact that there are no more total package procurements. It is one thing to say the total package procurement is a thing of the past and, therefore, we are not establishing a precedent if we settle these things, we still do have fixed ceilings and targets and, for that reason, if they bail out Grumman and Litton, the precedents will be unavoidable.

Mr. RULE. Well, the gut issue there, Senator, is that these companies and their lawyers are—have embarked on a real program, in my opinion, of trying to make the provisions of 5000.1 retroactive. That is the gut issue. Packard has said you won't do it any more, so these companies who entered into these contracts with their eyes wide open, they now want this prohibition retroactive.

Chairman PROXMIRE. Well, you say that Grumman's problems with the F–14 is the tight ceilings on the outer lots.

Mr. RULE. I didn't say that, Senator.

Chairman PROXMIRE. You didn't?

Mr. RULE. I said their problem was the $500 million buyin.

Chairman PROXMIRE. Let me ask this, isn't it true when Grumman reduced its bid by $474 million, $500 million, it voluntarily reduced its ceiling on the outer lots from 125 to 120 percent of target?

Mr. RULE. No, sir, I think as part of the 500 million reduction they reduced their ceiling from 130 to 123 percent. I think that is the fact, their ceiling on the entire contract.

Chairman PROXMIRE. Then the figures are different by the principle——

Mr. RULE. From 130 to 123 total ceiling reduction. That was part of the $500 million.

Chairman PROXMIRE. Well, isn't that part of the problem then that they did reduce the ceiling at the same time they cut the price by $500 million?

Mr. RULE. Well, they didn't pick $500 million out of the air, the $500 million, and there is a letter to this effect they sent in; it is made up, as I understand it, I have not seen this letter, it is made up of this reduction in ceiling, about $150 million reduction of their subcontract prices. And the balance was in expected savings and efficiency and overhead.

Chairman PROXMIRE. I want to thank both of you gentlemen very, much. I think we have gotten a great deal of very helpful information so far as this Senator is concerned and the subcommittee. We have a record that is going to be helpful to us in the future. And, Mr. Girardot, you made a fine statement, most helpful. I think too many of us ignore labor and are likely to consider it nothing but a cost and a help to get reelected when elections come around, and not because they have helpful and stimulating ideas that help keep costs down and serve the Government.

Mr. Rule, you are the most unusual and frank public servant who comes before this subcommittee, in my experience. We disagree on some things, which is of course inevitable, but I have the greatest admiration and respect for your courage and your capacity to stay in your job although you speak your mind. I don't know how you do it. Ernie Fitzgerald, who was here a few minutes ago, I think could learn a lot from you.

Mr. RULE. I have one request to make, Senator. I doubt if I am going to be asked to come up and testify again.

Chairman PROXMIRE. You will be asked, I don't know if they will allow you.

Mr. RULE. That is right. But if you ever invite me again please don't write the letter "Dear Gordon" and sign it "Bill." [Laughter.]

Chairman PROXMIRE. From now on, listen, "Mr. Rule", and signed "Chairman Proxmire."

Mr. RULE. I mean, I have never——

Chairman PROXMIRE. I understand.

Mr. RULE. I have never talked to you outside the hearing room.

Chairman PROXMIRE. That is correct.

Mr. RULE. But, gee, you would think we were, you know what, buddies. [Laughter.]

Chairman PROXMIRE. Well, I would be proud to have you as a bosom buddy, I must say, although we have never, that is right, we have never had any kind of association outside of the public hearing.

Mr. RULE. So don't give me that kind of help.

Representative CONABLE. The point is you may want to have him as a bosom buddy but he may not want it the other way. [Laughter.]

Chairman PROXMIRE. I am sure this is so.

Thank you, gentlemen. Mr. Conable said you wouldn't want me as a bosom buddy only from the standpoint of job security.

Tomorrow we will meet in this room at 10 p.m. to hear testimony from Commissioner Phillip A. Loomis, Jr., a member of the SEC. Perhaps he is the new chairman, Casey is the chairman now.

We also invited Assistant Secretary Charles Ill of the Navy, but he apparently will not appear, although I am not yet sure why Mr. Ill has declined to appear.

Mr. E. Clinton Towl of Grumman, as I announced yesterday, has also declined to appear.

We hope to schedule Mr. Ill and Mr. Towl for a later time.

[Whereupon, at 12:15 p.m., the subcommittee recessed, to reconvene at 10 a.m., Wednesday, December 20, 1972.]

THE ACQUISITION OF WEAPONS SYSTEMS

WEDNESDAY, DECEMBER 20, 1972

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 recess, at 10:05 a.m. in room 4221, Dirksen Senate Office Building, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire.

Also present: Loughlin F. McHugh, senior economist; Ross F. Hamachek and Richard F. Kaufman, economists; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The subcommittee will come to order.

The subcommittee had originally planned to devote this morning to an examination of the current status of the Navy's F–14 program. Toward that end, invitations to testify were sent to Admiral Zumwalt, Chief of Naval Operations, to Admiral Snead, the F–14 Program Manager, and to Mr. E. Clinton Towl, chairman of the board of Grumman Aerospace Corporation.

None of these invited witnesses are with us here today. Mr. Towl replied that in his opinion "Grumman witnesses would have nothing to add to the information which will presumably be provided * * * by the Navy." And the Navy, for its part, indicated that it had no original information to provide, citing the "vital contractual negotiations" now underway on the F–14 program and expressing the belief that "public testimony could have a serious effect on these very sensitive negotiations at this time."

I am deeply touched by the absence of Grumman and Navy witnesses on these grounds this morning. Grumman's willingness to allow the Navy to present the company's case is indeed ironic in light of the long-standing dispute between the two parties regarding virtually all aspects of the F–14 contract. If the Navy and Grumman do see eye to eye on the F–14 at this point, why is the company investing its scarce dollars in full-page newspaper ads denouncing the Navy's recent exercise of the Lot VF–14 option. And why, if the company is convinced of the merits of the arguments

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presented in those ads, does it refuse to discuss them free of charge in an open public forum?

Do they fear cross examination on their charges? As for the Navy, its statement that "vital contractual negotiations" are now underway on the F–14 program casts grave doubt on the sincerity of its professed intention to hold Grumman to the terms of its present contract.

The Navy has indicated a willingness to testify on the F–14 program at some later point in time. But the important question, of course, is when. It will do no good if that Navy testimony comes so late that its only purpose will be to afford the American taxpayer a ground level view of the truck which has just run him over.

Accordingly, I am writing today to Navy Secretary John Warner to seek a clarification of the Navy's position regarding testimony to this Subcommittee on the F–14 program. In my letter, I propose to ask Mr. Warner these questions:

First, does the Navy's statement that "vital contractual negotiations" are now underway on the F–14 program constitute an abandonment of its position that it intends to hold Grumman to its present contract?

Second, even if such negotiations are, in fact, taking place, in what specific way could public testimony on the problems confronting the F–14 program seriously affect the options open to the Navy in those negotiations? I intend to assure Mr. Warner that I would be perfectly willing to treat as "off limits" any specific subject area the public discussions of which could be demonstrated to restrict the Navy's options.

And third, is the Navy willing to commit itself now to appear before this Subcommittee to discuss the F–14 program before, rather than after, any action is taken which would relieve Grumman from its obligations under its present contract for production of the F–14?

I believe that Secretary Warner's answers to these questions will provide ample evidence of the Navy's commitment to the "taxpayer's right to know" of which Mr. Gordon Rule spoke so eloquently at yesterday's hearing of the Subcommittee.

I am also disturbed by the absence of Assistant Secretary Charles Ill from this morning's hearing. When the Navy informed us that the admirals we invited to testify on the F–14 and LHA programs would not appear to discuss those programs in public because of the "vital contractual negotiations" taking place, we invited Mr. Rule and Mr. Ill to testify instead on the general question, I stress the general question, of Navy procurement practices and policies. We did not ask these two witnesses to comment specifically on the F–14 or the LHA.

Mr. Rule, of course, appeared yesterday in his capacity as Director, Procurement Control and Clearance Section, Navy Material Command. But now I have received a letter from the Navy stating that Mr. Ill will not appear because in view of the "contractual negotiations" that are taking place, "it is deemed inappropriate for any Navy witness" to testify at the present time.

This is a most puzzling and inconsistent policy. We ask Mr. Rule, a Navy official, to testify on general procurement matters, and he is given permission to appear. We ask Mr. Ill, a Navy official, to testify, not on any specific programs, but also on general procurement matters, and the reply is that he cannot because of the "contractual negotiations."

Further, according to the letter I received yesterday, it is deemed inappropriate for any Navy witness to testify at this time.

Yet, the Navy permitted Mr. Rule to testify. We were not informed that it was deemed inappropriate for him to testify. If it was not inappropriate for Mr. Rule to testify, why would it be inappropriate for Mr. Ill to testify; and I repeat, Mr. Ill was not invited to talk about the F–14, the LHA, or any specific program.

But this dark cloud does have a silver lining. The refusal of other witnesses who have appeared means that we can concentrate on a critical and badly neglected element of our defense contracting problem: the plight of stockholders of defense firms present and future.

There are hundreds of thousands of these stockholders and in some cases they have invested all of their savings in firms for which defense contracts are critical to future earnings, and the future price of the stock of these corporations.

Disclosure of the consequences of these contractors' experiences with the Defense Department has been critically inadequate. Through stockholder ignorance, serious losses have been suffered. Almost 40 years ago Congress created the Security and Exchange Commission with one primary purpose and that was to require disclosure of the activities of corporations that would be sufficiently complete to enable stockholders to make prudent and informed investments.

In the case of defense contractors it does not seem, in the judgment of this Senator, that the SEC has done its job.

The purpose of our requesting testimony by the SEC this morning is to determine what we can do to achieve this more comprehensive disclosure so vital to the protection of investors and those firms that have defense contracts.

I want to thank Mr. Loomis for appearing, you are a brave soul or a foolish soul but, at any rate, you are appearing, and I think you are a fine Commissioner. As you know, I have great respect and admiration for your ability. You have appeared before the Senate Banking Committee, of which I have been a member for 15 years, many times as a staff member as well as Commissioner and I was delighted to see your appointment because I think it represents the kind of appointment we should have, men with great experience in the field and in the agency rising to the top.

We have asked you, Mr. Loomis, to discuss the matter of full disclosure by defense contractors in annual reports and other submissions of the SEC. Will you come forward? You have a good prepared statement. We would appreciate it if you could keep it to 10 or 15 minutes and then we will have questions.

Mr. LOOMIS. Thank you.

Chairman PROXMIRE. Go right ahead, Mr. Loomis.

STATEMENT OF HON. PHILIP A. LOOMIS, JR., COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY JOHN C. BURTON, CHIEF ACCOUNTANT, AND ANDREW STEFFAN, CHIEF FINANCIAL ANALYST

Mr. LOOMIS. Mr. Chairman——

Chairman PROXMIRE. Identify the distinguished gentlemen who are with you.

Mr. LOOMIS. Yes, Mr. Chairman, I am pleased to be here. I am accompanied on my right by Mr. John C. Burton, the Chief Accountant of the Commission; and on my left by Mr. Andrew Steffan, the Chief Financial Analyst of the Commission.

I intend, particularly in responding to your questions, to reply on them to a considerable extent because many of these problems are problems of accounting or of improvement of disclosure based often on engineering considerations and financial analysis considerations, and I am either an accountant nor financial analyst. My background is legal, and I was appointed to the Commission after many of the developments with which you are concerned had occurred.

I have a prepared statement which I shall summarize briefly. It covers about three primary subjects. First, the nature of the reporting requirements and disclosure requirements which the Commission has, that is, the types of things with respect to which disclosure is called for.

Secondly, I want to discuss briefly the role of the Commission in connection with the disclosures that come before it. I will discuss a number of changes in the reporting system that the commission is proposing or which it is considering which might have an impact on defense contacting.

The Commission's disclosure requirements apply, of course, across the whole segment of American industry, many thousands of companies, and they are not tailored to the peculiar problems of defense contracting, maybe they are not tailored at all to these problems, which until in relatively recent years did not seem to bulk so large from the disclosure viewpoint. So long as the Government relied to a large degree on cost plus fixed fee contracts, the disclosure problems were not insuperable and the accounting profession addressed itself to them. The new concepts of contracting have led to uncertainties which have changed that picture.

Since 1969 the Commission has required segmented disclosure by lines of business. This is of increasing importance in view of the diversification of American enterprise. It has also an impact on defense contracting, particularly where the company involved is engaged in several different defense programs or is a diversified company doing defense contracting as well as other lines of business, and getting segmented reporting prevents disclosures concerning defense contracting from getting buried in disclosure concerning some other business.

Another thing which the Commission has done in this same period, somewhat more recently, is to revamp entirely the system of periodic and annual reporting by companies under the Securities Exchange Act of 1934.

Until very recently those reports frankly, were not very meaningful. I found that out when I attempted to use them, and I joined with Commissioner Wheat in proposing changes, which have been made, which now provide that the annual report to the Commission contains much of the same information concerning the business of the company that would be found in a registration statement under the Securities Act. That has never been true before.

The staff has also set about attempting to obtain better disclosure concerning defense contracting. This resulted largely from the employment of the total package procurement program and the attendant problems and uncertainties. This, of course, was brought to our attention in connection with the difficulties Lockheed Aircraft had encountered with the C–5A program which, in turn, led to an investigation in depth of Lockheed's reporting and, subsequently, a general public investigation of disclosure by companies engaged in defense contracting.

As a result of these studies we did not find that it was necessary to make fundamental changes in our disclosure pattern to accommodate this particular industry and indeed, we did not find much use in putting in rules saying what was already said in our rules that full disclosure should be made, so the main emphasis and changing result of this has been increased staff examination of the problems of reporting in connection with defense contracts.

My prepared statement describes some of the history and content of our registration forms. I will not attempt to summarize that here.

We did put out a guideline. Guide 31, which is in a public release, is designed to assist people in responding to the items of reporting and that guide discusses matters pertinent to Government contracting, including such subjects as backlogs, unfilled orders, and the treatment of orders which are not firm or not yet funded, contracts awarded but not yet signed. This raises some of the problems which have been referred to as problems of claims against the Government.

In addition to the express requirement of the forms there is a general rule which provides that all the statements must not contain false statements or omit material facts required to be stated or necessary to make the statements not misleading.

There has been some discussion of annual reports to stockholders. Generally speaking, these are subject to whatever requirements exist under State law and under the rules of the exchanges where the company has stock listed. There are two qualifications. In the first place, it has been held that the annual report of stockholders is subject to the general fraud provisions of Rule 10b–5, incorporating the principles I mentioned above.

In addition, the Commission's proxy rules permit the company to use its annual report to satisfy the requirement that a financial report be sent to stockholders in connection with the solicitation of proxies for an annual meeting if it contains certain specified financial statements.

The Commission has not dealt more directly with the content of the annual report to stockholders, both because there is a question, and a serious question, as to its legal authority to prescribe the form and content of those reports, and also there has been a traditional

view that the Commission should not unduly interfere with the freedom of management to report to shareholders on its stewardship in any way which is not false or misleading.

The next topic discussed in the statement is the question of accounting, and here I just want to make a few points.

First, it was the decision of the Congress, expressly made in the 1934 act, to rely primarily on the accounting profession to audit and examine the financial statements of companies reporting to the Commission and reports filed with the Commission rather than relying on Government auditors and, consequently, the Commission over the years has placed great reliance on the accounting profession, and has sought to encourage and in recent years to prod and push the accounting profession to resolve some of the problems that do exist in connection with accounting.

I might mention that the defense contracting business, as it is now conducted, creates a problem of accounting. The whole structure of accounting was originally developed, and accounting principles were originally developed in the context of enterprises which engaged in a rather large number of small transactions which were finished quite rapidly and as to which there was little uncertainty as to what had happened.

In the case of defense contracting situations we have a small number of huge transactions taking place over a long period of time accompanied by great uncertainty. The traditional accounting model does not fit very well in this situation.

The main problem is the uncertainties as to what is going to happen in the future, a problem with which the accounting profession does not happily involve itself.

While the staff of the Commission examines registration statements and reports which are filed with it, the purpose of this review should not be misunderstood and its significance should not be overestimated. It is not provided for by statute at all. It is simply an administrative procedure which has grown up in order to improve the accuracy of the documents.

The responsibility for the accuracy and adequacy, of the material filed with the Commission is that of the issuer and as to its audited financial statements, certifying accountants, and other persons such as the management who are involved. It is not the responsibility of the Commission. The statute emphasizes this by imposing civil liabilities on issuers, accountants, and others for defective disclosure, particularly under the Securities Act of 1933.

The Commission has authority to make investigations and to conduct administrative proceedings in connection with these documents but it has been necessary to use that authority sparingly. When you consider that we receive each year something over 3,000 registration statements under the Securities Act, over 8,000 annual reports under the Exchange Act, and some 24,000 other periodical reports under the Exchange Act, it becomes clear that our limited resources would not permit investigation of more than a small fraction of them.

In addition, if the Commission were to investigate the accuracy of all Securities Act registration statements, the financing of American industry would probably grind to a halt. The Commission must in each case consider whether the apparent need for an investigation justifies the commitment of resources, the disruption of corporate financing and the disruption of the trading markets which would result.

Consequently, the staff's review is primarily designed to determine whether the information presented appears to be inaccurate or misleading on its face or on the basis of any other information in the possession of the staff. The staff may submit the material to interested Government agencies for their comment where Government activities are involved.

In general, the Commission believes that the present system of review is about the only one that is practical since its staff could hardly be expanded to the extent necessary to permit more intensive review, and any effort to do this would tend both to dilute the primary responsibility placed by the statute on the issuer, its accountants and its management, and it might also convey the unfortunate impression, which Congress in so many words attempted to prohibit, that the Government had in some way vouched for the adequacy of the disclosure or even for the merits of the securities involved.

While adhering to this general philosophy of review, the Commission has been continuing and emphasizing its effort to study disclosure in the hope of improving the quality of the information. It is for that purpose, I interpolate, that we fairly recently employed Mr. Steffan whose mission is to make these disclosure documents more useful to the people who use them.

A number of changes are under consideration. I will not attempt to summarize them all. One of the more significant is an announcement on this Monday, December 18, of several proposals designed—to make general information more meaningful to financial investors. We will revise our accounting regulations to require more disclosure of accounting policies, alternative accounting policies, and their impact on reported results. They would require analytical discussion of accounting and other matters in connection with the presentation of earnings, including the assumptions underlying the accounting results and the impact of those assumptions and of any changes therein.

Our Chairman in his statement of December 18, stated that the Commission and its staff believed this to be one of the most important steps that the SEC has taken. If you wish, Mr. Chairman, I would be happy to include the Chairman's statement and the accompanying releases in the record.

Chairman PROXMIRE. Fine, we will include that in the record in full.

[The documents referred to follow:]

[For Release: 2 P.M., EST, Monday, December 18, 1972]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C.

STATEMENT BY WILLIAM J. CASEY, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ON DISCLOSURE CONCERNING QUALITY OF EARNINGS

The Commission is today releasing for comment new rules and disclosure requirements on accounting policies, changes in accounting and in assumptions used in determining income and expense and differences in calculating income for tax and financial reporting purposes. We believe these significant new requirements will dissolve much of the serious concern which has developed about the ability of some corporations to exaggerate earnings or obscure declines in earnings by selecting from among acceptable accounting principles, shifting from one accounting method to another, changing assumptions used in determining income and expense, using available tax elections which enhance net income in a current year and depress net income in future years, and accelerating or deferring optional expense items like research and advertising and other steps of this kind.

It would seem necessary to full and fair disclosure of income and other financial data that management spell out how the choices it makes in the accounting and tax areas affect the financial results it reports to the public. I believe these requirements will go a long way to strengthen the confidence of investors, the credibility of corporations and the independence of accountants.

The Commission and its staff believe this to be one of the most important steps the SEC has ever taken. In my first public statement as Chairman I said: "The value of current reporting to investors and their advisors depends on its reliability and consistency. Also, the comparability of reporting by different companies has a great deal to do with the ability of investors to put their capital where it will be most effectively used. During the merger-conglomerate bubble of the mid-sixties, many of us were confused and dismayed by the extent to which pooling of interest and complex securities were used to inflate and pyramid earnings. . . . I hope that the accounting profession will move toward disclosure of all optional practices selected for the determination of operating results and financial position and at least a broad indication of the differences which would have been reported if an alternate practice had been followed. . . ."

Speaking about the same period, I subsequently stated: "The accountants were slow in tightening their rules, the SEC was slow in not requiring disclosures to correct misleading impressions and the analysts were slow in not putting the information which was available in proper perspective. It seems to me that corporate officers have a primary obligation to rise above accounting conventions and lay economic reality on the line."

The accounting profession has undertaken a renewed effort to develop uniform accounting standards. The Commission, believing that accounting standards should be set in the private sector, intends to fully support the profession in achieving it. As this effort succeeds, the need and importance of this kind of supplementary disclosure will recede. In the meantime, investors will have information on the significance of the accounting choices which corporations make and this will enhance investor confidence and corporate credibility.

I turn now to the textual substance of the requirements. One proposal, in the form of a disclosure guideline, would require an analytical textual supplement to the summary of earnings setting forth data about non-operating earnings, the impact of changes in accounting principles, estimates and assumptions, and material changes in the relative or absolute amount of such discretionary expenditures as research and advertising. This same guideline would also be applicable to reports and registration statements filed pursuant to the Securities Exchange Act of 1934.

The proposals also include amendments to Regulation S–X, which governs the form and content of financial statements contained in registration statements and reports filed with the Commission. These proposed amendments would require disclosure in such financial statements of accounting policies and of the dollar

impact of changes in such policies or of the use of alternative acceptable accounting principles or of principles not in prevailing use in a particular industry. In addition, disclosure would be required of the reasons for any variation between the statutory tax rate and the effective tax rate as well as the source of tax deferrals

I believe that these proposals are a major step forward for everyone interested in using and analyzing the content of financial statements. Investors will be better able to understand the reported results of operations, to separate these results from the impact of accounting and other non-operating matters, and to compare these results with those of similar companies. At the same time, company managements and public accountants will have an opportunity to enhance their credibility and overcome criticism that accounting principles are selected to "manage" reported results. While I recognize that implementation of these proposals may impose some additional costs on certain companies, I feel confident that overall benefits far outweigh these costs. After all, companies already have the numbers and these proposals would merely ask that the net effect of alternative methods be calculated or estimated and then presented. I would also point out that the Commission's staff and an industry advisory committee are studying ways to achieve reductions in reporting requirements to offset the additional disclosure burden that has become necessary. Their report will shortly be available for comment.

We look forward to constructive criticism from all concerned parties on these new reporting requirements and on how to minimize the burden of meeting them. These will assist us in the achievement of these desirable goals.

[For release, Dec. 18, 1972]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C.

Securities Act of 1933.
Release No. 5342.

Securities Exchange Act of 1934.
Release No. 9913.

Notice of proposed amendment to the guides for preparation and filing of registration statements under the Securities Act of 1933 and proposed adoption of guides for preparation and filing of reports and registration statements under the Securities Exchange Act of 1934 (File No. S7–463).

Notice is hereby given that the Securities and Exchange Commission is proposing to amend Guide 22, "Summary of Earnings," of the Guides for Preparation and Filing of Registration Statements (Release No. 4936) under the Securities Act of 1933 ("Securities Act"). In addition, the Commission is considering the adoption of the substance of amended Guide 22 as Guide 1, "Summary of Operations," of proposed Guides for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934 ("Exchange Act"). Guide 22 relates to summaries of financial information as called for by Item 6 of Form S–1 ("Summary of Earnings") and Item 6 of Form S–7 ("Statement of Income") under the Securities Act. Proposed Guide 1 would relate to similar summaries required by Item 2 of Forms 10 and 10–K ("Summary of Operations") under the Exchange Act. These proposals are designed to make more meaningful and understandable disclosure of financial information presented in registration statements filed pursuant to the Securities Act and in reports and registration statements filed to the Exchange Act.

Item 6 of Forms S–1 and S–7 provides in part that, in addition to the columnar presentation of summary financial data, registrants must supply information of material significance to investors in appraising the results shown. Guide 22 is

proposed to be amended to clarify the type of supplementary information and data to be included in order to enable investors to appraise the quality of the earnings reported in the summary. Whenever there are non-operating sources of revenue, expense or income, or changes in accounting principles or methods or their application, or in the underlying estimates or assumptions, any of which has, or all of which in the aggregate have, a material impact on net income, the matter and its impact must be described. The Guide would set forth a non-exclusive list of examples of matters that registrants should consider in making disclosure. Although these matters may be disclosed in other sections of the registration statement, the impact, when material, should also be highlighted in a textual paragraph immediately following the summary of earnings.

Item 2 of Forms 10 and 10–K also provides in part that registrants must supply information of material significance to investors in appraising the reported results of operations. In order to make clear that the disclosures required by Guide 22 as proposed to be amended, would apply to filings under the Exchange Act as well as to those under the Securities Act, the Commission proposes to create a new Guide for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934 and proposes to adopt the substance of Guide 22, as amended, as Guide 1 of such guides.

The Commission is also proposing today amendments to Regulation S–X which would improve disclosure of certain matters and would aid the investor in evaluating financial data. Securities Act Release No. 5343 would amend Rule 3–08 of Regulation S–X to require disclosure of accounting policies and the impact of their application on net income, if significant. Securities Act Release No. 5344 would amend Rule 3–16(o) of Regulation S–X to require more detailed disclosure of the components of tax expense and improved disclosure of the difference between the federal statutory and reported income tax rates.

The text of the proposed amendment to Guide 22 and the text of proposed Guide 1 follow:

* * * * * * *

(Guide No. 22 would be amended by adding the underlined text.)

Guide 22. Summary of Earnings

The content of the summary of earnings is specified in general in the instructions to the pertinent items of the form. The necessity of disclosing items in addition to those specified in such instructions will depend upon the circumstances. These instructions cannot, of course, cover all situations which may arise nor is it practicable to set forth a statement of policy dealing specifically with all possible situations. The existence of any unusual conditions affecting the propriety of the presentation and the necessity for the inclusion of an additional previous period should be considered.

Whenever the summary includes non-operating sources of revenue, expense or net income or whenever there are changes in accounting principles or methods or their application, or in the underlying estimates or assumptions, any of which has, or all of which in the aggregate have, a material impact on net income as reported, so state and give a brief description thereof in a textual paragraph immediately following the summary of earnings and disclose the separate and aggregate dollar amount effect on the reported results for the applicable periods. This paragraph is intended to enable investors to appraise the quality of earnings presented in the summary. While it is not feasible to specify all matters the impact of which should be disclosed, the following are examples which registrants should consider in making disclosure:

1. *The sale or disposition of property by a company not engaged in the business of selling such property;*

2. *Changes in the accounting treatment, or in the absolute or relative amounts, of such items as research, development, product introduction, start-up or advertising costs;*

3. *Extraordinary and unusual charges or gains, including charges associated with discontinuation of operations;*

4. Changes in the assumptions underlying deferred costs and the plan for amortization of such costs; and

5. Changes in assumed investment return and in actuarial assumptions used to calculate contributions to pension funds.

Disclosure is required with respect to all matters which have a material impact on reported results in the summary of earnings even though such matters offset one another. Also, where appropriate, reference should be made to disclosure called for by Rule 3-08 of Regulation S-X (Significant Accounting Policies).

When the text of the prospectus contains a discussion of factors indicating an adverse change in operating results subsequent to the latest period included in the summary of earnings, the summary should call attention to the change, in a headnote or in a footnote, and refer to the place in the prospectus where it is discussed.

* * * * *

Guide 1. Summary of Operations

The content of the summary of operations is specified in general in the instructions to the pertinent items of the form. The necessity of disclosing items in addition to those specified in such instructions will depend upon the circumstances. These instructions cannot, of course, cover all situations which may arise nor is it practicable to set forth a statement of policy dealing specifically with all possible situations. The existence of any unusual conditions affecting the propriety of the presentation and the necessity for the inclusion of an additonal previous period should be considered.

Whenever the summary includes non-operating sources of revenue, expense or net income or whenever there are changes in accounting principles or methods or their application, or in the underlying estimates or assumptions, any of which has, or all of which in the aggregate have, a material impact on net income as reported, to state and give a brief description thereof in a textual paragraph immediately following the summary of operations and disclose the separate and aggregate dollar amount effect on the reported results for the applicable periods. This paragraph is intended to enable investors to appraise the quality of earnings presented in the summary. While it is not feasible to specify all matters the impact of which should be disclosed, the following are examples which registrants should consider in making disclosure:

1. The sale or disposition of property by a company not engaged in the business of selling such property;

2. Changes in the accounting treatment, or in the relative or absolute amounts, of such items as research, development, product introduction, start-up or advertising costs;

3. Extraordinary and unusual charges or gains, including charges associated with discontinuation of operations;

4. Changes in the assumptions underlying deferred costs and the plan for amortization of such costs; and

5. Changes in assumed investment return and in actuarial assumptions used to calculate contributions to pension funds.

Disclosure is required with respect to all matters which have a material impact on reported results in the summary of operations even though such matters offset one another. Also, where appropriate, refrence should be made to disclosure called for by Rule 3-08 of Regulation S-X (Significant Accounting Policies).

* * * * *

All interested persons are invited to submit their views and comments on the foregoing proposals to amend Guide 22 an to adopt Guide 1 in writing to Andrew P. Steffan, Chief Financial Analyst, Division of Corporation Finance, Securities and Exchange Commission, Washington, D.C. 20549, on or before February 15, 1973. Such communications should refer to File No. S7-463. All such communications will be available for public inspection.

By the Commission.

RONALD F. HUNT, *Secretary.*

[For release Dec. 18, 1972]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C.

Securities act of 1933.
Release No. 5443.
Securities Exchange Act of 1934.
Release No. 9914.
Public Utility Holding Company Act of 1935.
Release No. 17817.
Investment Company Act of 1940.
Release No. 7567.

Notice of proposed amendment to regulation S-X to provide for disclosure of significant accounting policies (File No. S7–464).

The Commission today issued for public comment a proposed amendment of Rule 3-08 of Regulation S-X calling for increased disclosure of accounting policies and the impact of those policies on financial statements.

The proposed rule requires a Summary of Significant Accounting Policies to be included in the financial statement either separately or as the first note. The disclosure required includes a description of accounting principles followed and, under certain circumstances and where significant, an estimate of the dollar impact on net income of use of the principle followed as compared to alternative acceptable principles.

Such dollar estimate is required:

1. When the company uses more than one accounting principle in reporting similar kinds of transactions; or
2. When the company has changed its accounting principles in the past two years; or
3. When the principle used is not the prevailing principle used by companies in the same industry.

Examples of such situations include, but are not limited to, the following:

1. A company using FIFO cost for a portion of its inventory and LIFO cost for the balance would be required to show the impact on net income of using each method for all of its inventory.
2. A company using straight-line depreciation for some fixed assets and accelerated depreciation for the balance would be required to show the impact on net income of using each method for all of its fixed assets.
3. A company in the petroleum industry using full cost accounting for its producing properties would be required to show what its income would be under individual property unit costing which is the prevailing principle used in the industry.

The proposed rule would require this disclosure only for each significant accounting variation in the two most recent fiscal years and any subsequent interim period reflected and the comparable interim period in the most recent fiscal year and would define significant for this purpose as any accounting variation which has an impact of at least five percent on net income or which has an impact of more than 25 percent on the change in net income or net loss compared to the prior period. Any impact which would convert an increase in net income to a decrease (or vice versa) or which would convert a net income to a net loss (or vice versa) would also be deemed to be significant under this definition.

The text of the proposed amendment to Rule 3–08 follows:

Rule 3–08. Summary of Significant Accounting Policies.

(*a*) A summary of accounting policies shall be set forth either separately preceding the notes to financial statements or as the first such note. This summary shall include the following:

(1) A description of the accounting principles followed by the company and methods of applying those principles that materially affect the company's financial statements.

(2) If a company has used more than one accounting principle in reporting similar kinds of transactions during the two most recently completed fiscal years or in any interim period reported and the impact on net income of using different principles is significant, state the reasons for such use and disclose an estimate in dollars of the effect of reporting all transactions according to each of the principles used.

(3) If a company has changed its accounting principles during the two most recently completed fiscal years or in any interim period reported and the impact on net income is significant, state the reasons for the change and disclose an estimate in dollars of the effect of applying the prior principle on results reported after the change.

(4) If an accounting principle used by the company is different from that in prevailing use among other companies in the same industry during the two most recently completed fiscal years or in any interim period reported and the impact on net income is significant, state the reason for using such principle and disclose an estimate in dollars of the effect of using the prevailing principle.

(*b*) For purposes of this rule, the term "significant" shall mean having an impact of at least five percent on net income (or net loss) or having an impact of more than 25 percent on the amount of the change in net income (or net loss) between one period and the next. In addition, any impact which would convert an increase in net income from one period to the next to a decrease (or vice versa) or which would convert a net income to a net loss (or vice versa) will be deemed to be significant. Individual items shall be identified whether each item is significant or the total impact of all items is significant.

(*c*) In cases where information required to be included in the summary is the same as that required by other rules of this regulation, the information should not be duplicated. Specific reference should be made in the financial statements to the portion of the summary where the information appears.

All interested persons are invited to submit their views and comments on the foregoing proposal to amend Rule 3-08 of Regulation S-X in writing to John C. Burton, Chief Accountant, Securities and Exchange Commission, Washington, D.C. 20549, on or before February 15, 1973. Such communications should refer to File No. S7-464. All such communications will be available for public inspection.

By the Commission.

RONALD F. HUNT, *Secretary.*

[For release Dec. 18, 1972]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C.

Securities Act of 1933.
Release No. 5344.
Securities Exchange Act of 1934.
Release No. 9915.
Public Utility Holding Company Act of 1935.
Release No. 17818.
Investment Company Act of 1940.
Release No. 7568.

Notice of proposed amendment to Regulation S-X, to provide for improved disclosure of tax expense (File No. S7-465).

The Commission today issued for public comment a proposed amendment to Rule 3-16(o) of Regulation S-X calling for more detailed disclosure of the components of income tax expense and for improved disclosure of the reasons why total income tax expense differs from the amount calculated by multiplying the statutory United States Federal corporate income tax rate by the income before tax.

The proposed amendments would require companies to disclose the various items which cause the timing differences between book income and taxable income that result in deferred tax expense. The disclosure should describe the

source of the timing difference (revenue recognition, depreciation, research and development costs, etc.) and the extent to which new deferrals in each category are offset by the reversal of prior deferrals. This is designed to enable users of financial statements to ascertain the current and prospective cash drain which is associated with payment of income taxes.

When total income tax expenses differs by five percent or more from the amount calculated by multiplying the current statutory United States Federal corporate income tax rate by the income before tax, registrants would be required to state the reasons for this difference and the dollar amount attributable to each underlying cause. Such difference might arise from income which is nontaxable or taxed at capital gains rates, investment credits, favorable domestic or foreign tax rates, percentage depletion or other causes. This disclosure is designed to enable users of financial statements to distinguish between one-time and continuing tax advantages enjoyed by a company and to appraise the significance of changing effective tax rates. Similar disclosure will also be required when the difference, although less than five percent, has an impact of more than twenty-five percent on the amount of the change in net income (or net loss) between one fiscal year and the next or when the difference causes net income to increase when income before tax decreases (or vice versa) from one fiscal year to the next.

The proposed text of amended Rule 3-16(o), with the proposed changes in text indicated by italics, follows:

* * * * * * *

Rule 3-16—General Notes to Financial Statements

(o) *Income Tax Expense*

Disclosure shall be made, in the income statement or a note thereto, of the components of income tax expense, including: (1) taxes currently payable; (2) the net tax effects, as applicable, of (i) timing differences (*indicating the major separate dollar items which make up these differences and the extent to which new deferrals are offset by the reversal of prior deferrals*) and (ii) operating losses; and (3) the net deferred investment tax credits. Amounts applicable to *United States* Federal income taxes, *to foreign income taxes* and to other income taxes shall be stated separately for each component, unless the amounts applicable to *foreign or* other income taxes do not exceed five percent of the total for the component and a statement to that effect is made.

If the total income tax expense differs by five percent or more from an amount calculated by multiplying the current United States Federal statutory corporate income tax rate by the income before tax, state the reasons for this difference and the dollar amounts attributable to each of the underlying causes. If such difference is less than five percent but (i) has an impact of more than twenty-five percent on the amount of the change in net income (or net loss) between one fiscal year and the next or (ii) when the difference causes net income to increase when income before tax decreases (or vice versa) from one fiscal year to the next, the reasons for such difference and the impact in dollars of each underlying cause should also be set forth.

* * * * * * *

All interested persons are invited to submit their views and comments on the foregoing proposals to amend Rule 3-16(o) of Regulation S-X in writing to John C. Burton, Chief Accountant, Securities and Exchange Commission, Washington, D.C. 20549, on or before February 15, 1973. Such communications should refer to File No. S7-465. All such communications will be available for public inspection.

By the Commission.

RONALD F. HUNT, *Secretary.*

Mr. LOOMIS. The staff has concluded a public hearing on the use of projections, estimates and forecasts in filed documents and the Commission will have to decide what to do about that proposal. It is relevant to the problem under consideration because even to report annually in a normal way for a defense contractor involves a great many assumptions and projections as to what may happen in the future and that is where things have to some degree gone wrong.

In conclusion, the difficulty which the Commission has encountered in obtaining satisfactory disclosure in certain complex, long-term contracts stems primarily from the immense uncertainties which have existed in these programs as to the costs which will be incurred by the contractor, the amount which he will be entitled to recover from the Government, and the time and effort which will be involved in solving problems on the frontier of technology.

The difficulty is compounded by an apparent tendency on the part of contractor personnel to be, in good faith, overoptimistic as to what they can accomplish, together with the fact that underlying many of these problems are questions of engineering analysis and judgment which neither the Commission nor the accounting profession are well-qualified to review and evaluate.

It appears that even the skilled engineering and scientific staffs of the Department of Defense occasionally encounter problems in this area.

I think the problem for the Commission first became acute as we observed developments under the concept of total package procurement. It may be that we did not adequately appreciate the uncertainties which this concept introduced into the financial reporting of defense contractors, although we have become increasingly aware of it. We understand that the Defense Department no longer utilizes this concept, and it may well be that this will ameliorate our problems.

As mentioned above, we have been making efforts on the wide front to improve the quality of disclosure, and the area of defense contracting has had in recent years our attention, in my view, perhaps not enough, and it will continue to have our attention.

Thank you.

[The prepared statement of Mr. Loomis and attached SEC release, dated June 22, 1972, follow]:

PREPARED STATEMENT OF HON. PHILIP A. LOOMIS, JR.

My testimony will deal mainly with the subject of reporting by public companies to investors and to the SEC as it relates to defense contractors. I first plan to outline the nature of the current reporting requirements, the responsibility of independent auditors, and the role of the Securities and Exchange Commission. Then I will describe a number of changes in the reporting system the Commission is proposing or has under consideration which might have some impact on defense contractors.

Reporting for defense contractors has changed during the past few years because of both evolvement of disclosure requirements and more intense surveillance of individual companies undertaking long term contracts.

Since 1969, the Commission has required segmented reporting, or disclosure of the contribution to revenue and earnings by "line of business." In addition, the requirements for reporting annually to the Commission have been greatly expanded so as to call for much of the disclosure required when a company

registers securities for distribution under the Securities Act of 1933. These changes, affecting all companies, have been helpful to the staff's review of defense contractor reporting. Segmented reporting has provided more information about the results of defense contracting, particularly for diversified companies. Expansion of the periodic disclosure requirements has provided information which would otherwise have been unavailable if a company did not register under the 1933 Act in order to distribute securities.

In addition to generally expanded disclosure, the SEC staff has secured increased disclosure by various defense contractors. This staff effort resulted largely from employment of the "total package procurement" process and its attendant problems. Lockheed's difficulties with the C–5A program accentuated staff concern and resulted in, first, an examination in depth of Lockheed's reporting and, subsequently, a general investigation of disclosure by companies engaged in defense contracting. As a result of these studies, and of the continuing problems of certain contractors, the staff is undertaking special surveillance of companies engaged in all types of long term contracting.

CURRENT REPORTING REQUIREMENTS

A brief description follows of the current reporting requirements of the SEC. There are few items which pertain specifically to defense contractors or to any other industry, for that matter. Most requirements are general in nature and the staff determines whether specific registrants have interpreted the general requirements properly.

Under the Securities Act of 1933 companies are required to register securities to be distributed to the public. This registration is made according to Form S–1 in most cases, although companies meeting certain qualifications are permitted to file on abbreviated forms. Form S–1 requires generally a description of the offering, recently audited financial reports, a brief history of the company, an outline of material pending legal proceedings, and a discussion of the company's business, capital structure and management. This information is contained in Part I and made available to investors in a prospectus. To complete the registration, the company provides in Part II supporting information and documents, such as copies of materials contracts. Part II is available to the public; additional information may be provided to the Commission on a confidential basis.

The financial reports, which I will deal with later, and the description of business provide most of the pertinent information for your purposes. The description of the company's business, in most cases must include the contribution to sales and pretax income by "lines of business", and the contribution to sales of each class of similar products or services, which contributed 10 percent or more of the total for either of the last two fiscal years. In addition, a company must discuss its competition and customers.

Guide 31 of the "Guides for Preparation and Filing of Registration Statements" under the 1933 Act, which amplify the requirements of Form S–1 and other forms, calls for certain information which defense contractors might find particularly pertinent:

"Where material in the business of the registrant, information for a current period compared with a similar period 12 months earlier, and if significant, prior years, should be given with respect to backlog and levels of plant operation. In giving information as to backlog, the dollar amount of unfilled orders should represent only firm orders. However, there may be included as firm orders, government orders that are firm but not yet funded and contracts awarded but not yet signed, provided an appropriate footnote is added explaining the nature of such orders and the amount thereof. The portion of orders already included in sales or operating revenues on the basis of completion accounting should be excluded from the amount of backlog. There should be disclosed any seasonal aspects of the backlog and the total amount of any orders forming a part of such backlog not expected to be filled within the current fiscal year or, if sales for an interim period are shown, within the balance of such fiscal year following the end of such interim period."

Disclosure of other material matters necessary to make the required statements not misleading is required by Rule 408 under the Securities Act of 1933. Therefore, all material risks of defense contractors stemming from their contractual and other business relationships with the Government must be disclosed regardless of the form under which the issuer is filing.

The annual report required by the Securities Exchange Act of 1934 on Form 10–K has been amended in the past few years to call for disclosure similar to Form S–1 under the 1933 Act. Initial registration under the 1934 Act is required on Form 10 and is generally accomplished by "wrap-around" or incorporation of Form S–1. However, if a company becomes public by means other than a registered offering, a Form 10 must be filed containing generally the information required by Form S–1.

All disclosure requirements are subject to the rules which provide for nondisclosure of documents and information which, pursuant to Executive Order, have been classified by an appropriate department or agency of the United States for protection in the interests of national defense or foreign policy.

The form and content of the reports which companies annually send to their shareholders are, generally speaking, subject only to such requirements as may be imposed by state law or by the rules of the exchanges, if any, on which the companies' shares are listed. There are, however, two qualifications to this principle. In the first place, it has been held that the annual report to shareholders is subject to Rule 10b–5 under the Securities Exchange Act which generally prohibits false statements of material facts or material omissions in connection with the purchase of sale of a security; and secondly, companies normally use this annual report to comply with the requirement of the Commission's proxy rules concerning reports to be sent to shareholders in connection with the solicitation of proxies for the annual meeting. If this is done, the annual report must contain certain specified financial statements, which usually must be certified by independent accountants.

The Commission has not dealt more directly with the content of the annual report to shareholders both because of questions as to its legal authority to prescribe the form and content of such reports, and also because it has not been thought desirable to interfere with the freedom of management to report to stockholders on its stewardship in any way which is not false or misleading.

Financial Reporting: The Role of the Independent Auditor

The Commission describes in Regulation S–X the form and content of financial statements to be included in registration statements and report. These regulations contain some requirements that specifically affect defense contractors, but for the most part they are general in nature. The Commission relies on independent accountants to interpret the requirements, to examine the annual financial statements filed and to report on their conformity with generally accepted accounting principles.

When the securities acts were written, Congress assigned to independent public accountants the responsibility for audit of registrants' financial statements. This decision was made after considering the alternative of a corps of government auditors. We believe that this decision was a wise one and has worked in the best interests of investors and we would not not recommend a change.

Since the cumulative audit fees paid by registrants to their independent accountants probably approach ten times the total budget of the Commission, it is apparent that substantially greater reliance must be placed on the accounting profession than on cursory reviews by the Commission staff to assure the reliability of financial information filed with the Commission. Accordingly, the Commission devotes significant effort to communicating with the accounting profession and making accountants and auditors aware of its requirements.

In the defense industry, certain accounting and auditing situations arise that make the presentation and audit of financial statements particularly difficult. The accounting difficulties result, in part, from the inapplicability of the basic accounting model to the industry. Accounting was originally develped to describe the simple trading enterprise with many small cash transactions, each occurring in a short period of time with no significant uncertainties associated with each transaction. The defense industry is characterized by a small number of huge transactions taking place over a long period of time and clothed in great uncertainty. The model therefore does not fit and accounting statements under the circumstances are at best poor approximations of the business reality. It is possible that a project oriented probabalistic set of financial statements could be developed for the industry, but such would not be in accord with "generally accepted accounting principles" or with the expectations or needs of investors.

Auditing problems also arise from the characteristics of the industry. In order to present statements for a calendar year, it is necessary to make a large number of engineering and other estimates of future events. There must for each contract be an estimate of the cost to complete, the time to complete and the reaction of the customer to changes in the project which may involve intensive negotiation. Since auditors do not purport to be engineers or clairvoyants, it is extremely difficult for them to audit the accounting for a contract beyond satisfying themselves as to the legitimacy of costs incurred to date. They do, of course, review estimates, interview engineers and draw on their past experience with the company and the industry in appraising the reliability of the assumptions made. They also have the attribute of independence which enables them to examine a situation without the filter of self interest which inevitably affects management.

Disclosure of uncertainties and of the exposure to loss that may exist can assist the investor. Improving disclosure has been the thrust of Commission efforts in this area. The accounting profession has also made some attempts at improving accounting for government contracts. The principal authoritative statement devoted to the subject is Accounting Research Bulletin No. 43 which includes accounting and disclosure standards with respect to defense supply contracts. Major accounting problems discussed are:

(*a*) When should fees under such contracts be included in the contractor's income statement?

(*b*) What amounts are to be included in sales or revenue accounts?

(*c*) What is the proper balance sheet classification of unbilled costs and fees?

(*d*) What is the proper balance sheet treatment of various items, debit and credit, identified with such contracts?

In addition, Bulletin 43 deals with certain aspects of accounting for government contracts and subcontracts which are subject to renegotiation and with problems involved in contracts terminated for the convenience of the government.

In recent years, fixed price and cost-plus- incentive fee contracts have been used more frequently than cost-plus-fixed-fee contracts. However, neither the American Institute of Certified Public Accountants nor the Commission has made any specific pronouncements with regard to accounting for revenues, expenses and resulting gains or losses on defense contracts, and the principles set forth in Bulletin 43 are still looked upon as the authoritative statement with respect to accounting in regard to defense contracts. Accounting Research Bulletin No. 45 also has application to defense contractors since it applies to anyone engaged in long term types of manufacturing processes. Otherwise guidance for financial accounting with respect to such contracts is drawn from the body of generally accepted principles of accounting.

While the staff of the Commission emamines registration statements filed under the Securities Act of 1933 and, to a lesser degree owing to manpower limitations, reports filed under the Securities Exchange Act of 1934, the purpose of this review should not be misunderstood, and its significance should not be over-estimated. The responsibility for the accuracy and adequacy of the material filed with the Commission is primarily that of the issuer and, as to audited financial statements, of the certifying accountants. It is not the responsibility of the Commission. The statute emphasizes this by the civil liability which it places on issuer, accountants, and others for defective disclosure, particularly under the Securities Act of 1933.

While the Commission has authority to make investigations and to conduct administrative proceedings if it believes that these documents are inaccurate, it was early determined that this authority would have to be used sparingly. When you consider that we now recieve each year something over 3,000 registrations under the Securities Act, and over 8,000 annual reports and some 24,000 other reports under the Securities Exchange Act, it becomes clear that the limited resources of the Commission would not possibly permit investigation of more than a small fraction of these documents. In addition, if the Commission were to investigate the accuracy of all Securities Act registration statements, the financing of American industry would probably grind to a halt. The Commission must, in each case, consider whether the apparent need for an investigation justifies the commitment of resources and the disruption of corporate financing and of the trading markets that such investigation would entail.

The staff, accordingly, reviews registration statements and reports primarily to determine whether they appear to contain the information called for by the form and whether they appear to be inaccurate or misleading, either upon the basic of any other information in the possession of the staff. The staff may submit the material to interest government agencies for comment and, in many cases, has more or less lengthy discussions with members of management and with the company's lawyers and accountants. Following this consideration, the staff frequently issues a letter of comment which is nothing more than that. It contains the comments which the staff may have as a result of its review of the material.

In general, the Commission believes that the present system of review is about the only one which is practical since its staff could hardly be expanded to the size necessary to provide more intensive review in each case, and also because any effort by the Commission to do this would tend to dilute the primary responsibility placed by the statute on the issuer, its accountants and other persons participating in the filing, such as underwriters and members of management. It would also convey the unfortunate impression, which Congress expressly and in so many words attempted to prohibit, that the government had in some way vouched for the adequacy of the disclosure, or even the merits, of the securities involved. While adhering to this general philosophy of review, the Commission has been continuing and intensifying its effort to study disclosure in hope of improving the quality of the information provided to the investing public by all publicly held companies.

Changes Proposed and Under Consideration

The Commission has proposed a number of changes in the disclosure system during the past year which are not reflected in the current requirements I discussed earlier. These proposals, in many cases, are the work of the expanded senior accounting and analytical staff. More attention has been focused on the usefulness of financial reports and the effectiveness of disclosure requirements in providing analyticly meaningful information. Some of the proposals which relate directly or indirectly to defense contractors are discussed below.

Partly as a result of public hearings in the matter of "Hot Issues", the Commission proposed in July, 1972, that disclosure of customer relationships and research and development activity be expanded and that the requirements relating to these subjects and to backlog be comparable in both registration statements and annual reports under the 1934 Act. At the same time, companies were urged to avoid describing such matters as competition and material litigation in "boilerplate" language or stock phrases which do not provide meaningful disclosure.

More recently the Commission proposed amendments to require increased disclosure regarding special charges and to require timely review of the charges by the company's independent accountants. In connection with this proposal, companies were urged "to make special efforts to recognize incipient problems which might lead to these types of changes and to identify them clearly at the earliest possible time in financial statements and other forms of public disclosure".

On Monday, December 18, 1972, the Commission released several proposals designed to make financial information more meaningful to investors. Regulation S–X would be amended to require disclosure of accounting policies and their impact on reported results in certain cases, as well as certain information about taxes. One of the guides to Securities Act filings would be amended to require an analytical discussion of accounting and other matters in connection with the presentation of earnings. This guide would also become the first of the guides to filings under the Securities Exchange Act.

A number of proposals of this nature are also under consideration. One of the most significant in terms of departure from past policies would be the creation of guidelines for annual reports to shareholders. Without reducing flexibility in most areas, the Commission might choose to specify certain information which must be included.

The staff concluded last week its public hearings into use of projections, estimates and forecasts. A recommendation is expected by year-end as to whether the Commission should change its past practice of not permitting this type of information in filings with the SEC. This subject may be of particular interest to defense contractors because of need to base present reports on esti-

mates of future costs and technical prformance. If these estimates could be discussed, the current reports might be more useful.

The staff concluded in June, 1972, from its investigation of disclosure by defense contractors, that the Commission's present rules and disclosure forms are generally adequate with respect to requiring information about defense contracting. Accordingly, no specific proposals relating to this subject are now under consideration. However, the staff also concluded that actual disclosure by some defense contractors could be improved and the Commission issued a release June 22, 1972, pointing out the need for prompt and accurate disclosure and citing certain problems and factors which should be considered. A copy of the release is attached to this testimony. The staff is undertaking special surveillance on a continuing basis of all companies engaged in long term contracts, to determine whether the requirements are being met.

CONCLUSION

The difficulty which the Commission has encountered in obtaining satisfactory disclosure concerning certain complex, long-term defense contracts stems primarily from the immense uncertainties which have existed in these programs as to the costs which will be incurred by the contractor, the amount which he will be entitled to recover from the government, and the time involved in satisfactorily resolving technological problems which are both new and very difficult. I do not see any easy answer to this from our viewpoint. The contractor cannot tell us something that he does not know himself. This difficulty is complicated by an apparent tendency on the part of contractor personnel to be, in good faith, over-optimistic as to what they can accomplish, together with the fact that underlying many of these problems are questions of engineering analysis and judgment, which neither the Commission nor the accounting profession are well qualified to review and evaluate.

I think the problem for the Commission first became acute as we observed developments under the concept referred to as "total package procurement." It may well be that we did not at first adequately appreciate the uncertainties which this concept introduced into the financial reporting of defense contractors, although we became increasingly aware of this in the middle sixties. We understand that the Defense Department no longer utilizes this concept, and it may well be that this will ameliorate our problems. As mentioned above, we have been making efforts on a wide front to improve the quality of disclosure, and this area has had, and will continue to have, our attention.

ATTACHMENT

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., June 22, 1972.

Securities Act of 1933, Release No. 5263
Securities Exchange Act of 1934, Release No. 9650

NOTICE TO REGISTRANTS ENGAGED IN DEFENSE AND OTHER LONG TERM CONTRACTS AND PROGRAMS OF THE NEED FOR PROMPT AND ACCURATE DISCLOSURE OF MATERIAL INFORMATION CONCERNING SUCH ACTIVITIES

The Securities and Exchange Commission today emphasized the need for publicly held companies to make prompt and accurate disclosure to securities holders and the investing public of material information, both favorable and unfavorable, with respect to progress and problems encountered in the course of performing under long-term contracts and programs involving significant technical or engineering problems and significant dollar amounts, including certain defense procurement contracts.

There are a number of factors arising from defense and other forms of long-term contracting on which clear and meaningful disclosure is necessary if the public is to be adequately apprised of the investment merits and risks of the securities of companies significantly involved in this type of business. Many defense contracts, for example, are extremely complex in their terms, calling for multi-faceted weapons systems involving significant technological advances; such contracts may be performed over extended periods of time and may be subject to numerous changes in specifications or in delivery schedules.

In addition, significant additional costs may be incurred which were not anticipated at the time a bid was submitted for the contract. A contractor also may incur substantial costs before reaching agreement with the Government on the price for any contract changes. Thus, at any given time in the performance of such a contract an estimate of its profitability is often subject not only to additional costs to be incurred but also to the outcome of future negotiations or possible claims relating to costs already incurred. While long-term defense contractors have presented significant examples of these factors, there can be comparable risks and disclosure problems in other long-term contracts or programs, particularly those involving advanced technology.

Government contracts are subject to renegotiation of profit and to termination for the convenience of the Government, which in some cases may have a material financial impact upon the company. Extended periods of time may be required to settle claims and during such periods the possibility exists, particularly in major contracts, that the working capital of the company may be materially affected.

Contracts also vary as to type, such as, for example, cost-plus, fixed fee, fixed price, fixed price incentive, and so on. The ability to estimate progress at any given time may vary from contract to contract depending in part on the type of contract and its terms.

Because of the above factors, costs to be incurred in the performance of such contracts and ultimate profit to be realized often cannot be known in the early stages of the contract. Accordingly, such matters are necessarily the subject of estimates which are difficult to make with any certainty. Notwithstanding such difficulties, registrants have an obligation to make every effort to assure that progress on material contracts—such as earnings, losses, anticipated losses or material cost overruns—is properly reflected in the registrant's financial statements and, where necessary to a full understanding, discussed in appropriate textual disclosure.

The Commission in emphasizing its concern about adequate disclosure in these areas has taken into account the report of the staff, released today, on disclosure practices of companies engaged in defense contracting [1] and the problems encountered by certain defense contractors as illustrated by the brief case studies contained in that report.

The defense contracting investigation was instituted following the public release of an investigative staff report on the Lockheed Aircraft Corporation.[2] The severe problems encountered by Lockheed in connection with its C5A contract, viewed in the light of the investigative record in that matter, raised questions as to whether the various disclosures made by Lockheed concerning its problems had in retrospect been adequate. With respect to certain aspects of the C5A contract the staff in its Lockheed report concluded:

"Where there was a very general disclosure . . . touching upon some of these points . . . the statements made did not fully and adequately disclose all pertinent factors and it requires much reading between the lines, with knowledge of the underlying circumstances, to catch the issues and the real risks facing this Company." [3]

In view of the situation disclosed in the Lockheed report the Commission was concerned as to whether the Lockheed C5A contract involved problems typical of the defense industry. The Commission directed the staff to conduct an inquiry for the primary purpose of gathering information concerning disclosure of defense contracting and determining whether the Commission's rules and forms were adequate or whether they could or should be revised to provide a basis for improved disclosures in the future by such companies.

The defense contracting report has concluded that the Commission's present rules and disclosure forms are generally adequate and no amendments appear necessary. The staff noted, however, that the application of the present requirements by some defense contractors could be improved. Among other things, it was noted that disclosures vary in quantity and quality from company to company and to some extent according to the nature of the document in which they are contained—for example between the Form 10–K and

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[1] See, "In the Matter of Disclosures by Registrants Engaged in Defense Contracting," Administrative Proceeding File No. 3–2485 (June 22, 1972).

[2] See, "Report of Investigation in Re Lockheed Aircraft Corporation, HO–423 (May 25, 1970).

[3] *Ibid.* page 58.

Annual Report to Stockholders. In view of the fact that of these two documents, only the Annual Report to Stockholders receives wide public dissemination, the Commission urges issuers to make every effort to assure that disclosures contained therein are as complete and accurate as those contained in documents filed with the Commission. In this connection, the Commission has published for comment and is presently considering adoption of an amendment to Form 10–K which would require specification by all reporting companies of items of information supplied in Form 10–K but omitted from the Annual Report to Stockholders.[4]

The Commission has considered the issuance of a release containing specific guidelines for disclosure by registrants engaged in defense contracting or other long-term, material dollar amount operations involving similar risks. The Commission recognizes, however, that the nature of such undertakings, particularly in the area of long-term contracts involving procurement of sophisticated weapons systems, involves such varied and complex considerations—including severe definitional problems—as to make the imposition of inflexible guidelines impracticable. Rather, the Commission regards it as incumbent on issuers to assess the special problems in each material contract or program with a view to making adequate and understandable public disclosure. Further, in considering whether to issue formal guidelines, the Commission noted that the staff's report covers a period of time when procurement was often conducted under the concept of "Total Package Procurement", the method which played such a major part in the difficulties surrounding the Lockheed C5A contract. The Department of Defense has since recognized that development of major weapons systems by its nature is dealing with the unknown, and does not contemplate continued use of the Total Package Procurement method, providing instead that contracts and subcontracts calling for the development of a weapons system, wherever appropriate, will be on a cost contracting basis rather than a fixed price method.

Corporate managers are urged to review their policies with respect to corporate disclosure on defense and other long-term contracting and ensure that adequate disclosure policies are followed with respect to reports filed with the Commission or distributed to investors. The Commission further emphasizes that the responsibility for prompt and adequate disclosure rests with registrants and their professional advisors. The Commission also wishes to reiterate the statements made in our 1970 release regarding "Timely Disclosure of Material Corporate Developments." [5]

By the Commission.

RONALD F. HUNT, *Secretary.*

Chairman PROXMIRE. Thank you very much, Mr. Loomis.

I do appreciate your coming before us this morning and the sincerity of your statement. As you may detect from my opening statement, I am deeply disappointed in the failure of the SEC to do more and I think it could do more. I think there are all kinds of reasons for not doing something but I think in this case there are many things we could do.

WORK OF COMMITTEE MOVED SEC TO INVESTIGATE LOCKHEED

First, I want to, I think we ought to, set the record straight. This committee uncovered the Lockheed C–5 mess in 1968 and 1969. The SEC had done nothing. It seemed to have no understanding of the gravity of the Lockheed difficulties in defense contracting and its effect on its securities no knowledge of it, these required no disclosure concerning these grave difficulties. We asked the SEC, remember I wrote a letter to the Commission and asked the SEC, to look into several aspects of this problem, and only after we made that request did you conduct your investigation. That lasted a year,

[4] Securities Exchange Act of 1934, Release No. 9576 (April 20, 1972).
[5] Securities Act of 1933, Release No. 5092 (October 15, 1970).

I do not know why it took so long but it lasted a year, as I recall, before the report was issued. Now, is that not correct, is that how you understand the sequence of events?

Mr. LOOMIS. I was not on the Commission at the time but it is my understanding that is approximately right. The report, the investigation was commenced in 1969, and concluded in 1970, and I believe it was the work of this subcommittee that moved us into action, although I had no part in the decision to take it.

SEC MANPOWER

Chairman PROXMIRE. In your testimony you give several reasons for not doing more to require disclosure from defense contractors. One is that the limited resources of the Commission would not permit investigation of more than a fraction of the reports submitted. Will you give us a breakdown of the total number of professional and nonprofessional employees at SEC, and tell us what percentage is allocated to review reports filed in Washington and what percentage is assigned to investigations in the field? Can you give us that kind of an estimate off the top of your head? If not, can you give it for the record?

Mr. LOOMIS. I cannot give it off the top of my head. It is a difficult breakdown. Approximately a hundred people involved in the review of the documents filed with the Commission. The enforcement staff spends only a limited part of its time on this kind of thing. Most of their effort is devoted to investigating stock frauds, illegal sales.

Chairman PROXMIRE. Let us just hesitate a moment on that. One hundred people involved in investigating——

Mr. LOOMIS. No; involved in examining.

Chairman PROXMIRE. Examining, I should say. My first question was how many people do you have in the agency total, how much professional and nonprofessional employees there are in the SEC?

Mr. LOOMIS. There are about, I believe—I will correct this if I am wrong—some 1,300 or 1,400 employees in total. Professionals are maybe half that, in various professions. There are a lot of lawyers in the Commission because there is a lot of legal work and trial work to be done.[1]

Chairman PROXMIRE. But there are about 600 professionals, 650 professionals——

Mr. LOOMIS. Something like that.

Chairman PROXMIRE [continuing]. In the agency altogether, and a total of 1,300 or 1,400 people.

Mr. LOOMIS. That is right.

Chairman PROXMIRE. And about a hundred are assigned to reviewing reports, is that correct?

Mr. LOOMIS. What is that? I missed that.

Chairman PROXMIRE. About 100 are assigned to reviewing.

Mr. LOOMIS. About 100 are assigned to reviewing these filings. Now, there are additional people in supporting capacities There is an office of chief accountant of the division, and there is Mr. Steffan's office, some other people, there is a special proceedings unit.[1]

[1] See Mr. Loomis' letter, dated Jan. 3, 1973, pp. 1990–1991.

Chairman PROXMIRE. Are you saying there are a hundred professionals assigned to reviewing the reports?

Mr. LOOMIS. About a hundred in the branch of examinations.

Chairman PROXMIRE. Professionals and their assistants.

Mr. LOOMIS. Professionals, yes.

Chairman PROXMIRE. A hundred professionals?

Mr. LOOMIS. Yes.

Chairman PROXMIRE. That means you have approximately 15 percent to 20 percent of your personnel involved in investigating, what do the other 85 percent do?

Mr. LOOMIS. Not investigating, this is processing work, examining these documents. When you come to investigations, enforcement investigations, that is one of our major uses of manpower. Almost all of our field people are engaged in that kind of thing as well as one of our larger divisions, although I think its professional staff is smaller than the 100 that I mentioned here who are engaged in enforcement, but this enforcement, as I say——

Chairman PROXMIRE. How many do you have in that area, in the enforcement area?

Mr. LOOMIS. Offhand, and I will probably have to correct these figures, I would probably say 400 or 500. Those are not all professionals.

Chairman PROXMIRE. How many professionals, about half again?

Mr. LOOMIS. A little more than that.

Chairman PROXMIRE. All right.

Mr. LOOMIS. But, as I say, they have a very wide range of duties and their basic——

Chairman PROXMIRE. So about half of the SEC is involved either in the reviewing of reports or in following up the review with field investigations and enforcement.

Mr. LOOMIS. No, sir, I just want to emphasize again, that is only a minor part of the work of our enforcement staff. Our enforcement staff is primarily engaged in investigating violations and such things as stock fraud and con games and sale of securities illegally without registration, and in trying cases involving those things before the courts and before the Commission.

Chairman PROXMIRE. What you have described before you came to this last part is the proportion of the SEC involved in reviewing reports and then following up those reviews with enforcement and so forth?

Mr. LOOMIS. Yes; but the numbers do not—the number, the amount and time of our enforcement people that are spent in following up and investigating filings, I would think, is a relatively minor part of their work, maybe not more than 10 or 15 percent.

Chairman PROXMIRE. What I am trying to get at is you do have the capacity to investigate frauds and violations?

Mr. LOOMIS. Yes, we do, sir.

Chairman PROXMIRE. Fully and comprehensively, is that right? You certainly, if not, you certainly ought to have the staff to do it.

Mr. LOOMIS. We always feel, every law enforcement agency always feels, it does not have enough people.

Chairman PROXMIRE. Well, yes——

Mr. Loomis. But in general, I think we do do a satisfactory job in that area.

SPOT CHECKS OF LARGE CONTRACTORS

Chairman Proxmire. Well, as you know, we have not requested SEC to investigate all the documents submitted by registrants. We have asked that you make sure the major defense contractors fully disclose their problems and risks in connection with their defense contracts. Do you not have the staff resources to make spot checks of, say, the largest 25 defense contractors to see if they are complying with this?

Mr. Loomis. We do that to some extent.

Chairman Proxmire. To what extent?

Mr. Loomis. Well, I will ask Mr. Steffan to discuss that in a moment, but the difficulties are the ones that I have outlined, that there are uncertainties, engineering problems. As I say in my statement, we cannot very well expect a contractor to tell us something that he does not know himself.

Chairman Proxmire. Of course not, and I am not asking that you give us your estimate which nobody can give of the success or failure, how much the loss is going to be, how long it is going to take, how late they are eventually going to be, how much the overrun will eventually be, nobody knows that. All I am saying that some reasonable estimate of the risks involved, how much is at stake, that kind of thing be disclosed in the event of a relatively few defense contractors, the ones that are so big, investments are so widely held, that it could have a serious effect.

LOCKHEED

We have the problem of people who invested in Lockheed at 70, and no matter how diligent they were, how careful they were about getting all the information available, they had no way of knowing the great trouble Lockheed was in, and their stock dropped from about 70 to 10. The insiders at Lockheed knew, but the investing public had no knowledge about it.

Mr. Loomis. Well, I am not sure——

Chairman Proxmire. This is happening in some of these other cases, I am sure it is very likely to happen.

Mr. Loomis. I am not sure that even the insiders knew what the problems were but they knew them quicker than other people. You are correct, however, that it is not an easy job. Sure, you can have people say in their registration statement that defense contracting involves risks and uncertainties and things like that, and they are saying that but it does not help very much. The problem is to quantify the risks and uncertainties and that is not easy.

Chairman Proxmire. Well, for many, many, many months before the public knew about this the enormous overruns in the C–5A program were well known by the Air Force and by the management at Lockheed. It was not known by the public.

Mr. Loomis. Yes, I think we would agree that is true, as I said in my statement——

Chairman PROXMIRE. This is not—this is getting so, it is developing into a pattern.

Mr. LOOMIS. As I say in my statement, we were slow in catching on to that, and your Committee was very helpful.

Chairman PROXMIRE. These are matters of fact, not matters of engineering, engineering judgments or matters of new technology, they were matters of fact that were known by the management and known by the Defense Department and unknown by the public.

Mr. LOOMIS. That may be so, although the exact significance was at the time rather difficult to appraise. I mean, there were overruns, overestimates, but the Lockheed people were of the opinion until quite well along that in one way or another those would be taken care of. But the thing got out of hand, and that did not occur. But the loss on an overrun is not a fact. You cannot tell——

COST OVERRUNS SHOULD BE DISCLOSED

Chairman PROXMIRE. Should they not disclose this information, that you allude to, in their report? They knew they had an overrun, why should they not disclose that?

Mr. LOOMIS. They have an overrun over a target but the target is also changing and it is difficult. I think you are right they should have said there is an overrun, but how meaningful that would have been is questionable. But we might get back, maybe the estimate is wrong, maybe they will make more money on the later stages of the contract.

Chairman PROXMIRE. Let me ask you this, if the SEC does not have the capability to review contractors' statements should this not be disclosed to the investing public, which I think has assumed that the registration statements do meet SEC requirements?

Mr. LOOMIS. Well, I will say I think that your assumptions are a little extreme. I would not want to say we cannot do it, although we could do it better than we certainly—if we did not do what we had done the situation would be considerably worse.

EXPANDED SENIOR AUDITING AND ANALYTICAL STAFF

Chairman PROXMIRE. Let me ask, you mention an expanded senior auditing and analytical staff. By how much has this staff been expanded and what has it done to require greater disclosure by defense contractors?

Mr. STEFFAN. Let me speak, if I might, to the analytical staff. Mr. Burton can speak to the auditing side. I joined the Commission this summer, the end of June, and I now have one other professional in my office directly. In addition, at the same time, an office was created for disclosure policy and proceedings; that office, for example, conducted the hearings in the matter of "hot issues" and is completing its hearing on forecast and projection. If you add all these together we probably have seven professionals in analysis and disclosure policy who work in an interrelated fashion. This staff is largely composed of senior people, people who have had 5 years of experience

either with the Commission itself or in related businesses. This staff is not included in the 100 Mr. Loomis gave you earlier.

I think it would be fair to say to include my activity, Mr. Burton's activity, the senior auditing staff in the division of corporation finance itself and certain other related people, the number of professionals in the review process would increase by 50 percent, that is, you would have 150 people involved in review of registration statements while only 100 of those are in the actual day-to-day processing branches. I think that describes——

Chairman PROXMIRE. In view of the complexity, the size of the firms involved, the number of defense contractors, do you not think under these circumstances that there ought to be some way of notifying the investing public there is this very limited investigation of defense contracts or that there should be an appeal for a somewhat larger staff to the Congress, to the Office of Management and Budget?

Mr. STEFFAN. I think on the latter point we have done this, are continuing to ask for more staff and are getting more, and we hope to continue to increase both the analysis and auditing staff. We feel that in many cases rather than adding more people to the processing branches, which people are younger and might not have experience, it is better to try to add them at a more senior level.

Speaking to your first point, I think one of the problems——

Chairman PROXMIRE. How many more did you ask for?

Mr. STEFFAN. I cannot speak to that right now. Maybe—do you know, Mr. Burton? I have asked for a couple of more in my area over the next year.

Chairman PROXMIRE. Two more?

Mr. STEFFAN. That is through June of 1973. We would be increasing my specific office from three to five in 6 months, which I think is adequate, in view of the time period, to establish a new office involv- for extra review and so on.

Chairman PROXMIRE. Well, it may seem adequate to you but in view of the immensity of our defense contracting, the enormous amounts at stake here on the part of investors, I do not think it meets anything like the spirit of the Securities and Exchange, or the Securities Act of full disclosure of enabling investors to know what they are doing when they invest in one of these big defense firms.

Mr. STEFFAN. It is clearly not adequate to conduct the type of investigation that I understand was conducted with the Lockheed matter, which you precipitated, for each contractor or, for that matter, for each other major company involved in projects of great uncertainty, whether it is Boeing's 747 program or whether it is construction of a huge dam or roadbuilding project, that sort of thing. I do not think, and I must say my understanding of the legislative background of SEC law is not complete, but I do not think that we ever had hoped to be able to conduct independent investigations of all these matters on an ongoing basis.

Chairman PROXMIRE. No, I think that is right. We asked for spot checks but even spot checks, it seems to me, with your very small complement you can hardly do justice to that.

SPECIAL SURVEILLANCE OF COMPANIES ENGAGED IN LONG-TERM CONTRACTING

You said, Mr. Loomis, the staff as a result of the Lockheed investigation, is undertaking special surveillance of companies engaged in all types of long-term contracting. What do you mean by special surveillance and what specifically, is being done with regard to defense contractors?

Mr. LOOMIS. I meant the registration statements and the reports are examined more carefully and particularly the report, the annual report to the Commission. As I said, it used to be——

Chairman PROXMIRE. More carefully, what do you mean more carefully? Do you actually have an additional step or two that has to be gone through for defense contractors?

Mr. LOOMIS. Exactly.

Chairman PROXMIRE. What is that, what additional steps are there?

Mr. STEFFAN. When I arrived, one of the first projects I was given was to implement the suggestions in the release of June dealing with the investigations of the total defense contracting problem, and our first effort was to go back and review some of the activities that have deen unveiled and the nature of contract reporting. We prepared, with the help of the branches that had had experience in this area, a detailed reporting form which we are now asking each of the branches to prepare, not only on defense contractors but on long-term contractors of any type or sort. To determine what type of information is reported in the annual reporting process, and what type of information we need to give better disclosure.

To emphasize one point, up until really less than 2 years ago we received detailed information on this type of matter only in registration statements under the 1933 Act. In other words, the annual reporting, quarterly reporting, and monthly reporting to the Commission required by the 1934 Act did not provide detailed information of this sort or nature nor did it really provide the opportunity for staff review. We have begun a process in one case of defense and other long-term contractors of reviewing the 10–K annual and quarterly reports in much more detail.

Chairman PROXMIRE. Let me refer to the study of June 14 from the Division of Corporation Finance. The subject: public investigation, in the matter of disclosures by registrants engaged in defense contracting. You know what you are not getting, is that not right?

Mr. STEFFAN. Well, I would say that is true to a degree, and we probably know what we are not getting with defense contractors to a greater degree than we did with other long-term contractors. This overall process is designed to survey all this type of contracting.

Chairman PROXMIRE. You took a year to do this study, you take another year, why can we not get action now?

Mr. STEFFAN. I think we are getting action. The process of surveying each of these registration statements or reports and filling out this rather detailed form is designed to encourage the branch chiefs and branch personnel to request from contractors this type of disclosure in the documents they file and request amendments and

that sort of thing. And I think in the case, for example, of Grumman, since this process was undertaken, that the reporting in the 10–K and 8–K reports has probably been expanded and more effective than it had been before.

RELIANCE ON INDEPENDENT AUDITORS

Chairman PROXMIRE. Your other explanation for not doing more to require disclosure is that you rely heavily on independent auditors to interpret your requirements, and you go on to say that "substantially greater reliance must be placed on the accounting profession than on the cursory reviews by the Commission staff to assure the reliability of financial information filed with the Commission." I am not sure, Mr. Loomis, with all due respect, that is not just rhetoric or double talk.

In the first place, we are not asking for cursory reviews. Our complaint is that your reviews are too cursory. We want in-depth, comprehensive scrutiny of major defense contractors, especially when facts are brought to your attention that they are failing to disclose. In light of recent experience with Lockheed, Litton and Grumman, how can you rely on independent accounts to do SEC's job?

Mr. LOOMIS. Well, the question is, what is their job and what is SEC's job. Congress decided in 1934, and maintained that decision, that the auditing of the accounts and the presentation of financial statements of the companies, defense contractors and all others, should be done by independent public accountants, not by the Commission, in order to reduce the size of the bureaucracy and out of reliance on the accounting profession, and that—auditing is a detailed job which you do on site in the plants and offices concerned,—we have to place heavy reliance on that process because we are neither authorized nor staffed to go out and do that job ourselves.

SEC STUDY ON DISCLOSURES BY DEFENSE CONTRACTORS

Chairman PROXMIRE. Let us take a look at your own report and show how greatly inadequate that is. In your study, let us look at that report, the one I just referred to issued in June, in the matter of disclosures by registrants engaged in defense contracting.

There is a chart illustrating the results of the survey to show the amount of disclosure by defense contractors. The chart shows that the majority of the 34 firms surveyed disclose the facts in only two respects:

First, a discussion of the military programs generally and the total contributions of defense sales to revenue. Now, half the firms disclose renegotiation of excess profits. But most of the firms fail to disclose anything about the type of defense contracts they entered into, total contributions of defense sales to income, their backlog, or their method of accounting. Only 5 out of 34 contractors disclosed anything about cost overruns, only one disclosed its delivery problems, only one disclosed its claims against the Government, and none —zero, zip—disclosed the problem of estimating costs in defense contracts. Does not this survey show rather conclusively that the major

defense contractors are failing to disclose the facts about their military work?

Mr. LOOMIS. Senator Proxmire, this tabulation refers to the contents of the annual report to stockholders, which is a document which is neither filed with us nor reviewed by us nor do we have authority to prescribe its content. There is better disclosure in these areas, although not as good as it should be. It is historical and occurred in a period when we really had not got into this problem with other things we are doing now.

Chairman PROXMIRE. Let me ask you about disclosure 17 A, B, and C; are the charts on which you make a very helpful revelation of what you get, and is there better disclosure, on defense contracts surveyed under the 1933 act? How is that made public or is it made public?

Mr. LOOMIS. Those are in registration statements and in those instances where the defense contractor during the period involved made a new offering of securities. Several of them have not. That is the Securities Act registrations.

LACK OF FULL DISCLOSURE

Chairman PROXMIRE. All right. In that record, which is better than the other one, you have only 3 defense contractors report cost overruns, 25 who do not; estimation problems only 2, 26 do not; delivery problems only 2, 26 do not; cancellation possibilities 15 do, 13 do not; claims against the Government—Government against the company only 1 disclosed those, 27 did not; claims of the company against the Government, only 1 disclosed those, 27 did not; again, a somewhat better record, as I say, than before. You do not have zero, but you have a very poor showing and most stockholders would be left in the dark.

Mr. LOOMIS. Senator, I believe there are some 70 companies. Certainly not all of them had the type of problems that you are referring to. If they did not have them they did not have to disclose them.

Chairman PROXMIRE. In our experience, practically all large defense contractors have them if they are large enough to have a variety of contracts.

Mr. LOOMIS. Well, these included also companies such as, I believe, General Motors——

Chairman PROXMIRE. We asked the GAO to make a study of the major defense contracts for us and they found they were overwhelmingly in overrun; the overruns averaged around 40 to 50 percent of the original contract.

Mr. LOOMIS. I think, for example, companies like General Motors and A.T. & T. are defense contractors but maybe these problems are not as major to them.

Chairman PROXMIRE. Of course, these are defense contractors disclosures?

Mr. LOOMIS. Yes; but they also include companies having other businesses.

Chairman PROXMIRE. I understand. But in many defense contrac-

tors it is a very minor part of their operations; that is true, but this still looks as if it is pretty serious delinquencies.

I might say Litton has only 30 percent of its business in defense but look what it is doing to their operations. Their profits dropped down from about $50 million last year to $1 million this year and we all know now that it is public knowledge what difficulty they are in.

You point out the uniqueness of defense business and that accounting statements about it are at best poor approximations of reality; and you say that about all auditors can do is verify the legitimacy of costs incurred to date. Does this not prove that the SEC should not rely so heavily on independent auditors for compliance with your requirements?

Mr. LOOMIS. Well, who else should be rely upon? I think they are invaluable because otherwise we would have to rely on the management.

Chairman PROXMIRE. For the major contractors, more has to be done by the SEC. If this requires somewhat greater staff I think it is an excellent investment.

Mr. LOOMIS. Well, I hope the appropriations committees and OMB will agree.

Chairman PROXMIRE. Not only as a member of the Appropriations Committee but as chairman of the subcommittee that handles your money, I am very interested in that and I want to do all I can to help you.

Mr. LOOMIS. I agree. I have always personally felt, without knowing how to do it, because I am not skilled in the area, that we have not done enough about the defense contractors' problems.

Chairman PROXMIRE. When you talk about adding two men to your vital agency, your vital work, and we talk about billions and billions of dollars elsewhere, we are talking about, I am sure, a benefit-cost ratio which anybody would have to feel was immensely favorable and a good investment if we are going to provide protection for, as I say, the hundreds of thousands of investors in defense corporations.

SEC NEEDS TO DO MORE

Mr. LOOMIS. I agree with you entirely; I could not agree with you more. We should do much more in this area but we have a great number of other responsibilities, many of which most segments of the people and even most segments of the Congress regard as more our business than defense contracting. In fact you, Senator, I think correctly, are one of the few people who think that defense contracting is a major subject for us. The other Members of Congress, and so on, inquire on how many fraudulent people did we catch, what are we doing about the condition of the brokerage firms, and how do we improve their operations.

Chairman PROXMIRE. Of course, all these things are important. I realize you have many people who have different views on what you should do, but you are an independent agency, you are independent of the President in a very important sense. You are appointed, of course, by the President, but you have a degree of independence and a judicial capacity, you have to make decisions and judgments; you

can see with this colossal amount at stake is a very large sector of the investments and it is an area in which the Government has a peculiar responsibility and where knowledge could be enormously helpful to stockholders.

Mr. LOOMIS. I agree.

Chairman PROXMIRE. Here we could do more.

Mr. LOOMIS. I agree with you.

Chairman PROXMIRE. Did you want to reply?

Mr. BURTON. I just think, in the first place, the Commissioner's comments in regard to the danger of making——

SEC MAY CHARGE FEES FOR AUDITS

Chairman PROXMIRE. Let me just interrupt to say I am informed by the staff the SEC could charge fees for these audits, so the costs would not have to be borne by the taxpayer entirely.

Mr. LOOMIS. I would have a question about that. We have never charged anyone a fee for the privilege of being investigated by us, and the general guidelines that we have from OMB concerning fees are that we should not do that.

Chairman PROXMIRE. Let us think about it. Will you give me a memorandum on that?

Mr. LOOMIS. Surely.[1]

Chairman PROXMIRE. I would like to get your full opinion on it.

SEC NOT A GUARANTOR OF INVESTMENTS

Mr. BURTON. There is a real danger, I think, as Mr. Loomis pointed out in his statement, that the investiing public, when viewing increased activity on the part of the Commission, will look to the Commission as a guarantor of investment results which, I think, would be most unfortunate.

Chairman PROXMIRE. Of course.

Mr. BURTON. This is a danger. I am not certain as to what audit responsibility, and you used the word audit, you believe the Commission should have in looking at such engagements. I know that public accountants spend a great deal of time and resources investigating contracts. I know 10 years ago in working public accounting I spent some time in looking at a longtime contractor who was not a Government contractor and we spent a good deal of time and were not able to do other than to satisfy ourselves that historical estimates were reasonable and therefore there were grounds for placing reliance on the company engineering estimate and this is an area in which the engineering estimate is the key to the profitability of the contract.

NEED FOR DISCLOSURE

Chairman PROXMIRE. Any investor who thinks that the SEC can guarantee results, is awfully foolish, and we would not expect anything of that kind at all. It is just that the SEC should be able to require, one way or another, adequate disclosure so that a prudent

[1] See memorandum, pp. 2021–2023.

investor can make an investment based on the information available, and from everything I see is, in the defense contracting area this is, not the case.

Mr. BURTON. Well, of course, a cost overrun, as I think Mr. Loomis said, is not necessarily material information to an investor as long as it will not be costly to the company in terms of its inability to collect these overruns from the Government, and this depends on the nature of the contract. I am not making a judgment in terms of Lockheed's cost overrun because I think that clearly was perhaps——

Chairman PROXMIRE. Yes, of course not. What we are saying is that the fact of the cost overrun and whatever can be disclosed about the size of the overrun, if it is available, should be made available just as promptly and fully as possible without making any judgment as to whether or not the company will have to bear the burden on that. That is something which almost always is worked out on the basis of some kind of negotiations or some kind of political decision. But the fact of it is material and imporant for a prudent investor.

SPECIAL GUIDELINES

Let me ask, do not the facts also strongly suggest, Mr. Loomis, that because defense is a special kind of business which presents unusual accounting and auditing problems, that special guidelines for disclosure ought to be issued by SEC?

Mr. LOOMIS. I think you are right on that. Our problem has been in the past to provide meaningful guidelines. The result of this investigation that you refer to was, as I recall, a conclusion on the basis that the reporting structure should not be changed and the new rules were not the answer. I think essentially that is the conclusion. But that the attention of the public and of defense contractors should be drawn to these problems, and this was discussed in the release which is attached to my prepared statement.

Chairman PROXMIRE. Here is my problem. You referred to the notice to defense firms issued by the SEC on June 22. In my view, Mr. Loomis, that was the weakest, wishy-washiest action you could have taken in light of the incredible and indusputable failure of defense contractors to comply with the disclosure requirements. In fact, did not the SEC staff itself propose guidelines for disclosure by defense contractors?

I have a copy of the proposed guidelines here, and those guidelines would be a lot more forceful and effective kind of action.[1]

Mr. LOOMIS. I was not particularly——

Chairman PROXMIRE. Instead of sending a general notice to do better, we would like to have guidelines here, guidelines would indicate what they would have to do.

Mr. LOOMIS. I will look at that further. I did not participate in that at all, either in the formulation of those guidelines or any decisions with respect to them. I think there was some sentiment in some quarters that those guidelines might do more harm than good, but I do not know why because I was not involved.

[1] The full text of the proposed guidelines and the notice of June 22 may be found on pp. 2483–2492.

Chairman PROXMIRE. Well, how could they do more harm than good? To whom would they do harm?

Mr. LOOMIS. Well, there are——

Chairman PROXMIRE. First, let us go through the guidelines and maybe that is the thing to do. I have a copy of them, I presume you are thoroughly familiar with them. Let me examine the staff's proposed guidelines for a few minutes. They proposed that contractors be specifically required to describe their major contracts, to describe the types of contracts and explain how each type affects profitability and future claims for allowable costs, to discuss the difficulty in estimating costs, the fact that contracts are subject to renegotiation of profit and termination for the convenience of the Government, that it may take long periods of time to settle claims, they require that problems in meeting specificiations or delivery schedules be stated and material cost overruns. Now, why should not these guidelines be issued so that firms be required to disclose this information to the public. I can see how it might do damage to some firm that wants to be able to sell its stock at a value higher than they should, than the public would pay for it if the public had the facts, but I cannot see how this would do any damage to an honest firm or to an investor. How could they do more harm than good?

Mr. LOOMIS. Well, that probably was not the way to put it but I think there was a conclusion reached that these detailed guidelines would create impressions which were not always justified as to problems of defense contracting for all companies doing it in all kind of ways. Maybe Mr. Steffan would answer that.

WHO KILLED THE GUIDELINES?

Chairman PROXMIRE. I would like Mr. Steffan to answer who killed the guidelines, who killed Cock Robin?

Mr. STEFFAN. I am afraid I was not here when that happened but I am not sure it is fair to say that they were killed either, because——

Chairman PROXMIRE. Well, they are not in effect.

Mr. STEFFAN [continuing]. Well, let me just speak to this after the fact. I think, in the first place, there was some concern that the matters investigated both here and in the Lockheed report, and the conclusions reached about the type of disclosure, were related very heavily to the total package procurement type of contract which was at that time, and I guess is still, being phased out except for the contracts in effect.

Chairman PROXMIRE. Let me just interrupt to say in my mind this total package procurement has taken a whale of a beating. Again, this committee criticized that first and at that time the Air Force said it was the greatest type of contract, Mr. Charles said it was the greatest contract conception that had ever been advanced by the Defense Department. They championed it. Finally, they came around to agreeing it was not good and threw it out, but this cannot be held responsible. We are going to continue to have problems in the future, have overruns in the future, and have defense contractors

in deep trouble in the future and the total package procurement concept is not anything like the end of our problem.

Mr. STEFFAN. No, what I am saying, I think to a degree some of the conclusions reached were reached on the basis of investigations of companies involved in this kind of contract and I think there was some feeling, that is my impression, I do not know accurately, that it would be unwise to develop guidelines that would be so specifically related to this type of investigation which would not perhaps, which could be deemed by certain types of companies not to apply to their other contracting.

Secondly, I think that not only the types of things that you mentioned in the proposed guidelines but also other matters in this report which are related have been pointed out in this special survey project that we are undertaking as matters which should be considered for disclosure, and I think we are having a good effect in many cases.

I think——

Chairman PROXMIRE. How long will it take? This is already 6 months.

Mr. STEFFAN. Well, it is in practice now.

You see, when a company——

Chairman PROXMIRE. The guidelines were not issued, the defense contractors are not required to comply?

Mr. STEFFAN. The guidelines were not issued in response to your question but there are surveys being done in relation to this information as the contractors file their quarterly and annual reports and financial statements, so I think we are getting disclosure to some degree.

Chairman PROXMIRE. I do not understand how this can be done without your knowledge, you are a Commissioner, you should have had a vote on it or was it done by the Chairman without a vote?

Mr. LOOMIS. As I understand it, this decision bascially was made before I was appointed to the Commission.

Chairman PROXMIRE. You were the legal counsel of the SEC.

Mr. LOOMIS. Yes, but it was not my job to deal with this kind of problem.

Chairman PROXMIRE. Who made the decision then, the previous Commission or the Commission that was constituted before you were appointed?

Mr. LOOMIS. I presume the Commissioners as then constituted.

Chairman PROXMIRE. When? What was the date?

Mr. LOOMIS. Although some of it was made after I was there, but the staff on further consideration concluded that it would be unwise to issue these guidelines, and I am not an expert in that question and I presumably concurred. I want to apologize for indicating that I was not there because some of it happened after I was there.

Chairman PROXMIRE. In your June 22 release you said it would be impracticable to impose specific guidelines because defense contracts are so complex. Tell us which of the proposed guidelines are impracticable. Give us an example of why it would be impracticable to require defense firms to disclose their cost overruns or their claims against the Government.

Mr. LOOMIS. Well, I suppose you would have to define what a cost overrun is. It is one thing if you are going over an estimate that you have and it is another thing if you are going over the total amount of the contract.

Chairman PROXMIRE. The cost overrun is a very simple arithmetic determination. It is whenever the costs go above the target, and the amount by which they do.

Mr. STEFFAN. It is estimated costs, is it not?

Chairman PROXMIRE. It can be—they estimate this regularly, it is estimated costs.

Mr. STEFFAN. But it is estimated costs.

Chairman PROXMIRE. They are required to make that kind of report, are they not, to the Defense Department? They are required to make that kind of report regularly to the, Defense Department so they know what it is.

Mr. BURTON. There is a question as to how relevant it is to investors as a general principle. In other words, what I think one of the problems the Commissioner saw with the detailed guidelines, and I also was not present when that was done, but in one——

Chairman PROXMIRE. Let me say that the reason it is relevant is it means they are going to sell this product at a loss unless the Government bails them out, and again, you do not know exactly what effect this is going to have on income or the the price of the stock but at least you know this is an element that could have an effect, an element that could be of very great significance; perhaps it will not be of significance but the stockholders should be told about it and what it is so they can make their own evaluation.

Mr. BURTON. Well, there is a question as to his ability to make a reasonable evaluation, and the danger——

Chairman PROXMIRE. There is certainly no question about his inability to make a reasonable evaluation if he knows nothing about it at all.

Mr. BURTON. But there is a risk he will make a wrong evaluation about it because when something is pointed out in corporate disclosure, when something is pointed out, it automatically assumes a considerable importance. In some companies, and I am not making this a general statement because in some cases cost overruns are a relevant disclosure, but when it is disclosed it may well create an element of concern that is not justified in terms of the investment picture of a particular corporation. Perhaps by calling for too much disclosure you can create fear which does not balance the relevance of a particular disclosure to the degree of risk in the investment in the particular company.

Chairman PROXMIRE. You are treading on awfully dangerous grounds in that response, maybe you are right, but I am shocked and surprised that you would say that a cost overrun, a material fact, should not be disclosed to permit the investor make his own judgment on it. You may say make the wrong judgment, sure, of course, but at least you give the facts to the extent that you can.

As I say, the defense contractors know if they have a cost overrun, they have to, they are required by the Government to make an

estimate to the Government on it. Why should not that be disclosed to the investor, and if some investors are foolish and make a misjudgment on the basis of the fact that has been disclosed there is nothing in the world we can do about that. But certainly, you do not imply that the best investor is an ignorant investor who does not know the facts; the less he knows about it the better investments he makes, is that it?

Mr. BURTON. No, that was not what I intended to imply but I think the investor can be misled by selective disclosure, and one of the dangers, particularly——

Chairman PROXMIRE. That is why we want full disclosure of every cost overrun, not selective.

Mr. BURTON. But when you are dealing with cost overruns you are already selecting in terms of the total picture of a corporation. Now again, if you are talking about a company whose sole business is defense, then you are talking about a situation where virtually every case of a material cost overrun would be material investment information.

Chairman PROXMIRE. Now, I see your point. Your point is you have a firm that maybe has 1 percent of its business in defense.

Mr. BURTON. Or 10.

Chairman PROXMIRE. It has a small cost overrun, it discloses the cost overrun, the investor gets the notion that because there is a cost overrun this is bad, better sell the stock, the value of the stock drops unfairly.

Well now, it seems to me this puts a very poor judgment on the capability of a corporation to hire people who have any knowledge of semantics. In the first place, they can say that it is a small cost overrun, that it only amounts to a fraction of a percent perhaps of their operations, that it will not be significant. They can tell the truth. Nobody is keeping them from disclosing what kind of a cost overrun it is. All we say is it should be disclosed.

Mr. STEFFAN. I think one other point here is that a company is required to disclose any material anticipated writeoff or expected loss at the time they conclude this will occur, and the auditors are expected to confirm that and enforce that, and I think that is one aspect. Of course, there is a mechanism——

Chairman PROXMIRE. Of course, they can write it off; of course, it is too late and by then the stockholder has suffered his loss.

SEQUENCE OF EVENTS REGARDING GUIDELINES

Let me get back to Mr. Loomis here and follow up about these guidelines. You said, as I understand it, in part, the decision may have been made when you were there, before you were a Commissioner, you were not sure. Give us as much as you can of the sequence of this and if you cannot give to us now for the record directly, will you give it to us later?

Mr. LOOMIS. I think I should elaborate on it later because I do not have all of the details in mind.[1]

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[1] See Mr. Loomis' letter, dated Jan. 3, 1973, pp. 1990–1991.

As I understand it, these guidelines were submitted to the Commission for its consideration, the Commission requested the staff to consult with outside professional groups and Government agencies as to what the impact of this would be. The staff reported a good deal of concern, and the conclusion, for some of the reasons that have been discussed, was that it would be unwise to attempt to put out specific guidelines.

Chairman PROXMIRE. I understand you requested comments on these from a number of Government agencies, including the Defense Department.

Mr. LOOMIS. Yes, sir, I think that is correct.

Chairman PROXMIRE. Could those comments be made available to the subcommittee?

Mr. LOOMIS. I would suppose that they would but I do not know the terms under which they were obtained.

Chairman PROXMIRE. Well, I cannot see that they would do the Kremlin any good. Why should they not be disclosed publicly?

Mr. LOOMIS. I personally would have no objection, I do not even know what form they took, whether it was a memorandum of a conversation or something, I just have not seen the documents, but I will endeavor to make sure they get to you if there are such documents.

Chairman PROXMIRE. I understand they were formal replies that were made and those comments are available and we would like very much to get them and if they cannot be disclosed to the subcommittee will you tell us why?

Mr. LOOMIS. I certainly will do that.[1]

CORRESPONDENCE CONCERNING LITTON

Chairman PROXMIRE. I want to discuss my requests that the SEC look into Litton's failure to make full disclosure in its annual reports. My most recent letter from Chairman Casey is dated August 18, 1972. Are you familiar with that letter?

Mr. LOOMIS. I read the exchange of correspondence.

Chairman PROXMIRE. I happen to know Litton has had a copy of that letter for some time. Since I have not released it, Litton's copy must have come from SEC.

Mr. LOOMIS. Which copy?

Chairman PROXMIRE. The August 18 letter from Chairman Casey. What I want to know is, who gave this letter to Litton and why it was given to them?

Mr. LOOMIS. I am informed that your staff was asked whether there would be any objection to giving it to Litton and we were told there would be no objection, so it was.

Chairman PROXMIRE. Well, my staff tells me they were not informed about that. Dick Kaufman, who is handling this particular matter, was not informed.

Ken McLean, did you know about this? He is the other man who handles matters with me for the SEC and Litton. He also did not know.

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[1] See Mr. Loomis' letter, dated Jan. 3, 1973, pp. 1990–1991.

ANTICIPATED RECOVERIES FROM CLAIMS

My original request was that SEC check whether Litton has reported earnings based on its expected recovery of large claims against the Navy. Your reply was that they have counted $22.1 million out of $73.8 million in dispute as current assets, and that another $10 million of Navy claims is carried as accounts receivable offsetting prior expenses. Is this not misleading financial information to put into an annual report? Is it not true that of the $168 million in claims the Navy has offered to pay less than $7 million? In other words, Litton has made claims of $168 million. The Navy has almost treated these claims with contempt, they say that they are going to honor $7 million of these claims. If Litton receives only the $7 million the Navy says they will provide, will that not seriously affect Litton's earnings?

Mr. LOOMIS. I wonder if I could ask Mr. Steffan to respond to that because this is an aspect of the thing that I have not gotten personally into.

Chairman PROXMIRE. All right.

Mr. STEFFAN. You are correct that if they received nothing other than the $7 million that is being offered to them by the Navy they would write-off the difference between the $7 million and the $32 or $34 million. I think actually, that number is up to $41 million.

Chairman PROXMIRE. The total is $168 million and only $7 million of the $168 million?

Mr. STEFFAN. That is right. Well, as I understand it, approximately $94 million of the $167 million of the claims is related to incidents on which there has been no Navy settlements, that is in the Armed Services Board of Contract Appeals at this time.

Chairman PROXMIRE. The Navy offered nothing. The Navy consider it and offered nothing, zero.

Mr. STEFFAN. Well, perhaps that is correct. My understanding is there has been no settlement by the Navy on that matter at all. The other two matters relate to the submarines, and ammunition ships, and the total offered by the Navy for those two, including escalation, was $7 million or approximately that, at least that is what Litton released.

The amount, then, which they have on in the assets on their books in excess of that $7 million would have to be written off if they did not receive more than the $7 million in their settlement with the Navy.

Chairman PROXMIRE. That is your conclusion, but how does the poor investor know about that? Your reply was, as I say, they have accounted for $22.1 million, not $7 million in dispute in its current assets and another $10 million of Navy claims is carried as accounts receivable offsetting prior expenses.

Mr. STEFFAN. Right.

Chairman PROXMIRE. Well, does that not distort——

Mr. STEFFAN. It distorts——

Chairman PROXMIRE [continuing]. Both their earnings and current assets and current ratio and other elements that a prudent investor would want to look at, would have to know about?

Mr. STEFFAN. Assuming there is no recovery, yes, it would be a distortion and would require a write down. On the other hand, if they recovered more in their settlement it requires a write-up. This is an estimate.

Chairman PROXMIRE. All I am asking, and we do not know, we agree if there should be a settlement that this full information should be disclosed and they should not proceed to go substantially several times above what the Navy offered and put that into their report. What they should do is to state what the Navy has offered, what they have claimed, and let the stockholder judge it, and not incorporate that into their earnings and their balance sheet.

Mr. STEFFAN. Well, of course, they have not reported earnings on this amount, but I will grant you it is really semantics because if they do not receive the amount they would have to reduce their earnings. But they have not actually reported earnings on this amount. But I think that the fact is they have isolated this amount in their reports, in their most recent annual report, the amount had grown to $41 million and they did indicate that this was subject to dispute, and I believe, and they talk about having referred this to the ASBCA.

Chairman PROXMIRE. In their 1971 report they put the money in before the Navy offered them anything, I understand.

Mr. STEFFAN. I think that is correct, yes, not that much but I think there was an amount in there.

SEC INQUIRY

Chairman PROXMIRE. What really flabbergasted me about your response to my request that you determine whether SEC's disclosure requirments have been violated by Litton's accounting and reporting practices, Mr. Loomis, was your statement and I quote: "This is basically an area involving the judgment of the company's management and its independent auditors." Tell me what SEC did to determine whether Litton complied with your requirements. Is it true that you only looked at the auditors' certification on the annual report and then talk with Litton officials?

Mr. LOOMIS. You mean—this is not the August 18 letter? You are referring to an earlier letter?

Chairman PROXMIRE. That is right.

Mr. LOOMIS. In your earlier letter I suspect that that was, although I again was not participating, I did not handle this matter, that is probably about all that was done at that stage, that they—what we often do in this kind of a situation where the question has been raised as to the accuracy of an accountant's auditing financial statements we ask him how he got to where he did. Later considerably more inquiry was made before we sent you the August 18 letter.

Chairman PROXMIRE. Well, Chairman Casey's August 18 letter stated and I quote: "The staff will be reviewing subsequent developments to be certain they are properly reflected in future reports." What has been done so far? And are satisfied with Litton's latest annual report?

Mr. STEFFAN. Well, let me comment, please, again on that. Subsequent to the, one of the, earlier replies, possibly the one you were

quoting, there were conversations with the Navy in relation to these contracts, and testimony that you have been involved with, was read and studied, and all these matters were discussed with Litton and its accountants. The Navy's reaction was not any different from what has been largely, I think, testified to, and basically they agree that while their offer of settlement on these particular claims we were discussing earlier was less than, substantially less than, the claimed amount themselves they agreed that their offer had been based largely on specific contract points and not on a matter of equity which, I understand, is a significant consideration and one which the ASBCA has acted on in the past and considering in a number of instances.

The subsequent monitoring of this involved rather extensive continued meeting and discussion with Litton and so far there have not been substantial developments since the August 18 period in the progress on either of these claims or on the LHA program and there has not been much change in the nature of their reporting except they have discussed these problems in their reports to shareholders.

Chairman PROXMIRE. In other words, you have not done anything?

Mr. STEFFAN. No, I would not say that is true. I think we have continued to conduct the type of investigation that you recommended we do with all these contractors and other large companies.

LITTON ANNUAL REPORT

Chairman PROXMIRE. Well now, Litton's fiscal year 1971 annual report states and I quote: "The outlook for Defense and Marine System is good." Is there any doubt in your mind that that statement was inaccurate and in fact misleading?

Mr. STEFFAN. Well, I do not know that it is fair to select that statement alone from the report without looking at the extensive discussion of these two contracts and other matters relating to the LHA that is also in that report. Are you talking about 1971, I am sorry.

Chairman PROXMIRE. 1971, yes, sir. There is no discussion of the contracts in 1971?

Mr. STEFFAN. It would be hard for me to know what was the knowledge about those contracts at that time, and the total perspective in their business.

Chairman PROXMIRE. Yesterday we had an enormous amount of documentation on the great difficulties Litton is having in exactly this area, defense and marine systems, and they have been having it for years and, of course, we now know that they have suffered big losses, big losses, and the losses may be a lot bigger. So for them to tell the investing public the outlook is good is just misleading and inaccurate.

Is there any doubt that Litton and many other large defense contractors are failing to disclose the risks and problems they are experiencing on their defense contracts?

Mr. STEFFAN. Is there any doubt?

Chairman PROXMIRE. Any doubt they are failing to disclose the risks and losses that they are suffering.

Mr. STEFFAN. In Litton's case or did you speak——

DISCLOSURES BY OTHER CONTRACTORS

Chairman PROXMIRE. How about other defense contractors?

Mr. STEFFAN. Well, I think that the contractors that I have studied, which are largely at the moment Litton and Grumman, have disclosed and discussed their problems quite adequately in the press and in their reports to us. I think it is very difficult for Litton to estimate the outcome of particularly this LHA contract, and I think that is one of the major problems.

Chairman PROXMIRE. Let me get into very briefly, much more briefly, Grumman.

Mr. LOOMIS. I just wanted to make one comment on the problem.

Chairman PROXMIRE. Yes, sir.

Mr. LOOMIS. There is sort of an inherent problem in getting these people to discuss as we might wish to see them discuss the claims that they may have against the Government. There is a risk that they will not get it but they hestitate to say "We probably will not get them."

Chairman PROXMIRE. I would not expect them to get that, no. No, I think you are right, and I would not expect that. We would not expect that and they should not say that. All I am saying we should find out what we are finding out in these hearings, their claims are such and such, the Navy has allowed such and such, and the matter is in litigation and that will be determined. Those material facts are not disclosed.

Mr. LOOMIS. I agree that should be disclosed. There are again other aspects of it when you are dealing with the nature of the claim and the manner in which it arose and that kind of thing would have to be in there, too.

Chairman PROXMIRE. We have been talking about the need for defense contractors to disclose the existence of cost overruns and other problems on defense contracts as soon as they arise. A related concern, it seems to me, is the manner in which problems are disclosed.

GRUMMAN AND F–14

Let us take the case of Grumman Corp. and its problems on the F–14.

Grumman officials knew in the fall of 1971, after they agreed on October 1, 1971, to produce Lot 4 of the F–14 program, that the company would suffer a sizeable loss on this work which was scheduled to begin in late 1971 and to continue until mid-1974 when the final Lot 4 F–14 aircraft were to be delivered to the Navy. The company projected this loss, for the whole period of Lot 4 work, at approximately $35 million on a pre-tax corporate-wide basis. It then decided to write off this whole projected loss, which amounted to $4.46 per share, in the final quarter of 1971. The net result, after Grumman had reported a profit of $1.88 per share for the first 9

months of 1971, was a reported loss for the full year of $2.58 per share and that, of course, is a dramatic turn around, almost catastrophic turn around, I am sure, in terms of the investors evaluation of their stock.

During the year 1972, with these losses written off in advance, Grumman reported a profit of $.84 per share for the first six months of 1972, followed by a deficit of $.64 per share in the third quarter, when the company reanalyzed its projected loss for the whole period of Lot 4 work and wrote off another $20 million. The question is this: I wonder if you would comment on the propriety of this reporting practice, which writes off in 1971 and 1972 projected losses for 1971-1974 and bears no real relationship to the profitability of the corporation at actual points of time over this period?

Mr. LOOMIS. I have some observations but I would also like Mr. Burton to have some.

Chairman PROXMIRE. All right.

Mr. BURTON. The accounting principles that would be involved, which I think are generally accepted accounting principles, and probably the only generally accepted accounting principles, are that a loss should be recognized as soon as it is perceived and, therefore, as soon as the company determines that it has a loss on a contract, even though this loss is one which will be suffered over 3 or 4 years work it is required to provide in full for the loss at the current time.

If there is adequate disclosure of this fact presumably the investor in subsequent periods will not be fooled in seeing profitability reported while, at the same time, there may be some cash drain under the contract.

The Commission in September proposed rules which would require substantial additional disclosure for any material unusual charges and credits to income which would require corporations to indicate the periods during which the costs either which had been incurred or were to be incurred, were expected to be incurred, so that where a large write-off occurs the investor will be able to perceive in what period the actual cash drain will be suffered or has been suffered in the case of writing off fixed assets and inventory already paid for.

We have received comments, extensive comments, on this proposal and our final proposals will be presented by the staff to the Commission next week, which will call for substantial additional disclosure of such items.

The question as to whether or not the basic accounting principle is realistic is one that goes to the inherent conservative bias that accounting statements have had which say that losses should be recognized when they are incurred.

INVESTOR CONFUSED

Chairman PROXMIRE. Well, what this all means, of course, is that you get an investor very, very confused. You put him in a position where he thinks that this corporation lost money, sure, they lost money in the past, but in 1972, after having lost in the third quarter of 1971 a large amount now they are beginning to move ahead. The

earnings are good and favorable. Why would not the honest way to deal with the investor be to require full disclosure as long as Grumman had this knowledge to announce the F–14 program would result in losses over the whole 1971–1974 period and then report those losses as they occur rather than write them off, as they did, and have their profit statement fluctuate wildly as it did back and forth between profit and loss status with, of course, I am sure, misunderstanding on the part of the investing public.

Mr. BURTON. Well, I think that Mr. Loomis already stated, made a statement, that the accounting model, the generally accepted accounting principles model, does not apply very well to any industry in which there are long-term contracts which are subject to great uncertainty.

Chairman PROXMIRE. That is exactly right, and that is why the SEC has a job. If this were automatic it could be done by computers, then you would not need intelligent and experienced and wise judgment on the part of the SEC staff and the Commission. But obviously, this is a unique kind of a situation where the SEC ought to step in and provide the investor with the kind of discriminating understanding he needs here.

Mr. BURTON. Well, I agree completely that full disclosure of the write-off is necessary.

The other question, you raise, which is the question as to whether or not the full impact of the loss should be charged to income at the point where it is first perceived or whether it should be spread over the life of the contract is a matter of basic generally accepted accounting principles which have been, I think, generally understood by the investor to provide that losses are charged off as soon as they are recognized.

Now, I think it is fair to say that the Commission is deeply concerned about the general practices of registrants, the American industry in general, to take large writeoffs, and this is by no means confined to the defense industry, and we have seen in the past year and a half very substantial extraordinary charges. The Accounting Principles Board has an exposure draft opinion which will not change the underlying rules but will, I think, limit the extent to which these losses can be treated as extraordinary, and our disclosure requirements will also, I think, amend this problem at least to the extent of disclosure.

The underlying accounting issue, which is really a theoretical issue, which says does a loss spread over a long period of time or does it accrue at the point where it is recognized, is one of fundamental accounting principles, and while we have statutory authority to set such prinicples we believe that in large part the activities of the Accounting Principles Board and the accounting profession in setting principles have served the public well and created a set of principles which generally lead to reasonable understanding of what is going on.

Chairman PROXMIRE. Of course, they have served the public well, they are very honorable, capable people, but here is a case where it does not serve the public well and in those cases, it seems to me, there ought to be wisdom on the part of the SEC that will provide

the sort of disclosure that will inform the investor that the profit which was reported in 1972 should be modified by a company statement, at least, as to what it really means, that there are losses which are going to be, which are, inevitable and definite and certain, which should affect their judgment as to meaning of that profit if they have to report it that way.

Mr. Loomis, did you want to comment further on this before I ask you a followup question?

Mr. LOOMIS. I have always thought it was a desirable item of disclosure when you know you are going to have a loss to say so and not wait and let that information remain undisclosed.

Now, the impact of the proposals that Mr. Burton referred to should assist in enabling investors in subsequent periods to appreciate the significance of the fact that the loss has been charged off before and as a result does not have to be charged off again. You cannot very well charge it off twice.

ADDITIONAL RESOURCES NEEDED TO CRACK DOWN ON GIANT CONTRACTORS

Chairman PROXMIRE. I would like to have a statement, Mr. Loomis, of the additional resources you would need, including what additional staff and additional funds to really crack down on the giant contractors to the extent of forcing them to comply with disclosure requirements and to protect the public from sudden shock waves caused by defense contracting problems. Will you supply that for the record?

Mr. LOOMIS. Yes, sir.[1] I do not take short hand so I am not sure I got everything that you said.

Chairman PROXMIRE. What I am asking is in effect what additional resources you need, additional staff you need, or additional funds you need, in order to require full disclosure on the part of the major defense contractors.

Let me conclude, and this is absolutely no derogation of either you or the two very able men who accompany you today; certainly they are highly competent, but the fact is that in connection with major defense contractors, the SEC is just not performing its job of protecting the investing public by requiring adequate disclosure. It is a sad statement but it seems to me this is true, and let that word go out to the investing public so they are prepared to understand it.

Thank you very, very much. Thank you for a helpful appearance this morning, and I am sure that we are going to be on the road to improvement, but we have a long way to go and I think you know that.

Mr. LOOMIS. What is that?

Chairman PROXMIRE. I say we have a long way to go.

Mr. LOOMIS. We quite agree.

Chairman PROXMIRE. Yes.

Tomorrow we will continue these hearings at 10 o'clock in the morning in this room with testimony by Barry Shillito, Assistant Secretary of Defense; John Malloy, Assistant Secretary of Defense

[1] See Mr. Loomis' letter, dated Jan. 3, 1973, pp. 1990–1991.

for Procurement; and B. B. Lynn, Director of the Defense Contract Audit Agency.

[Whereupon, at 11:35 a.m., the subcommittee recessed, to reconvene at 10 a.m., Thursday, December 21, 1972.]

[The following information was subsequently supplied for the record by Mr. Loomis:]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., January 3, 1973.

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

DEAR SENATOR PROXMIRE: In the course of my appearance before your Subcommittee on December 20th, you asked me to provide a number of items of additional information, and the purpose of this letter is to attempt to respond to those requests and also to correct certain errors and omissions which I do not think are of major importance.

Turning to the latter item first, I stated in response to your question, that the Commission has some 13 or 14 hundred employees in toto. Actually, we have some 1500. I also discussed the number of people assigned to reviewing registration statements and reports and additional people in supporting capacities, or a total of approximately 150. This number is understated by reason of a circumstance which I believe is not televant to the subject matter of your hearings, and that is the recent transfer of somewhat over 30 people form the Division of Corporate Regulation to the Division of Corporation Finance. These people continue, as they did before the transfer, to process and examine the filings of investment companies registered under the Investment Company Act of 1940.

There is also a smaller unit having an authorized strength of ten and a presently funded staff of eight in the Division of Enforcement which is concerned with investigations and proceedings involving the accuracy and adequacy of material filed with us by corporations generally. They can call on other enforcement personnel for assistance when necessary, but as I explained at the hearings, the great bulk of our enforcement efforts are concerned with such matters as possible frauds in securities transactions, misconduct or violations of law by registered broker-dealers, registered investment advisers, and registered investment companies, and possible illegal distributions of unregistered securities.

At the hearings, you referred to the fact that the proposed guidelines for disclosure in defense contracting contained in the preliminary draft of the Staff Report In the Matter of Disclosures by Registrants Engaged in Defense Contracting were submitted to the Department of Defense and others for comment, and you requested copies of the letters of comment which we received. I am advised that there are four such letters—one from the Department of Defense, one from the Chairman of the Committee on National Defense of the American Institute of Certified Public Accountants, and two from committees of the American Bar Association, one from a committee of the Section on Public Contract Law, and one from a subcommittee of the Section on Corporation Banking and Business Law. I attach copies of all four letters, together with the attachments to the letter from the Department of Defense.

You will note that the Defense Department's letter did not discuss the proposed guidelines as such, but rather discussed procedures currently followed by the Defense Department in the acquisition of major defense systems. I am informed, however, that our staff had discussions with representatives of the Department, and at those meetings, the Department's representatives expressed considerable concern with the proposd guidelines primarily upon the basis that to single out persons engaged in defense contracting in the manner proposed might have a drastic adverse impact on the defense industry in that it would raise the inference that defense contracting is riskier than other businesses, when, in the view of the Defense Department, this is not the case, and also the Department felt that this would have the effect of driving necessary capital away from the industry. They also expressed the view that the guidelines were addressed primarily to disclosure problems which had resulted from

the uncertainties created by the use of the total package procurement concept for the development of complex new weapons systems, and that since this concept would no longer be used, guidelines based upon it would be inappropriate. The respresentatives of the American Bar Association and of the American Institute of Certified Public Accountants expressed similar concerns as you will note from their letters.

After these consultations, the staff recommended that in lieu of the guidlines, we put out the release which was issued in June of 1972, and the Commission accepted this recommendation. As I mentioned in the hearings, I regret the initial inference that these decisions occurred before I became a member of the Commission, when in fact they did not, and I participated in them. I just got my timing mixed up.

At the hearings, you requested a memorandum on the subject of our charging fees for audits of defense contractors. Such a memorandum is attached. It concludes that there is, at best, serious doubt as to whether the Commission has authority to impose fees of this nature. It should also be noted that even if we did have authority to do this and imposed such fees, we would not be allowed to keep them. They would be covered into the Treasury as miscellaneous receipts, and it would still be necessary for Congress to appropriate whatever funds were required.

Finally, you asked me for an estimate of the additional resources the Commission would need to have to really crack down on the giant contractors and in order to require full disclosure on their part. It was not clear to me exactly what you had in mind in the way of additional work by the Commission's staff in this area, but I have the impression from your remarks that you were speaking of considerably more than the processing activities which we discussed at the hearings and were suggesting something in the nature of the staff performing a field audit of these contractors. I have asked the staff to prepare estimates on this assumption. They informed me that if this was done, as to the 25 or so large defense contractors, excluding therefrom, however, companies like General Motors and American Telephone and Telegraph Company, which have significant defense contracts, but which are not primarily engaged in defense contracting, the cost would be over $5,000,000. They further estimate that a typical large government contractor would have an annual audit fee from its certified public accountants in the range of $250.000 to $1,000,000. As you will note, the staff believes that we could do the job for less than the audit fees that they are believed to incur, but it would still require a significant increase in the budget of the Commission, which for the current year is approximately $29,700,000.

If I can provide you with any further information, please let me know.

Sincerely,

PHILIP A. LOOMIS JR.,
Commissioner.

Attachments.

GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE,
Washington, D.C., May, 22, 1973.

Hon. WILLIAM J. CASEY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR MR. CHAIRMAN: At the request of the Commission's staff we are hereby providing as a supplemental addition for the record "In the Matter of Disclosures By Registrants Engaged in Defense Contracting", Administrative Proceeding File No. 3-2485, the current Department of Defense policy on the acquisition of major defense systems. It was also requested that we supply for the same record a statement explaining the difference between the current policy and that previously in effect. with particular reference to the type of contracts to be utilized in acquiring such systems.

The current Department of Defense policy in this area is set forth in DoD Directive 5000. 1 dated July 13, 1971. A copy of this directive is supplied as Enclosure 1. The following is quoted as it appears in subparagraph 7 of paragraph III. C. of the directive.

"7. Contract type shall be consistent with all program characteristics including risk. It is not possible to determine the precise production cost of a new

complex defense system before it is developed; therefore, such systems will not be procured using the total package procurement concept or production options that are contractually priced in the development contract. Cost type prime and subconstracts are preferred where substantial development effort is involved. Letter contracts shall be minimized. When risk is reduced to the extent that realistic pricing can occur, fixed-price type contracts should be issued. Changes shall be limited to those that are necessary or offer significant benefit to the DoD. Where change orders are necessary, they shall be contractually priced or subject to an established ceiling before authorization, except in patently impractical cases."

One of the primary reasons for the financial difficulties which some contractors and subcontractors have experienced under contracts awarded under the previous policy is that the Department of Defense asked, and contractors, provided, firm bids to produce a weapon system that had not yet been developed. Contractor bids were consistently low and were accepted without adequate consideration being given to potential technical problems, program stretchouts and the cost growth normally associated with that particular type of weapon system. DoD Directive 3200. 9 dated July 1, 1965 and rescinded on August 29, 1970 provided for paper studies by contractors which would serve as a basis for selecting one contractor to perform the development work on a firm fixed price or fully structured incentive basis. As an implementation of this policy, the Armed Services Procurement Regulation contained the concept of total package procurement which as defined therein provided for contracting at the outset of the acquisition phase, under a single contract containing price, performance and schedule commitments, the maximum practical amount of design, development, production and support needed to introduce and sustain a system or component in the inventory. As further specified in section 1–330 firm fixed price or fixed price incentive contracts were to be used in this total package approach. A copy of DoD Directive 3200. 9 and of section 1–330 as it existed prior to its deletion on September 30, 1970 are furnished herewith as Enclosures 2 and 3 respectively.

The new policy of the Department of Defense recognizes that development by its nature is dealing with the unknown and now provides that wherever appropriate contracts and subcontracts providing for the development of a weapons system will be on a cost basis rather than of a fixed price type and will not contain contractually priced options for follow-on production.

I trust the above information will meet the Commission's needs in this regard.

Sincerely,

J. FRED BUZHARDT.

JULY 13, 1971.

DEPARTMENT OF DEFENSE DIRECTIVE

Subject: Acquisition of Major Defense Systems.

I. PURPOSE

This Directive established policy for major defense system acquisition in the Military Departments and Defense Agencies (referred to as DoD Components).

II. APPLICATION

This Directive applies to major programs, so designated by the Secretary of Defense/Deputy Secretary of Defense (referred to as SecDef). This designation shall consider (1) dollar value (programs which have an estimated RDT&E cost in excess of 50 million dollars, or an estimated Production cost in excess of 200 million dollars); (2) national urgency; (3) recommendations by DoD Component Heads or Office of Secretary of Defense (OSD) officials. In addition, the management principles in this Directive are applicable to all programs.

III. POLICY

A. Mode of Operation.—Successful development, production and deployment of major defense systems are primarily dependent upon competent people, rational priorities and clearly defined responsibilities. Responsibility and authority for the acquisition of major defense systems shall be decentralized to the maximum practicable extent consistent with the urgency and importance

of each program. The development and production of a major defense system shall be managed by a single individual (program manager) who shall have a charter which provides sufficient authority to accomplish recognized program objectives. Layers of authority between the program manager and his Component Head shall be minimum. For programs involving two or more Components, the Component having dominant interest shall designate the program manager, and his charter shall be approved by the cognizant official without OSD. The assignment and tenure of program managers shall be a matter of concern to DoD Component Heads and shall reflect career incentives designed to attract, retain and reward competent personnel.

1. The DoD Components are responsible for identifying needs and defining, developing and producing systems to satisfy those needs. Component Heads are also responsible for contractor source selection unless otherwise specified by the SecDef on a specific program.

2. The OSD is responsible for (a) establishing acquisition policy, (b) assureing that major defense system programs are pursued in response to valid needs and (c) evaluating policy implementation on each approved program.

3. The OSD and DoD Components are responsible for program monitoring, but will place minimum demands for formal reporting on the program manager. Nonrecurring needs for information will be kept to a minimum and handled informally.

4. The SecDef will make the decisions which initiate program commitments or increase those commitments. He may redirect a program because of an actual or threatened breach of a program threshold stated in an approved Development Concept Paper (DCP). The DCP and the Defense Systems acquisition Review Council (DSARC) will support the SecDef decision-making. These decisions will be reflected in the next submission of the Program Objective Memorandum (POM) by the DoD Component.

B. Conduct of Program.—Because every program is different, successful program conduct requires that sound judgment be applied in using the management principles of this Directive. Underlying specific defense system developments in the need for a strong and usable technology base. This base will be maintained by conducting research and advanced technology effort independent of specific defense systems development. Advanced technology effort includes prototyping, preferably using small, efficient design teams and a minimum amount of documentation. The objective is to obtain significant advances in technology at minimum cost.

1. Program Initiation:

(*a*) Early conceptual effort is normally conducted at the discretion of the DoD Component until such time as the DoD Component determines that a major defense system program should be pursued. It is crucial that the right decisions be made during this conceptual effort; wrong decisions create problems not easily overcome later in the program. Therefore, each DoD Component will designate a single individual, such as the Assistant Secretary for R&D, to be responsible for conceptual efforts on new major programs.

(*b*) The considerations which support the determination of the need for a system program, together with a plan for that program, will be documented in the DCP. The DCP will define program issues, including special logistics problems, program objectives, program plans, performance parameters, areas of major risk, system alternatives and acquisition strategy. The DCP will be prepared by the DoD Component, following an agreement between OSD and that Component on a DPC outline. The Director, Defense Research and Engineering (DDR&EV) (or the Assistant Secretary of Defense (TElecommunications) for his programs) has the basic responsibility for coordination of inputs for the DCP and its submittal to the DSARC for consideration and to the SecDef for subsequent decision. If approved, the program will be conducted within the DCP thresholds.

2. Full-Scale Development. When the DoD Component is sufficiently confident that program worth and readiness warrant commitment of resources to full-scale development, it will request a SecDef decision to proceed. At that time, the DSARC will normally review program progress and suitability to enter this phase and will forward its recommendations to the SecDef for final decision. Such review will confirm (a) the need for the selected defense system in consideration of threat, system alternatives, special logistics needs, estimates

of development costs, preliminary estimates of life cycle costs and potential benefits in context with overall DoD strategy and fiscal guidance; (b) that development risks have been identified and solutions are in hand; and (c) realism of the plan for full-scale development.

3. Production/Deployment. When the DoD Component is sufficiently confident that engineering is complete and that commitment of substantial resources to production and deployment is warranted, it will request a SecDef decision to proceed. At that time, the DSARC will again review program progress and suitability to enter substantial production/deployment and forward its recommendations to the SecDef for final decision. Such review will confirm (a) the need for producing the defense system in consideration of threat, estimated acquisition and ownership costs and potential benefits in context with overall DoD strategy and fiscal guidance; (b) that a practical engineering design, with adequate consideration of production and logistics problems is complete; (c) that all previously identified technical uncertainties have been resolved and that operational suitability has been determined by test and evaluation; and (d) the realism of the plan for the remainder of the program. Some production funding for long lead material or effort may be required prior to the production decision. In such cases, the SecDef will decide whether a DSARC review and revised DCP are required. In any event, full production go-ahead will be authorized by approval of the DCP.

C. Program Considerations.—1. System need shall be clearly stated in operational terms. With appropriate limits, and shall be challenged throughout the acquisition process. Statements of need/performance requirements shall be matched where possible with existing technology. Wherever feasible, operational needs shall be satisfied through use of existing military or commercial hardware. When need can be satisfied only through new development, the equivalent needs of the other DoD Components shall be considered to guard against unnecessary proliferation.

2. Cost parameters shall be established which consider the cost of acquisition and ownership; discrete cost elements (e.g., unit production cost, operating and support cost) shall be translated into "design to" requirements. System development shall be continuously evaluated against these requirements with the same rigor as that applied to technical requirements. Practical trade-offs shall be made between system capability, cost and schedule. Traceability of estimates and costing factors, including those for economic escalation, shall be maintained.

3. Logistic support shall also be considered as a principal design parameter with the magnitude, scope and level of this effort in keeping with the program phase. Early development effort will consider only those parameters that are truly necessary to basic defense system design, e.g., those logistic problems that have significant impact on system readiness, capability or cost. Premature introduction of detailed operational support considerations is to be avoided.

4. Programs shall be structured and resources allocated to ensure that the demonstration of actual achievement of program objectives is the pacing function. Meaningful relationships between need urgency, risk and worth shall be thereby established. Schedules shall be subject to trade-off as much as any other program constraint. Schedules and funding profiles shall be structured to accommodate unforeseen problems and permit task accomplishment without unnecessary overlapping or concurrency.

5. Technical uncertainty shall be continually assessed. Progressive commitments of resources which incur program risk will be made only when confidence in program outcome is sufficiently high to warrant going ahead. Models, mock-ups and system hardware will be used to the greatest possible extent to increase confidence level.

6. Test and evaluation shall commence as early as possible. A determination of operational suitability, including logistic support requirements, will be made prior to large-scale production commitments, making the use of the most realistic test environment possible and the best representation of the future operational system available. The results of this operational testing will be evaluated and presented to the DSARC at the time of the production decision.

7. Contract type shall be consistent with all program characteristics including risk. It is not possible to determine the precise production cost of a new complex defense system before it is developed; therefore, such systems will not be procured using the total package procurement concept or production options

that are contractually priced in the development contract. Cost type prime and subcontracts are preferred where substantial development effort is involved. Letter contracts shall be minimized. When risk is reduced to the extent that realistic pricing can occur, fixed-price type contracts should be issued. Changes shall be limited to those that are necessary or offer significant benefit to the DoD. Where change orders are necessary, they shall be contractually priced or subject to an established ceiling before authorization, except in patently impractical cases.

8. The source selection decision shall take into account the contractor's capability to develop a necessary defense system on a timely and cost effective basis. The DoD Component shall have the option of deciding whether or not the contract will be completely negotiated before a program decision is made. Solicitation documents shall require contractor identification of uncertainties and specific proposals for their resolution. Solicitation and evaluation of proposals should be planned to minimize contractor expense. Proposals for cost-type or incentive contracts may be penalized during evaluation to the degree that the proposed cost is unrealistically low.

9. Management information/program control requirements shall provide information which is essential to effective management control. Such information should be generated from data actually utilized by contractor operating personnel and provided in summarized form for successively higher level management and monitoring requirements. A single, realistic work breakdown structure (WBS) shall be developed for each program to provide a consistent framework for (a) planning and assignment of responsibilities, (b) control and reporting of progress, and (c) establishing a data base for estimating the future cost of defense systems. Contractor management information/program control systems, and reports emanating therefrom, shall be utilized to the maximum extent practicable. Government imposed changes to contractor systems shall consist of only those necessary to satisfy established DoD-wide standards. Documentation shall be generated in the minimum amount to satisfy necessary and specific management needs.

IV. IMPLEMENTATION

1. Each DoD Component will implement this Directive within 90 days and forward two (2) copies of each implementing document to the SecDef.

2. The number of implementing documents will be minimized and necessary procedural guidance consolidated to the greatest extent possible. Selected subjects to be covered by DoD Directives/Instructions or joint Service/Agency documents in support of this Directive are listed in Enclosure 1. Each DoD Component will forward the joint Service/Agency documents for which it is responsible to the SecDef for approval prior to issuance.

DAVID PACKARD,
Deputy Secretary of Defense.

RELATED POLICY

[Responsibility for the following policy documents is assigned to the cognizant office indicated. In each case, the cognizant office shall (a) generate the policy, or (b) delegate authority to a lead DOD component for preparation and subsequent issue of a joint service/agency regulation, agreement, or guide after approval by OSD]

Policy subject	Cognizant office	Responsible DOD component
The DOD Technology Base	DDR&E	
The DCP and the DSARC	DDR&E	
Defense System Engineering	DDR&E	Air Force.
Proposal Evaluation and Source Selection	ASD(I&L)/ DDR&F	
Cost Analysis	ASD(SA)	
Acquisition of Data	ASD(I&L)	
Cost/Schedule Control Systems	ASD(C)	Do
Test and Evaluation	DDR&E	Navy.
Priorities and Allocations	ASD(I&L)	
Manufacturing Technology	ASD(I&L)	
Quality Assurance	ASD(I&L)	
Logistic Support	ASD(I&L)	
Standardization	ASD(I&L)	
Value Engineering	ASD(I&L)	

JULY 1, 1965.

DEPARTMENT OF DEFENSE DIRECTIVE

Subject: Initiation of Engineering and Operational Systems Development.

Refs: (a) DoD Directive 3200. 9, "Project Definition Phase," February 26, 1964 (hereby canceled).

(b) DoD Instruction 3200. 6, "Reporting of Research, Development and Engineering Program Information," June 7, 1962.

(c) DoD Directive 5500.10, "Rules for the Avoidance of Organizational Conflicts of Interest," June 1, 1963.

(d) DoD Instruction 7045.2, "DoD Programming System; Procedures for Program Changes," January 29, 1965.

(e) DoO Directive 7045.1, "DoD Programming System," October 30, 1964.

(f) DoD Directive 4105.62, "Proposal Evaluation and Source Selection," April 6, 1965.

(g) DoD Directive 7250.5, "Reprogramming of Appropriated Funds" March 4, 1963.

I. PURPOSE

This Directive establishes Department of Defense policies governing Concept Formulation and Contract Definition in the initiation of Engineering Development and Operational Systems Development (herein called Engineering Development) of major projects.

II. CANCELLATION

Reference (a) is hereby superseded and canceled.

III. APPLICABILITY AND SCOPE

The provisions of this Directive apply during the Engineering Development by Military Departments and Defense Agencies (hereafter referred to as DoD Components) of items meeting the criteria of Subsection VI.B. For items that do not meet these criteria, the provisions of this Directive are optional.

IV. DEFINITIONS

Concept Formulation describes the activities preceding a decision to carry out Engineering Development. These activities include accomplishment of comprehensive system studies and experimental hardware efforts under Exploratory and Advanced Development, and are prerequusite to a decision to carry out Engineering Development.

Contract Definition (formerly referred to as Project Definition Phase) is that phase during which preliminary design and engineering are verified or accomplished, and firm contract and management planning are performed.

V. OBJECTIVES

A. The objective of Concept Formulation is to provide the technical, economic and military bases for a conditional decision to initiate Engineering Development.

B. The overall objective of Contract Definition is to determine whether the conditional decision to proceed with Engineering Development should be ratified. The ultimate goal of Contract Definition, where Engineering Development is to be performed by a contractor, is achievable performance specifications, backed by a firm fixed price or fully structured incentive proposal for Engineering Development. Included in this overall objective are subsidiary objectives to:

1. Provide a basis for a firm fixed price or fully structured incentive contract for Engineering Development.
2. Establish firm and realistic performance specifications.
3. Precisely define interfaces and responsibilities.
4. Identify high risk areas.
5. Verify technical approaches.
6. Establish firm and realistic schedules and cost estimates for Engineering Development (including production engineering, facilities, construction and production hardware that will be funded during Engineering Development because of concurrency considerations).
7. Establish schedules and cost estimates for planning purposes for the total project (including production, operation and maintenance).

VI. POLICY

A. Organizational Conflicts of Interest.—Participation in Contract Definition by competing contractors will not bar their participation in continued Engineering Development under the organizational conflict of interest rules contained in reference (c) and in the Armed Services Procurement Regulation (ASPR) when two or more contractors are used in Contract Definition. In cases where Contract Definition is conducted by a sole-source contractor (see Subsection VI.F.1.b), these rules will not apply because the material generated during Contract Definition will not be used in a competitive procurement. However, such rules will exclude a contractor from participation in Contract Definition if he has performed, under Government contract prior to Contract Definition, work which has as a primary objective the generation of a statement of work for Engineering Development and the prior contract specifically stated the exclusion.

B. Application.—

1. All new (or major modifications of existing) Engineering Developments and Operational Systems Developments as defined in reference (b), estimated to require total cumulative RDT&E financing in excess of 25 million dollars, or estimated to require a total production investment in excess of 100 million dollars, shall be in accordance with this Directive unless specific waivers are granted by written approval of the Director of Defense Research and Engineering.

2. Other projects may be required to be conducted in accordance with this Directive, in whole or in part, at the discretion of the DoD Component or as directed by the DDR&E.

C. Concept Formulation.—The experimental tests, engineering, and analytical studies that provide the technical, economic and military bases for a decision to develop the equipment or system will be accomplished in the Concept Formulation period. Conditional approval to proceed with an Engineering Development will depend on evidence that the Concept Formulation has accomplished the following prerequisites:

1. Primarily engineering rather than experimental effort is required, and the technology needed is sufficiently in hand.
2. The mission and performance envelopes are defined.
3. The best technical approaches have been selected.
4. A thorough trade-off analysis has been made.
5. The cost effectiveness of the proposed item has been determined to be favorable in relationship to the cost effectiveness of competing items on a DoD-wide basis.
6. Cost and schedule estimates are credible and acceptable.

D. Technology Advancement.—The key criterion in the degree of technology advancement permitted in Engineering Development is the level of confidence in the probability of successful development. It is not intended that a system will be limited to an assembly of off-the-shelf components. It is intended that the technology that is required to meet a system specification not exceed in quantitative performance that which can be demonstrated either in developmental form or in laboratory form. Projection into Engineering Development of anticipated developmental achievement will be permitted only when sufficient quantitative results have been obtained, in laboratory or experimental devices, to allow such projection with a high confidence. In general, these projections will assume the probability of Engineering Developments matching but not exceeding laboratory results.

E. Initiation of Development. Conditional approval to proceed with Engineering Development of an item meeting the criteria of Subsection VI.B.1 will be formalized by a Format B (see reference (d)) signed by the Secretary of Defense. This Format B is in response to a request from the appropriate DoD Component for initiation of Engineering Development. The request shall be either by memorandum to DDR&E or, if required by reference (e), by a Program Change Proposal (PCP). The request shall be accompanied by an up-to-date Technical Development Plan (TDP) submitted in accordance with reference (b) and containing a plan for the conduct of Contract Definition. The TDP will specifically address and highlight the accomplishment of the prerequisites of Subsection VI.C, including references to, and summaries of, pertinent studies (or experimental hardware developments) together with any other

information required to substantiate the achievement of these prerequisites. The Format B will include approval of or modification to the proposed plans in the TDP and designation of a source selection authority (see reference (f)). The request from the Dod Component, if in memorandum form, must be preceded by a PCP needed to introduce the item into the Five Year Force Structure and Financial Plan. Related financing requirements will be processed in accordance with reference (g) and other applicable established procedures.

F. Conduct of Contract Definition.—Contract Definition shall be conducted in accordance with the following fundamentals:

1. *Participating Organizations.*—In general, the interests of the Government will be best served by using industrial organizations for the conduct of Engineering Development. Normally, in-house laboratories can contribute most effectively to the Exploratory and Advanced Development efforts and as technical directors for, rather than by conducting, Engineering Development. It is recognized that exceptions to this policy may be necessary; where necessary, such exceptions will be authorized on a case-by-case basis.

(*a*) *Contract Definition by Competitive Contractors.*—Contract Definition will generally be conducted as a DoD-financed effort by two or more contractors working in close collaboration with the DoD Component having development responsibility. A fully competitive environment shall be established, with the competition in terms of concept, design approach, trade-off solutions, management plans, schedule and similar factors as well as overall cost. Competition shall be maintained until negotiations for a satisfactory contract for Engineering Development have progressed, in the judgment of the system/project manager, to the point at which competition is no longer required. It should be recognized that negotiation with one contractor is permitted and sometimes desirable. Competitive negotiations (and the resultant contract) should in no case be based exclusively on cost.

(*b*) *Contract Definition by Sole-Source Contractor.*—In the case of major modifications to (1) an existing Engineering Development project or (2) an item already in the inventory, Contract Definition may be conducted on a sole-source basis by the contractor responsible for the predecessor item, provided that competition is not feasible or desirable.

(*c*) *Contract Definition by In-House Laboratories.*—Contract Definition may be conducted by In-House Laboratories when they will perform all or most of the Engineering Development effort. Contract Definition in this case will include all provisions of this Directive except those relating to a competitive environment and a fully structured incentive contract.

2. *Request for Proposal for Contractor-Conducted Contract Definition.*—A Request for Proposal (RFP) shall solicit a planning purpose proposal for Engineering Development and a firm proposal covering the contractor's effort during Contract Definition. The RFP must communicate fully the DoD's intent and, based upon DoD definition prior to release of the RFP, delineate system parameters fully, identifying those that are mandatory and those which are subject to deviation. It is essential that the RFP encourage alternative sand stimulate initiative and creativity by the contractors. The RFP shall include the information outlined in Enclosure (I).

3. *Contracting for Contract Definition.*—It is the intention of the DoD that each contractor will be fully compensated under the terms of his contract for his proposed work during Contract Definition. Any action that suggests cost sharing, such as prior announcement of funds available for Contract Definition, shall be avoided. Contract Definition shall be conducted using fixed price contracts. It is the intent of the DoD to reimburse one or more of the Contract Definition contractors for key personnel during the period from submission of the proposal package until award of a definitive Engineering Development contract in order to maintain the cadre of competent, knowledgeable personnel. These personnel may be engaged in assigned tasks, such as refinement of specifications.

4. *Total System Trade-offs.*—Trade-offs should be used to obtain, within the mission and performance envelopes, an optimum balance between total cost, schedule, and operational effectiveness for the system. In this context, total cost means the total cost of acquisition and ownership (development, production, deployment, operation, and maintenance); operational effectiveness includes all factors influencing effectiveness in operational use (such as "pure"

performance, reliability and maintainability); and system includes the hardware itself and all other required items, such as facilities, personnel, data, training equipment, etc.

5. *Specifications.*—The specifications which are developed during Contract Definition should be performance specifications rather than detailed design specifications. In general, performance specifications are preferred for Engineering Development because detailed design specifications severely limit the latitude of design, engender contract changes, and require excessive precontract negotiation. The policy of requiring performance specifications as an output of Contract Definition is not intended to prevent contractors from studying proposed designs and including detailed design information in the Contract Definition report.

6. *Proposal Package.*—

(*a*) As a product of the Contract Definition effort, each participant shall submit, in accordance with Enclosure (2), a complete technical, management, and cost proposal package for the Engineering Development.

(*b*) In the case of contractor conducted Contract Definition, the type of Engineering Development proposal preferred (for firm fixed price, fixed-price-incentive or cost-plus-incentive-fee contract) will have been specified by the Government.

(*c*) Proposals for incentive contracts will include specific incentive features based upon guidance furnished by the DoD in the RFP and subsequently. Incentive guidance typically will include the relative importance of cost, schedule, and performance; important milestones; and performance parameters upon which incentives will be based.

7. *Contract Definition Schedule.*—It is intended that the contract period of Contract Definition will require no longer than six months with three to four months the norm. Further, it is intended that decision action required after Contract Definition report and proposal submission, including full action on any required PCP, be expedited, with the objective of a signed definitive contract within 18 weeks after submittal of reports and proposals.

8. *Contracting for Engineering Development.*—

(*a*) Source selection processes will be governed by the provision sof reference (f). The authority for the source selection, both in choice of Contract Definition contractors and choice of the Engineering Development contractor, will be designated in the Format B which gives conditional approval of the Engineering Development. Source selection for Engineering Development shall be based upon proposals as initially submitted in order to stimulate the best possible proposals. Technical data ordered under DoD-financed contracts which specify experimental, developmental or research work and which are obtained with unlimited rights may be used by the Government after the Contract Definition proposal packages are submitted. Therefore, the negotiations referred to in this paragraph may include negotiations to improve the final product by incorporation of desirable features from other Contract Definition studies to the extent that the Government has unlimited rights in the technical data describing such features.

(*b*) The contract for Engineering Development (or the contractor portions when Engineering Development is an in-house effort with some contractor portions) shall be executed in definitive form prior to initiation of the contractor Engineering Development effort, The contract shall be fixed price or incentive in the order of preference as indicated in the ASPR.

G. Actions Resulting from Contract Definition.—

1. Whether the conditional decision is to be ratified after Contract Definition depends upon confirmation during Contract Definition of the technical, financial and schedule factors. Therefore, as a result of Contract Definition, the DoD Component will make one of the following alternative recommendations:

(*a*) To contract for the Engineering Development based upon the proposals received.

(*b*) To contract for the Engineering Development by an alternative source, provided that source has met the objectives of paragraph V.B. and, further, provided that selection of the alternative source is in the best interests of the Government.

(c) To continue further Contract Definition effort.
(d) To defer or abandon the Engineering Development effort.
(e) To undertake further Exploratory or Advanced Development of key components and/or system studies.

2. The Program recommendation of Subsection VI. G.1. above shall be by memorandum to DDR&E, unless the provisions of reference (e) require a specific PCP document. Related financing requirements will be processed in accordance with reference (g) and other applicable established procedures. The recommendation shall be accompanied or followed within 60 days by an up-to-date TDP. OSD will act on the recommendation by memorandum or Format B, as appropriate, to the DoD Component.

VII. WAIVERS TO THIS DIRECTIVE

If a DoD Component considers it in the best interests of the Government to waive application of any portion of this Directive to a specific project, the reasons for the waiver shall be submitted to DDR&E. DDR&E shall have authority to grant waivers for all provisions of this Directive that are not specifically reserved to the Secretary of Defense.

VIII. DETAILED GUIDANCE

The Director of Defense Research and Engineering will provide more detailed guidance in the form of a DoD Guide for Contract Definition.

IX. IMPLEMENTATION

Each Military Department and Defense Agency will implement this Directive within 60 days and forward three copies of each implementing document to the Director of Defense Research and Engineering.

X. EFFECTIVE DATE

This Directive is effective immediately.

ROBERT S. MCNAMARA,
Secretary of Defense.

INFORMATION IN THE REQUEST FOR PROPOSAL FOR CONTRACTOR-CONDUCTED CONTRACT DEFINITION

It is essential that information be included in the Request for Proposal (RFP) on which potential contractors may base high quality proposals. Both technical and managerial aspects of the proposed Engineering Development must be considered thoroughly in the RFP and the resultant proposals. The RFP shall include, but shall not be limited to, the following items (except as specifically exempted by the DDR&E) :

1. Mandatory requirements based upon approved program guidance.
2. Results of prior studies (including feasibility,cost effectiveness, major trade-offs, operational analysis, logistics analysis, etc.) deemed necessary for adequate background information for the contractors.
3. Criteria against which proposals will be evaluated, and their relative importance in general terms.
4. Outline of the Government's plan for system/project management, including identification of pertinent Government organizations and communications channels within the Government and between Government and contractors.
5. A network showing planned activities, information submissions, reviews, approvals and decisions for Contract Definition and Engineering Development, indicating their interdependence and approxmiate time phasing.
6. A work statement for the Contract Definition.
7. A specimen work statement for Engineering Development.
8. Documentation that will be required during Contract Definition.
9. Details of the format and content of the proposal package for Engineering Development.
10. Incentive features desired in the Engineering Development proposal, including relative importance of incentives and specific schedule and performance items that will be subject to incentives.
11. Statement of the Government's requirements for system/project management.

12. Quantitative reliability and maintainability goals and demonstration concepts.
13. Concurrency considerations, production quantities and similar information provided as a basis for schedule and cost estimating purposes.
14. Identification of specifications, with any waivers or deviations, planned to be written into the resulting Engineering Development contract.
15. Required documentation during the Engineering Development.
16. Mandatory subsystem breakdown (if any).
17. Government furnished equipment.
18. A request for other information that the DoD Component requires.

INFORMATION IN THE PROPOSAL PACKAGE

The proposal package for Engineering Development shall contain but shall not be limited to, the following items (except as specifically exempted by the DDR&E):

1. A list of each of the end items required for operation and maintenance.
2. Performance specifications for each of the end items.
3. The work breakdown structure for Engineering Development as a whole (primarily oriented to hardware or product rather than to function); the statement of work in the proposal and the resulting authorizing document will be itemized in accordance with the work breakdown structure.
4. A PERT [1] network plan for the Engineering Development of all items contained in the system or subsystem on which the participant proposed indicating events that interface with the work of other participants. In addition, a planning and decision network for the period beyond Engineering Development, including production, operation, maintenance, training, logistics, and deployment.
5. Principal objectives and features of the overall system design, including recommendations for its operational use based on operational concepts established by the DoD Component.
6. A recommended plan for maintenance of the system based upon maintenance and logistic concepts established by the DoD Component.
7. Detailed cost estimates for the Engineering Development (which include cost estimates for the items of the work breakdown structure) consistent with PERT/Cost; together with planning estimates for the period beyond Engineering Development (investment and operating cost for five years, including production, operation, maintenance, etc.).
8. A milestone schedule for the Engineering Development consistent with the PERT network and validated by recycling the PERT planning process, together with planning schedules for the period beyond Engineering Development (investment and operation for five years, including production, training, maintenance, etc.).
9. Quantitative reliability and maintainability specifications for the system and major subsystems and proposed test plans to demonstrate their achievement.
10. Time/cost/performance trade-off decisions that have been made with respect to major alternatives, including subsystems and components, and backup information showing the operational and cost effectiveness of these alternatives.
11. Required new designs and technology, if any, and a proposed test plan to demonstrate feasibility, including justification of the decision that existing designs or techniques are not applicable.
12. Foreseeable technical problems, and proposed solutions including backup efforts, if necessary.
13. Other problems that could not be defined or resolved during Contract Definition.
14. Technical specifications and performance requirements for those items of system and subsystem support for which early Engineering Development is required (such as facilities, training equipment, documentation, etc.); and analysis and delineation of the remaining major aspects relating to system and subsystem support (such as logistics planning, pare-parts planning, etc.).
15. Delivery schedules and requirements for data and documentation.
16. Proposed schedule of production engineering and production tooling with relation to the Engineering Development, if appropriate.

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[1] Program Evaluation and Review Technique.

17. Participant commitments for managing the project including:

(*a*) Planned participant project-management structure and organization.

(*b*) Key project management and technical personnel by name and experience, together with statements of responsibility and authority for Engineering Development.

(*c*) Management-control and cost-control techniques, including reporting procedures.

(*d*) Make-buy subcontracting procurement plan and gold-flow implications, if any.

(*e*) Facility requirements, if any.

18. Developing agency-participant coordination networks.

19. Contractor proposals on the specific features of an incentive contract. (This arrangement is considered important because it will permit the negotiation of targets and incentive patterns into the contract while competitive proposals are still available and furnish the basis for incentive provisions in the contract).

20. Specific reference to those Government specifications requiring waiver or deviation, including a statement of such waiver or deviation.

1–329.4 *Requests for Procurement Records.*

(a) Request for copies of procurement records shall be reviewed in accordance with Departmental procedures issued in accordance with DoD Directive 5400.7.

(b) Request for copies, or for the inspection of procurement records should be addressed to the procuring activity, purchasing office or other appropriate activity having cognizance of the information or document desired by the party making the request. If the identity of the activity is not known, the request should be addressed to the most appropriate office as follows:

Army: Office of the Assistant Secretary of the Army (Installations & Logistics), Department of the Army, Washington, D.C. 20310.

Navy: Chief of Naval Material (MAT 05), 18th Street and Constitution Avenue N.W., Washington, D.C. 20360.

Air Force: Director, Administrative Services, Headquarters, United States Air Force, Washington, D.C. 20330.

DSA: Staff Director, Administration, Headquarters, Defense Supply Agency, Attention DSAH—, Cameron Station, Alexandria, Virginia 22314.

DCA: Indormation Services Officer, Room 4430, HQ, DCA, Navy Service Center, 8th and S. Courthouse Road, Arlington, Virginia 20305.

DASA: HQ, Defense Atomic Support Agency, Washington, D.C. 20305.

1–339 Total Package Procurement. Total Package Procurement (TPP) involves combining as a single package the procurement of related requirements such as the design, development, production, and support. The purpose of this paragraph is to introduce the TPP concept, outline its potential application, and set forth some general guidance. Each Department has an Office of Primary Responsibility (OPR) as set forth under 1–330.6(c) that is to follow the evolution of TPP and furnish appropriate guidance within its Department. Suggestions and innovations pertaining to the TPP concept, its application, and the method of implementation should be brought to the attention of the appropriate OPR.

1–330.1. *General.*

(a) *Purpose.* The purpose of Total Package Procurement (TPP) is to procure under the influence of competition as much of the total design, development, production and support requirements for a system or component as may be practicable, thereby:

(i) providing firmer 5-year force structure program package planning information concerning performance cost and shcedules;

(ii) discouraging contractors from "buhing in" on the design and development effort with the intention of recovering on the subsequent production program;

(iii) permitting program decision and source selection based on binding performance, price and schedule commitments by contractors for the total program or major part of it;

(iv) providing a firmer basis for projecting total acquisition and operational costs for use in source selection, and in the determination of appropriate contractual incentives;

(v) motivating contractors to design initially for economical production and support ofsoperational hardware which may not recieve sufficient emphasis in the absence of productions commitments;

(vi) requiring contractors to assume more responsibility for program success, thereby permitting the Government to monitor programs more in terms of surveillance and less in terms of detailed management.

(b) *Definition.* TPP is a method of procuring at the outset of the acquisition phase under a single contract containing price, performance and schedule commitments, the maximum practical amount of design, development, production and support needed to introduce and sustain a system or component in the inventory.

1–330.2 *Application.* The application of TPP must be determined on a case by case basis, but TPP shall not be applied to Advanced or Exploratory Development. For Engineering Development or Operational Systems Development Programs, all prerequisites of DoD Directive 3200.9 shall be met and the force structure sufficiently defined to reflect the probable production and/or support requirements. TPP should not be applied to those programs subject to rapidly changing operational requirements or technology.

1–330.3 *Policy.* Where the Criteria set forth in 1–330.2 have been met, TPP will be given consideration as the method for acquiring Operational Systems Development and the associated production and support effort for service use. TPP will be considered for application in those procurement situations where subsequent production and/or support requirements are anticipated and it would be impractical to complete such requirements other than as part of the initial procurement.

1–330.4 *Implementation.*

(a) TPP procurement plans involving Engineering Development or Operational Systems Development Programs will be submitted to the Department's OPR for approval (see 1–330.6(c)). Other TPP procurement plans may be subject to such reviews and approvals as deemed appropriate by the individual Departments.

(b) Contract Definition Requests for Proposals for Engineering Development or Operational Systems Development Programs will specify if TPP is contemplated.

(c) Request for Proposals/Request for Quotations (RFP/RFQ) should fully define the scope of the procurement (what the total package consists of) and include (i) specific guidelines for the composition of proposals and (ii) the criteria which will be considered in source selection. Use of a model definitive contract as an attachment to the RFT/RFQ is encouraged.

(d) Consideration must be given to maintenance and supply concepts. The key factors influencing logistics (such as deployment, utilization rates and maintenance demads) should be established if these items are to be included as a part of the total package. In most cases, it will be appropriate to postpone specific identification of spares and support items. In such instances, consideration should be given to requiring the competing contractors to submit a pricing formula, to be used for competitive evaluation of the proposals and for incorporation into the contract for future pricing of these requirements. Alternatively, the Government may specify the method to be used in pricing spares and support items which may be identified and ordered from time to time during the life of the contract.

(e) Specifications stressing, as far as possible, performance rather than design should be used on TPP Engineering Development or Operational Systems Development contracts since detailed design specifications tend to stifle technical innovation, to require excessive administration, and to engender contract changes.

(f) Firm fixed price or fixed price incentive contracts will be used for TPP. Normally, prior to source selection, definitive contracts will be signed by all responsive responsible offerors who submit proposals within a competitive range (see 3–805.1). This will allow the Government to sign the definitive contract of the successful offeror at completion of source selection and minimize the need for post source selection negotiations.

1–330.5 *Special Provisions.* A TPP contract must be tailored to the specific program and structured so that the contractor's responsibilities are clearly delineated. The contractor should be vested with maximum authority to manage TPP programs with a minimum of Government direction consistent

with the type of contract selected, since subsequent direction and changes by the Government will tend not only to constrict the contractor's ability to fulfill his commitments but to dilute the contractor's responsibilities, thus negating many of the benefits of TPP. The use of performance specifications should reduce the number of changes and their impact and will eliminate changes which do not result in performance improvements. While the Government should strive to avoid involvement in the detailed management of TPP, it must nevertheless maintain sufficient visibility as to the progress of the program and retain the right to intervene if the success of the program is in jeopardy. Other contractual provisions which should be considered in TPP include:

(i) obligations for total system responsibility, specifying that such responsibility is not reduced even though Government-frunished property (GFP) may be integrated into the end item (*provided* such property is suitable under the Government Property clause) and extending the contractor's responsibility to the performance of the system in an operational environment;

(ii) obligations for correction of defects at no change in contract price (*e.g.*, firm fixed price of target cost, target profit, ceiling price and incentive provisions), or if less than full correction is directed by the Government, agreement to reduce the contract price accordingly;

(iii) pricing arrangements for alternate schedules and quantities;

(iv) pricing arrangements for items for which there is a contingent requirement (*i.e.*, production, spares, etc.); and

(v) appropriate protection for the contractor and the Goverment against major inflationary or deflationary fluctuations in the national economy when the TPP covers an extended period of time (normally more than three years).

1–330.6 *Other Guidance.*

(a) The funding method to be employed must be determined in advance and set forth in the RFP/RFQ for the TPP. The design and development portion TPPs normally will be funded incrementally from Research and Development appropriations. Unless approval is obtained to fund incrementally the production and other supplies and services included in the TPP, this portion of the TPP must be either fully funded or funded in fiscal year segments.

(b) TPP may involve associate contractors or Government-furnished property crucial to total systems performance. Nevertheless, the Government should strive to hold one contractor solely responsible for the satisfactory performance of the system in its operational environment. This may require advance agreements between associate contractors and reconsideration of those items to be Government-furnished, and will require special systems responsibility provisions in the prime contract.

(c) Offices of Primary Responsibility for TPP are:

(i) Army—Office of the Assistant Secretary of the Army (Installation & Logistics);

(ii) Navy—Chief of Naval Material (ATTn:MAT 02);

(iii) Air Force—Headquarters USAF (AFSPP); and

(iv) DSA—Headquarters DSA (DSAH–PP).

Each OPR will keep the other OPRs apprised of its experience and refinements in application and management of total package procurements.

(d) Those activities requiring guidance in determining the applicability or application of TPP to a specific program should consult their appropriate Command headquarters.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
New York, N.Y., February 22, 1972.

Re Proposed Guidelines for Disclosure by Companies Engaged in Defense Contracting.

MR. CLARENCE SAMPSON,
Associate Chief Accountant, Securities and Exchange Commission, Washington, D.C.

DEAR MR. SAMPSON: We appreciate the opportunity to comment on the Commission's draft entitled "Report of Disclosures by Registrants Engaged in Defense Contracting," and the related proposed release. We believe that the

proposed guidelines in some instances contain significant modifications of current practice. Therefore we suggest that prior to publishing a formal proposed release that members of the Commission staff and representatives of the AICPA's Committee on National Defense meet to discuss further the contents of the proposal as well as our comments which are summarized below.

We cannot disagree that some modification of financial and nonfinancial disclosures with respect to long-term contracting activities seems appropriate. However, the proposal as presently drafted would impose on registrants who have defense contracts disclosure requirements above and beyond those customarily recognized with respect to persons performing under long-term contracts for non-defense related customers. We believe to limit development of such disclosure requirement in this manner will result in dealing on a piecemeal basis with issues which are much broader in scope.

As the draft report indicates, your staff research upon which the proposed disclosure guidelines are based was concerned with the larger defense contractors. If these guidlines are to be developed in a manner which will allow broad applications to all long-term contracts, additional consideration of required disclosures appears to be imperative.

It is unfortunate that "Total Package Procurement" attempted by the Defense Department had such drastic results for some of the country's largest suppliers to that Department. There is no question that the "Public Investigation in the Matter of Disclosure by Registrants Engaged in Defense Contracting" revealed inconsistencies and uncertainties on the part of certain suppliers. However, "Total Package Procurement" has been discontinued because of the very problems your investigation disclosed. Therefore, it would appear more equitable if all registrants engaged in long-term type manufacturing or construction contracts were admonished to be more alert to the problems that exist and more accurate in making disclosures in reports to stockholders and in filings with the Securities and Exchange Commission.

Notwithstanding the previous suggestions, the following comments are offered for your consideration at this time. We have two comments of general applicability, as follows:

1. Many terms included in the proposed requirements are not clearly defined. As examples, the draft is not specific in that is meant by "unfilled orders," "funded" contracts, contract "claims" and "cost overruns."

2. The proposed requirements do not stipulate the extent to which the disclosures are required to be a part of the financial statements. We believe that at least two of the proposed disclosures (1 and 2) require information not currently covered by the independent public accountant's opinion. A change in this area has significant implications beyond that which can be achieved by a release which states ". . . the Commission has concluded that its rules and forms promulgated under the Acts are adequate. However, it appears that in several instances the application of these requirements by defense contractors has resulted in less than satisfactory disclosures."

We have the following comments with respect to the specific content of the proposed requirements.

Page 1, Paragraph 3

In this paragraph the staff has defined the "risk characteristic" of contracting operations as arising from "renegotiation of profits or termination at the election of the government." We believe, in fact, that the risk arises from the size and complexity of contract programs. The thrust of the paragraph should be redirected toward this end.

Page 2, Paragraph 1

We question whether or not criteria based on sales and income of prior periods is the most meaningful basis upon which to determine applicability. In addition, a 10% materiality level may be too stringent and result in superflous and extraneous disclosure in certain situations. The real test should relate to the size and complexity of the programs. We suggest that further study be given to these criteria.

Requirement 1

We agree with the general thrust of the requirement to disclose "The dollar amount of unfilled orders . . . ." We believe that this disclosure is generally

made. It is also a reaffirmation of AICPA comments made in response to the Wheat Disclosure Study in 1969. Currently, we believe this data should be presented in material accompanying financial statements but not incorporated into the statement (including footnotes) to be covered by the auditor's report. Data as to unfilled orders is meaningful additional information but not necessary to a fair presentation of financial statements. Notes to financial statements are generally restricted to clarification and detailing of data already a part of the financial statements.

We also believe there should be more guidance as to the type of descriptive comment which should accompany the unfilled order disclosures. In order for unfilled order data to be presented with reasonable consistency, definitions and guidelines should be developed. Examples of matters which should be considered are as follows:

When does the unfilled order become firm enough to be counted?

What are the criteria for being "funded?" We believe this term is not universally understood or applied by those companies engaged in long-term contracting activities.

What is meant by "significance of the circumstances?"

Should work to be performed by a subcontractor be included?

Should the amount be adjusted for estimated contract price revision of approved change orders?

We have an additional question with respect to the proposed requirement which states ". . . future periods during which performance under such orders is expected to take place." We assume that this requirement could be satisfied by a general indication of the period covered by the unfilled orders.

Requirement 2

Our understanding of the purposes of this disclosure is to inform the defense contractor's stockholders of the type of activities being engaged in by the company. In our opinion, this proposed disclosure is not of a financial nature and therefore should not be associated with the financial statements.

Requirement 3

We believe that the disclosure of ". . . the type of contract or contracts under which the company operates . . . ." should be included in a separate footnote to the financial statements which describes the accounting policies followed by a defense contractor.

We do not specifically understand what information would be contained in the requirement to explain "how each type (contract) affects profitability and future claims for allowable costs." We suggest that the requirement be clarified or deleted.

Requirement 4

This disclosure should indicate that estimating is the basis for recording profits, etc. A general disclosure as to the difficulty of cost estimating and price negotiations would have the effect of diluting the confidence in the financial statements of a defense contractor. The requirement should be restricted to those cases where specific significant situations arise as to estimates and price negotiation problems. Typically where these situations have arisen disclosure has been made and the accountant's report qualified.

Requirement 5

We are not sure why these disclosures are suggested. Renegotiation is considered on a single year basis and actually has little or no relationship to any particular contract. Most registrants do disclose the status of renegotiation, particularly if there is any possibility of a refund because of a determination by the Renegotiation Board that excessive earnings have been realized. If there is little or no exposure to a refund, we do not understand how the reader of financial statements can benefit from this information.

We are equally puzzled by the disclosure that contracts are subject to termination at the convenience of the government. Whenever a contract is terminated for convenience, the government is required to settle with the contractor on an equitable basis, giving due consideration to proportionate profit or fee. Contracts terminated for cause, of course, do generally have serious financial consequences which should be disclosed.

Requirement 6

We believe that a general requirement to disclose this possibility is inappropriate and may very well be misleading. We believe that this disclosure should be made only when a specific situation arises that has a material financial effect on a defense contractor.

Requirement 7

We suggest that the information requested be combined in the "accounting policies" footnote referred to in our comments on Requirement 3.

Requirement 8

We believe that this disclosure should be required only if the expenditures in question are not charged to expenses as incurred. Fair presentation of financial information requires that commitments, when significant in relation to the overall financial position of a company, should be disclosed in a note to the financial statements. Therefore, we question the reference to commitments in this requirement.

The phrase "specifically provided" should be clarified. Does this requirement apply to a specific contract or overhead rate which includes bid and proposal costs, etc.?

Requirement 9

We suggest that this proposed requirement be deleted. In instances where such problems are known, generally accepted accounting principles require that the estimated additional cost or expense be immediately charged to operations. No additional disclosure should be required unless the registrant's financial condition is impaired as a result of the charge.

Requirement 10

Further clarification is needed to make this requirement meaningful. Overruns of substantial amounts can be incurred on incentive type contracts and still have no adverse effect on the registrant's financial condition.

Requirement 11

We believe that this proposed requirement should be limited to disclosing the existences and to briefly indicate the status of claims by the company against the government and/or vice versa.

As stated earlier, we believe that promulgation of disclosure requirements for long-term contracting activities will have wide implications. To ensure that such requirements are universally understood and consistently applied, their development should be considered by all parties affected. We would be happy to meet with members of the staff to further discuss the proposed release.

Sincerely,

GERALD E. GORANS,
Chairman, Committee on National Defense.

AMERICAN BAR ASSOCIATION,
Chicago, Ill., February 29, 1972.

Re Comments on the Draft Staff Report: "In the Matter of Disclosures by Registrants Engaged in Defense Contracting," Administrative Proceeding File No. 3-2485.

Mr. THOMAS HOLLOWAY,
Director, Division of Corporation Finance, Securities and Exchange Commission, Washington, D.C.

DEAR MR. HOLLOWAY: Thank you for providing copies of the Staff Report and the proposed Release, "Proposed Guidelines for Disclosures by Companies Engaged in Defense Contracting," under cover of your February 1, 1972 letter to Mr. Simmons as Chairman of the Weapons Systems Contracting Committee and of the Securities and Exchange Commission Committee of the Section of Public Contract Law. Our two Committees are pleased to submit the following comments of their members for your consideration.

I. SUMMARY AND CONCLUSIONS

We recognize the desirability of maintaining or increasing the credibility of financial statements of all companies including Government contractors. At the

same time, our review of the Proposed Guidelines leads us to believe that issuance in their present form might well require contractors to issue reports which would confuse and might actually mislead the investing public.

First, the proposed Guidelines lead to a strong implication that "defense contracts" intrinsically are more risky than other forms of business, whereas, in fact, many defense contracts are substantially less so than many lines of commercial business. The avowed goal of "disclosure of certain risks characteristic of such operations" is therefore not served by requiring disclosure of substantial amounts of descriptive material with respect to Government contracts without regard to whether such contracts present significant identifiable risks in relation to the contractor' overall business. In fact, the reporting requirements imposed will make it more likely that material information will tend to be lost in a mass of less significant data.

Second, apart from the question of definition referred to below, a number of the indicia of risk selected for reporting are not valid indicators. For example, the fact that a contract is subject to termination for convenience of the Government in most cases does not represent a major risk of loss other than a proportionate loss of anticipated profits and in some cases may even represent a proportionate reduction in anticipated losses. In other cases, however, such a termination may result in inability to amortize substantial capital investment. Similarly the fact that there are actual or potential overruns does not necessarily represent a risk. As to claims, which the Proposed Guidelines appear to use as another indicia of risk, the great majority of claims if not the dollars on Government contracts are settled administratively without litigation in a relatively short time even though some such claims may involve prolonged litigation. As a general observation, it is characteristic of Government contracts that they cover, by specific contractual provisions, many more contingencies than are covered in the usual commercial contract and to a considerable extent they give the Government theoretical rights which in practice it would be self-defeating for the Government to exercise in most cases. Thus, despite the fact that some Government contracts do indeed present major risks to the contractor, it would be seriously misleading as to most contracts for the contractor to report all the potential risks presented by the contract provisions.

Third, we feel that some of the Proposed Guidelines could increase significantly the use of broad estimates in financial statements, making it more difficult if not impossible, for the legal community to fulfill its role in enforcement of the Securities Laws by the granting or withholding of legal opinions in connection with such statements.

Fourth, the reporting requirements in the Proposed Guidelines could appear to call for inclusion of possibly vague and wholly subjective layman's language to describe complex legal arrangements and relationships such as those involved in the many and varied types of Government contracts. Apart from the existing technical agency Regulations, there is at present no agreed-upon body of layman's language upon which lawyers can draw which would reduce the chance of liability for material nondisclosure or for misrepresentation.

Fifth, the Proposed Guidelines may create new problems by the apparent requirements that technological difficulties be described subject to the laws and regulations concerning dissemination of classified information. The attempt to meet this requirement could result in a misleading inbalance in disclosure between classified and non-classified information.

Sixth, the terminology used in the Proposed Guidelines is an important problem in itself. Thus, there is no single agreed-upon definition in the Government contracting area of such terms as "significant R&D" or of "claim" or of "overrun." The meaning of these terms in the cases, the agency regulations, the General Accounting Office reports, Congressional documents, etc., varies depending largely on the context.

Seventh, the fact that a procurement is carried out by an agency other than one of the Military Departments does not by itself identify that procurement as inherently less complex, or as subject to fewer difficulties, or as one which will not engender the kinds of financial statement problems which your Proposed Guidelines are meant to solve. For an example, complex, expensive, technologically advanced systems involving research and development risk, are procured by the National Aeronautics and Space Administration under contract clauses and pursuant to regulations similar to those employed by the Army, the Navy, and the Air Force for equally advanced hardware.

In summary, we point out that by issuing the Proposed Guidelines as now drafted, the Commission would leave all of these issues, including those pertaining to proper definition of terms, to later administrative or judicial solution via administrative proceeding or litigation. The lack of clear standards for such later determinations would leave both Government agencies and industry—the whole community—subject to uncertainty and, in some cases, to unnecessary liability. This problem is worsened by the number of such determinations left open by the Proposed Guidelines. Given the difficulty of obtaining private financing for defense business, particularly at the present time, the added uncertainty produced by release of the Proposed Guidelines could have serious results for the taxpaying public.

Therefore, we recommend that the Commission adopt one of the following courses of action rather than issue the Proposed Guidelines as now drafted:

1. The Commission should require the interested parties (and here we include representatives of the Government agencies as well as from industry, *i.e.*, the entire Government contracting community) to produce guidelines which meet Commission requirements within a specific period of time at the end of which the Commission will issue guidelines in any event; *or*

2. The Commission Staff should re-draft the Proposed Guidelines with the problems outlined above in mind.

We favor the first approach because of the complexity of the body of law which now applies to Government contracts.[1]

II. GENERAL COMMENTS

A. Effect of Imposing Additional Reporting Requirements on Defense Contracts

As suggested earlier, the effect of requiring defense contractors to report substantial amounts of additional information regarding their defense business may well create the impression that all defense business is substantially more risky than commercial business without regard to whether the particular contractor's business in fact is more risky. Furthermore, the volume of information required may well confuse rather than clarify and the volume and complexity of the data reported may obscure the real risks involved in a particular contract.

B. Materiality of Particular Data Required To Be Reported

The presence or absence of a particular clause does not normally reveal what the actual risk is. Rather, it requires overall evaluation of the contract provisions in relation to the particular work being undertaken *and the actual experience to date in performance of the contract* to make a reasonable assessment of risk at any particular point of time. Furthermore, certain risks—for example, the risk of termination and liability for substantial breach—are inherent under almost any contract, Government or commercial, regardless of whether there is a specific contractual provision creating such a risk. As to that particular example, it would, therefore, be misleading to create the impression that Government contracts are unusually risky because they include a provision permitting the Government to terminate for default. The same is true of other contract provisions. At most, the Proposed Guidelines should require reporting of material identifiable risks where there is a reasonable probability that such risks will materialize.

C. The Problem of Increasing the Employment of Estimates and of Subjective Language

One of the Proposed Guidelines calls for disclosure of "the type of contract or contracts . . . with an explanation of how each type affects profitability and future claims for allowable costs." On the basis of the SEC Staff's apparent field of interest, we believe that the term "equitable adjustment" should be substitued for "allowable cost" in view of the specific meaning of the term "allowable cost" as used in Government contracting.

In any event, however, this Proposed Guideline along with others would appear to require significantly increased usage of estimates in financial state-

[1] Members of the accounting profession and members of the Section of Corporation, Banking and Business Law, ABA, with whom we have discussed this matter, indicate that there may be important issues in their areas of interest as well, and that if there are, appropriate comments will be made by them to the Commission. We therefore make no attempts to discuss these areas in our report.

ments. Moreover, the requirement for description in layman's language of the complicated types of contracts used in Government procurement increases certain specific legal dangers, including liability for material non-disclosure and for negligent or innocent misrepresentation. There is now no agreed upon lay definition of, for example, a "fixed-price incentive contract with an 60/40 share line to a ceiling of 115 percent. . . ." [2] Given time to accomplish the task, the Government contracting community could probably develop a lay definition of this complex legal relationship. Absent such agreement, we believe that the Proposed Guideline requirement for such language will significantly increase the difficulty of companies' obtaining the requisite legal opinions in connection with financial statements which include such descriptions, and result in disclosures which are less, rather than more, meaningful to the investing public.[3]

D. The Problem of Classified Information

In accordance with applicable SEC Rules [4], classified information shall not be disclosed in financial statements, yet, as a practical matter, the technological problems required to be disclosed by the Proposed Guidelines are those *most* likely to be classified as involving breakthrough in the state of technology with military applications. If both the rules pertaining to classification and the Proposed Guidelines are followed a material inbalance in disclosure may be created in a given financial statement. We have considered but rejected suggesting that the Proposed Guidelines limit the disclosure requirement in this area to a "Dollar Estimate" of technological problems, since this is likely to produce misleading or unintelligible financial reports. Additional analysis of Commission requirements in this area is required.

E. The Problem of Definition of Terms

Proposed Guideline No. 2 refers to "whether *products* or *research and development* is involved." (Emphasis added.) Proposed Guideline No. 4 refers to "significant technological advances." Guideline No. 10 refers to "material cost overrun" and uses in part of the definition of "overrun" the phrase "which exceeds the price set in the contract plus. . . ." Guideline No. 10 refers to "material cost overrun" and uses in part of the definition of "overrun" the phrase "which exceeds the price set in the contract plus. . . ." Guideline No. 11 uses the term "claims . . . whether by the Government against the company or the company against the Government."

There are other terms which are subject to the same difficulty: the present lack of an agreed-upon judicial or other definition of such terms except in a specific context. For example, even the Defense Department does not draw a clear line between "products" and "research and development." Some of the categories which DOD uses in choosing among contract types are "research and exploratory development," "development," "advanced development," etc.[5] Similarly, there is no agreed-upon judicial or other definition of "significant technological advance." The word "claim" itself is probably pretty clear standing alone, but the Proposed Guidelines do not make clear when a claim becomes a claim for financial reporting purposes, *i.e.*, when a Government Technical Representative tells a company official he is considering "making a claim"?; when a Contracting Officer orally tells a company official?; or when a Contracting Officer writes an official letter requesting a specific amount of money?; etc. Nor is it clear whether as used in the Proposed Guidelines "claims" would include pricing actions pursuant to contract clauses, *e.g.*, change orders, or is limited to extra-contractual actions such as suits for breach of contract.

To define the term "overrun" requires a definition of each term connected with any given statement of its meaning. Thus, in the example quoted from the Proposed Guidelines, the term "price set in the contract" may be quite unclear, as for example in an incentive type of contract in which there is a target price and a ceiling price. The lack of clarity in the definitional term makes the main term "overrun" quite unclear.

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[2] See, *e.g.*, DOD and NASA Guide, *"Incentive Contracting Guide,"* October 1969, which bears the following designations: NASA—NHB 5104.3A; Army—FN 38-34; Navy—NAVMAT P-4283; Air Force—AFP 17-1-5; and Defense Supply Agency—DSAH 7800.1.

[3] See Note 1, *supra*.

[4] Rule 170 under the securities Act of 1933 as cited at p. 10 of the Draft Report.

[5] See, *e.g.*, Chapter 2 of the Armed Services Procurement Regulation Manual for Contract Pricing (ASPM No. 1), 14 February 1969, U.S. Government Printing Office.

Tract Pricing (ASPM No. 1), 14 February 1969, U.S. Government Printing Office.

In summary, as a minimum the terms used in the Proposed Guidelines require the most careful definition, preferably on an "agreed-upon" basis perhaps among members of the Government contracting community and its legal, accounting and other advisors and the Securities and Exchange Commission.

F. The Problem With Singling Out "Defense Contracts" When Other Government Contracts Present the Same Difficulties

We understand that "defense contracts" are singled out by the Proposed Guidelines because the Commission's Study include only them in keeping with its charter. However, it appears to us that many of the problems discussed in the Commission's Study relate, by their nature, to U.S. Government contracts of certain kinds and types in general. Thus, the Commission's Study pinpoints those financial statement problems which can occur in a certain type of Government procurement regardless of whether that procurement is conducted by a military or a civilian agency. Indeed, the regulations, statutes and case law of Government contracts have developed on the basis of the *substance* of the contract—not on the basis of what Government agency signed it.[6] Indeed, there are great similarities between the contract provisions used by the various Government agencies, and the choice of provision depends largely upon the type of procurement. And, the various Boards of Contract Appeals and the United States Court of Claims have developed substantially a single body of law governing and interpreting Government contracts based upon the substance of the procurement, the type of contract employed and the specific clauses contained therein, etc., regardless of which Government agency signed on behalf of the United States. The Proposed Guidelines would appear to carve out a portion of a single area of the law—and in many cases, of a single company's business—for special treatment without a truly rational basis for such different handling. We believe the Guidelines for Disclosure should govern all similar Government contracts. There is no reason for singling out "defense" contracts from other Government contracts with the same relevant problems.

G. The Overall Problem of Emphasis in the Proposed Guidelines

The emphasis in the Draft Staff Report appears to be upon the disclosure of the special risks that may be involved in Government contracts which are not normally involved in commercial work and hence unexpected by the average investor. However, the Proposed Guidelines depart from this emphasis. Thus, while we have no quarrel with the requirement that disclosure be made of the possibility of "Renegotiation" and of "Termination for Convenience" as per current regulations, we do point out that these are only two of the many clauses used in Government contracting in general and in major space, weapons, and construction systems contracts in particular. The emphasis on one or two of these particular clauses would appear to be misplaced. Indeed, the relative importance of a particular contract provisions may depend upon either or both of (1) the technological circumstances of a procurement or (2) the Government administrative climate of the particular contract.

We recommend that the Proposed Guidelines be drafted in terms of disclosure of actual *known* risks assumed by the contractor at the time the financial statement is made, together with appropriate up-dating of disclosures when these risks change. This would include actual technological risks, the actual risks involved in claims and disputes, the actual risk of default or convenience termination, and so on, when, because of *known* circumstances, such risks present a reasonable probability of material exposure and hence are truly relevant to the financial statement.

III. SPECIFIC COMMENTS ON THE PROPOSED GUIDELINES

A. Proposed Guideline No. 1

The use of the term "unfilled orders" together with the term "funded" in this Guideline creates a legal problem. Presumably, this Guidelines refers to multi-year contracts or option contracts. In either case the Government does not have what it regards as "an order" until the funds are made available and the appropriate notices sent.[7] Thus, the Guidelines should be clarified to make clear what is meant to be disclosed, *i.e.*, presumably the existence of an option or of a multi-year increment, its amount, and other relevant facts.

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[6] See the reference cited at Note 2. *supra.*

[7] See, *e.g., International Telephone and Telegraph, ITT Defense Communications Division* v. *United States,* U.S. Court of Claims No. 147-70, Slip Opinion, January 21, 1972.

B. Proposed Guideline No. 2

We have discussed the problem of security above at II.D. and the problem of definition of terms above at II.E. We note here that the term "significant technological advance" appears in Guideline No. 4, which creates an added definitional problem. And it would appear that the relevant threshold for purposes of disclosure is *not* simply a line somewhere between "products" and "research and development," but between the "less risky" and the "truly risky" contract based upon all relevant factors.

C. Proposed Guideline No. 3

As we point out above at II.C., an agreed-upon description of the types of Government contract in lay language is required to make this Guideline really practical. It is our understanding that mere reference to, *e.g.*, the Armed Services Procurement Regulation, will not be satisfactory. Similarly, guidance is required as to the exact meaning of the question "how each type affects profitability and future claims." We feel that any such statement would necessarily have to relate to a limited time period. Again, it is assumed that reference to the appropriate laws and regulations is not enough and that lay language is required.

D. Proposed Guideline No. 4

If more is required by this Guideline that a statement concerning "the difficulty in estimating costs," etc., additional guidance is needed, particularly in the definitional area, *e.g.*, "significant technological advance." Where the factors mentioned in this Proposed Guideline are relevant to a particular company, we cannot disagree with the need for disclosure in financial statements.

E. Proposed Guideline No. 5

We cannot object to the disclosure of the presence of "renegotiation" and "Termination for the Convenience of the Government" contract terms, but as we point out above at II.G., the emphasis here seems misplaced. Second, it is not clear what should be reported under the heading of "the possible financial impact of renegotiation or termination." If only extant *facts* are meant to be reported here, rather than "guesstimates" about what might possibly happen under these two particular clauses, the Proposed Guideline should be rewritten to so state. For example, this Guideline might be interpreted to require a dollar estimate in each and every case where one of these clauses applies. We do not think this would be desirable.

F. Proposed Guideline No. 6

We believe that the intended term relating to working capital is "materially reduced" rather than "seriously impaired." Moreover, it does not appear useful to require reference to the probability that extended periods of time may be required to settle claims with resultant serious reduction of working capital, unless there is some reasonably probability that this in fact will occur.

G. Proposed Guideline No. 7

We have no additional comment.

H. Proposed Guideline No. 8

We believe that this Guideline has reference to so-called "bidding expense" or "proposal expense." However, this should be clarified.

I. Proposed Guideline No. 9

This Guideline should be clarified with reference to the rules governing the release of classified information. In addition, this Guideline should be changed to require reports only if these problems will result in material additional expense which the company will not recover under its contracts.

J. Proposed Guideline No. 10

We have described above at II.E. the problem with the definition of "material cost overrun." If an appropriate definition can be obtained for "cost overrun," we are in agreement with the inclusion of this Guideline.

K. Proposed Guideline No. 11

We have described above at II.E. the problem of defining "claims." We further call your attention to the problem engendered by the requirement for the disclosure of the "status" of such claims. We would agree that a statement

telling the legal status of the claim—whether before an administrative body, a court, etc.—might be practicable; but we do not believe it practicable to require disclosure of the negotiating position of either the Government or the contractor. In fact it could be seriously prejudicial to the parties and misleading to the investing public to make such a disclosure, since the negotiating position of the parties generally may not reflect the actual anticipated outcome of negotiations.

L. Proposed Guideline No. 12

We have called your attention at II.E. above to the problem of defining "claims" and particularly of stating when such a "claim" comes into existence for disclosure purposes. With appropriate guidance and agreed-upon definitions in this area, disclosure would appear practicable and useful.

IV. CONCLUSION AND RECOMMENDATIONS

Based upon the problems with the Proposed Guidelines outlined above, we conclude that the goal of maintaining or increasing the credibility and integrity of financial statements in the Government contracting community can be best carried out by a choice of the following two means:

1. The Commission should release its Report together with a statement that guidlines for disclosure will be issued at a specific date thereafter, and that the Government contracting community should arrange to recommend such guidelines to the Commission prior to that date. We are certain that the Government contracting community would cooperate with the Commission in this endeavor. Moreover, the burden would be thrown upon the relevant Government agencies and upon the contracting industry and its advisors to develop language which would provide appropriate disclosure from the Commission's standpoint in language that could be understood by the layman.

Or, in the alternative,

2. The Commission Staff should rewrite the Proposed Guidelines in the light of the existing problems. This might be a two-stage process in which "interim guidelines" were promulgated using the guidelines that can be rewritten quickest to be followed by a full set of guidelines at a later, but still relatively early, date.

We feel that this matter is important enough to take the time and to make the effort to obtain practical and workable Guidelines. This seems to us particularly true in view of the current difficulty of obtaining private financing for defense contracts. There would appear to be no reason to take action with the result that the burden upon the taxpayers would increase.

We understand that the Commission Staff is satisfied that some of the financial statements which have been filed by Government contractors are considered by the Staff to meet the requirements of the Proposed Guidelines. We request that such reports be identified for the guidance of others.

We sincerely appreciate the opportunity to comment upon the Proposed Guidelines and are willing to participate in such further activity related to this matter as the Commission Staff may deem useful.

Sincerely,

WILLIAM M. SIMMONS,
Chairman, Weapons Systems Contracting Committee.
Chairman, Securities and Exchange Commission Committee.
1700 K Street, N.W.
Washington, D.C. 20006
202–833–1420

LABRUM AND DOAK.
Philadelphia, Pa., April 14, 1972.

Re In the Matter of Disclosures by Registrants Engaged in Defense Contracting Proposed Guidelines, Adm. Proc. File No. 3–2485.

Mr. ALAN B. LEVENSON,
Director, Division of Corporation Finance, Securities and Exchange Commission, Washington, D.C.

DEAR MR. LEVENSON: The undersigned have been appointed as a special subcommittee by A. A. Sommer, Jr., Chairman of the Federal Regulation of Secu-

rities and Committee of the Section of Corporation, Banking and Business Law of the American Bar Association, for the purpose of examining the "Proposed Guidelines for Disclosures by Companies Engaged in Defense Contracting." In submitting the following comments we hope they may be of some assistance to the Commission in its deliberations on the Proposed Guidelines. However, we emphasize that no opportunity has been given to the members of the full Committee, the Section or the Association, to consider the comments of this subcommittee. The views are those of the members of this subcommittee only and do not represent as such an official position of the Association.

In our consideration of the matter, we have considered the comments in the letter of February 29, 1972, addressed to Mr. Thomas N. Holloway, Associate Director of your Division, by William M. Simmons, Chairman both of the Weapons Systems Contracting Committee, and the Securities and Exchange Commission Committee, Section of Public Contract Law, American Bar Association, to which we will refer herein as the "Public Contracts Section Letter". We have also had the benefit of the views expressed in the letter dated February 22, 1972, addressed to Clarence Sampson, Associate Chief Accountant for the Commission, by Gerald E. Gorans, Chairman, Committee on National Defense of the American Institute of Public Accountants.

We are generally in agreement with the comments made in the Public Contracts Section Letter. We regard the opinions expressed therein as worthy of careful consideration by the Commission, in the light of the experience they reflect in connection with the specific questions raised by the Proposed Guidelines. Inasmuch as our own Federal Regulation of Securities Committee of the Corporate Section is concerned with the entire field of securities regulation by the Commission, as well as any disclosure regulations or guidelines directed to special fields of business, we have sought to examine the questions raised from the overall perspective of their relation to the current guideline regulations and standards of disclosure generally applicable.

Before proceeding with our comments, we pause to note that, although the Proposed Guidelines make it clear that they apply only where "a material portion of the business" is represented by defense contracts, the Proposed Guidelines are not expressly confined to material disclosures as to such part of the business. For example, Proposed Guidelines Nos. 9 and 11 are not limited to "material" problems or claims. While we recognize that the concept of materiality is firmly embedded in existing regulations, we suggest that clarity would be enhanced by appropriate language for this purpose.

We regard the general implications of the Proposed Guidelines, from a disclosure policy standpoint, as falling into three separate categories, namely:

First, those which are clearly intended to elicit information of a purely descriptive nature, whether current or historical;

Second, those which, as presently worded, appear to present problems of determining whether certain items of expense or performance experience require chargeoff, or establishment of reserves for anticipated losses; and

Third, those which appear to involve substantial predictive elements.

In the first category, subject to the "Specific Comments" in the Public Contracts Section Letter regarding the need for clarification and definition of terms, as to Proposed Guideline No. 1 (Letter, p. 18), No. 2 (p. 19), and No. 11 (p. 23): we regard Nos. 1 (dollar amount of unfilled orders and periods of performance applicable); 2 (description of major programs); 7 (accounting method used); and 11 (amounts and status of claims—other than renegotiation—by and against the contractor) as free from any controversial issues. To us, they appear logical specific applications of disclosure standards presently generally applicable, without imposing any substantial burdens on the contractor. No. 1 should be relatively easy to supply or estimate, and the information so furnished may be quite valuable. No. 2 is a logical expansion of the "Description of the Business" now required under Item 9 of Form S–1, and Item 1 of Form 10, for registration of securities under the '33 and '34 Acts, respectively; and Item 11 is no more than a specific application of the "Pending Legal Proceedings" required by Items 12 and 10 of Forms S–1 and 10, respectively, in a field in which "claims", in government contract parlance, at certain stages attain status equivalent to general business litigation.

The second category, in which we place Proposed Guideline Nos. 8, 9 and 10, presents more difficulty. No. 8 calls for an analysis of expenditures or commit-

ments in anticipation of securing contracts or for which reimbursement is not specifically provided by existing contracts. While we recognize the importance of such analysis, we fail to perceive any unique questions of this nature which are peculiar to the business of defense contractors; any such expenditures for which reimbursement is not reasonably anticipated would seem clearly to require chargeoff, either as such expenditures are incurred, or when their nonreimbursable status has become fairly evident. While the evidence cited in the Staff Report suggests the possibility that this analysis may not have been adequate in the case of certain defense contractors, no special problems uniquely applicable to their case would seem to justify a special disclosure of all such expenditures. In our view, the basic question involves proper accounting treatment of such items, and if the Commission considers a guideline necessary, it should be directed only to the necessity of including the chargeoff of such costs in the financial statements.

In the same category, we regard Proposed Guidelines No. 9 (known problems in meeting specifications or delivery schedule), and No. 10 (disclosure of aggregate gross amounts of cost overruns not reimbursable). While we are somewhat uncertain concerning the precise significance of the present wording of Proposed Guideline No. 9 (see Public Contracts Section Letter, p. 22), it would seem that once again the question depends on analysis to determine whether the "known problems" require provision for losses in carrying out the remaining portion of the contract.

The same comment applies to even greater extent on Proposed Guideline No. 10; if there have been substantial "aggregate gross amounts of such overruns", in the sense mentioned—i.e., costs incurred to date plus estimated costs in excess of contract price plus reimbursable amounts—and if they are subject to estimates, such estimates would seem to require provision for loss reserves.

In that connection, we note the reference (Draft of Staff Report, p. 21) to, and agree with, the statement by Textron, Inc., that "current accounting principles provide for losses to be recorded as soon as recognized and that such losses, if material should be disclosed in annual reports and reports filed with the Commission." We believe the principle applies both to the effect of past experience in the categories covered by Proposed Guidelines 8, 9 and 10, and to anticipated losses where the contractual situation makes it virtually certain that the losses are inevitable.

In this connection, attention is called to the comment by the Committee on National Defense of the American Institute of Certified Public Accounts (p. 2) that the Proposed Guidelines "do not stipulate the extent to which the disclosures are required to be part of the financial statements." We agree with the comment; however, it should be noted that to the extent the items here discussed are treated as matters to be expensed or reserved, as we have suggested, the consequence would necessarily follow that the result must be included in the financial statements.

If on the other hand Nos. 8, 9 or 10 are intended to cover such items before they become susceptible to such treatment, we question whether there should be any distinction between the standard for disclosure, on the one hand, and for financial accounting, on the other. The result would impose a requirement of speculation which (aside from the predictive aspect discussed hereafter) would range between two extremes, which appear quite unacceptable. At one end the result could be a requirement to discuss the various possibilities and their potential consequences, in terms that would increase and complicate the contents of disclosure statements, to a degree inconsistent with the present Commission trend toward simplication.

At the other end, the requirement would be interpreted as a direction to disclose by way of *mention* only, the possibilities in question, in which event the result would enhance, rather than reduce, the possibility of a misleading result. Nor, in view of the nature of the problem, does it appear that any effort to steer a course between the two extremes would be likely to succeed.

Thus far, we have discussed those Proposed Guidelines which are apparently directed to matters of a descriptive or historical nature. A more serious problem with which this subcommittee is concerned arises from those aspects which appear to call, not for descriptive information, but rather for elements of a predictive nature.

Before we come to that question, we digress briefly to consider the ambiguity of Proposed Guideline No. 3, which calls for disclosure of the type of con-

tracts involved, together with "an explanation of how each type affects profitability and future claims for allowable costs". Proposed Guideline No. 3, as it stands (calling for statement of the type of contracts and "explanation of how each type affects profitability and future claims for allowable costs"), may be interpreted in one of two ways:

(1) either it is intended to provide no more than a general summary of the legal provisions in the various forms of contracts involved, in which case the material could be susceptible to treatment by stereotyped paragraphs; in which event the problem must be defined as one of translation into lay language, as the Public Contracts Section Letter points out (pp. 4, 19); or

(2) it requires a specific and detailed analysis of the subject forms in their application to the specific contracts in question, in which event we believe the result would mean an infusion of material so massive as to be self-defeating.

In addition to the requirement describing the types of contracts, Guideline No. 3 requires a prediction of "how each type affects profitability in future claims for allowable costs." A prediction of this kind is not only difficult to make; it is inherently unsound because the "type" of contract is only one of several factors which will ultimately determine the effect on profitability. We recommend that if the Commission feels that it is useful to have a general description of the types of contracts, the clause of Guideline No. 3 on the effect on profitability be deleted.

We turn now to consider Proposed Guidelines Nos. 4 (estimate of profitability of particular contracts), 5 (the possible financial impact of renegotiation or termination) and 6 (the possibility that due to the magnitude of the contract, and the extended periods of time, working capital may be seriously impaired).

Here the problem of interpretation of the present text is crucial. If, as appears to be the case, the Proposed Guidelines in essence call for the use of estimates and predictions in disclosure statements, they apparently go beyond anything which is now required under settled disclosure policy.

The extent of the departure from present philosophy will be evident on comparison of the present requirements of Item 9 of Form S–1, and its counterpart in Item 1 of Form 10. These Items now require information which related exclusively to *current* or *historical* developments. This remark applies equally to Instruction #4 of subparagraph (a) in both Items, which reads as follows:

"4. Appropriate disclosure shall be made *with respect to any material portion of the business which may be subject to* renegotiation of profits or termination of contracts or subcontracts at the election of the Government." (Italic supplied)

Obviously, there is a clear distinction between requiring information showing what portion of the business "may be subject" to renegotiation of profits, or termination, and how such renegotiation or termination will affect future results. To this extent, and to the extent that the Proposed Guidelines call for any estimates or predictions concerning the results of future operations, they appear inconsistent with the historical policy which the Commission thus far has consistently followed. It has thus far been the consistent view of the Commission that, in the words of a prominent member of our full Committee, "The Securities Act, like the hero of 'Dragnet', is interested exclusively in facts," as compared to conjectures and speculations as to the future. Heller, DISCLOSURE REQUIREMENTS UNDER FEDERAL SECURITIES REGULATION, 16 *Business Lawyer* 300 (Jan., 1961) at 307. At least in one instance, the Commission has pointed to such projections as one example of misleading statements: Rule 14a–9, Example #1.*

Obviously, the general question whether disclosure should include predictions of results of future operations is not an appropriate topic for discussion here; and the undersigned do not intend by these comments to suggest any views thereon. But assuming that such extension of present disclosure requirements *is* desirable, we oppose its introduction as an innovation in the narrow segment of business which defense contracting represents.

* The historical policy of the Commission has been recently subjected to strong attack: See, for example, Solomon, PRO FORMA STATEMENTS, PROJECTIONS AND THE S.E.C., 24 *Business Lawyer* 389 (Jan., 1969); Kripke, SEC REFORM, 45 *N.Y.U. L. Rev.* 1151, 1197-1201 (1970). But the "Disclosure Policy Study" (March 27, 1969), Ch. III-C4, recommended no change in this respect.

In point of fact, the selection of that industry as the appropriate unit for this purpose would seem especially unfortunate, in view of the contrast between the surface appearance of predictability of government contracts and the everyday actualities of doing such business. As the Public Contracts Section Letter points out (p. 4), despite the wide scope and complexity of provisions of Government do not represent any fair measure of those which are actually applied in practice.

Furthermore, any requirement of preduction or estimation of the outcome of renegotiation proceedings present difficulties which seem insurmountable. Those difficulties have been graphically summarized recently in an article entitled FEDERAL RENEGOTIATION—A LAWYER'S NIGHTMARE, 17 *The Practical Lawyer* No. 7 (Nov., 1971) p. 45, by Theodore Kostos, of the Philadelphia Bar. As he points out, in any renegotiation proceeding, the criteria for establishing profits as "excessive" are quite subjective (p. 45) ; since the burden of proof is on the contractor to establish that his profit is *not* excessive, the process of litigating before the Board is "like chasing a phantom in the night" (p. 54). Although the Board is required to give a contractor a Statement of Facts and Reasons in explanation of its decisions, such a statement is "relatively worthless . . . very general and stereotyped and does not really get into the specifics of a particular case" (*ibid*). Under such circumstances, any estimate or prediction regarding the outcome would seem to be more misleading than informative.

The basic difficulty, of course, is that the problems to which the Proposed Guidelines are directed arise in an area much wider than the defense contracting field. It is not only because, as the Public Contract Law Section Letter points out (p. 5), other Government contracts which do not involve the national defense are marked by the same degree of complexity and risk. It is also because most of the problems with which the Proposed Guidelines are concerned, arise from the long-range commitments characteristic of such contracts, and the fact they involve commitments which run over more than a single reporting year.

But such problems arise in the case of every business which has made long-term commitments; there, too, a fixed price at which the business may agree to manufacture, sell or buy, can be a source of substantial losses. For example, the attached piece from the *Wall Street Journal* (March 15, 1972, p. 11, col. 1) recounts the consequences to Ampex Corporation of a three-year contract with Warner Communications, Inc., whereby Ampex guaranteed the other party $60 million for tape rights, in contemplation of a certain level of sales by Ampex which it failed to realize. Similarly, the consequences of deficient performance by a defense contractor is no different, from a disclosure standpoint, from the experience of the Pratt & Whitney Division of United Aircraft Corporation, which, according to the attached dispatch to the *Washington Post* (reproduced here from the *Philadelphia Inquirer*, March 13, 1972, p. 21, col. 1) is now faced with a $94 million claim for defective performance of its JT9D engine, used in the Boeing 747's—and this, after a prior chargeoff in 1971 of $137 million extraordinary loss to reflect "unanticipated engine costs".

The examples, selected at random from current press reports, are by no means unusual. There are numerous enterprises which derive a substantial part of their income from commitments ranging over a period of more than one fiscal year—construction companies, for instance, which engage in large building contracts, either as general or subcontractors (which, incidentally, present the identical problem of accounting methods when a change is made from the completed contracts to the percentage of completion method). The Pratt & Whitney case is typical of any manufacturer of a new product, which because of its size and cost may expose the producer to unanticipated consequences of faulty design or defective performance for any of a number of possible causes; current press reports abound with cases in which auto manufacturers are encountering problems on recall of large numbers of vehicles, which, at any given stage in a model year, may generate the prospect of substantial claims. Such cases may even involve larger sums, where they may result in accidents causing personal injuries.

This may well be the consequence of a heightened public awareness of the right of the public to insist upon greater responsibility by the manufacturer;

it is not here suggested that such a philosophy of disclosure should be opposed. The point is that in approaching such problems, and in insisting on prognostication to a degree not previously required, the Commission should recognize the implications of the shift, and examine the question from the standpoint of its consistency with the policy of disclosure generally applicable to all companies. Perhaps the above considerations may end in a proposal of amendments to S–1 Item 9 or Form 10 Item 1; in such case, the entire question of the extent to which such prognostication may be consistent with the present text of the '33 and '34 Acts would emerge in proper perspective. We suggest that the efficacy of the system is not improved by singling out a particular segment of one industry, so that investors must become specialists in that segment to review and appraise such disclosures.

SUMMARY AND CONCLUSIONS

In general, the undersigned are of the opinion that:

1. Any disclosures to be required in the subject connection should not extend to any which are immaterial in their actual or potential effect. For example, Proposed Guideline No. 11 should be specifically limited to "material" claims. If Guideline No. 9 is retained, it should be specifically limited to "material" claims. If Guideline No. 9 is retained, it should be specifically limited to "material" problems.

2. The subcommittee endorse the views expressed in the Public Contracts Section Letter of February 29, 1972, and agree with the recommendations therein set forth.

3. Subject to the comments there made suggesting clarification, we regard Proposed Guidelines Nos. 1, 2, 7 and 11 as useful and helpful standards of details which should be included in disclosure by defense contractors.

4. Insofar as Proposed Guidelines Nos. 8, 9 and 10 deal with certain categories of expenditures which present problems of chargeoff to current or past operations, we are of the opinion that any attempt to require analysis beyond those presently applied to determine chargeoffs or reserves in financial statements is undesirable. We recommend that these three Guidelines be deleted, or if the Commission feels that one or more of them are useful, they be redrafted as Guidelines of what should be covered in the financial statements. In that connection, we recommend that the Proposed Guidelines specifically indicate the degree to which the various items to be disclosed should, or should not, be included in the financial statements.

5. We interpret proposed Guidelines Nos. 3, 4, 5 and 6 to call for estimates and predictions of the results of future operations, which we regard as inconsistent with present general disclosure policy. These Guidelines should either be reworded to make it clear that they only require general cautionary language (which admittedly is not very useful) or they should be deleted. In any event, if Nos. 3 and 5 are retained, the phrases therein relating to the effect on profitability or financial condition should be deleted.

6. We do not consider that the major problems to which the Proposed Guidelines are addressed are in any manner peculiar to the defense contracting industry or to the Government contracting field and should, if promulgated, be made applicable to all companies in which the effect of long-term commitments or contracts may have a material effect on earnings.

Very truly yours,

LEWIS WEINSTOCK, *Chairman.*

Copies to:

Section of Corporation, Banking and Business law: Donald J. Evans, Esq., A. A. Sommer, Jr., Esq., S. J. Weiss, Esq.

Section of Public Contract Law: William M. Simmons, Chairman, Weapons Systems Contracting Committee and Securities and Exchange Commission Committee.

American Institute of Certified Public Accountants; Mr. Edward M. Musho.

Subcommittee on 1933 Act Registrations, Warren F. Grienenberger, Chairman.

Subcommittee on 1933 Act—General, Carl Schneider, Chairman.

Subcommittee on Reporting Companies Under the 1934 Act, Douglas H. McCorkindale, Chairman.

[From the Wall Street Journal, Mar. 15, 1972]

AMPEX DEFICIT WAS $82.9 MILLION IN 3RD QUARTER—MAKER OF PRERECORDED TAPE ESTIMATES ITS FISCAL 1972 LOSS AT ALMOST $90 MILLION—SOME CONTRACTS RENEGOTIATED

REDWOOD CITY, CALIF.—Ampex Corp. disclosed it had a loss of $82.9 million in its third quarter and estimated its deficit for fiscal 1972, ending April 30, will total almost $90 million.

Sales for the quarter, ended Jan. 29, were $54.3 million. A year earlier, Ampex earned $1.4 million, or 12 cents a share, on sales of $83 million. For the nine months, the financially troubled maker of recording equipment had a loss of $86.3 million, against net income of $2.7 million, or 25 cents a share, a year earlier. Nine-month sales declined to $209.6 million from $221.9 million.

Ampex estimated it will show a loss of about $3 million for the fourth quarter. In fiscal 1971, the company had a deficit of $12 million on sales of $290.9 million. The company didn't give an estimate of fiscal 1972 sales.

In February, Ampex announced it would incur a loss "substantially" more than a $40 million deficit previously estimated pending a special audit of its music division where reserves established for that division were proving inadequate. The magnitude of the final loss was anticipated in a March 9 Wall Street Journal story detailing Ampex's problems in which outside sources indicated it could run to $70 million or more.

The story explained how Ampex, the nation's largest producer of prerecorded tape, had signed agreements with record companies for tape rights, promising guarantees that it couldn't meet in a flattened market for its tape. The story also said that Ampex had pumped more tape into the market than it could bear, creating serious inventory problems.

THREE-YEAR PACT CITED

The story specifically mentioned a three-year contract with Warner Communications Inc., formerly Kinney Services Inc., signed in 1970 whereby Ampex guaranteed Warner $60 million for tape rights. Sales, the story said, were falling well under levels needed to meet the guarantee.

Arthur K. Hausman, Ampex president, announced yesterday a "satisfactory renegotiation" of the contract under which Ampex formerly manufactured and marketed stereo tapes of Atlantic, Atco, Warner and Reprise recordings. Under the renegotiated agreement, Ampex will continue to make the recorded tapes, but Warner Communications will market them through its own recently established distribution system.

Ampex said the third quarter loss reflects adjustments that result, in part, from discontinued operations, provisions for contract settlements, unearned amounts under royalty guarantees, allowances for doubtful accounts, changes in lease accounting, inventory writedowns and other reserve and asset revaluations.

Earlier, Ampex, which also has had problems collecting bills for its tape from dealers, had announced that it was ending its production of consumer tape recorders. In The Journal's story, sources told how the company had been unable to compete against Japanese manufacturers in the recorder market.

MUSIC DIVISION AUDIT

The nine-month deficit, as well as the projected fourth quarter loss, Ampex said, reflects the results of the special audit of the music division along with an additional financial review of the total corporation by its outside auditors, Touche, Ross & Co.

Mr. Hausman, who succeeded William E. Roberts as Ampex president and chief executive officer last November, said: "During the preceding four months, substantial changes have been made in the areas of consolidation of divisions within the corporation, elimination of unprofitable product lines and reduction of operating expenses." He added: "During this difficult period, the company has been working closely with our financial institutions for the continued development of the company's present programs."

[From the Philadelphia Inquirer, Mar. 15, 1972]

COSTS OF JUMBO JET ENGINES STILL CLIMB AS P & W FACES BUYERS' CLAIMS

(By Robert J. Samuelson)

WASHINGTON.—For Pratt & Whitney, the JT9D—the engine for the Boeing 747—has become an aerospace nightmare.

More than twice as powerful as engines on the 707s and the DC-8s, the JT9D has been misbehaving ever since its introduction in early 1970.

Pratt & Whitney's parent, United Aricraft Corp., is totaling up the bill. Late last year, it charged off a $137 million dollar extraordinary loss to reflect unanticipated engine costs.

Even though most of the serious financial and safety problems seem passed, that figure still could balloon further. It includes United's assessment of how much of a $94 million dollar claim from Boeing will have to be paid, and the estimate could prove conservative.

Moreover, new troubles always threaten. In the last three months, for example, Pan American World Airways has suffered an estimated $17 to $18 million dollars in extra costs for engine parts that had to be replaced. Technically, these engine flaws aren't covered by warranties, but Pan Am officials clearly expect to be reimbursed for some of the outlay.

Pratt & Whitney's exasperating experience with the JT9D provides a fascinating glimpse into the brutal world of giant engine manufacturing. It is a small world. Pratt & Whitney has but two major rivals—Rolls Royce and General Electric—and the demands of the competition proved so exacting for Rolls Royce that it collapsed into insolvency last year, only to be saved by a massive infusion of money from the British Government.

Success, however, can be extremely lucrative. Until last year, United recorded consistently large profits and, even with the $137 million dollar writeoff, the company doesn't plan to reduce its dividends.

The financial and technological barriers to becoming a major jet engine manufacturer are enormous—the development costs of the JT9D, for example, ran an estimated $500 million dollars—and, in the sixties, Pratt & Whitney occupied the enviable spot of being sole supplier for both Boeing and McDonnell Douglas jets.

The biggest profits lie in the spare parts and replacements during the 10-to-15 year life of those jets, when the airlines can turn only to Pratt & Whitney for service. As a rule of thumb, the spares are reckoned to be worth 40 percent of total revenues on an engine project.

Nevertheless, the history of the JT9D clearly shows that there is a less glamorous and rewarding side of the business.

Pratt & Whitney's problem developed at a singularly inauspicious time for both the airlines and the aerospace industry. Airline deficits soared just as the giant 747s entered service, and unexpected engine costs simply inflated the losses, creating intense pressure for Pratt & Whitney to come up with a quick fix.

The slowdown in airline traffic also killed orders for the 747, and Boeing has sold only 207 of the $23 million planes—probably not enough for Pratt & Whitney to break even on the engine program.

Yet, as unpleasant as Pratt & Whitney's problems have been, they clearly could have been worse, in retrospect, the company probably should count itself lucky that the 747s weren't grounded for safety reasons; the National Transportation Safety Board was agitating for drastic action in the summer of 1970, when the shutdown rate for the JT9Ds—the number of times the engine had to be turned off per 1,000 hours of flight time—was more than four or five times normal.

Fires erupted frequently. Though some were less serious than they seemed, others reflected major engine error; heavy components that were breaking under stress. Moving at extremely high speeds, these parts threatened to do extensive damage to the engines and, possibly, to the wings.

What happened?

Unlike most previous commercial jets. the JT9D lacked a military predecessor and, therefore, the opportunity to discover the correct fundamental design flaws.

To achieve improvements, the new engine had to operate at much higher temperatures than its predecessors. The temperature on the crucial turbines that drive the giant fans was to be about 250 degrees hotter than before—and that proved to be the JT9D's achilles' heel.

Some of the parts could not withstand the higher temperatures for prolonged periods; they cracked. New alloys had to be developed, cooling systems had to be improved; most engines have now been retrofitted with the changes.

Combined with some other troubles, the turbine problems caused delivery delays which may be the source of Boeing's claim against United; maintenance costs for both airlines and Pratt & Whitney rose spectacularly.

MEMORANDUM

January 3, 1973.

To: Hon. William Proxmire, Chairman, Subcommittee on Priorities and Economy in Government, Joint Economic Committee.

From: Commissioner Philip A. Loomis, Jr., Securities and Exchange Commission.

Subject: Possible Assessment of Fees for More Intensive Examination or Audit of Defense Contractors.

During the hearings, I expressed some possible disagreement with your suggestion that your staff felt that the Commission had authority to impose fees to cover the costs of more intensive investigation or auditing of defense contractors in an effort to obtain better disclosure. You requested a memorandum on this subject.

The Commission's authority to charge fees comes from three sources. One, Section 6(b) of the Securities Act of 1933, requires that where registration statements for offerings of securities are filed, a fee of 1/50 of 1% of the maximum aggregate offering price, but in no case less than $100, be paid. Section 31 of the Securities Exchange Act requires every national securities exchange to pay the Commission a registration fee for the privilege of doing business in an amount equal to 1/500 of 1% of the aggregate dollar amount of the sales of securities, on the exchange. While this fee is, in form, levied on the exchanges, in practice, the exchanges pass it on to their members, who in turn pass it on to their customers by an additional charge noted on the confirmation. The third source of authority for fees is found in Title V of the Independent Offices Appropriation Act of 1952, codified as 31 U.S. Code Annotated, Section 483a. I attach a copy of this statute. As you will note, it authorizes the charging of fees where any work, service, document, benefit, privilege, authority, franchise, license, permit, certificate, registration or similar thing of value is furnished, granted or issued by any federal agency to or for any person, including corporations and businesses, and provides that such fees, in the case of agencies in the executive branch, shall be as uniform as practicable and subject to such policies as the President may prescribe. It further provides that any amount so determined shall be collected and paid into the Treasury as miscellaneous receipts.

We collect fees under this Act, including fees for registrations and reports under the Securities Exchange Act. All large defense contractors are subject to these fees, but they are modest in amount and are designed only to cover the cost of our normal review and processing and not of an audit or investigation. I attach a copy of Securities Act Release No. 5229, dated January 25, 1972, which prescribes the fees presently in force under Title V.

It may not be entirely clear whether the reference in Title V to agencies in the executive branch who are to be subject to regulations of the President would include the Commission, but it seems that the Bureau of the Budget (now Office of Management and Budget) which acts for the President in these matters, has so interpreted it since their Circular No. A–25, September 1959, which is still in force, provides that requirements therein are applicable to all federal activities, with certain exceptions not here pertinent such as postal rates and reclamation projects, except that it does not apply to activities of the legislative and judicial branches and the municipal government of the District of Columbia.

The problem with charging substantial fees to defense contractors to defray the cost of audits and investigations to determine whether they are in compliance with the law is that making such an audit or investigation of a company is hardly furnishing it with a license, permit, registration or "similar thing of value or utility" and consequently, we have never interpreted this statutory provision as authorizing us to charge fees to cover the costs of investigations or enforcement proceedings. It is my understanding from conversations that the Office of Management and Budget has concurred in this view, and regards enforcement activities as primarily benefiting broadly the general public rather than the person being investigated.

The recent decision of the United States Court of Appeals for the District of Columbia Circuit in *New England Power Company* v. *Federal Power Commission*, 467 F. 2d 425 (1972), seems to me to take a similar view of the authority granted to impose fees by Title V. In that case, the Federal Power Commission, in addition to imposing fees for specific permits and approvals, had also imposed upon gas and electric utilities subject to its jurisdiction, annual fees designed to defray the cost of discharging regulatory responsibility to prevent the imposition of rates and charges which were unjust and unreasonable. The Power Commission urged that this was permissible under Title V because this regulation, although beneficial to consumers, also redounded to the benefit of the regulated industries by creating an "economic climate" beneficial to them. The Court of Appeals rejected this argument and set aside the Commission's order imposing these fees. It concluded that the regulation was primarily designed for the benefit of the public and that no particular regulated company was a "special beneficiary" either of the regulatory scheme or of the "economic climate" which resulted.

I am inclined to believe that similarly our efforts to obtain full disclosure by defense contractors, particularly if these efforts were intensified as you suggest, would be primarily for the benefit of the public and that no defense contractor would be a special beneficiary of these efforts.[1]

There would be an additional problem insofar as registration statements under the Securities Act of 1933 are involved since, as mentioned above, Congress has specifically provided a fee to be paid in connection with such registrations, and Title V states that nothing contained in this section shall repeal or modify existing statutes proscribing bases for calculation of any fee, or fixing the amount of any fee.

In addition, it is noted Title V provides that all amounts collected thereunder shall be paid into the Treasury as miscellaneous receipts so that we would still have to rely on appropriated funds to conduct the activities you describe, although the Appropriations Committees of the Congress would, of course, take into account the fact that a fee was being paid if one were to be imposed.

We estimate that we will collect during the current fiscal year approximately $23,000,000 in fees, of which some $13,200,000 will come from registration fees provided for in Section 6 of the Securities Act; about $5,200,000 will come from the fees levied pursuant to Title V; about $4,300,000 will come from the fees levied on stock exchanges by Section 31 of the Securities Exchange Act of 1934; and some $400,000 coming from miscellaneous sources, particularly the fees paid by those registered broker-dealers who are not members of any self-regulatory organization.

The Office of our General Counsel concurs in the conclusions expressed in this memorandum.

31 United States Code Annotated, Section 483a

Services as self-sustaining; uniformity; regulations; deposit in Treasury; effect on other laws

It is the sense of the Congress that any work, service, publication, report, document, benefit, privilege, authority, use, franchise, license, permit, certificate, registration, or similar thing of value or utility performed, furnished, provided, granted, prepared, or issued by any Federal agency (including wholly owned Government corporations as defined in the Government Corporation Control Act of 1945) to or for any person (including groups, associations,

[1] In connection with the discussion earlier in this memorandum, it may be noted that the Court of Appeals appears to have assumed that Bureau of the Budget Circular No. A-28 was applicable to the Federal Power Commission without discussing any possible distinction between that Commission and any other government agency in the context of Title V.

organizations, partnerships, corporations, or businesses), except those engaged in the transaction of official business of the Government, shall be self-sustaining to the full extent possible, and the head of each Federal agency is authorized by regulation (which, in the case of agencies in the executive branch, shall be as uniform as practicable and subject to such policies as the President may prescribe) to prescribe therefor such fee, charge, or price, if any, as he shall determine, in case none exists, or redetermine, in case of an existing one, to be fair and equitable taking into consideration direct and indirect cost to the Government, value to the recipient, public policy or interest served, and other pertinent facts, and any amount so determined or redetermined shall be collected and paid into the Treasury as miscellaneous receipts: *Provided* That nothing contained in this section shall repeal or modify existing statutes prohibiting the collection, fixing the amount, or directing the disposition of any fee, charge or price: *Provided further*, That nothing contained in this section shall repeal or modify existing statutes prescribing bases for calculation of any fee, charge or price, but this proviso shall not restrict the redetermination or recalculation in accordance with the prescribed bases of the amount of any such fee, charge or price.

THE ACQUISITION OF WEAPONS SYSTEMS

THURSDAY, DECEMBER 21, 1972

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 recess, at 10:05 a.m., in room 4221, Dirksen Senate Office Building, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire.

Also present: Ross F. Hamachek, Richard F. Kaufman, economists; George D. Krumbhaar, Jr., minority counsel; and Michael J. Runde, administrative assistant.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The subcommittee will come to order.

Two days ago one of our witnesses described the lengths to which some defense firms are driven in order to "get the contract." Some will slash their proposals by hundreds of millions of dollars, knowing they would lose money if they actually had to produce and deliver the weapons in question for the amount agreed upon with the Government. But they are so confident that the Government will bail them out of any financial difficulties they may experience that they are willing to "buy in" to a contract at practically any price.

The pattern of contractor buy-ins and Government bail-outs has become all too familiar. A high Navy official told this subcommittee that the evidence suggested the Grumman Corp. lowered its proposal for the F–14 aircraft program by $475 million during the final stages of the bidding on that contract. Coincidentally, that is approximately the same sum Grumman is now asking for, I should say. The Navy has recently announced its decision to hold Grumman to the original contract price. Grumman replied that it would halt production rather than lose money on the deal by accepting only the amount stated in the contract.

Grumman has now taken its case to the public with expensive full-page ads, a somewhat bizarre course of action for a company that claims to be so short of cash. But the Navy and Grumman have not completed their moves yet and the question going through many minds is whether they are slugging it out or doing a minuet.

What seems clear to me is that the favorite pastime in the defense community is a sport called the "Military Money Game." The real objective is not so much to get the contract as to get the money.

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The contract is only a condition precedent to turning on the Federal tap. As a legal document it is looked upon almost with contempt by many contractors and by some Government officials as well.

A contract is a contract in the military money game only to the extent that it permits the giant defense firms to obtain the public funds they need. These pieces of paper rarely stand in the way of price increases, delivery delays and performance failures.

One of the newest gambits to be uncovered is the progress payment loophole. Through this device flows hundreds of millions of dollars of taxpayers' money into the private hands of the defense community. On Monday the Comptroller General explained how the Lockheed Corp. was able to obtain $400 million in excess progress payments. The Government auditors who first discovered this situation referred to the payments by the Air Force as "unauthorized." The General Accounting Office called them "inappropriate." By any name, the taxpayer was the fall guy to the tune of millions.

Today we will discuss other ingenious, if not unethical, methods employed by defense contractors to obtain money to which they are not entitled. Appropriately, this discussion comes just before the Christmas season.

Our witnesses this morning are Barry J. Shillito, Assistant Secretary of Defense, Installations and Logistics; his deputy, John M. Malloy, Deputy Assistant Secretary of Defense, Procurement; and B. B. Lynn, newly appointed Director of the Defense Contract Audit Agency.

Gentlemen, it is good to see you here this morning. It has been touch and go all week as to whether Government witnesses would appear and it is good that you could join us.

Mr. Shillito, I want to especially welcome you before our committee once again.

Mr. Shillito has a distinguished record of Government service and he has held his present office since 1969. You have a distinguished record. I understand you have been with the Defense Department now for 6 years. You have been associated with defense procurement, well, 5 years with the Defense Department and 1 brief year of close association. You have had 14 years altogether, I understand, working on procurement problems on one side or the other, on one side of the table or the other, and you are one of the most extraordinarily experienced procurement men in the country. I am delighted that you are here. I do not know anybody who could cast clearer light on the past record and give us a better insight and understanding than you can.

You have two other distinguished gentlemen with you, I see. Before you start, as you know, we have a rule, we try to make the remarks of the witnesses as limited as possible because we have the statement submitted in advance, and we would ask you, if you would, to confine your remarks to 10 or 12 minutes. At the end of 12 minutes we will ring a bell. You do not have to finish on that bell, but if you would conclude and give us your conclusion or summary right after that, we would appreciate it.

You have a 50-some page prepared statement here, and the entire prepared statement of 52 pages will be, and the exhibits will be, printed in full in the record. So you proceed, sir.

STATEMENT OF HON. BARRY J. SHILLITO, ASSISTANT SECRETARY OF DEFENSE FOR INSTALLATIONS AND LOGISTICS, ACCOMPANIED BY JOHN M. MALLOY, DEPUTY ASSISTANT SECRETARY FOR PROCUREMENT, VICE ADM. ELI T. REICH, DEPUTY ASSISTANT SECRETARY FOR PRODUCTION ENGINEERING AND MATERIEL ACQUISITION, COL. BRUCE BENEFIELD, USAF, CHAIRMAN OF THE CONTRACT FINANCE COMMITTEE, BERNARD LYNN, DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY, JOSEPH WELSCH, DEPUTY ASSISTANT SECRETARY OF DEFENSE FOR AUDIT, CYRIL BUEHRLE, DIRECTOR, BANKING AND CONTRACT FINANCING, OFFICE OF COMPTROLLER, DEPARTMENT OF NAVY, HARVEY GORDON, ASSISTANT TO DEPUTY ASSISTANT SECRETARY OF THE AIR FORCE FOR PROCUREMENT, ARNOLD BUETER, DEPUTY COMPTROLLER, AIR FORCE, AND CAPT. RONALD FLOTO, USA, ANALYST IN THE OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)

Mr. SHILLITO. Thank you very much, Mr. Chairman.

It is a pleasure—no, it is not really a pleasure—it is again an opportunity that I find myself stimulated by to have the chance to appear before your subcommittee.

Before I get started, I might introduce the balance of our people.

As you mentioned, Mr. J. M. Malloy, who is my Deputy Assistant Secretary for Procurement, is on my right; Adm. Eli Reich, who is the Deputy Assistant Secretary for Production Engineering and Material Acquisition, is on my left; we have Col. Brice Benefield behind me here, who is chairman of the Contract Finance Committee; Bernard Lynn, Director, Defense Contract Audit Agency, on the right of Mr. Malloy, and next to Colonel Benefield is Mr. Joseph Welsch who is the Deputy Assistant Secretary of Defense for Audit; Mr. Cyril Buehre right here behind me is the Director of Banking and Contract Financing, Office of Comptroller, Department of Navy. Mr. Harvey Gordon is with us, the Assistant to the Deputy Assistant Secretary of the Air Force for Procurement; Mr. Gordon is right behind Colonel Benefield; Mr. Arnold Bueter, the Deputy Comptroller of the Air Force, is on the far right, and I have with me Capt. Ronald Floto also, who is an analyst in the Comptroller's office.

I think with the help of these gentlemen we should be able to answer most of the questions you might care to raise.

Chairman PROXMIRE. Before you start, I would like to ask a question which—this will not count on your time.

Mr. SHILLITO. I appreciate that, Mr. Chairman.

Chairman PROXMIRE. Your response to my question will not, but it is something that all of us are deeply concerned about, and I think you are in a good position to give us some light on, and it does not have anything to do with your testimony this morning.

As you know, we have greatly intensified our bombing raids over Vietnam. We have lost, on the basis of the present acknowledged re-

ports by our Government, we have lost some six B–52's. This seems to me to be extraordinary and alarming to have lost that many in such a short time of our bombing fleet.

Can you explain why we have lost that many and put it in perspective?

Mr. SHILLITO. Mr. Chairman, first of all, the operational side of defense is not really an I. & L. responsibility. I am sure though that the action that has been taken has been entirely thought through with the idea of moving us towards a sound peace. I would indeed have to assume the North Vietnamese have a competency that allows them to at least hit a few of these B–52's or it just wouldn't have happened, but other than that, Mr. Chairman, I do not feel that— –

Chairman PROXMIRE. You see——

Mr. SHILLITO [continuing]. It would not be proper for me to get into that.

Chairman PROXMIRE. I would not expect you to comment on the strategy, the wisdom of it or whatever, but what I would want you to tell us about is, you are an expert in procurement, why these B–52's are so vulnerable.

We have, as I understand it, what, 200 B–52's available for bombing there? We have lost six of them. We can hit with a hundred every day, and at this rate we are going to, it is going to be a very serious problem in a relatively short time, or is this something, could you tell us whether or not this is an alarming rate of loss?

Mr. SHILLITO. Mr. Chairman, I was a bomber pilot in World War II and it was not abnormal then to have a complete squadron wiped out in a bombing mission.

To me, of course, maybe just due to my background, six does not alarm me.

At the same time, I would have to say that you get very concerned when any of these kinds of things happen, no question about it. Again I would emphasize that operations are not a day-to-day concern of our installations and logistics people. Naturally, as an American citizen, it bothers me very much any time we lose a man or any time we lose an airplane, and I am sure this is the way the President feels and I am sure this is the way Secretary Laird feels.

COST OF B–52

Chairman PROXMIRE. How much do these B–52's cost?

Mr. SHILLITO. Any number that I would give you, Mr. Chairman, would be an estimate——

Chairman PROXMIRE. All right.

Mr. SHILLITO. [continuing]. At the time they were bought, do you recall, Mr. Malloy, I don't know whether anyone from the Air Force would recall, I would think about $10 million, maybe something like that. The unit flyaway cost for the B–52 was slightly less than $8 million.

Chairman PROXMIRE. And the replacement cost would be considerably higher.

Mr. SHILLITO. Indeed it would.

Chairman PROXMIRE. Might be twice as high.

Mr. SHILLITO. This is indeed possible, sir.

Chairman PROXMIRE. Twice as high wouldn't be unreasonable.

Can you give us any estimate of how much the increased bombing is costing?

Mr. SHILLITO. I cannot give you that, Mr. Chairman.

Chairman PROXMIRE. It makes sense that we would probably have to replace these bombers, too, wouldn't it? We cannot very well suffer a depletion, a loss of six in a week or less than a week and not replace them.

Mr. SHILLITO. Of course, it is only a portion of our B–52 fleet that is in the Pacific, as you know, sir.

Chairman PROXMIRE. Well, I understand about half of it.

Mr. SHILLITO. I had better stay away from where aircraft are and that sort of thing.

Chairman PROXMIRE. Yes; but the number is well known, it is around 400 or 500 B–52's, I guess, that are operational and about 200 of those are being used and losing six in less than a week the statistics are very depressing and alarming.

Well, thank you very much. Again I didn't mean to get you off the track. We have very important other information to discuss but thought it would be helpful to get your comment on it this morning.

Mr. SHILLITO. Mr. Chairman, as I mentioned to you in my letter of December 6, the transition, the budget responsibility. Vietnamization, all these things have taken on a greater priority than preparing for these hearings for which I apologize. I have consequently not had the opportunity to plan this hearing in the detail I would like to. Of course, the subject matters that were touched on in your letter that I responded to are subject matters that I have lived with for a long time and, with the help of the gentlemen I have with me I should be able to answer most of the questions that are specifically spelled out in your letter.

I regret very much that there are no other members of this committee able to be here today because the subject matters that you did want to touch on, as I say, are important. I wish they could have participated but possibly like myself, with the binds we have been in, including the holiday season, why, maybe they too have had problems, but I would suggest. However, recognizing the importance of that which we were talking about, that at an appropriate time the balance of your committee, sir, have the opportunity to get into some of these matters——

Chairman PROXMIRE. I can assure you they will.

We have some followup hearings in mind for this.

Mr. SHILLITO [continuing]. Because these gentlemen, many of them, have been very helpful to us in many ways as far as our problems of defense.

You say, and you are right, I have submitted a very voluminous report which I thought was necessary in order to cover the subject matter.

Chairman PROXMIRE. It is welcome, we are delighted to have it and, as I say, the full report will be made available to other members of the committee.

Mr. SHILLITO. Thank you.

I did not include in this report, nor do I plan to discuss, Mr. Chairman, programs in which negotiations are in process. I would like as best we can to stay with the subjects which you spelled out.

DEFENSE BUDGET

First of all, I will just make a comment or so on our defense budget.

As a percent of GNP it is lower today than it has been at any time in the past 2 decades. I want to emphasize that within Defense our budget has shifted, as you are aware, and almost 60 percent as we move into 1974, will be devoted to manpower costs. This compares with about 43 percent for manpower in 1964. We are spending many $20 billions more for people than was the case in 1964 and we have less people today in the Department of Defense for this additional $20 billion that we are spending than was the case in 1964.

In current dollars, defense spending has risen almost $25 billion since 1964; other Federal spending, about $103 billion; State and local spending, almost $113 billion.

Now, one thing I think we agree very much on is that we have to obtain more in the way of hardware for our defense dollars. Mel Laird feels this way, Dave Packard felt this way, Ken Rush feels this way and I feel this way, Mr. Chairman.

Consequently we have to minimize our manpower expenditures and we have to minimize the costs of individual weapons; if we do not, our force size, our weapons capability, is going to suffer.

Trend lines are such that our country could very easily find itself in a position of inferiority rather than parity. We just cannot allow this to happen.

Adm. Tom Moorer has made statements in this regard several times in the past year. He has suggested that particularly as regards strategic nuclear power between the United States and the Soviet Union, there has been a significant shift in power, and we no longer have the predominance of strategic power to provide what for a quarter of a century has significantly contributed to our avoidance of nuclear war.

With regard to the balance between the general purpose forces of the Soviet Union and the United States, he also made it clear that the Soviets were slowly coming abreast of us in relation to our tactical Air Force and are continuing to widen the gap in relation to our ground combat force.

MAJOR WEAPON SYSTEM

Next, I would like to touch briefly on major systems.

My prepared statement goes into detail on the entire major systems subject. Since early 1969 we have been attempting to do a better job as regard the acquisition of weapons systems. Our policies, as far as I am concerned, are sound. We are convinced that we are moving in the right direction.

The development concept paper, the area coordinating paper, Defense Systems Acquisition Review Council, cost analysis improvement group, our test and evaluation, prototype competition, the reduction of concurrency, designing to costs—all of these things I

touch on in the prepared statement. They are all interdependent. Again our policies are sound.

I would emphasize here that we have a lot to do in the implementation of our policies, no question about that, Mr. Chairman. It is not a question of new policies, it is the implementation of the policies that we have in most instances.

PROGRESS PAYMENTS

Now in your letter you touched on progress payments. This being, as you said, just before Christmas, I know that you are interested in progress payments. Before I discuss this subject I would like to emphasize one point. That is, that our problems in connection with most of the topics that you mentioned in your letter are surfaced as a result of our internal review; as a result of the internal reviews within the DOD. The audit reports on progress payments typify this.

We are, in essence, our own severest critic in most every way. At least we want to be our severest critic and, of course, we do surface these audit reports. These audit reports, in turn, for additional criticism on the part of other people.

Progress payments are an essential element of defense production. It has been a longstanding policy that we have progress payments. Most contracts, for complex hardware, involve extended periods of performance and large investment of contractors, and tie up their working funds. Without progress payments very few contractors would have the financial resources or working capital to perform defense work on major weapons systems. Thus, it is in the Government interests to make progress payments.

During the past year we have made four major changes with regard to progress payments. These changes, in most cases, were surfaced by our internal audit, our analysis of our operations.

First of all, we changed our payment of direct material and subcontract costs. Payments now are made only on the basis of cash disbursed. Other major changes include uniform biweekly payments; the elimination of the alternate method of recoupment or liquidation of progress payments until cost and profit trends are known; and more accurate data gathering on the status of our progress payments.

My prepared statement goes into these changes. These are changes again that I believe move us in the proper direction. I might mention, too, as indicated in my prepared statement, that we have had significant reduction in progress payments outstanding through June 1969.

Now, there is one other point that has to be made on progress payments and this deals with a misunderstanding on the part of a lot of people—such as, in your introductory comment, Mr. Chairman—as regards those instances when progress payments have been premature. That really is the proper word, premature.

I won't quarrel with the fact that there are such instances, there is no doubt about it. But, at the same time, many of the press releases

would give the average American the impression that we are paying more for the item involved than required. I want to clear up this possible misimpression. It is vital, I feel, to understand that providing premature working capital funds to a contractor should not be interpreted as a loss to the Government. It should be clearly understood that the deficiencies noted did not result in the payment of any significant amount that would not otherwise have been paid at some future period to the contractor involved. Admittedly, some payments again were premature, no question. We have taken into consideration this particular problem and I feel we have taken action to correct this.

So in summary, we believe we are moving in the right direction with regard to progress payments.

INDUSTRIAL PLANT EQUIPMENT

As far as industrial plant equipment—my next subject—when I appeared before the committee last year I was pleased to be able to tell you that we had been able to selectively reduce the amount of industrial plant equipment in the possession of contractors by 25 percent in the last 2 years. I am again pleased to state that this reduction is continuing. By June 30, 1972, the acquisition value of industrial plant equipment in the possession of contractors was down by 37 percent when compared to June 30, 1968.

My prepared statement goes into this in some detail, and I should mention here too, that on June 30, 1972, we had 461 phaseout plans that have been approved for Government-owned industrial plant equipment in contractor plants. As I recall it takes something like 650 phaseout plans in total to get this job done and we are moving in that direction.[1]

INDUSTRIAL PREPAREDNESS

My next subject is industrial preparedness. We find ourselves faced with a number of problems with regard to industrial preparedness. We are concerned about the impact of the defense expenditures on defense-related industries.

The disappearance of production capability for defense in terms of skills of people, has had serious implications, not only for industry and the economy as a whole, but more importantly for defense readiness in terms of preparedness plans. We have made many studies on this.

We were able to depict those industries that would be going through a declining period as far as defense expenditures are concerned. This decline has had a significant impact, as I said, on employment. We have also been able to highlight those industries that can maintain relative stability in the face of our declining defense budget. All of thse are tied to industrial preparedness.

As a consequence of our studies we are placing greater emphasis on industrial preparedness measures to assure the retention of sufficient capacity, when possible, to serve as a springboard for recreating the production base necessary to meet emergency or to meet mobilization requirements.

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[1] The full text of a GAO report on "Use of Government-Owned Equipment By Certain Large Contractors on Commercial and Defense Work," may be found on pp. 2493–2529.

AEROSPACE INDUSTRY

Next the aerospace industry. You asked that I talk about this. I have attempted to very briefly say a few words about the aerospace industry in my prepared statement.

Government policy as related to this industry has not been the primary responsibility, as you know, of the DOD. At the same time we are concerned, very concerned, with respect to the industry's health. This matter is of sufficient importance that I would urge that this committee make it a point to discuss the entire subject with others in the executive branch, Treasury, Commerce, Transportation, and others, sir. I had the occasion recently to review a depiction of the world market for aircraft, 1975 to 1985. It was estimated in this particular depiction that the world market for commercial aircraft would be about $148 billion in this 10-year period. It was also estimated that the United States could obtain about $118 to $120 billion of the $148 billion if we could compete, but that this will drop to something like $40 billion U.S. sales if we are not able to fully compete. This industry, of course, has received a lot of criticism, and an awful lot of the criticism of this industry is deserved. At the same time, this industry exports today something like $4 billion. The industry must reduce its costs, and in many instances its overhead in order to maintain its international competitive position. This we appreciate.

At the same time, this industry is one of the single largest areas on the positive side of our country's balance of payments ledger. I assume that this has to be a subject that this committee, of all committees, is particularly interested in because here is an industry that has problems but, at the same time, is able to compete on the international market better than any other segment of industry in this country. At the same time it has a lot of inefficiencies that have to be corrected while enhancing its international sales position.

Chairman PROXMIRE. We are going to have hearings on the 27th and 28th of this month on the supersonic transport which is only one phase, and a relatively modest phase.

Mr. SHILLITO. Sure.

Chairman PROXMIRE. But it has great implications for the future of this industry and, as I say we are going to have these hearings next week.

Mr. SHILLITO. All I am saying is that the Government has to help this industry. I am not talking about handout or anything like that, I am saying the Government cannot let the competency of this industry in the international marketplace get away from us. That is all I am really saying, Mr. Chairman, and I think this committee can help in seeing that does not happen.

I do not think there is too much necessity for me going into detail on the subject of profits.

DEFENSE PROFITS

The gong has rung. Christmas bells are ringing. Over half of my prepared statement deals with the subject of profits. This has to be a

subject that you are interested in above all others, just based on your press releases. You referred to our recent planned approach to profit on capital as a secret plan that would double profits of defense contractors at the expense of the taxpayers. Those are your words, and this is just completely incorrect, Mr. Chairman. I hope that you have gone over my prepared statement, and as a result of the questions and the discussion that can come out of our meeting today, that we can show you that your statement is just absolutely incorrect. In fact, I should say, Mr. Chairman, that based on a test whereby we superimposed the planned approach on a representative sample of the entire 1970 negotiated procurement universe, we determined that the aggregate going in profits will be about the same.

Now we can go into this to any degree that you might care to. I will admit that cosmetically some of the weightings look bad, but we are not in the business of doing things necessarily in a cosmetic way. So again I would urge that we get into this as deeply as you might care to. And again I emphasize this is a test. We are going to watch the test closely.

We also expect GAO to watch the test with us very closely. We expect to allow all and sundry to see what happens as a result of this test. We have a procurement circular out, Defense Procurement Circular 107, which I would like to introduce in the record. Again my prepared statement covers this entire subject rather thoroughly.

[The circular referred to follows:]

DEFENSE PROCUREMENT CIRCULAR

11 DECEMBER 1972 NUMBER 107

This Defense Procurement Circular is issued by direction of the Assistant Secretary of Defense (Installations and Logistics) pursuant to the authority contained in 5 U. S. Code 301, 10 U. S. Code 2202, DOD Directive No. 4105.30, and ASPR 1-106.

All Armed Services Procurement Regulation material and other directive material published herein is effective upon receipt except as otherwise indicated.

Unless otherwise indicated in the introductory language preceding an item, each item in this Circular shall remain in effect until the effective date of that subsequent ASPR revision which incorporates the item, or until specifically canceled.

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CONTENTS

ITEM I--MINORITY BUSINESS ENTERPRISE PROGRAM - REPORTING REQUIREMENTS

DD Form 1140-1 has been revised to require data from prime contractors on subcontract and purchase commitments to minority-owned concerns. A copy of the revised form is on the following page. Notwithstanding the statement on the bottom of the 1 September 1972 edition of the form, its use is optional for the quarterly reporting period October 1, 1972 through December 31, 1972, and mandatory thereafter.

DEFENSE PROCUREMENT CIRCULAR #107 — 11 DECEMBER 1972

DEFENSE SMALL BUSINESS SUBCONTRACTING PROGRAM QUARTERLY REPORT OF PARTICIPATING LARGE COMPANY ON SUBCONTRACT COMMITMENTS TO SMALL AND MINORITY BUSINESS CONCERNS

Form Approved OMB No. 22-R163

1. COGNIZANT MILITARY AGENCY AND REPRESENTATIVE		2. QUARTERLY PERIOD FROM / TO
3a. NAME OF COMPANY, PLANT OR DIVISION COVERED	b. ADDRESS (Number, Street, City, State and Zip Code)	
4a. NAME OF COMPANY IF DIFFERENT FROM ITEM 3a	b. ADDRESS (Number, Street, City, State and Zip Code)	
5a. MILITARY SUBCONTRACT AND PURCHASE COMMITMENTS TO SMALL BUSINESS CONCERNS (Net)	DOLLAR AMOUNT (To nearest Dollar)	c. TOTAL (5a + 5b)
b. MILITARY SUBCONTRACT AND PURCHASE COMMITMENTS TO LARGE BUSINESS CONCERNS (Net)	DOLLAR AMOUNT (To nearest Dollar)	
d. MILITARY SUBCONTRACT AND PURCHASE COMMITMENTS TO MINORITY BUSINESS CONCERNS (Net)	DOLLAR AMOUNT (To nearest Dollar)	
6a. TYPED NAME AND TITLE OF COMPANY OR SUBDIVISION LIAISON OFFICER	b. SIGNATURE	7. DATE OF REPORT

GENERAL INSTRUCTIONS

1 This report is to be submitted for each calendar quarter by all Defense contractors maintaining DEFENSE SMALL BUSINESS SUBCONTRACTING PROGRAMS, except small business concerns. The original of each report shall be submitted direct to Office of the Assistant Secretary of Defense (I&L), Attn: Director of Small Business and Economic Utilization Policy, Pentagon Building, Washington, D.C 20301. Four (4) copies shall be submitted to the cognizant military agency representative who established reporting arrangements under the Defense Small Business Subcontracting Program. Reports shall be submitted not more than 25 days after the close of the quarter being reported. Data pertaining to individual companies will be treated as confidential, for use of appropriate Department of Defense and Small Business Administration personnel only.

2. Each reporting company, division or plant shall report the required information for the reporting unit as a whole on the basis of the total "mix" of Department of Defense business, *(e.g., commitments for subcontracting work shall not be segregated as between subcontracts under prime or under subcontracts, nor as between subcontracts arising from work for the Army, Navy, Air Force or Defense Supply Agency).*

SPECIFIC INSTRUCTIONS

ITEM 1. Specify the military department or agency and its representative who established reporting arrangements under the Defense Subcontracting Small Business Program.

ITEM 2. Enter the day, month and year of the first and last days of the period covered by this report.

ITEM 3. Enter the name of the reporting company or subdivision thereof *(e.g., division or plant)* which is covered by the data submitted. A company may elect to report on a corporate, division or plant basis.

ITEM 4 If the report is for a division, plant or other subdivision of a company, enter the name of the company of which the reporting subdivision is a part.

ITEM 5a. Enter the net dollar amount of the commitments made by the reporting organization during the quarter to small business concerns for military contracts and purchases. The reporting company may accept the representation of a supplier that it is a small business concern under Definition 1.

b. Enter the net dollar amounts of commitments made by the reporting organization during the quarter to large business concerns for military subcontracts and purchases.

c. Enter the total net dollar amount of commitments made by the reporting organization during the quarter to all business concerns for military subcontracts and purchases.

d. Enter the net dollar amounts of commitments made by the reporting organization during the quarter to minority business concerns for military subcontracts and purchases. *(Included in a & b.)*

ITEM 6. Self explanatory.

ITEM 7. Enter the date *(day, month, year)* this report is submitted.

DEFINITIONS

1. SMALL BUSINESS CONCERN. A small business concern is a concern that meets the pertinent criteria established by the Small Business Administration and set forth in Paragraph 1-701 of the Armed Services Procurement Regulation.

2 MILITARY SUBCONTRACTS AND PURCHASES. Military subcontracts and purchases as used herein means procurement by a business concern of any article, material or service, including Defense portion of stock inventory and, where reasonably determined to be attributable to Defense contracting, purchases of plant maintenance, repair, operation, and capital equipment, entering into the performance of a military supply, service or facility contract received by that business concern from (i) a military department or (ii) another business concern. Procurement of Experimental, Developmental and Research work is to be included. *(NOTE: National Aeronautics and Space Administration and Atomic Energy Commission are not military departments for the purpose of this report.)*

3. COMMITMENTS. "Commitments" as used herein is defined as a contract, purchase order or other legal obligation executed by the reporting Company for goods and services to be received by the reporting Company. Commitment shall include increases to purchase orders and contracts less downward adjustments to purchase orders and contracts as a result of contract changes, cut-backs, or terminations.

4. MILITARY SUBCONTRACTS AND PURCHASE COMMITMENTS. Military subcontract and purchase commitments will include all commitments *(net, after adjustments)* to a supplier of subcontracted or purchased articles, materials or services as defined in 2 above except purchases from a company, division or plant which is an affiliate of the reporting Company.

5. MINORITY BUSINESS CONCERN. A minority business concern is a concern that meets the criteria set forth in Paragraph 1-332.3 of the Armed Services Procurement Regulation.

NOTE: Request for deviation from this reporting form must be submitted for consideration through the cognizant military agency to the office of the Assistant Secretary of Defense (I&L), Attn: Director of Small Business and Economic Utilization Policy.

IF ADDITIONAL SPACE IS NEEDED, USE REVERSE OF FORM.

DD, FORM 1140-1, SEP 72 — PREVIOUS EDITIONS OF THIS FORM ARE OBSOLETE.

ITEM II--INDEX OF 100 COMPANIES WHICH RECEIVED THE LARGEST DOLLAR VOLUME OF MILITARY PRIME CONTRACT AWARDS IN FISCAL YEAR 1972

(For Use in Distributing Renegotiation Performance Reports as Required by 1-319(e))

Company	Company
A M F, Inc.	Hayes International Corp.
A M General Corp.	Hercules, Inc.
A R O, Inc.	Honeywell, Inc.
Aerojet-General Corp.	Hughes Aircraft Co.
Aerospace Corp. (N)	Humble Oil & Refining Co.
American Telephone & Telegraph Co.	
Asiatic Petroleum Corp.	I C I America, Inc.
Avco Corp.	I T T Arctic Services, Inc.
	International Business Machines Corp.
Bendix Corp.	International Telephone & Telegraph Corp.
Boeing Co.	Itek Corp.
Caltex Oil Products Co.	
Chamberlain Mfg. Corp.	Johns Hopkins University (N)
Chrysler Corp.	
Collins Radio Co.	Kiewit-Morrison-Knudsen-Fischbach-Moore (JV)
Control Data Corp.	
Curtiss-Wright Corp.	
	L T V Aerospace Corp.
Day & Zimmerman, Inc.	Lear Siegler, Inc.
Diamond Reo Trucks, Inc.	Litton Systems, Inc.
	Lockheed Aircraft Corp.
E Systems, Inc.	
Eastman Kodak Co.	Magnavox Co.
Esso International Corp.	Martin-Marietta Aluminum Sales, Inc.
	Martin-Marietta Corp.
F M C Corp.	Massachusetts Institute of Technology (N)
Fairchild Camera & Instrument Corp.	Mason & Hanger Silas Mason Co.
Fairchild Industries, Inc.	McDonnell-Douglas Corp.
Federal Cartridge Corp.	MITRE Corp. (The) (N)
Federal Electric Corp.	Mobil Oil Corp.
Flying Tiger Corp.	Motorola, Inc.
G T E Sylvania, Inc.	National Presto Industries, Inc.
Garrett Corp.	Newport News Shipbuilding & Dry Dock Co.
General Dynamics Corp.	Norris Industries
General Electric Co.	North American Rockwell Corp.
General Motors Corp.	Northrop Corp.
Global Associates	
Goodyear Aerospace Corp.	Olin Corp.
Goodyear Tire & Rubber Co.	
Gould, Inc.	P R D Electronics, Inc.
Grumman Aerospace Corp.	Pacific Architects & Engineers, Inc.
Gulf & Western Industries	

Company	Company
Pan American World Airways, Inc.	T R W, Inc.
Philco-Ford Corp.	Texas Instruments, Inc.
	Teledyne, Inc.
R C A Corp.	Teledyne Industries, Inc.
Raymond-Morrison-Knudsen-Brown-Root-Jones (JV)	Textron, Inc.
Raytheon Co.	Thiokol Chemical Corp.
Remington Arms Co., Inc.	Uniroyal, Inc.
	United Aircraft Corp.
Sanders Associates, Inc.	United States Lines
Sea-Land Service, Inc.	
Shell Oil Co.	Vitro Corp. of America
Singer Co.	
Singer-General Precision, Inc.	Western Electric Co., Inc.
Sperry-Rand Corp.	Westinghouse Electric Corp.
Standard Oil Co. of California	Western Union Telegraph Co.
Standard Oil Co. of Indiana	
System Development Corp.	Xerox Corp.

(JV) Joint Venture
(N) Nonprofit Institution

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ITEM III--1973 EDITION OF ASPR

A new edition of the ASPR is in preparation. The new edition will consist of the 1969 edition and the eleven revisions issued through 28 April 1972, together with certain other changes approved for publication since Revision No. 11. It is currently planned that the new edition will be published as of 16 April 1973. Users of the Regulation contemplating a new or additional subscription to ASPR may wish to await the new edition.

* * * * *

ITEM IV--CONTRACTOR CAPITAL EMPLOYED POLICY

Policy Evaluation Period

3-808.7 Establishes a revised method for determining prenegotiation profit objectives under certain contracts by specifically recognizing contractor capital to be employed in contract performance.

Rather than constituting the implementation of a new policy, the publication of this regulation represents a continuation of policy development that began approximately three years ago. The regulation is being published now in order that a more comprehensive evaluation of the proposed policy may be conducted. All aspects of this regulation are subject to change as greater experience and understanding of the impact of its provision is gained during this controlled test period.

During this phase of the evaluation the proposed policy may be applied only to solicitations issued after 1 January 1973 meeting the criteria in 3-808.7(b) and only when mutually agreed by the offeror and the contracting officer. The offerors' requests for application of the contractor capital employed policy shall be submitted with the initial price proposal in response to the RFP.

Notwithstanding 3-808.7(b)(iv), the contractor capital employed policy may be applied to proposals ranging between $500,000 and $3 million, provided the offeror requesting application of the policy has received negotiated defense prime contract awards averaging between $500,000 and $3 million for the respective profit center during the previous twelve (12) month period. The decision to employ this concept on such contracts will require agreement between the contracting officer and the offeror.

Suggestions for changes to improve the approach for determining pre-negotiation profit objectives are solicited and should be directed through channels to the service monitor for this program.

Forms Reproduction

Local reproduction of forms is authorized.

Training Program

A training program covering utilization of this phase of the concept has been developed by the Department of Defense. The program is now in process and will be revised as changes to the policy are introduced. Personnel interested in attending the training seminars should check with their local procurement training office to determine specific eligibility criteria, dates, and locations of sessions.

Examples

Case examples illustrating application of the attached contractor capital employed policy are included.

DD Form 1499

A revised DD Form 1449 (1 Sep 72) and changes to Section XXI, Part 3, conforming to the new 3-808.7, are included in this DPC.

3-808.7 Contractor Capital Employed.

(a) General. On certain contracts (see paragraph (b) below), the weighted guidelines profit objective shall be adjusted to include recognition of the estimated amount of operating and facilities capital a contractor will employ in contract performance. This adjustment is designed to correct inequities and disincentives that can occur when a weighted guidelines profit objective based solely upon cost is used in negotiating contracts for which the ratio of required contractor investment to contract cost varies over a wide range. The recognition of capital is achieved through the use of a Contract Capital Index (CCI) as explained in (d) below.

(b) Applicability. A Contract Capital Index shall be computed and applied when each of the following criteria is met:

(i) the weighted guidelines (WGL) are applicable (3-808.2);

(ii) the primary purpose of the contract is production of hardware items;

(iii) the proposed engineering costs (engineering labor plus related overhead and G&A) are 25% or less of the total proposed in-house costs; and

(iv) the total estimated contract cost is $3 million or more.

Under normal circumstances, a Contract Capital Index shall not be computed for Time and Material contracts, contracts for services, research and development, inspection, repair and overhaul, and similar labor-intensive efforts.

(c) Determining a Profit or Fee Negotiation Objective. Except for "Selected Factors" and "Special Profit Consideration" an initial profit or fee objective is developed using the normal WGL method. Under the heading of "Selected Factors," the "Source of Resources" element is disregarded.

"Special Profit Consideration" (when applicable) shall be additive to the capital adjusted profit objective.

(d) Contract Capital Index. The Contract Capital Index is computed as follows:

(i) The amount of capital a contractor will use to perform a contract is computed (see paragraph (e) below).

(ii) This amount is divided into the total estimated contract cost to develop a "capital turnover rate."

(iii) Using the "capital turnover rate" and contract type, a Contract Capital Index (expressed as a percentage of cost) is obtained from the "Contract Capital Index Table."

(iv) The adjusted profit objective is computed by adding the Contract Capital Index to 50% of the profit or fee objective developed using weighted guidelines.

(e) Capital Employed.

(1) General. The capital estimated to be employed in the performance of a contract by a contractor shall be developed on the basis of separate estimates for Operating Capital and Facilities Capital.

(2) Operating Capital. For the purpose of the capital employed policy, Operating Capital is defined as the net current assets necessary for financing the performance of Federal Government contracts. The Operating Capital estimate for a proposed contract action shall be derived from the historical accounting data of a Profit Center unless one of the following conditions exists:

(i) the Profit Center has no negotiated contract experience for the last completed contractor fiscal year, for the contract type (either cost type or fixed price type) to be used; or

(ii) the average annual estimated cost of the contract is greater than 50% of the Profit Center's annual cost incurred for that contract type (cost or fixed price) in the last completed fiscal year; or

(iii) the Profit Center was during the last completed fiscal year, transferred from one DoD component to another for contract administration cognizance and/or payment action.

When any of the above conditions exists, the contractor shall be required to project operating capital requirements.

a. Historical Data Method.

1. DD Form 1858 "Profit Center Historical Operating Capital" shall be utilized by contractors to report the required account average balances recorded in the Profit Center's historical accounting records separately for cost type and fixed price type contracts for both prime and subcontract Federal Government business. This financial data shall include transactions attributable to all Government subcontracts being performed by the Profit Center.

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2. Section I of DD Form 1858 will normally be completed by a contractor annually, within 60 days following the close of the contractor's last completed fiscal year, and shall be used by all DoD procurement activities to estimate operating capital requirements for the entire performance period of a contemplated contract action. Section II of DD 1858 shall be completed by the Contracting Officer using his own cost objectives at the time of the pre-negotiation profit evaluation. For definitization of a letter contract, the latest complete contractor fiscal year available at the time the definitive contract is negotiated shall be used to estimate the Operating Capital requirements for the entire performance period of the contract.

3. Annual costs incurred are to be reported separately for cost and fixed price type contracts. Annual costs incurred are the total costs allowed or allowable under ASPR Section XV, Part 2.

4. All Federal Government work shall be included in calculating the amounts reported on DD Form 1858.

b. Projected Method. When it is necessary that Operating Capital requirements be estimated on an individual contract projection basis (see 3-807.7(e)(2)), the contractor shall complete DD Form 1859 "Contract Average Operating Capital Projection" in lieu of DD Form 1858. This method estimates the Operating Capital requirements on the basis of the cost incurrence, delivery, and payment schedules anticipated for an individual contract action. Consequently, contract Operating Capital estimates on DD Form 1859 shall be consistent with other related proposal data for that contract and, to a large degree, should be a by-product of this data. Justification for using this alternative method of estimating a contract's Operating Capital requirements shall be furnished with the DD Form 1859 as part of the proposal package.

(3) Facilities Capital.

a. Facilities Capital to be reported includes land, buildings, machinery, equipment, vehicles, tools, patterns and dies, furniture and fixtures, and similar capitalized property having a physical or bodily substance. All reported Facilities Capital shall be classified into one of the categories as described below:

(i) Land - Includes non-depreciable real estate and related non-depreciable improvements and property rights, including land leasehold improvements that are subject to amortization.

(ii) Buildings - Includes depreciable real estate and related depreciable improvements, including building leasehold improvements that are subject to amortization.

(iii) Equipment - Includes all reported Facilities Capital other than that classified as Land or Buildings, including all improvements not included in (i) or (ii) above that are subject to amortization.

b. The estimate of Facilities Capital to be employed in the performance of a proposed contract action is derived from "Overall Profit Center" facilities capital data projected by the contractor.

c. DD Form 1860 "Profit Center Facilities Capital Projection" shall be used by the contractor to project estimated book values of fixed assets to be employed by a Profit Center in the conduct of all its business, including non-Federal Government work. A separate Form 1860 shall be prepared for each contractor fiscal year during which Government contract performance is anticipated. Regardless of whether a contractor submits operating capital data on DD Form 1858 or 1859, DD Form 1860 shall be used for Facilities Capital projections. Submission of Forms 1858 and 1860 will be initiated under the same circumstances as Forward Pricing Rate Agreements (see 3-807.12(b)), and will normally be submitted and evaluated as complementary documents and procedures. If this procedure is not applicable, submissions may be made annually or with individual contract pricing proposals, as agreed to by the contractor and the cognizant ACO.

d. Facilities Capital to be reported for this purpose shall include only those tangible fixed assets (i) used in the regular business activities of a Profit Center, (ii) not intended for sale, (iii) capitalized on the books in accordance with the contractor's accepted accounting system, and (iv) that, except for land, are subject to an allowable depreciation or amortization expense in accordance with the contractor's accepted accounting system. Leasehold improvements (as distinguished from the lessor's real or personal property) and ADP system software that meet the criteria of (i) through (iv) above shall be reported as Facilities Capital. All other recorded intangible fixed assets, either subject to amortization (e.g., patents, copyrights, franchises), or not subject to amortization (e.g., goodwill, trademarks) shall not be reported as Facilities Capital.

e. Facilities Capital is the total net book values of: (i) all contractor-owned fixed assets recorded on the books of the Profit Center, (ii) all leased fixed assets, under control of the Profit Center, when constructive costs of ownership of such fixed assets have been allowed in lieu of rental costs, and (iii) an allocable share of general purpose assets of the nature of (i) and (ii) above which are held, or controlled by the corporation outside the Profit Center. Net book values reported for each year are after amortization and depreciation allowable under Section XV, Part 2, and are the average of the beginning and ending final year balances. The reported net book values of facilities available to a contractor for less than a full fiscal year's depreciation, or amortization should be reported on an annualized basis.

f. The projection of facilities (land, buildings, and equipment) book values and overhead allocation bases is an integral part of a contractor's overhead rate forecasting process. Therefore, projections of Facilities Capital data and allocation bases on DD Form 1860 shall be consistent with the data base used by a contractor for overhead rate forecasting. For example, net book values of fixed assets reported on DD Form 1860 shall be the same values that generate related depreciation expenses in projected overhead pools, and the Facilities Capital allocation bases shall be reconcilable with the bases projected for overhead rate pricing purposes.

g. If a Forward Pricing Rate Agreement for overhead rates has been negotiated, the inclusion or exclusion of net book value for capital-employed determinations shall be consistent with the allowability or unallowability of costs generated by those facilities, for overhead and pricing purposes. For example, if costs of excess facilities have been disallowed in forward pricing rates, the value of those same facilities shall be excluded from the capital base. The file shall contain similar information relative to the overhead and Facilities Capital allocation bases. When audited overhead data are used for contract pricing, both the audit report recommendations and subsequent contract pricing negotiations shall treat the facilities values and allocation bases reported on DD Form 1860, and the related facilities expenses and bases contained in the overhead rate(s) proposal on a consistent basis.

h. In either of the above methods for allocating indirect expenses to individual contracts, overhead rates often are arrived at on an "overall" basis, i.e., without settlement of individual elements of the overhead cost proposal. Under such circumstances it will be necessary, when establishing a contract profit objective, for the Government negotiators to estimate any adjustments to the proposed Facilities Capital data considered appropriate. Also, when an advance agreement covering the cost of idle facilities or idle capacity exists for a contractor Profit Center, the fixed asset values reported on DD Form 1860 shall be consistent with the provisions of such agreement.

i. Leased property is a special case. If full rental costs have been accepted in overhead pools, no capitalized value shall be recognized. If rental costs have been limited to the constructive cost of ownership, the constructive value of the leased property shall be recognized. When contractors enter into a long-term lease of property whereby the conditions of such lease require the advance payment by the tenant to the lessor of the total rental amount for the cumulative term of the lease, such prepaid rental payments made by the contractor under a long-term lease shall be treated similarly to contractor-owned fixed assets and a capitalized value of the prepayment shall be included in the category of "Leased Property" on the DD Form 1860, provided that the lease payments are

otherwise considered allowable under Section XV. The capitalized value reported for each year shall be the average of the prepaid lease account for the year, except when such leased facilities were available for only a portion of the year; in those circumstances, an annualized (see e. above) prepayment amount shall be reported. In the event any leased fixed assets are included as Facilities Capital, a separate attachment to DD Form 1860 shall show the following information:

(i) Description of the asset
(ii) Initial valuation of leased property and basis for value
(iii) Amortization Schedule
(iv) Net book value included on DD Form 1860
(v) Identification of Government authority and date when determination was made to allow only the constructive cost of ownership for the asset, in lieu of full lease or rental costs. (Not applicable in case of prepaid leases.)

j. A Profit Center is defined for this purpose as the lowest accounting level (e.g., division, plant, product line) for which the balance sheet items of accounts receivable, inventory, accounts payable, and tangible fixed assets (land, buildings and equipment) are available.

k. A Productive Burden Center is the accounting level within a Profit Center for which overhead rates are calculated for distribution of indirect costs. The Productive Burden Center structure listed on DD Form 1860 shall be compatible with that used for pricing purposes on the contractor's cost proposal (DD Form 633). DD Form 1860 shall include all Productive Burden Centers in the Profit Center, without regard to the proportions of Government and commercial business involved. Contractors utilize various methods of overhead pooling and distribution bases, sometimes with multiple allocations between pools. When an elaborate overhead allocation system is utilized, or when there are a large number of Productive Burden Centers within a Profit Center, contractors are encouraged to consolidate and simplify allocation of Facilities Capital to a limited number of allocation bases. However, any consolidated structure used shall be compatible with the contractor's cost breakdown, so that consolidated Facilities Factors can be equitably applied to appropriate contract allocation bases (see DD Form 1861).

l. Service or support centers are cost centers for the collection of costs for performing specific functional services, e.g., data processing center, plant services, administrative services, or wind tunnel facility. The fixed asset values of service or support centers whose costs are allocated to contracts through a G&A expense rate may be treated similarly to a Productive Burden Center or handled in accordance with the "undistributed" definition below. When service or support center costs are occasionally charged direct to customers

on a use charge basis, e.g., computer direct charge, the fixed asset values shall be handled similarly to a Productive Burden Center as defined above.

m. Distributed Facilities is the net book value of all fixed assets that are identified in the plant records as wholly assigned to a Productive Burden Center. Such identification usually results in related charges (e.g., depreciation or taxes) direct to the using burden center. When some costs of a service or support center are charged direct to customers on a "use charge" basis (e.g., computer center), the assets of such center shall be allocated between "distributed" and "undistributed" assets in the ratio that the service or support center direct charges bear to the indirect charges.

n. Undistributed Facilities is the net book value of all fixed assets which are not specifically assigned to a Productive Burden Center (e.g., housekeeping and general service equipment, land, or general plant buildings), and that portion of corporate fixed assets that are allocable to the Profit Center (e.g., general office equipment, corporate headquarters, and land). Undistributed assets are allocated to Productive Burden Centers on any reasonable basis that approximates the actual absorption of the related costs of such assets.

o. Allocation Bases are the direct input bases (e.g., direct labor dollars, direct labor hours, direct material dollars or machine hours) projected to be incurred in or by each Productive Burden Center (including service or support centers) for the purpose of allocating overhead costs or use charges. As stated in paragraph f. above, the estimated allocation base projected for the capital employed computation shall be consistent with the base projected for estimating overhead expense rates of each burden center. In addition, when a Productive Burden Center allocation base estimated for overhead rate purposes normally includes the efforts to be expended in the accomplishment of IR&D and B&P tasks, the allocation base for this profit on capital computation shall exclude such efforts. Such allocation base exclusions (e.g., engineering direct labor dollars, model shop direct labor hours) shall be consistent with the estimated amounts of these bases used in establishing the allowable costs under either an advance agreement or a formula computation.

(f) Evaluation of Contractor's Submissions.

(1) Contracting Officer Action.

a. The cognizant ACO shall, with the assistance of the cognizant auditor, evaluate contractor's capital-employed data when submitted. The evaluation shall be in writing and furnished to the PCO with other field pricing support information.

b. The PCO shall obtain the ACO and auditor's evaluation of capital-employed data prior to the negotiation of profit or fee for use in completing DD Form 1861, and Section II, DD Form 1858.

(g) Contract Capital Employed.

(1) DD Form 1861 and Section II of DD Form 1858 shall be prepared by the contracting officer based upon his cost estimate and assessment of the auditor's evaluation of capital data.

(2) The completed DD Form 1861 contains the various Profit Centers' operating and facilities capital-employed factors applicable to the contract cost objectives. It provides, by Profit Center, the estimated contractor operating and facilities capital to be employed, and, by dividing the total capital into the contract cost objective, determines the Capital Turnover Rate.

(h) Capital Risk Level.

(1) Compensation for cost risk is described in ASPR 3-808.5(c) and is related to contract type. Capital risk shall be related to contract type as follows:

Contract Type	Capital Risk Level
CPFF	Low
CPIF	Medium
FPI, FPR	High
FFP	Very High

(2) In those instances when contractor capital employed is considered in definitization of letter contracts for which more than 20% of the total expected costs have been incurred (including negotiated subcontracts), PCO's may select a lower Contract Capital Index. The selection should reflect the PCO judgment of the specific circumstances of the letter contract being definitized. The Contract Capital Index selected may vary between that index shown in the risk level column designated for the particular contract type and that shown in the next lower risk column for the capital turnover particular to the contract. In the case of CPFF contracts, the PCO may reduce the appropriate index by as much as 10%.

(3) When this Regulation is applicable to CPIF and FPI contracts for which the contractor share of costs in excess of target cost is more than 20% for CPIF and 30% for FPI contracts, the PCO may increase the appropriate Contract Capital Index by a maximum of 10%. Correspondingly, when the contractor's share is less than 20% for CPIF and 30% for FPI contracts, the PCO may apply a reduction of as much as 10%. The size of the incentive adjustment of a Contract Capital Index is dependent upon the PCO's assessment of the impact of the shareline upon the risk associated with the specific contract. In the case of multiple sharelines, a dollar weighted average shall be used in applying the test of applicability of this paragraph.

(4) In no event shall the effect of the flexibilities provided for in this paragraph serve to increase the ordinarily appropriate Contract Capital Index by more than 10%. Conversely, the compound effect of these flexibilities shall under no circumstances reduce the ordinarily appropriate Contract Capital Index below that shown in the next lower risk level column, or by more than 10% of the capital index shown in the low risk (CPFF) column.

(i) Contract Capital Index. The following table relates the Capital Risk Levels to Capital Turnover Rates to provide a Contract Capital Index.

CONTRACT CAPITAL INDEX TABLE

CAPITAL TURNOVER RATE	CAPITAL RISK LEVEL			
	LOW	MEDIUM	HIGH	VERY HIGH
1.2 & below	8.3	10.0	11.7	13.3
1.3	7.7	9.2	10.8	12.3
1.4	7.1	8.6	10.0	11.4
1.5	6.7	8.0	9.3	10.7
1.6	6.3	7.5	8.8	10.0
1.7	5.9	7.1	8.2	9.4
1.8	5.6	6.7	7.8	8.9
1.9	5.3	6.3	7.4	8.4
2.0	5.0	6.0	7.0	8.0
2.2	4.5	5.5	6.4	7.3
2.4	4.2	5.0	5.8	6.7
2.6	3.8	4.6	5.4	6.2
2.8	3.6	4.3	5.0	5.7
3.0	3.3	4.0	4.7	5.3
3.3	3.0	3.6	4.2	4.8
3.6	2.7	3.3	3.8	4.4
4.0	2.5	3.0	3.5	4.0
4.5	2.2	2.7	3.1	3.6
5.0	2.0	2.4	2.8	3.2
6.0	1.7	2.0	2.3	2.7
8.0	1.3	1.5	1.8	2.0
10.0	1.0	1.2	1.4	1.6
15.0	.7	.8	.9	1.1
20.0 & above	.5	.6	.7	.8

Interpolate when extracting the Contract Capital Index.

(j) Capital-Adjusted Profit Objective.

(1) DD Form 1547 shall be used by the contracting officer to determine a cost-based profit objective by the WGL method (except that the Source of Resources and Special Profit Consideration factors are omitted).

(2) The Contract Capital Turnover Rate (line 11) is carried forward from DD Form 1861. A Contract Capital Index (line 12) is extracted from the table and added to one-half the WGL profit objective to compute the Capital Adjusted Profit Objective (line 13).

(k) Total Profit Objective.

(1) The Total Profit Objective (line 15) is the sum of the Capital-Adjusted Profit Objective (line 13) and Special Profit Consideration (line 14).

(2) The Total Profit Objective (line 15) shall be used to negotiate the contract profit or fee.

(l) (not used)

(m) Administration and Reporting.

(1) To provide the data necessary for evaluation of the profit-on-capital policy, reports shall be made using DD Form 1858 (or DD Form 1859 if used), DD Form 1860, and DD Form 1861. DD Form 1499 shall continue to be used pursuant to 21-300 through 21-304. A complete reporting package shall consist of DD Forms 1499, 1858 (or 1859), 1860, and 1861.

(2) Applicability. The reporting requirement shall apply to those purchasing offices listed in 21-301.

(3) Coverage. Reports shall be submitted when both the following conditions are met:

a. A DD Form 1499 must be filed pursuant to 21-302.

b. The Contractor Capital Employed policy (3-808.7) is used in the development of pre-negotiation profit objective.

(4) Due Date and Distribution. The due date and distribution of the reports shall be the same as that prescribed for DD Form 1499 (21-303).

(5) Authority. The use of DD Forms 1858, 1859 and 1860 are authorized by OMB No. 22R0306. Authority for DD Form 1499 is cited in ASPR 21-303. The use of DD Form 1861 is authorized by RCS-DD-I&L(M)1216.

WEIGHTED GUIDELINES PROFIT/FEE OBJECTIVE

INSTRUCTIONS: 1. See ASPR 3-808 for determination of assigned weight factors.
2. See ASPR 3-811 for documentation of profit objective.

1. RFP/RFQ OR CONTRACT NO.	2. CONTRACTOR		3. CONTRACT TYPE	
4.	COST INPUT TO TOTAL PERFORMANCE (ASPR 3-808.3(b))			
COST CATEGORY a	GOVERNMENT'S COST OBJECTIVE b	ASPR 3-808 WEIGHT RANGE c	ASSIGNED WEIGHT d	WEIGHTED PROF.IT/FEE (Col b x d) e
DIRECT MATERIALS: PURCHASED PARTS	$	1% TO 4%	%	$
SUBCONTRACTED ITEMS		1% TO 8%	%	
OTHER MATERIALS		1% TO 4%	%	
ENGR DIRECT LABOR		9% TO 15%	%	
ENGR OVERHEAD		6% TO 9%	%	
MFG DIRECT LABOR		5% TO 9%	%	
MFG OVERHEAD		4% TO 7%	%	
OTHER COSTS			%	
			%	
			%	
			%	
GENERAL AND ADMINISTRATIVE		6% TO 9%	%	
TOTAL	$			$
5. COMPOSITE PROFIT/FEE ON COST INPUT TO TOTAL PERFORMANCE (Col e ÷ Col b)				PROFIT/FEE OBJECTIVE %
6. COST RISK	ASPR 3-808.5(c)	0% TO 7%		%
7. PERFORMANCE	ASPR 3-808.5(d)	-2% TO +2%		%
8. SELECTED FACTORS	ASPR 3-808.5(e) & .7(i)	-2% TO +2%		%
9. SPECIAL PROFIT	ASPR 3-808.6 & .7(j)	0% TO +6%		%
10. COST-BASED PROFIT/FEE OBJECTIVE (Lines 5 thru 9)				%
11. CONTRACT CAPITAL TURNOVER RATE			DD Form 1861	x
12. CONTRACT CAPITAL INDEX			ASPR 3-808.7(i)	%
13. CAPITAL-ADJUSTED PROFIT OBJECTIVE			Line 12 * 50% of Line 10	%
14. SPECIAL PROFIT (Replaces line 9 if applicable)			ASPR 3-808.7(j)	%
15. TOTAL PROFIT OBJECTIVE			(Line 13 + Line 14)	%
DATE	PREPARED BY		SIGNATURE	

DD FORM 1 SEPT 72 1547 PREVIOUS EDITION OF THIS FORM IS OBSOLETE.

PROFIT CENTER HISTORICAL OPERATING CAPITAL

CONTRACTOR: PROFIT CENTER: ADDRESS:	FISCAL YEAR ENDED

SECTION I

GROSS OPERATING CAPITAL REQUIRED *(Federal Government Contracts Only)*		CONTRACT TYPE	
		FIXED PRICE	COST REIMBURSEMENT
AVERAGE ACCOUNTS RECEIVABLE		A	B
AVERAGE GROSS INVENTORY		C	D
LESS PROGRESS PAYMENTS, ADVANCES, REIMBURSEMENTS AND OTHER CREDITS		E	F
AVERAGE NET INVENTORY INVESTMENT	C-E D-F	G	H
AVERAGE CONTRACT INVESTMENT	A+G B+H	I	J
ANNUAL COSTS INCURRED *(By Contract Type)*		K	L
GROSS OPERATING CAPITAL EMPLOYED FACTORS	I*K J*L	M •	N •

FINANCING BY TRADE ACCOUNTS PAYABLE		TOTAL PROFIT CENTER	FEDERAL GOVERNMENT CONTRACTS
AVERAGE TRADE ACCOUNTS PAYABLE		O	P
ANNUAL COSTS INCURRED	R= K+L	Q	R
ACCOUNTS PAYABLE FINANCING FACTOR	O*Q P*R	S •	T •

NET OPERATING CAPITAL EMPLOYED FACTORS		FIXED PRICE	COST REIMBURSEMENT
FIXED PRICE CONTRACTS	M-T=S	U •	
COST REIMBURSABLE CONTRACTS	N-T=S		V •

SECTION II

CONTRACT OPERATING CAPITAL *(Complete for each Procurement Action)*	RFP/CONTRACT PIIN NUMBER		CONTRACT TYPE
PERFORMING PROFIT CENTERS	CONTRACT ESTIMATED COSTS	NET OPERATING CAPITAL EMPLOYED FACTORS	ESTIMATED OPERATING CAPITAL REQUIRED
	W	X •	Y
		•	
		•	
OPERATING CAPITAL - TOTALS	Z		A*

DD FORM 1 SEP 72 1858

PROFIT CENTER HISTORICAL OPERATING CAPITAL

INSTRUCTIONS
(DD Form 1858)

Purpose. This form has two sections. The purpose of the first section is to determine the operating capital historically required by each Profit Center in performing the federal government contracts, in terms of a factor per dollar of costs incurred. The purpose of the second section is to determine the estimated operating capital required to perform a specific contract or procurement action, by application of the appropriate historical factor to the contract estimated or proposed costs.

Basis. The Profit Center operating capital data and factors should represent actual experience in the latest complete fiscal year, for federal government contracts or subcontracts and by the two principal types. Therefore the effects of commercial *(non-government)* production is excluded.

Net Operating Capital. Net Operating Capital Employed Factors represent the net investment after subtracting financing by Trade Accounts Payable.

Heading. Identify the contractor, Profit Center and Fiscal Year to which the historical data pertains.

SECTION I

Average Accounts Receivable (A & B). Enter the average federal government contract accounts receivable balances. Normally the sum of the monthly balances divided by twelve, although unusual billing or payment patterns may require more detailed analysis to determine a representative average.

Average Gross Inventory (C & D). Determine average contract gross inventory balances, by a monthly or more frequent method. Include raw materials, supplies, work in process and finished goods inventories committed to federal government contracts. Pooled inventories that support both government and commercial work should be allocated on a usage or other equitable basis.

Progress Payments, Advances, Reimbursements, Credits (E & F). Enter any credit balances recorded separately, that offset and reduce the contractors investment in inventories.

Average Net Inventory Investment (G & H). This is the average net investment after offsetting the above credit balances. If the contractor's system nets credits directly in the accounts, this average may be determined directly from the accounts, i.e. omit the 'Gross' and 'Credit' steps.

Average Contract Investment (I & J). The sum of Average Accounts Receivable and Average Net Inventory. These totals should reflect the contractor's average operating capital investment in each type of government contract.

Annual Cost Incurred (K & L). Enter the total annual costs incurred by the Profit Center on each type of contract. Costs unallowable under ASPR Section 15, and uncontracted costs *(e.g. contractor's share of cost-sharing contracts)* must be screened out so that these values are the same that flow through the above Accounts Receivable and Net Inventory.

FINANCING BY TRADE ACCOUNTS PAYABLE

Average Trade Accounts Payable (O & P). Trade Accounts Payable are the outstanding balances of 'outside' vendor, supplier and subcontractor billings, for purchases and subcontracts covering materials, components and services. Exclude non-trade payables and accruals, e.g. payrolls, taxes, insurance, contingencies and fees. Isolate Federal Government Contract payables if possible *(P).* Otherwise enter the Total Profit Center payables *(O).*

Annual Costs Incurred (Q & R). Enter total annual costs that correspond to the above Trade Accounts Payable. Government costs incurred *(R)* is the sum of the two contract types *(K + L).*

Accounts Payable Financing Factor (S & T). The quotient of Average Trade Accounts Payable divided by Annual Costs Incurred.

Net Operating Capital Employed Factors (U & V). The result of the Gross O.C. Factors *(M & N)* less the appropriate A P Financing Factor *(T or S).* This represents the contractor's net operating capital employed for each dollar of cost.

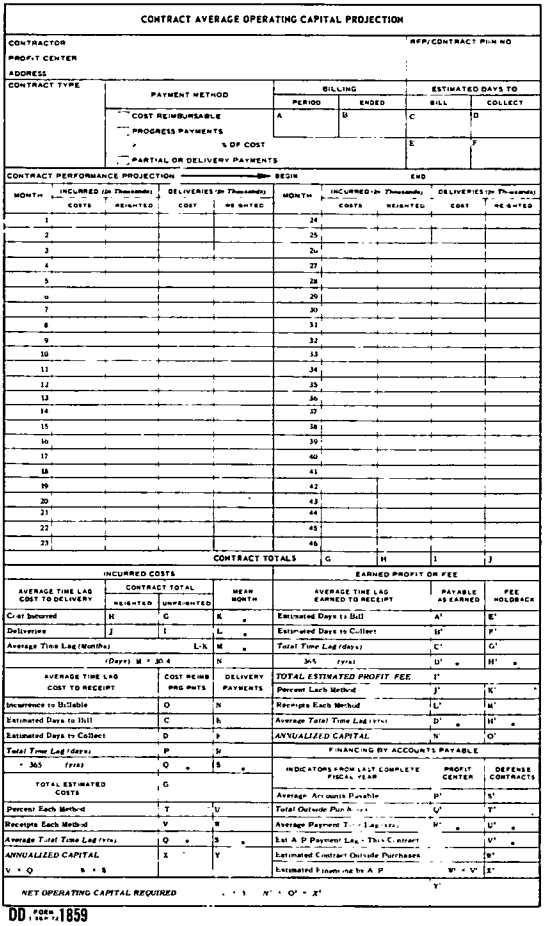
SECTION II
CONTRACT OPERATING CAPITAL

Timing & Identification. This section is completed only when estimating the operating capital requirements for an individual procurement action. Identify the specific RFP/Contract PIIN number and the contract type.

Performing Profit Centers and Contract Costs. List all Profit Centers expected to perform the contract, and enter the Contract Estimated Costs *(W)* to be incurred by each. The Total Costs *(Z)* must agree with the DD 633 cost proposal.

Net Operating Capital Employed Factors (X). The selection of the appropriate Net Operating Capital Employed Factor is determined by *(a)* the Profit Centers listed, and *(b)* the current Contract Type. Collect the latest historical data on Section(s) I for each Profit Center and determine the contract type for the current procurement action.

Estimated Operating Capital Required (Y). The product of Profit Center estimated costs *(W)* times the appropriate Operating Capital Factor *(X).* Sum the Profit Center requirements to arrive at the contract total operating capital *(A').*



CONTRACT AVERAGE OPERATING CAPITAL PROJECTION

CONTRACTOR — RFP/CONTRACT PLN NO

PROFIT CENTER

ADDRESS

CONTRACT TYPE

PAYMENT METHOD

- COST REIMBURSABLE
- PROGRESS PAYMENTS
- % OF COST
- PARTIAL OR DELIVERY PAYMENTS

BILLING PERIOD ENDED		ESTIMATED DAYS TO BILL	COLLECT
A	B	C	D
		E	F

CONTRACT PERFORMANCE PROJECTION — BEGIN — END

MONTH	INCURRED (In Thousands) COSTS	INCURRED (In Thousands) WEIGHTED	DELIVERIES (In Thousands) COST	DELIVERIES (In Thousands) WEIGHTED	MONTH	INCURRED (In Thousands) COSTS	INCURRED (In Thousands) WEIGHTED	DELIVERIES (In Thousands) COST	DELIVERIES (In Thousands) WEIGHTED
1					24				
2					25				
3					26				
4					27				
5					28				
6					29				
7					30				
8					31				
9					32				
10					33				
11					34				
12					35				
13					36				
14					37				
15					38				
16					39				
17					40				
18					41				
19					42				
20					43				
21					44				
22					45				
23					46				
CONTRACT TOTALS			G	H		I		J	

INCURRED COSTS

AVERAGE TIME LAG COST TO DELIVERY	CONTRACT TOTAL WEIGHTED	CONTRACT TOTAL UNWEIGHTED	MEAN MONTH
Cost Incurred	H	G	K
Deliveries	J	I	L
Average Time Lag (Months)		L-K	M
(Days) M × 30.4			N

AVERAGE TIME LAG COST TO RECEIPT	COST REIMB PRG PMTS	DELIVERY PAYMENTS
Incurrence to Billable	O	N
Estimated Days to Bill	C	b
Estimated Days to Collect	D	b
Total Time Lag (days)	P	M
× 365 (yrs)	Q	S
TOTAL ESTIMATED COSTS	G	
Percent Each Method	T	U
Receipts Each Method	V	W
Average Total Time Lag (yrs)	Q	S
ANNUALIZED CAPITAL	X	Y
V × Q	b × S	

EARNED PROFIT OR FEE

AVERAGE TIME LAG EARNED TO RECEIPT	PAYABLE AS EARNED	FEE HOLDBACK
Estimated Days to Bill	A'	E'
Estimated Days to Collect	B'	F'
Total Time Lag (days)	C'	G'
365 (yrs)	D'	H'
TOTAL ESTIMATED PROFIT FEE	I'	
Percent Each Method	J'	K'
Receipts Each Method	L'	M'
Average Total Time Lag (yrs)	D'	H'
ANNUALIZED CAPITAL	N'	O'

FINANCING BY ACCOUNTS PAYABLE

INDICATORS FROM LAST COMPLETE FISCAL YEAR	PROFIT CENTER	DEFENSE CONTRACTS
Average Accounts Payable	P'	S'
Total Outside Purchases	Q'	T'
Average Payment Time Lag (yrs)	R'	U'
Est A P Payment Lag - This Contract		V'
Estimated Contract Outside Purchases		W'
Estimated Financing by A P	W' × V'	X'

NET OPERATING CAPITAL REQUIRED . . . Y

DD FORM 1859

CONTRACT AVERAGE OPERATING CAPITAL PROJECTION
INSTRUCTIONS for DD Form 1659

PURPOSE. The purpose of this form is to estimate the contract average operating capital requirements, by relating projected contract costs and profits to the time required to recover those costs and profits from the government procurement activity or finance office.

METHOD OF PAYMENT. The various methods of payment by the government involve only three bases:

1. Payments based on costs incurred over time periods (Cost Reimbursement and Progress Payments).
2. Fee payments based on percent-of-completion, and
3. Payments based on physical delivery of end items or contract completion (Partial Payments and Delivery Payments).

This form accommodates conditions created by all three bases.

HEADING. Identify the Contractor and principal Profit Center, with address, where the contract will be performed. Identify the specific contract or contractual action by RFP or contract PIIN number. Identify the contract type.

PAYMENT METHOD. Check the appropriate blanks to show Cost Reimbursable or Partial/Delivery Payments. If a fixed contract authorizes Progress Payments, check that block and show the Progress Payment Rate (% of Cost). For Cost Reimbursable or Progress Payments, enter the Billing Period (e.g., monthly) and cut-off (e.g., EOM). For each method of payment checked, estimate the average days that will be required to bill and collect each series of payments under this specific contract and conditions. The estimated average days should be based on the most recent comparable experience with the specific procurement/administrative activity and finance office involved, adjusted for any conditions peculiar to this contract action. Since payment patterns vary substantially among government procurement/administrative activities and finance offices, the contractor should use (and be prepared to demonstrate) his recent actual experience with the government activities involved. For example, a history of unusual payment delays by specific government activities should be clearly reflected in the "estimated days to collect."

CONTRACT PERFORMANCE PROJECTION. Required only for Partial/Delivery Payments. The purpose is to establish the relationship between the rate of cost incurrence, and the rate of billable deliveries. Project the contract estimated cost over the proposed period of performance. Project deliveries (at either cost or price) over the anticipated realistic delivery schedule, not necessarily that requested in the RFP. Enter incurred and delivered cost to nearest thousand, e.g., $142,789 would be entered as $142. Weight each month's cost and deliveries by the nearest numerical (not calendar) month, e.g., 1st month's cost = 1, 5th month's deliveries = 5. Total all columns. Contract total costs (G) must agree with the cost proposal. Total deliveries (I must agree with either the proposed cost or price.

INCURRED COSTS

AVERAGE TIME LAG - COST TO DELIVERY. Required only for Partial/Delivery Payments. The purpose is to reduce the data shown in the average time lag in days between cost incurrence and billable delivery. Divide the contract total weighted costs incurred (H) by the unweighted (G) to determine the mean month of all costs. Divide the contract total weighted deliveries (J) by the unweighted (I), to determine the mean month of all deliveries. Subtract the cost mean (K) from the delivery mean (L) to determine the average time lag, from cost to delivery, in months (M). Multiply by 30.4 to convert the lag to Average Days (N).

AVERAGE TIME LAG - COST TO RECEIPT. This part develops the total time lag, from cost incurrence to recovery by government payment, for each of the two methods of payment. Use of the two columns must correspond with the payment method(s) checked above.

COST INCURRENCE TO BILLABLE:

- Cost Reimbursable or Progress Payments. Enter the number of days representing one-half of the billing period (O). This is the time lag from the mid-point or mean of the period's costs, to the date they become billable. For a monthly billing period, use 15.2 days.
- Delivery Payments. Enter the average time lag, in days, determined in Average Time Lag, Cost to Delivery (N).

DAYS TO BILL: Enter the estimated average days to bill each basis of payment (C & E). The cut-off is normally the date of billings, if they are promptly mailed.

DAYS TO COLLECT: Enter the estimated average days to collect each basis of payment (D & F). The cut-off is normally the day payment is first recorded in company records. Both Days to Bill and Days to Collect should be supportable by recent comparable experience, rather than broad average, since payment patterns vary among government procurement activities and finance offices. See "Payment Method" above.

TOTAL TIME LAG. Add each column to determine the Total Average Time Lag, in days, from cost incurrence to recovery. (P & R). Divide each column by 365 to convert days to fractions of a year (Q & S).

TOTAL ESTIMATED COSTS. Enter the total estimated costs proposed on DD Form 633. Must agree with Contract Totals above (G).

PERCENT UNDER EACH PAYMENT METHOD:

Cost Reimbursement only - 100% in first column (T).
Delivery Payments only - 100% in second column (U).
Progress Payments and Delivery Payments - stated percent of cost in the first column (e.g., 80%), remainder in the second column (e.g., 20%).

RECEIPTS UNDER EACH METHOD. Multiply the total estimated costs by the percent to be recovered under each basis. (V & W).

AVERAGE TOTAL TIME LAG (yrs): Bring down the respective Total Time Lags (yrs) from above (Q & S).

ANNUALIZED CAPITAL REQUIRED: Multiply the receipts under each method (V & W) by the appropriate Average Total Time Lag (yrs). (Q & S). Enter product in X & Y.

EARNED PROFIT OR FEE:

Average Time Lag - Earned to Receipt: The purpose is to estimate operating capital required because of delays in collecting contract profit or fee.

Estimated Days to Bill & Collect:

Fixed Price Profit - The entire time lag (A', B', C' & D') is identical to "Incurred Costs - Delivery Payments" (E & F).

Contract Fee:

Payable as Earned (A', B', C' & D') - estimate the average time lag for currently payable fee vouchers. The period begins with the end of the billing period (D).

Fee Holdback (E', F', G' & H') - estimate the time lag to bill and collect the fee holdback. The period begins with the date of contract completion.

TOTAL ESTIMATED PROFIT/FEE: Enter the total proposed on DD Form 633 in J'.

PERCENT EACH METHOD:

Fixed Price Profit - enter 100% in J'.
Cost-type Fee - enter the currently payable portion (e.g., 85%) in J'. Enter the close-out holdback (e.g., 15%) in K'.

RECEIPTS EACH METHOD: Multiply the total estimated profit or fee (J') by the percent to be paid each way (J' & K').

ANNUALIZED CAPITAL REQUIRED: Multiply the receipts under each method (L' & H') by the average time lag (D' & H'). Enter the products in N' & O'.

FINANCING BY ACCOUNTS PAYABLE:
INDICATORS FROM LAST COMPLETE FISCAL YEAR. Determine the average Trade Accounts Payable during the latest fiscal year, for both the total Profit Center and the Defense Contracts portion (P' & R'). If defense contract Accounts Payable are not isolated in the records, allocations based on outside purchases may be used to estimate.

TOTAL OUTSIDE PURCHASES. Enter the total outside purchases from suppliers and subcontractors that generated the above Trade Accounts Payable. (Q' & T').

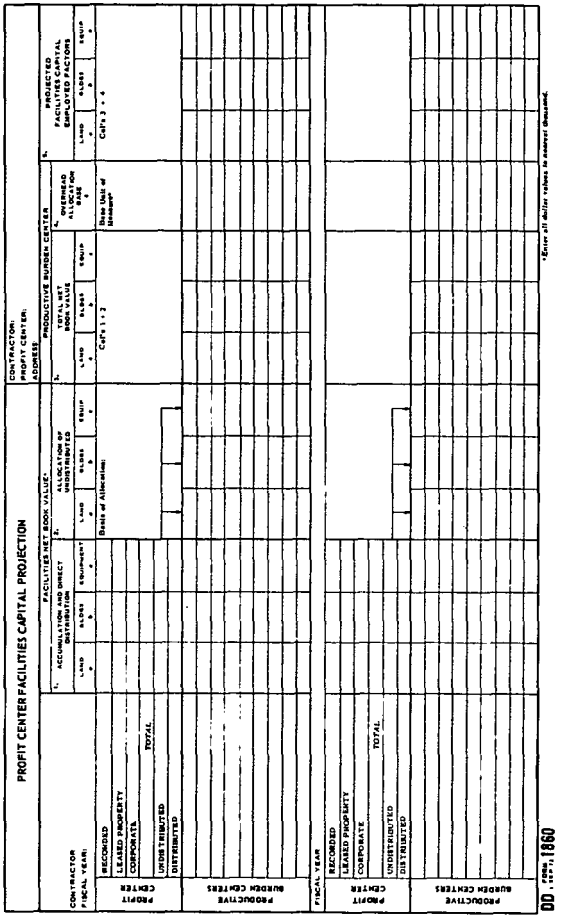
AVERAGE ACCOUNTS PAYABLE PAYMENT LAG (yrs). Divide each average Accounts Payable by the corresponding Total Outside Purchases, to determine the historical average payment lag for each class of purchases. (R' & U').

ESTIMATED ACCOUNTS PAYABLE PAYMENT LAG - THIS CONTRACT. Using the historical indicators as a guide, estimate a reasonable payment lag time for outside purchases under this contract (V'). Departures from the Defense Contract historical indicator should be supportable by anticipated changes in supplier/subcontractor relations.

ESTIMATED CONTRACT OUTSIDE PURCHASES. Total the planned outside direct purchases for this contract (W'). The estimate should agree with the DD Form 633 cost proposal, supporting shortout and/or the Make-or-Buy program. Common materials and supplies cleared thru stores should be included.

ESTIMATED FINANCING BY ACCOUNTS PAYABLE. Multiply Contract Outside Purchases by the estimated Accounts Payable payment lag, in years, to estimate the amount of contract financing by Trade Accounts Payable (X').

NET OPERATING CAPITAL REQUIRED. (Y'). Sum the annualized capital required for each series of payments (X + Y + N' + O') and subtract the Estimated Financing by Accounts Payable (X').



PROFIT CENTER FACILITIES CAPITAL PROJECTION

CONTRACTOR:
PROFIT CENTER:
ADDRESS:

CONTRACTOR FISCAL YEAR:	FACILITIES NET BOOK VALUE: 1. ACCUMULATION AND DIRECT DISTRIBUTION: LAND (a)	BLDGS (b)	EQUIPMENT (c)	2. ALLOCATION OF UNDISTRIBUTED: LAND (d)	BLDGS (e)	EQUIP (f)	PRODUCTIVE BURDEN CENTER 3. TOTAL NET BOOK VALUE: LAND (g)	BLDGS (h)	EQUIP (i)	4. PROPOSED ALLOCATION BASE	5. PROJECTED FACILITIES CAPITAL EMPLOYED FACTORS: LAND (j)	BLDGS (k)	EQUIP (l)
PROFIT CENTER													
RECORDED				Basis of Allocation:			Cols 1 + 2			Base Unit of Measure*	Cols 3 + 4		
LEASED PROPERTY													
CORPORATE													
TOTAL													
UNDISTRIBUTED													
DISTRIBUTED													
PRODUCTIVE BURDEN CENTERS													
FISCAL YEAR													
RECORDED													
LEASED PROPERTY													
CORPORATE													
TOTAL													
UNDISTRIBUTED													
DISTRIBUTED													
PRODUCTIVE BURDEN CENTERS													

*Enter all dollar values in nearest thousand.

DD FORM 1860

PROFIT CENTER FACILITIES CAPITAL PROJECTION

INSTRUCTIONS
(DD Form 1656)

PURPOSE. The purpose of this form is to (a) project and accumulate total facilities values for each Profit Center by contractor fiscal years, and (b) reduce those values to Facilities Capital Employed Factors applicable to the total Overhead Allocation Base of each Productive Burden Center.

BASIS. All data pertains to the same fiscal years for which the contractor prepares capital budgets and overhead projections, and should be compatible with both of those procedures. More specifically, facilities values projected here should relate to facility - generated costs proposed or allowed in overhead rate projections.

IDENTIFICATION. Identify the contractor, profit center, address and fiscal years to which the data pertains. Sufficient fiscal years must be projected to cover the estimated performance periods of contracts to be negotiated.

DEFINITIONS. See ASPR 3-808.7(e)(3)(i) for definitions of the facilities values to be included, the different sources and classes of those values, the distinction between Distributed and Undistributed facilities, and definitions of Productive Burden Centers and Overhead Allocation Bases.

PRODUCTIVE BURDEN CENTERS. List every Productive Burden Center within the Profit Center for which overhead rates are calculated for the allocation of indirect costs. The structure reported must be compatible with that used in DD 633 cost proposals or supporting detail.

LAND, BUILDINGS, EQUIPMENT. 'Land' is non-depreciable realty, improvements and property rights. 'Buildings' is depreciable realty and related improvements. 'Equipment' is all depreciable property other than Buildings.

RECORDED, LEASED PROPERTY, CORPORATE. 'Recorded' facilities are the normal Fixed Assets owned by and carried on the books of the Profit Center. 'Leased Property' is the capitalized value of leases for which constructive costs of ownership have been allowed in lieu of rental costs under ASPR 15-205.34 & .48. The government determination must be identified. 'Corporate' facilities are the Profit Center's allocable share of corporate-owned and leased facilities. All of the above are summed on the 'Total' line which represents the Profit Center's total facilities values recognized for this purpose.

DIRECT DISTRIBUTION. (Col's 1a, b, c). All facilities values that are identified in the plant records as wholly assigned to or located in Productive Burden Centers, are listed against the applicable P.B.C. Detail is totaled upward to the Profit Center 'Distributed' line. Profit Center 'Undistributed' is the remainder of the P.C. 'Total'. Both source and distribution of Profit Center facilities values must balance at the 'Total' line.

ALLOCATION OF UNDISTRIBUTED. (Col's 2a, b, c). Profit Center 'Undistributed' facilities are allocated to Productive Burden Centers on any reasonable basis that approximates the actual absorption of the related costs of such facilities. This allocation will usually reflect the method of allocating G&A and/or Service Center costs for the purpose of computing overhead rates.

PRODUCTIVE BURDEN CENTER
TOTAL NET BOOK VALUE (Col's 3a, b, c). The sum of Col's 1a, b, c, & 2a, b, c. Total each class of facility separately, and prove back to the Profit Center 'Total'.

OVERHEAD ALLOCATION BASE (Col 4). The direct input bases (e.g., DL$, DLH, DM$, M-H, etc.) projected to be incurred in or by each P.B.C. (including service/support centers) for the purpose of allocating overhead or use charges. Identify each base unit-of-measure, which must be compatible with the bases used for applied overhead in DD 633 cost proposals or supporting detail. Quantities must agree with negotiated overhead rates for forward pricing purposes or FPRAs (ASPR 3-807.12).

PROJECTED FACILITIES CAPITAL-EMPLOYED FACTORS (Col's 5a, b, c). The quotients of the P.B.C. Total Net Book Values (Col's 3a, b, c) separately divided by the P.B.C. Overhead Allocation Bases (Col. 4). Carry each Factor to three decimal places, e.g., X.XXX. This Factor represents the amount of Facilities Capital required to support each unit of the Overhead Allocation Base.

CONTRACT CAPITAL EMPLOYED

CONTRACTOR: PROFIT CENTER: ADDRESS:	RFP/CONTRACT PIIN NO.
	PERFORMANCE PERIOD

1. PROFIT CENTERS PRODUCTIVE BURDEN CENTERS	2. FISCAL YEARS	3. CONTRACT OVERHEAD ALLOCATION BASES	ESTIMATED FACILITIES CAPITAL EMPLOYED					
			4. FACILITIES FACTORS			5. FACILITIES AMOUNTS		
			LAND (a)	BLDGS (b)	EQUIP (c)	LAND (a)	BLDGS (b)	EQUIP (c)
6. CONTRACT FACILITIES CAPITAL EMPLOYED								
7. CONTRACT OPERATING CAPITAL EMPLOYED		*DD Form 1858 or 1859*						
8. TOTAL CAPITAL EMPLOYED		*Sum Lines 6 + 7*						
9. CONTRACT TOTAL ESTIMATED COST		*DD Form 1547*						
10. CONTRACT CAPITAL TURNOVER RATE		*Line 9 ÷ 8*				X		

DD FORM 1 SEP 72 1861

95-328 O - 73 - pt. 6 - 29

INSTRUCTIONS
(DD Form 1861)

PURPOSE. The purpose of this form is to compute the estimated Contract Capital Turnover Rate, as an index of capital employed on the Contract. An intermediate step is to determine the facilities capital to be employed in each Profit Center and Productive Burden Center, using the Facilities Factors developed on DD Form 1860.

HEADING. Complete the identification data at the top of the form. The Performance Period determines the Facilities Factors, by Fiscal Year, that must be used in the computations.

1. PROFIT CENTERS AND PRODUCTIVE BURDEN CENTERS. List the contractor Profit Centers and Productive Burden Centers that will perform work on this procurement action. The breakdown is extracted from the cost proposal shredout, price analysis report and/or audit report, and must correlate to the facilities breakdown used on DD Form 1860.

2. FISCAL YEARS. For each of the above organizational elements, breakout the Fiscal Years of performance by each. This breakout is secured from the same source as the above.

3. CONTRACT OVERHEAD ALLOCATION BASES. For each Productive Burden Center and Fiscal Year, enter the amount of the related Allocation Base used to derive the contract estimated total cost. These bases should be the same as those used for burdening contract overhead. The base units of measure (e.g., DL$, DLH, DM$, etc.) must agree with those used in Col. 4 of DD Form 1860.

4a, b & c. FACILITIES CAPITAL EMPLOYED FACTORS. Carry forward the appropriate Facilities Factors from Col's 5 of DD Form 1860. Profit Centers, Productive Burden Centers and Fiscal Years must agree.

5a,b & c. FACILITIES CAPITAL EMPLOYED AMOUNTS. The products of each Contract Overhead Allocation Base (3) times its related Facilities Factors (4a, b & c.).

6. CONTRACT FACILITIES CAPITAL EMPLOYED. Sum the above to determine the total facilities capital employed, by class.

7. CONTRACT OPERATING CAPITAL EMPLOYED. Carry forward the Operating Capital from DD Form 1858 or 1859.

8. TOTAL CAPITAL EMPLOYED. The sum of all classes of capital employed (lines 6 & 7).

9. CONTRACT TOTAL ESTIMATED COST. The total estimated or proposed cost, or cost objective, for the contract. For a contractor, this must agree with his DD Form 633 cost proposal. For a procurement contracting officer, with his DD Form 1547, total cost objective.

10. CONTRACT CAPITAL TURNOVER RATE. The quotient of Contract Total Estimated Cost (9) divided by the Contract Total Capital Employed (8).

EXAMPLES

INTRODUCTION

These examples are presented to demonstrate several ways of developing pre-negotiation profit objectives using the capital-employed concept. They are not all inclusive, but are intended to serve as guidance for parties in a negotiation. Application of this new policy requires the same good judgment and common sense by the negotiators for both sides as existing policies.

All examples have the same set of facts leading up through the determination of a capital turnover rate on DD Form 1861 (Contract Capital Employed). Further discussion of the procedure for developing the capital turnover rate is included in the instructions for DD Forms 1858 (Profit Center Historical Capital), 1859 (Contract Average Operating Capital Projection), 1860 (Profit Center Facilities Capital), and DD 1861 and the explanations accompanying each filled-out form in the example.

Both DD Forms 1858 (historical method) and 1859 (projected method) are filled out for purposes of this example only. In practice only one will be used; rules for determining the method to use are in ASPR 3-808.7 (e)(2). The examples are calculated in such a way that the operating capital is the same whether DD 1858 or DD 1859 is used. This is a very rare circumstance; it is done here to facilitiate subsequent steps in the example.

Since the operating capital is the same, the method used (historical or projected) makes no difference in determining the prenegotiation profit objective. When the historical method is used, the

Profit Adjustment for Additional Capital Investment (Item II of this DPC (page 68)) is added after negotiations are complete.

Using the turnover rate developed on Form 1861, several variations which the policy permits are shown. In all examples the weighted guidelines profit/fee objective is determined to be 10.004%. The only variation is in the areas where capital employed has an impact and are shown on the DD 1547 (revised).

Example 1 - Basic example, FPI contract 70/30 share line

Example 2 - Definitization of a Letter Contract

Example 3 - Contractor Cost Share Less Than 30%

Example 4 - Contractors Cost Share More Than 30%

Example 5 - Definitization of a Mature Letter Contract and Contractor Cost Share Less Than 30%

A more detailed explanation of each example accompanies the DD 1547 extract for it.

The complete list of items in the example package is as follows:

FACT SITUATION FOR ALL EXAMPLES

1. ABC, Inc., recently received Request for Proposal #N00099-72-R-99999 from an agency of the Department of Defense, for the design and manufacture of Target Drones. The RFP included the following terms and conditions:

a. The contract type would be Fixed Price Incentive (FPI).

b. Progress Payments would be made on 80% of 'eligible costs', under ASPR E-510.1 made effective 1/1/72 by DPC #94.

c. ABC, Inc. requests use of the capital-employed concept and therefore submits certain 'capital-employed' forms for each Profit Center, Productive Burden Center and Fiscal Year involved in performing the contract. (DD Forms 1858 (or 1859), 1860, and 1861).

d. After analysis of ABC, Inc. capital data the PCO approves offeror's request to consider capital employed in development of his prenegotiation profit objective.

2. ABC, Inc., included the organization chart on page 32 in their proposal package. Narrative information revealed that ABC intended to perform the contract entirely within their Government Group, involving both the Vehicle and Controls Divisions, and that the anticipated period of performance was from 3/1/72 to 9/30/73. Each division qualified as a separate Profit Center under the instructions provided in ASPR 3-808.7 and in turn contained Engineering and Manufacturing Productive Burden Centers, plus certain Service and Support Centers.

3. A DD Form 633 summarized ABC, Inc's., Price Proposal and was supported by a breakout by organizational segments and years of performance. The breakout is included on page 33. (The DD 633 summarizing the data is not shown.) All data was covered by a Certificate of Cost or Pricing Data since PL 87-653 applies, and was adequate for evaluation by the government negotiating team.

STEP-BY-STEP PROCEDURE

Step 1: Mr. Bill Smith, the Government Sales Manager for ABC, Inc. decides to respond to RFP #N00099-72-R-99999. He develops his cost data in the usual manner and prepares a cost breakout (page 33) and a DD 633. He also determines that no proposals have been previously submitted and evaluated for the current year in these profit centers, so he requests that Section I of DD 1858 and a DD 1860 be prepared by his staff for the Vehicles Division and for the Controls Division. (If DD 1858 - Section I and DD 1860 have already been prepared and the factors determined, no additional preparation is required. Copies of previous DD 1858 - Section I's and DD 1860's are adequate for inclusion with the proposal package.)

Step 2: Once the DD 1858 and DD 1860 for each profit center have been prepared, Bill completes the preparation of his proposal.

Step 3: Bill Smith submits the entire proposal to the requesting activity. It is given to the PCO along with other responses, and the cost and price analysis begins.

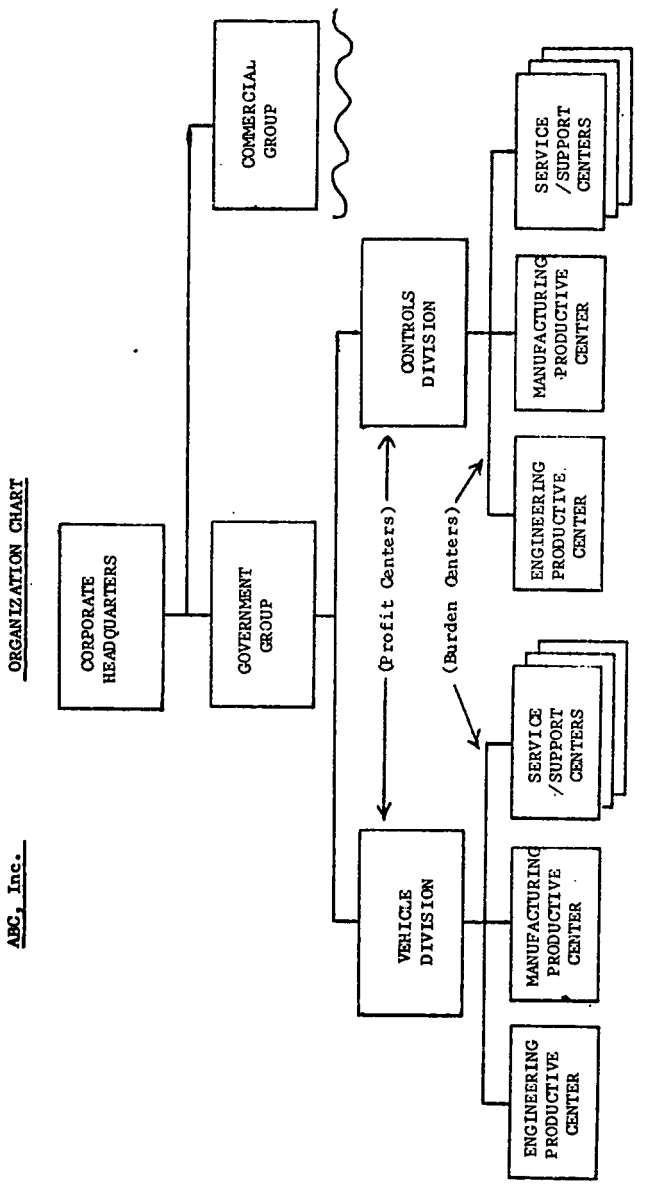
Step 4: Harry Charger, the PCO, requests audit and pricing assistance from the resident auditor or ACO. The auditor completes his evaluation of the DD 1858-Section I (or DD 1859) and DD 1860 data as part of his normal audit procedure and presents his audit report. When all the data is assembled, Harry and his staff develop their government cost estimates and capital factors.

Step 5: When the government cost estimate is prepared, Harry then prepares his DD 1858-II and DD 1861 and from that generates his pre-negotiation profit objective. He applies the operating capital and facilities capital factors to the cost estimates to determine contract capital employed and the turnover rate; also develops his weighted

guideline objective. He completes his DD 1547 - Weighted Guidelines Profit/Fee Objective (page 54) by determining the capital index and adding the other factors.

Step 6: Negotiations are conducted and concluded with an agreement satisfactory to both parties.

Step 7: Harry fills out the DD 1499, "Report of Individual Contract Profit Plan" (Revised) (page 60) and submits it through regular channels. As part of his reporting package he also submits the contractor's DD 1858 (or DD 1859) and DD 1860, and his own DD 1861.


ABC, Inc.
ORGANIZATION CHART
CORPORATE HEADQUARTERS
COMMERCIAL GROUP
GOVERNMENT GROUP
(Profit Centers)
(Burden Centers)
VEHICLE DIVISION
CONTROLS DIVISION
ENGINEERING PRODUCTIVE CENTER
MANUFACTURING PRODUCTIVE CENTER
SERVICE /SUPPORT CENTERS
ENGINEERING PRODUCTIVE CENTER
MANUFACTURING PRODUCTIVE CENTER
SERVICE /SUPPORT CENTERS

COST PROPOSAL BREAKOUT
(SUPPORT FOR DD 633)

COST ELEMENT	VEHICLE DIVISION			CONTROLS DIVISION			TOTAL
	1972	1973	Total	1972	1973	Total	COSTS
Direct Materials							
Purchased Parts			25,000			85,000	110,000
Subcontracted Items			765,000			225,000	990,000
Engineering Labor	66,000	9,000	75,000	210,000	45,000	255,000	330,000
Engineering Overhead	85,000	15,000	100,000	295,000	65,000	360,000	460,000
Manufacturing Labor	125,000	575,000	700,000	210,000	300,000	510,000	1,210,000
Manufacturing Overhead	145,000	675,000	820,000	280,000	420,000	700,000	1,520,000
Other Direct Costs			140,000			80,000	220,000
SUBTOTAL			2,625,000			2,215,000	4,840,000
General & Administrative			330,000			330,000	660,000
TOTAL COST PROPOSED			2,955,000			2,545,000	5,500,000
PROFIT @ 15%							825,000
TOTAL PRICE PROPOSED							6,325,000

TEST FOR APPLICABILITY OF
CAPITAL-EMPLOYED CONCEPT
ASPR 3-808.7 (b) (iii)

RATIO OF ENGINEERING COSTS TO IN-HOUSE COSTS

PROPOSED ENGINEERING COSTS:			
Labor		330,000	
Overhead		460,000	
		790,000	
G&A ($\frac{660,000}{4,840,000}$ = 13.639%)			108,000
TOTAL ENGINEERING			898,000
PROPOSED IN-HOUSE COSTS:			
Total Cost		5,500,000	
Less Outside Procurement:			
Purchased Parts	110,000		
Subcontracted	990,000	1,100,000	
TOTAL IN-HOUSE			4,400,000
RATIO OF ENGINEERING TO IN-HOUSE			20.409%

Note to DD Form 1858

1. This historical method for estimating working capital is a much easier method for estimating operating capital in most instances. It is intended to be prepared annually by the contractor not more than 60 days after the close of his fiscal year and can be audited by DCAA at the same time as data is audited for Forward Pricing Rate Agreements (where FPRA's are used). For the second and successive contracts involving a profit center in a fiscal year, the information in Section I should be available.

2. Information on payables specifically for Federal Government Contracts should be used if available, because it is more relevant. In many instances it will not be available and information for the profit center can be used as a substitute. The DD 1858's in the example have entries under the "Federal Government Contracts" heading (labeled P, R,& T). Had this not been available, entries O, Q, and S would have been used. The same Accounts Payable Financing Factor (either entry S or T) is subtracted from both fixed price and cost reimbursable Gross Operating Capital Employed Factors to arrive at the Net Operating Capital Employed Factors for the respective contract types.

3. Section II is prepared in accordance with the instructions on the form. It must be filled out for each contract action by the contracting officer. Since operating capital allocated depends on the cost estimate used, operating capital estimates used by contractors and contracting officers will differ by a factor reflecting the different cost estimates used. Section II - DD 1858 on page 38 reflects the contractor's cost estimate and the operating capital factors developed. The PCO's "markup" using his own cost estimates is on page 50.

PROFIT CENTER HISTORICAL OPERATING CAPITAL

Form Approved
O.M.B. No. 22R0306

CONTRACTOR: ABC, Inc.
PROFIT CENTER: Vehicle Division
ADDRESS:

FISCAL YEAR ENDED: 12-31/71

SECTION I

GROSS OPERATING CAPITAL REQUIRED (Federal Government Contracts Only)		CONTRACT TYPE: FIXED PRICE	CONTRACT TYPE: COST REIMBURSEMENT
AVERAGE ACCOUNTS RECEIVABLE		A 1,100,000	B 2,200,000
AVERAGE GROSS INVENTORY		C 20,200,000	D 18,000,000
LESS PROGRESS PAYMENTS, ADVANCES, REIMBURSEMENTS AND OTHER CREDITS		E 15,150,000	F 18,000,000
AVERAGE NET INVENTORY INVESTMENT	C-E D-F	G 5,050,000	H 0
AVERAGE CONTRACT INVESTMENT	A+G B+H	I 6,150,000	J 2,200,000
ANNUAL COSTS INCURRED (By Contract Type)		K 30,000,000	L 20,000,000
GROSS OPERATING CAPITAL EMPLOYED FACTORS	I+K J+L	M .205	N .110
FINANCING BY TRADE ACCOUNTS PAYABLE		**TOTAL PROFIT CENTER**	**FEDERAL GOVERNMENT CONTRACTS**
AVERAGE TRADE ACCOUNTS PAYABLE		O	P 1,500,000
ANNUAL COSTS INCURRED	R= K+L	Q	R 50,000,000
ACCOUNTS PAYABLE FINANCING FACTOR	O+Q P+R	S .	T .030
NET OPERATING CAPITAL EMPLOYED FACTORS		**FIXED PRICE**	**COST REIMBURSEMENT**
FIXED PRICE CONTRACTS	M-T or S	U .175	
COST REIMBURSABLE CONTRACTS	N-T or S		V .080

SECTION II

CONTRACT OPERATING CAPITAL (Complete for each Procurement Action)	RFP/CONTRACT PIIN NUMBER		CONTRACT TYPE
PERFORMING PROFIT CENTERS	CONTRACT ESTIMATED COSTS	NET OPERATING CAPITAL EMPLOYED FACTORS	ESTIMATED OPERATING CAPITAL REQUIRED
	W	X .	Y
		.	
		.	
OPERATING CAPITAL - TOTALS	Z		A'

DD FORM 1 SEP 72 1858

PROFIT CENTER HISTORICAL OPERATING CAPITAL

INSTRUCTIONS
(DD Form 1858)

Purpose. This form has two sections. The purpose of the first section is to determine the operating capital historically required by each Profit Center in performing the federal government contracts, in terms of a factor per dollar of costs incurred. The purpose of the second section is to determine the estimated operating capital required to perform a specific contract or procurement action, by application of the appropriate historical factor to the contract estimated or proposed costs.

Basis. The Profit Center operating capital data and factors should represent actual experience in the latest complete fiscal year, for federal government contracts or subcontracts and by the two principal types. Therefore the effects of commercial *(non-government)* production is excluded.

Net Operating Capital. Net Operating Capital Employed Factors represent the net investment after subtracting financing by Trade Accounts Payable.

Heading. Identify the contractor, Profit Center and Fiscal Year to which the historical data pertains.

SECTION I

Average Accounts Receivable (A & B). Enter the average federal government contract accounts receivable balances. Normally the sum of the monthly balances divided by twelve, although unusual billing or payment patterns may require more detailed analysis to determine a representative average.

Average Gross Inventory (C & D). Determine average contract gross inventory balances, by a monthly or more frequent method. Include raw materials, supplies, work in process and finished goods inventories committed to federal government contracts. Pooled inventories that support both government and commercial work should be allocated on a usage or other equitable basis.

Progress Payments, Advances, Reimbursements, Credits (E & F). Enter any credit balances recorded separately, that offset and reduce the contractors investment in inventories.

Average Net Inventory Investment (G & H). This is the average net investment after offsetting the above credit balances. If the contractor's system nets credits directly in the accounts, this average may be determined directly from the accounts, i.e. omit the 'Gross' and 'Credit' steps.

Average Contract Investment (I & J). The sum of Average Accounts Receivable and Average Net Inventory. These totals should reflect the contractor's average operating capital investment in each type of government contract.

Annual Cost Incurred (K & L). Enter the total annual costs incurred by the Profit Center on each type of contract. Costs unallowable under ASPR Section 15, and uncontracted costs *(e.g. contractor's share of cost-sharing contracts)* must be screened out so that these values are the same that flow through the above Accounts Receivable and Net Inventory.

FINANCING BY TRADE ACCOUNTS PAYABLE

Average Trade Accounts Payable (O & P). Trade Accounts Payable are the outstanding balances of 'outside' vendor, supplier and subcontractor billings, for purchases and subcontracts covering materials, components and services. Exclude non-trade payables and accruals, e.g. payrolls, taxes, insurance, contingencies and fees. Isolate Federal Government Contract payables if possible *(P)*. Otherwise enter the Total Profit Center payables *(O)*.

Annual Costs Incurred (Q & R). Enter total annual costs that correspond to the above Trade Accounts Payable. Government costs incurred *(R)* is the sum of the two contract types *(K + L)*.

Accounts Payable Financing Factor (S & T). The quotient of Average Trade Accounts Payable divided by Annual Costs Incurred.

Net Operating Capital Employed Factors (U & V). The result of the Gross O.C. Factors *(M & N)* less the appropriate A/P Financing Factor *(T or S)*. This represents the contractor's *net* operating capital employed for each dollar of cost.

SECTION II
CONTRACT OPERATING CAPITAL

Timing & Identification. This section is completed only when estimating the operating capital requirements for an individual procurement action. Identify the specific RFP/Contract PIIN number and the contract type.

Performing Profit Centers and Contract Costs. List all Profit Centers expected to perform the contract, and enter the Contract Estimated Costs *(W)* to be incurred by each. The Total Costs *(Z)* must agree with the DD 633 cost proposal.

Net Operating Capital Employed Factors (X). The selection of the appropriate Net Operating Capital Employed Factor is determined by *(a)* the Profit Centers listed, and *(b)* the current Contract Type. Collect the latest historical data on Section(s) I for each Profit Center and determine the contract type for the current procurement action.

Estimated Operating Capital Required (Y). The product of Profit Center estimated costs *(W)* times the appropriate Operating Capital Factor *(X)*. Sum the Profit Center requirements to arrive at the contract total operating capital *(A')*.

PROFIT CENTER HISTORICAL OPERATING CAPITAL

Form Approved
O.M.B. No. 22R0306

CONTRACTOR: ABC, Inc.
PROFIT CENTER: Controls Division
ADDRESS:

FISCAL YEAR ENDED: 12-31/71

SECTION I

GROSS OPERATING CAPITAL REQUIRED (Federal Government Contracts Only)		CONTRACT TYPE: FIXED PRICE	CONTRACT TYPE: COST REIMBURSEMENT
AVERAGE ACCOUNTS RECEIVABLE		A 900,000	B 1,140,000
AVERAGE GROSS INVENTORY		C 13,040,000	D 9,000,000
LESS PROGRESS PAYMENTS, ADVANCES, REIMBURSEMENTS AND OTHER CREDITS		E 9,780,000	F 9,000,000
AVERAGE NET INVENTORY INVESTMENT	C-E D-F	G 3,260,000	H 0
AVERAGE CONTRACT INVESTMENT	A+G B+H	I 4,160,000	J 1,140,000
ANNUAL COSTS INCURRED (By Contract Type)		K 20,000,000	L 10,000,000
GROSS OPERATING CAPITAL EMPLOYED FACTORS	I÷K J÷L	M .208	N .114
FINANCING BY TRADE ACCOUNTS PAYABLE		**TOTAL PROFIT CENTER**	**FEDERAL GOVERNMENT CONTRACTS**
AVERAGE TRADE ACCOUNTS PAYABLE		O	P 1,050,000
ANNUAL COSTS INCURRED	R= K+L	Q	R 30,000,000
ACCOUNTS PAYABLE FINANCING FACTOR	O÷Q P÷R	S .	T .035
NET OPERATING CAPITAL EMPLOYED FACTORS		**FIXED PRICE**	**COST REIMBURSEMENT**
FIXED PRICE CONTRACTS	M-T or S	U .173	
COST REIMBURSABLE CONTRACTS	N-T or S		V .079

SECTION II

CONTRACT OPERATING CAPITAL (Complete for each Procurement Action)	RFP/CONTRACT PIIN NUMBER		CONTRACT TYPE
	N00099-72-R-99999		FPI
PERFORMING PROFIT CENTERS	**CONTRACT ESTIMATED COSTS**	**NET OPERATING CAPITAL EMPLOYED FACTORS**	**ESTIMATED OPERATING CAPITAL REQUIRED**
VEHICLE DIVISION	W 2,955,000	X .175	Y 517,000
CONTROLS DIVISION	2,545,000	.173	440,000
		.	
OPERATING CAPITAL - TOTALS	Z 5,500,000		A' 957,000

DD FORM 1 SEP 72 1858

PROFIT CENTER HISTORICAL OPERATING CAPITAL

INSTRUCTIONS

Purpose. This form has two sections. The purpose of the first section is to determine the operating capital historically required by each Profit Center in performing the federal government contracts, in terms of a factor per dollar of costs incurred. The purpose of the second section is to determine the estimated operating capital required to perform a specific contract or procurement action, by application of the appropriate historical factor to the contract estimated or proposed costs.

Basis. The Profit Center operating capital data and factors should represent actual experience in the latest complete fiscal year, for federal government contracts or subcontracts and by the two principal types. Therefore the effects of commercial *(non-government)* production is excluded.

Net Operating Capital. Net Operating Capital Employed Factors represent the net investment after subtracting financing by Trade Accounts Payable.

Heading. Identify the contractor, Profit Center and Fiscal Year to which the historical data pertains.

SECTION I

Average Accounts Receivable (A & B). Enter the average federal government contract accounts receivable balances. Normally the sum of the monthly balances divided by twelve, although unusual billing or payment patterns may require more detailed analysis to determine a representative average.

Average Gross Inventory (C & D). Determine average contract gross inventory balances, by a monthly or more frequent method. Include raw materials, supplies, work in process and finished goods inventories committed to federal government contracts. Pooled inventories that support both government and commercial work should be allocated on a usage or other equitable basis.

Progress Payments, Advances, Reimbursements, Credits (E & F). Enter any credit balances recorded separately, that offset and reduce the contractors investment in inventories.

Average Net Inventory Investment (G & H). This is the average net investment after offsetting the above credit balances. If the contractor's system nets credits directly in the accounts, this average may be determined directly from the accounts, i.e. omit the 'Gross' and 'Credit' steps.

Average Contract Investment (I & J). The sum of Average Accounts Receivable and Average Net Inventory. These totals should reflect the contractor's average operating capital investment in each type of government contract.

Annual Cost Incurred (K & L). Enter the total annual costs incurred by the Profit Center on each type of contract. Costs unallowable under ASPR Section 15, and uncontracted costs *(e.g. contractor's share of cost-sharing contracts)* must be screened out so that these values are the same that flow through the above Accounts Receivable and Net Inventory.

FINANCING BY TRADE ACCOUNTS PAYABLE

Average Trade Accounts Payable (O & P). Trade Accounts Payable are the outstanding balances of 'outside' vendor, supplier and subcontractor billings, for purchases and subcontracts covering materials, components and services. Exclude non-trade payables and accruals, e.g. payrolls, taxes, insurance, contingencies and fees. Isolate Federal Government Contract payables if possible *(P).* Otherwise enter the Total Profit Center payables *(O).*

Annual Costs Incurred (Q & R). Enter total annual costs that correspond to the above Trade Accounts Payable. Government costs incurred *(R)* is the sum of the two contract types *(K + L).*

Accounts Payable Financing Factor (S & T). The quotient of Average Trade Accounts Payable divided by Annual Costs Incurred.

Net Operating Capital Employed Factors (U & V). The result of the Gross O.C. Factors *(M & N)* less the appropriate A/P Financing Factor *(T or S).* This represents the contractor's *net* operating capital employed for each dollar of cost.

SECTION II
CONTRACT OPERATING CAPITAL

Timing & Identification. This section is completed only when estimating the operating capital requirements for an individual procurement action. Identify the specific RFP/Contract PIIN number and the contract type.

Performing Profit Centers and Contract Costs. List all Profit Centers expected to perform the contract, and enter the Contract Estimated Costs *(W)* to be incurred by each. The Total Costs *(Z)* must agree with the DD 633 cost proposal.

Net Operating Capital Employed Factors (X). The selection of the appropriate Net Operating Capital Employed Factor is determined by *(a)* the Profit Centers listed, and *(b)* the current Contract Type. Collect the latest historical data on Section(s) I for each Profit Center and determine the contract type for the current procurement action.

Estimated Operating Capital Required (Y). The product of Profit Center estimated costs *(W)* times the appropriate Operating Capital Factor *(X).* Sum the Profit Center requirements to arrive at the contract total operating capital *(A').*

95-328 O - 73 - pt. 6 - 30

Note to DD Form 1859

1. The projected method for estimating operating capital requires significantly more data than the historical method and is for use only when historical data is an inadequate or inappropriate basis for estimating. It has the disadvantages of requiring much more estimated data and having to be completed in its entirety for each contract action.

2. Costs for all profit centers performing work under a contract are aggregated on one DD 1859. Unlike the historical method which requires a DD 1858-Section I for each profit center, there will be only one DD 1859 per proposal.

3. The net operating capital required total is carried forward to line 7 on DD 1861.

CONTRACT AVERAGE OPERATING CAPITAL PROJECTION

Form Approved
O.M.B. No. 22R0306

CONTRACTOR: ABC, Inc.
PROFIT CENTER: VEHICLE & CONTROLS DIVISIONS
ADDRESS:

RFP/CONTRACT PIIN NO.: N00099-72-R-99999

CONTRACT TYPE	PAYMENT METHOD	BILLING PERIOD A	BILLING ENDED B	ESTIMATED DAYS TO BILL C	ESTIMATED DAYS TO COLLECT D
FPI	☐ COST REIMBURSABLE				
	☒ PROGRESS PAYMENTS @ 80 % OF COST	Monthly	EOM	10	20
	☒ PARTIAL OR DELIVERY PAYMENTS			5	25

CONTRACT PERFORMANCE PROJECTION: ——→ BEGIN: 3/1/72 END: 9/30/73

MONTH	INCURRED (In Thousands) COSTS	INCURRED (In Thousands) WEIGHTED	DELIVERIES (In Thousands) COST	DELIVERIES (In Thousands) WEIGHTED	MONTH	INCURRED (In Thousands) COSTS	INCURRED (In Thousands) WEIGHTED	DELIVERIES (In Thousands) COST	DELIVERIES (In Thousands) WEIGHTED
72-3 1	50	50			24				
4 2	200	400			25				
5 3	300	900			26				
6 4	400	1600			27				
7 5	400	2000			28				
8 6	400	2400			29				
9 7	400	2800			30				
10 8	400	3200			31				
11 9	400	3600	500	4500	32				
12 10	400	4000	500	5000	33				
73-1 11	400	4400	500	5500	34				
2 12	350	4200	500	6000	35				
3 13	350	4550	500	6500	36				
4 14	300	4200	500	7000	37				
5 15	250	3750	500	7500	38				
6 16	200	3200	500	8000	39				
7 17	150	2550	500	8500	40				
8 18	100	1800	500	9000	41				
9 19	50	950	500	9500	42				
20					43				
21					44				
22					45				
23					46				
			CONTRACT TOTALS			G 5500	H 50550	I 5500	J 77000

INCURRED COSTS

AVERAGE TIME LAG COST TO DELIVERY	CONTRACT TOTAL WEIGHTED	CONTRACT TOTAL UNWEIGHTED	MEAN MONTH
Cost Incurred	H 50550	G 5500	K 9.2
Deliveries	J 77000	I 5500	L 14.0
Average Time Lag (Months)		L-K	M 4.8
(Days) M × 30.4			N 146

AVERAGE TIME LAG COST TO RECEIPT	COST REIMB PRG PMTS	DELIVERY PAYMENTS
Incurrence to Billable	O 15.2	N 146
Estimated Days to Bill	C 10	E 5
Estimated Days to Collect	D 20	F 25
Total Time Lag (days)	P 45.2	R 176
÷ 365 (yrs)	Q .124	S .482
TOTAL ESTIMATED COSTS	G 5,500	
Percent Each Method	T 80 %	U 20 %
Receipts Each Method	V 4400	W 1100
Average Total Time Lag (yrs)	Q .124	S .482
ANNUALIZED CAPITAL V × Q / W × S	X 546	Y 530

EARNED PROFIT OR FEE

AVERAGE TIME LAG EARNED TO RECEIPT	PAYABLE AS EARNED	FEE HOLDBACK
Estimated Days to Bill	A' 5	E'
Estimated Days to Collect	B' 25	F'
Total Time Lag (days)	C' 30	G'
÷ 365 (yrs)	D' .082	H' .
TOTAL ESTIMATED PROFIT/FEE	I' 825	
Percent Each Method	J' 100 %	K' %
Receipts Each Method	L' 825	M'
Average Total Time Lag (yrs)	D' .082	H' .
ANNUALIZED CAPITAL	N' 68	O'

FINANCING BY ACCOUNTS PAYABLE

INDICATORS FROM LAST COMPLETE FISCAL YEAR	PROFIT CENTER	DEFENSE CONTRACTS
Average Accounts Payable	P'	S' 2550
Total Outside Purchases	Q'	T' 15000
Average Payment Time Lag (yrs)	R' .	U' .170
Est A/P Payment Lag - This Contract		V' .170
Estimated Contract Outside Purchases		W' 1100
Estimated Financing by A/P W' × V'		X' 187

NET OPERATING CAPITAL REQUIRED X + Y + N' + O' − X' → Y' 957

DD FORM 1 SEP 72 1859

CONTRACT AVERAGE OPERATING CAPITAL PROJECTION
INSTRUCTIONS

PURPOSE. The purpose of this form is to estimate the contract average operating capital requirements, by relating projected contract costs and profits to the time required to recover those costs and profits from the government procurement activity or finance office.

METHOD OF PAYMENT. The various methods of payment by the government involve only three bases:

1. Payments based on costs incurred over time periods (Cost Reimbursement and Progress Payments).
2. Fee payments based on percent-of-completion, and
3. Payments based on physical delivery of end items or contract completion (Partial Payments and Delivery Payments).

This form accommodates conditions created by all three bases.

HEADING. Identify the Contractor and principal Profit Center, with address, where the contract will be performed. Identify the specific contract or contractual action by RFP or contract PIIN number. Identify the contract type.

PAYMENT METHOD. Check the appropriate blocks to show Cost Reimbursable or Partial/Delivery Payments. If a fixed contract authorizes Progress Payments, check that block and show the Progress Payment Rate (% of Cost). For Cost Reimbursable or Progress Payments, enter the Billing Period (e.g., monthly) and cut-off (e.g., EOM). For each method of payment checked, estimate the average days that will be required to bill and collect each series of payments under this specific contract and conditions. The estimated average days should be based on the most recent comparable experience with the specific procurement/administrative activity and finance office involved, adjusted for any conditions peculiar to this contract action. Since payment patterns vary substantially among government procurement/administrative activities and finance offices, the contractor should use (and be prepared to demonstrate) his recent actual experience with the government activities involved. For example, a history of unusual payment delays by specific government activities should be clearly reflected in the "estimated days to collect."

CONTRACT PERFORMANCE PROJECTION. Required only for Partial/Delivery Payments. The purpose is to establish the relationship between the rate of cost incurrence, and the rate of billable deliveries. Project the contract estimated cost over the proposed period of performance. Project deliveries (at either cost or price) over the anticipated realistic delivery schedule, not necessarily that requested in the RFP. Enter incurred and delivered cost to nearest thousand, e.g., $142,789 would be entered as $143. Weight each month's cost and deliveries by the contract numerical (not calendar) month, e.g., 1st month's cost × 1, 5th month's deliveries × 5. Total all columns. Contract total costs (G) must agree with the cost proposal. Total deliveries (J) must agree with either the proposed cost or price.

INCURRED COSTS

AVERAGE TIME LAG - COST TO DELIVERY. Required only for Partial/Delivery Payments. The purpose is to reduce the data above to the average time lag in days between cost incurrence and billable delivery. Divide the contract total weighted costs incurred (H) by the unweighted (G) to determine the mean month of all costs. Divide the contract total weighted deliveries (J) by the unweighted (I), to determine the mean month of all deliveries. Subtract the cost mean (K) from the delivery mean (L) to determine the average time lag, from cost to delivery, in months (M). Multiply by 30.4 to convert the lag to Average Days (N).

AVERAGE TIME LAG - COST TO RECEIPT. This part develops the total time lag, from cost incurrence to recovery by government payment, for each of the two methods of payment. Use of the two columns must correspond with the payment method(s) checked above.

COST INCURRENCE TO BILLABLE:

- Cost Reimbursable or Progress Payments. Enter the number of days representing one-half of the billing period (O). This is the time lag from the mid-point or mean of the period's costs, to the date they become billable. For a monthly billing period, use 15.2 days.

- Delivery Payments. Enter the average time lag, in days, determined in Average Time Lag, Cost to Delivery (N).

DAYS TO BILL: Enter the estimated average days to bill each basis of payment (C & E) The cut-off is normally the date of billings, if they are promptly mailed.

DAYS TO COLLECT: Enter the estimated average days to collect each basis of payment (D & F). The cut-off is normally the day payment is first recorded in company records. Both Days to Bill and Days to Collect should be supportable by recent comparable experience, rather than broad average, since payment patterns vary among government procurement activities and finance offices. See 'Payment Method' above.

TOTAL TIME LAG: Add each column to determine the Total Average Time Lag, in days, from cost incurrence to recovery. (P & R). Divide each column by 365 to convert days to fractions of a year (Q & S).

TOTAL ESTIMATED COSTS: Enter the total estimated costs proposed on DD Form 633. Must agree with Contract Totals above (G).

PERCENT UNDER EACH PAYMENT METHOD:

Cost Reimbursement only - 100% in first column (T).
Delivery Payments only - 100% in second column (U).
Progress Payments and Delivery Payments - stated percent of cost in the first column (e.g., 80%), remainder in the second column (e.g., 20%).

RECEIPTS UNDER EACH METHOD: Multiply the total estimated costs by the percent to be recovered under each basis. (V & W).

AVERAGE TOTAL TIME LAG (yrs): Bring down the respective Total Time Lags (yrs) from above (Q & S).

ANNUALIZED CAPITAL REQUIRED: Multiply the receipts under each method (V & W) by the appropriate Average Total Time Lag (yrs). (Q & S). Enter product in X & Y.

EARNED PROFIT OR FEE:

Average Time Lag - Earned to Receipt: The purpose is to estimate operating capital required because of delays in collecting contract profit or fee.

Estimated Days to Bill & Collect:

Fixed Price Profit. The entire time lag (A', B', C' & D') is identical to 'Incurred Costs - Delivery Payments' (E & F).

Cost-type Fee:

Payable as Earned (A', B', C' & D') - estimate the average time lag for currently payable fee vouchers. The period begins with the end of the billing period (E).

Fee Holdback (E', F', G' & H') - estimate the time lag to bill and collect the fee holdback. The period begins with the date of contract completion.

TOTAL ESTIMATED PROFIT/FEE: Enter the total proposed on DD Form 633 in I'.

PERCENT EACH METHOD:

Fixed Price Profit - enter 100% in J'.
Cost-type Fee - enter the currently payable portion (e.g., 85%) in J'. Enter the close-out holdback (e.g., 15%) in K'.

RECEIPTS EACH METHOD: Multiply the total estimated profit or fee (I') by the percent to be paid each way (J' & K').

ANNUALIZED CAPITAL REQUIRED: Multiply the receipts under each method (L' & M') by the average time lag (D' & H'). Enter the products in N' & O'.

FINANCING BY ACCOUNTS PAYABLE:
INDICATORS FROM LAST COMPLETE FISCAL YEAR. Determine the average Trade Accounts Payable during the latest fiscal year, for both the total Profit Center and the Defense Contracts portion (P' & S'). If defense contract Accounts Payable are not isolated in the records, allocations based on outside purchases may be used to estimate.

TOTAL OUTSIDE PURCHASES. Enter the total outside purchases from suppliers and subcontractors that generated the above Trade Accounts Payable. (Q' & T').

AVERAGE ACCOUNTS PAYABLE PAYMENT LAG (yrs). Divide each average Accounts Payable by the corresponding Total Outside Purchases, to determine the historical average payment lag for each class of purchases. (R' & U').

ESTIMATED ACCOUNTS PAYABLE PAYMENT LAG - THIS CONTRACT. Using the historical indicators as a guide, estimate a reasonable payment lag time for outside purchases under this contract (V'). Departures from the Defense Contract historical indicator should be supportable by anticipated changes in supplier/subcontractor relations.

ESTIMATED CONTRACT OUTSIDE PURCHASES. Total the planned outside direct purchases for this contract (W'). The estimate should agree with the DD Form 633 cost proposal, supporting shredout and/or the Make-or-Buy program. Common materials and supplies cleared thru stores should be included.

ESTIMATED FINANCING BY ACCOUNTS PAYABLE. Multiply Contract Outside Purchases by the estimated Accounts Payable payment lag, in years, to estimate the amount of contract financing by Trade Accounts Payable. (X').

NET OPERATING CAPITAL REQUIRED. (Y'). Sum the annualized capital required for each series of payments (X + Y + N' + O') and subtract the Estimated Financing by Accounts Payable (X').

NOTES TO DD FORM 1860

1. The basis of allocation of undistributed assets in each profit center between the engineering productive burden center and the manufacturing productive burden center (located under Item 2) should be related to the manner in which the expenses generated by these assets are absorbed in the overhead rate. The choice of the basis for allocation is up to the contractor within the limits stated above. The base unit of measure in the allocation base (column 4) is determined by his accepted method of overhead allocation. In the example, the basis for allocation of undistributed assets assumes an analysis was made of overhead distribution. These bases for allocation must be consistent for all fiscal years during which the contract will be performed.

2. The sum of the entries in Column 2a for the engineering and manufacturing burden centers is equal to the entry in the undistributed line, Column 1a. The same relationship holds for Column 1b and 2b and 1c and 2c.

3. The base unit of measure used for allocation in Column 4 refers to all work done in a productive burden center, not government work alone.

4. The average of the beginning of year and end of year values is used to determine asset values for DD 1860. When an asset has not been or is not expected to be owned for an entire year, an annualized asset value is used.

5. This form is submitted annually, and projections must be consistent with capital budgets and the overhead rate projections of the submitting corporation. Should these budgets be revised significantly up or down between annual submissions, a new set of DD 1860's should be submitted reflecting the changes.

PROFIT CENTER FACILITIES CAPITAL PROJECTION

Form Approved
O.M.B. No. 22R0306

CONTRACTOR: ABC, Inc.
PROFIT CENTER: VEHICLE DIVISION
ADDRESS:

CONTRACTOR
FISCAL YEAR: 1972

		FACILITIES NET BOOK VALUE*						PRODUCTIVE BURDEN CENTER				
		1. ACCUMULATION AND DIRECT DISTRIBUTION			2. ALLOCATION OF UNDISTRIBUTED			3. TOTAL NET BOOK VALUE			4. OVERHEAD ALLOCATION BASE	5. PROJECTED FACILITIES CAPITAL EMPLOYED FACTORS
		LAND a	BLDGS b	EQUIPMENT c	LAND a	BLDGS b	EQUIP c	LAND a	BLDGS b	EQUIP c	d	LAND a	BLDGS b	EQUIP c
PROFIT CENTER	RECORDED	200	2,300	3,490	Basis of Allocation:			Col's 1 + 2			Base Unit of Measure*	Col's 3 + 4		
	LEASED PROPERTY			100	Analysis of distribution of related overhead.									
	CORPORATE	40	150											
	TOTAL	240	2,450	3,590							DL$			
	UNDISTRIBUTED	240	2,450	100										
	DISTRIBUTED			3,490										
PRODUCTIVE BURDEN CENTERS	Engineering			115	66	669	27	66	669	142	1,800	.03666	.37166	.07888
	Manufacturing			3,375	174	1781	73	174	1781	3448	4,800	.03625	.37104	.71833
FISCAL YEAR 1973														
PROFIT CENTER	RECORDED	200	2,200	3,495							DL$			
	LEASED PROPERTY			200										
	CORPORATE	60	330											
	TOTAL	260	2,530	3,695										
	UNDISTRIBUTED	260	2,530	100										
	DISTRIBUTED			3,595										
PRODUCTIVE BURDEN CENTERS	Engineering			335	47	461	18	47	461	353	1,200	.03916	.38416	.29416
	Manufacturing			3,260	213	2069	82	213	2069	3342	5,400	.03944	.38314	.61888

DD FORM 1860

*Enter all dollar values to nearest thousand.

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2079

PROFIT CENTER FACILITIES CAPITAL PROJECTION

Form Approved
O.M.B. No. 22R0306

CONTRACTOR: ABC, Inc.
PROFIT CENTER: CONTROLS DIVISION
ADDRESS:

CONTRACTOR
FISCAL YEAR: 1972

		FACILITIES NET BOOK VALUE*						PRODUCTIVE BURDEN CENTER					
		1. ACCUMULATION AND DIRECT DISTRIBUTION			2. ALLOCATION OF UNDISTRIBUTED			3. TOTAL NET BOOK VALUE			4. OVERHEAD ALLOCATION BASE	5. PROJECTED FACILITIES CAPITAL EMPLOYED FACTORS	
		LAND a	BLDGS b	EQUIPMENT c	LAND a	BLDGS b	EQUIP c	LAND a	BLDGS b	EQUIP c	d	LAND a	BLDGS b	EQUIP c
PROFIT CENTER	RECORDED	80	980	1,520	Basis of Allocation:			Col's 1 + 2			Base Unit of Measure*	Col's 3 + 4		
	LEASED PROPERTY			40	Analysis of distribution of related overhead.						DL$			
	CORPORATE	20	80											
	TOTAL	100	1,060	1,560										
	UNDISTRIBUTED	100	1,060	50										
	DISTRIBUTED			1,510										
PRODUCTIVE BURDEN CENTERS	Engineering			110	43	457	22	43	457	132	1,600	.02687	.28562	.08250
	Manufacturing			1,400	57	603	28	57	603	1428	2,100	.02714	.28714	.68000

FISCAL YEAR 1973

PROFIT CENTER	RECORDED	80	960	1,490							DL$			
	LEASED PROPERTY			50										
	CORPORATE	20	90											
	TOTAL	100	1,050	1,540										
	UNDISTRIBUTED	100	1,050	60										
	DISTRIBUTED			1,480										
PRODUCTIVE BURDEN CENTERS	Engineering			120	37	390	22	37	390	142	1,400	.02642	.27857	.10142
	Manufacturing			1,360	63	660	38	63	660	1398	2,400	.02625	.27500	.58250

DD, FORM SEP 71 1860

*Enter all dollar values to nearest thousand.

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PROFIT CENTER FACILITIES CAPITAL PROJECTION

INSTRUCTIONS

(DD Form 1860)

PURPOSE. The purpose of this form is to (a) project and accumulate total facilities values for each Profit Center by contractor fiscal years, and (b) reduce those values to Facilities Capital Employed Factors applicable to the total Overhead Allocation Base of each Productive Burden Center.

BASIS. All data pertains to the same fiscal years for which the contractor prepares capital budgets and overhead projections, and should be compatible with both of those procedures. More specifically, facilities values projected here should relate to facility - generated costs proposed or allowed in overhead rate projections.

IDENTIFICATION. Identify the contractor, profit center, address and fiscal years to which the data pertains. Sufficient fiscal years must be projected to cover the estimated performance periods of contracts to be negotiated.

DEFINITIONS. See ASPR 3-808.7(e)(3)(i) for definitions of the facilities values to be included, the different sources and classes of those values, the distinction between Distributed and Undistributed facilities, and definitions of Productive Burden Centers and Overhead Allocation Bases.

PRODUCTIVE BURDEN CENTERS. List every Productive Burden Center within the Profit Center for which overhead rates are calculated for the allocation of indirect costs. The structure reported must be compatible with that used in DD 633 cost proposals or supporting detail.

LAND, BUILDINGS, EQUIPMENT. 'Land' is non-depreciable realty, improvements and property rights. 'Buildings' is depreciable realty and related improvements. 'Equipment' is all depreciable property other than Buildings.

RECORDED, LEASED PROPERTY, CORPORATE. 'Recorded' facilities are the normal Fixed Assets owned by and carried on the books of the Profit Center. 'Leased Property' is the capitalized value of leases for which constructive costs of ownership have been allowed in lieu of rental costs under ASPR 15-205.34 & .48. The government determination must be identified. 'Corporate' facilities are the Profit Center's allocable share of corporate-owned and leased facilities. All of the above are summed on the 'Total' line which represents the Profit Center's total facilities values recognized for this purpose.

DIRECT DISTRIBUTION. (Col's 1a, b, c). All facilities values that are identified in the plant records as wholly assigned to or located in Productive Burden Centers, are listed against the applicable P.B.C. Detail is totaled upward to the Profit Center 'Distributed' line. Profit Center 'Undistributed' is the remainder of the P.C. 'Total'. Both source and distribution of Profit Center facilities values must balance at the 'Total' line.

ALLOCATION OF UNDISTRIBUTED. (Col's 2a, b, c). Profit Center 'Undistributed' facilities are allocated to Productive Burden Centers on any reasonable basis that approximates the actual absorption of the related costs of such facilities. This allocation will usually reflect the method of allocating G&A and/or Service Center costs for the purpose of computing overhead rates.

PRODUCTIVE BURDEN CENTER TOTAL NET BOOK VALUE (Col's 3a, b, c). The sum of Col's 1a, b, c, & 2a, b, c. Total each class of facility separately, and prove back to the Profit Center 'Total'.

OVERHEAD ALLOCATION BASE (Col 4). The direct input bases (e.g., DL$, DLH, DM$, M-H, etc.) projected to be incurred in or by each P.B.C. (including service/support centers) for the purpose of allocating overhead or use charges. Identify each base unit-of-measure, which must be compatible with the bases used for applied overhead in DD 633 cost proposals or supporting detail. Quantities must agree with negotiated overhead rates for forward pricing purposes or FPRAs (ASPR 3-807.12).

PROJECTED FACILITIES CAPITAL-EMPLOYED FACTORS (Col's 5a, b, c). The quotients of the P.B.C. Total Net Book Values (Col's 3a, b, c) separately divided by the P.B.C. Overhead Allocation Bases (Col. 4). Carry each Factor to three decimal places, e.g., X.XXX. This Factor represents the amount of Facilities Capital required to support each unit of the Overhead Allocation Base.

NOTE TO DD FORM 1861

1. This form brings together all previously calculated information for the purposes of determining a capital turnover rate. The capital turnover rate can also be thought of as the number of dollars of cost supported by a dollar of capital.

2. The "PCO's Negotiation Objective" and Section II of DD 1858 must be prepared prior to beginning preparation of this form.

3. Each productive burden center involved in the contract must be entered for each year affected. The Contract Overhead Allocation Base (Column 3) used in this example is direct labor dollars, taken from the "PCO's Negotiation Objective" (page 49).

4. The overhead allocation base unit of measure for the contract must be the same as overhead allocation base unit of measure in Column 4 of DD 1860.

5. When this form is completed the capital employed will have been determined and the turnover rate calculated. Up through this point the only variation in the procedure for determining a capital turnover rate that can take place is a decision being made as to whether the historical method or the projected method for determining the estimated capital employed should be used. After this point in determining a prenegotiation profit objective, several different variations in methods of calculation are possible.

PCO's NEGOTIATION OBJECTIVES

NOTES

1. After the normal cycle of technical review, audit evaluation, price analysis and pre-negotiation conference, the PCO determined the following negotiation cost objectives:

2. The overhead allocation bases are adjusted and spread by years of performance, since overhead rates have been separately proposed and negotiated by years.

COST ELEMENT	VEHICLE DIVISION			CONTROLS DIVISION			TOTAL
	1972	1973	Total	1972	1973	Total	COSTS
Direct Materials							
Purchased Parts			20,000			80,000	100,000
Subcontracted Items			700,000			200,000	900,000
Engineering Labor	62,000	8,000	70,000	190,000	40,000	230,000	300,000
Engineering Overhead	76,000	14,000	90,000	270,000	60,000	330,000	420,000
Manufacturing Labor	115,000	525,000	640,000	190,000	270,000	460,000	1,100,000
Manufacturing Overhead	130,000	620,000	750,000	250,000	380,000	630,000	1,382,000
Other Direct Costs			130,000			70,000	200,000
General & Administrative			300,000			300,000	600,000
TOTAL COST OBJECTIVES			2,700,000			2,300,000	5,000,000

PROFIT CENTER HISTORICAL OPERATING CAPITAL

Form Approved
O.M.B. No. 22R0306

CONTRACTOR: ABC, Inc.
PROFIT CENTER: Vehicle Division
ADDRESS:

FISCAL YEAR ENDED: 12-31/71

SECTION I

GROSS OPERATING CAPITAL REQUIRED (Federal Government Contracts Only)	CONTRACT TYPE	
	FIXED PRICE	COST REIMBURSEMENT

Since the PCO's cost objective was less than the contractor's cost proposal, he recomputed the estimated operating capital required by 'markup' of ABC's DD 1858.

(NOTE: If used, the DD 1859 would also be adjusted for the PCO's cost objective.)

ACCOUNTS PAYABLE FINANCING FACTOR	O÷Q P÷R	S .	T .
NET OPERATING CAPITAL EMPLOYED FACTORS		FIXED PRICE	COST REIMBURSEMENT
FIXED PRICE CONTRACTS	M-T or S	U .173	
COST REIMBURSABLE CONTRACTS	M-T or S		V .079

SECTION II

CONTRACT OPERATING CAPITAL (Complete for each Procurement Action)	RFP/CONTRACT PIIN NUMBER		CONTRACT TYPE
	N00099-720R-99999		FPI
PERFORMING PROFIT CENTERS	CONTRACT ESTIMATED COSTS	NET OPERATING CAPITAL EMPLOYED FACTORS	ESTIMATED OPERATING CAPITAL REQUIRED
	W	X	Y
VEHICLE DIVISION	2,700,000	.175	472,500
CONTROLS DIVISION	2,300,000	.173	397,900
		.	
OPERATING CAPITAL - TOTALS	Z 5,000,000		A' 870,400

DD FORM 1 SEP 72 1858

CONTRACT CAPITAL EMPLOYED

CONTRACTOR: ABC, Inc.
PROFIT CENTER: VEHICLE & CONTROLS DIVISIONS
ADDRESS:

RFP/CONTRACT PIIN NO.: N00099-72-R-99999
PERFORMANCE PERIOD: 3/1/72 - 9/30-73

1. PROFIT CENTERS PRODUCTIVE BURDEN CENTERS	2. FISCAL YEARS	3. CONTRACT OVERHEAD ALLOCATION BASES	ESTIMATED FACILITIES CAPITAL EMPLOYED					
			4. FACILITIES FACTORS			5. FACILITIES AMOUNTS		
			LAND (a)	BLDGS (b)	EQUIP (c)	LAND (a)	BLDGS (b)	EQUIP (c)
VEHICLE DIV.								
Engineering	1972	62 DL$	.0367	.3717	.0789	2	23	5
	1973	8	.0392	.3842	.2942	-	3	2
Manufacturing	1972	115 DL$	.0363	.3710	.7183	4	43	83
	1973	525	.0394	.3831	.6189	21	201	325
CONTROLS DIV.								
Engineering	1972	190 DL$	.0269	.2856	.0825	5	54	16
	1973	40	.0264	.2786	.1014	1	11	4
Manufacturing	1972	190 DL$	.0271	.2871	.6800	5	55	129
	1973	270	.0263	.2750	.5825	7	74	157
6. CONTRACT FACILITIES CAPITAL EMPLOYED						45	464	721
7. CONTRACT OPERATING CAPITAL EMPLOYED		DD Form 1858 or 1859				870		
8. TOTAL CAPITAL EMPLOYED		Sum Lines 6 + 7				2100		
9. CONTRACT TOTAL ESTIMATED COST		DD Form 1547				5000		
10. CONTRACT CAPITAL TURNOVER RATE		Line 9 ÷ 8				x 2.381		

DD FORM 1 SEP 72 1861

INSTRUCTIONS
(DD Form 1861)

PURPOSE. The purpose of this form is to compute the estimated Contract Capital Turnover Rate, as an index of capital employed on the Contract. An intermediate step is to determine the facilities capital to be employed in each Profit Center and Productive Burden Center, using the Facilities Factors developed on DD Form 1860.

HEADING. Complete the identification data at the top of the form. The Performance Period determines the Facilities Factors, by Fiscal Year, that must be used in the computations.

1. PROFIT CENTERS AND PRODUCTIVE BURDEN CENTERS. List the contractor Profit Centers and Productive Burden Centers that will perform work on this procurement action. The breakdown is extracted from the cost proposal shredout, price analysis report and/or audit report, and must correlate to the facilities breakdown used on DD Form 1860.

2. FISCAL YEARS. For each of the above organizational elements, breakout the Fiscal Years of performance by each. This breakout is secured from the same source as the above.

3. CONTRACT OVERHEAD ALLOCATION BASES. For each Productive Burden Center and Fiscal Year, enter the amount of the related Allocation Base used to derive the contract estimated total cost. These bases should be the same as those used for burdening contract overhead. The base units of measure (e.g., DL$, DLH, DM$, etc.) must agree with those used in Col. 4 of DD Form 1860.

4a, b & c. FACILITIES CAPITAL EMPLOYED FACTORS. Carry forward the appropriate Facilities Factors from Col's 5 of DD Form 1860. Profit Centers, Productive Burden Centers and Fiscal Years must agree.

5a,b & c. FACILITIES CAPITAL EMPLOYED AMOUNTS. The products of each Contract Overhead Allocation Base (3) times its related Facilities Factors (4a, b & c.).

6. CONTRACT FACILITIES CAPITAL EMPLOYED. Sum the above to determine the total facilities capital employed, by class.

7. CONTRACT OPERATING CAPITAL EMPLOYED. Carry forward the Operating Capital from DD Form 1858 or 1859.

8. TOTAL CAPITAL EMPLOYED. The sum of all classes of capital employed (lines 6 & 7).

9. CONTRACT TOTAL ESTIMATED COST. The total estimated or proposed cost, or cost objective, for the contract. For a contractor, this must agree with his DD Form 633 cost proposal. For a procurement contracting officer, with his DD Form 1547, total cost objective.

10. CONTRACT CAPITAL TURNOVER RATE. The quotient of Contract Total Estimated Cost (9) divided by the Contract Total Capital Employed (8).

NOTE TO DD FORM 1547 (REVISED)

1. All items through line 10 are determined just as with any weighted guidelines negotiation, with weights assigned in the manner prescribed in ASPR 3-808 with two exceptions:

a. Nothing is deducted for the use of government furnished equipment. The "Source of Resources" subcomponent of "Selected Factors" is not used with this concept. Other subcomponents of "Selected Factors" continue to be used in the current manner.

b. "Special Profit Consideration", if appropriate, is included on line 14 when the contractor capital employed concept is used. Line 9 is not used in those instances.

2. The use of contractor capital employed is reflected only in lines 11 through 15. In the examples that follow, lines 1 through 10 remain the same and are not reproduced.

WEIGHTED GUIDELINES PROFIT/FEE OBJECTIVE

INSTRUCTIONS: 1. See ASPR 3-808 for determination of assigned weight factors.
2. See ASPR 3-811 for documentation of profit objective.

1. RFP/RFQ OR CONTRACT NO.	2. CONTRACTOR	3. CONTRACT TYPE
N00099-72-R-99999	ABC, Inc.	FPI

4. COST INPUT TO TOTAL PERFORMANCE (ASPR 3-808.5(b))

COST CATEGORY (a)	GOVERNMENT'S COST OBJECTIVE (b)	ASPR 3-808 WEIGHT RANGE (c)	ASSIGNED WEIGHT (d)	WEIGHTED PROFIT/FEE (Col b x d) (e)
DIRECT MATERIALS: PURCHASED PARTS	$ 100,000	1% TO 4%	2 %	$ 2,000
SUBCONTRACTED ITEMS	900,000	1% TO 5%	3 %	27,000
OTHER MATERIALS		1% TO 4%	%	
ENGR DIRECT LABOR	300,000	9% TO 15%	12 %	36,000
ENGR OVERHEAD	420,000	6% TO 9%	7 %	29,400
MFG DIRECT LABOR	1,100,000	5% TO 9%	7 %	77,000
MFG OVERHEAD	1,380,000	4% TO 7%	6 %	82,800
OTHER COSTS	200,000		2 %	4,000
			%	
			%	
			%	
GENERAL AND ADMINISTRATIVE	600,000	6% TO 8%	7 %	42,000
TOTAL	$ 5,000,000			$ 300,200

				PROFIT/FEE OBJECTIVE
5. COMPOSITE PROFIT/FEE ON COST INPUT TO TOTAL PERFORMANCE (Col e ÷ Col b)				6.004 %
6. COST RISK	ASPR 3-808.5(c)	0% TO 7%		3.000 %
7. PERFORMANCE	ASPR 3-808.5(d)	-2% TO +2%		1.000 %
8. SELECTED FACTORS	ASPR 3-808.5(e) & .7(i)	-2% TO +2%		%
9. SPECIAL PROFIT	ASPR 3-808.6 & .7(i)	0% TO +6%		%
10. COST-BASED PROFIT/FEE OBJECTIVE (Lines 5 thru 9)				10.004 %
11. CONTRACT CAPITAL TURNOVER RATE	2.2x	2.4x	DD Form 1861	x 2.381
12. CONTRACT CAPITAL INDEX	6.4%	5.8%	ASPR 3-808.7(i)	5.857 %
13. CAPITAL-ADJUSTED PROFIT OBJECTIVE			Line 12 + 50% of Line 10	10.859 %
14. SPECIAL PROFIT (Replaces line 9 if applicable)			ASPR 3-808.7(i)	- %
15. TOTAL PROFIT OBJECTIVE			(Line 13 + Line 14)	10.859 %

DATE	PREPARED BY	SIGNATURE

DD FORM 1 SEPT 72 1547 PREVIOUS EDITION OF THIS FORM IS OBSOLETE.

EXAMPLE 2

DEFINITIZATION OF LETTER CONTRACTS

Assume that ABC, Inc's. proposal is to definitize a letter contract for which 35% of the total work has been accomplished, and 40% of estimated costs have been incurred. The PCO concludes that ABC, Inc's. cost risk is substantially reduced by the cost and production history. Under ASPR 3-808.7(b), the PCO has the authority to adjust the contract capital index for the appropriate turnover from the FPI column to a minimum of the index contained in the CPIF columns. In order to make this adjustment he must find the actual capital index for a CPIF contract. The PCO, considering the specific circumstances of the contract, decides that a downward adjustment to a capital index mid-way between FPI and CPIF (High and Moderate Risk) is appropriate. Based upon this subjective assessment the capital index applicable to this contract is 5.452%. Profit objective computations are as follows:

CALCULATIONS

FPI	2.381	turnover	5.857%
CPIF	2.381	turnover	5.048%
			.809%

PCO decides to adjust to mid point

.809 ÷ 2 = .405

FPI Capital Index	5.857%
Less	.405%
Adjusted Capital Index	5.452% to line 12

WGL Cost Based Profit/Fee Objective (line 10) 10.004%

½ WGL Objective =	5.002
Adjusted Capital Objective (line 12)	5.452
Total Profit Objective (line 13 & line 15)	10.454

10. COST-BASED PROFIT/FEE OBJECTIVE (Lines 5 thru 9)			10.004 %
11. CONTRACT CAPITAL TURNOVER RATE	DD Form 1861	x	2.381
12. CONTRACT CAPITAL INDEX	ASPR 3-808.7(i)		5.452 %
13. CAPITAL-ADJUSTED PROFIT OBJECTIVE	Line 12 + 50% of Line 10		10.454 %
14. SPECIAL PROFIT (Replaces line 9 if applicable)	ASPR 3-808.7(i)		— %
15. TOTAL PROFIT OBJECTIVE	(Line 13 + Line 14)		10.454 %

DATE	PREPARED BY	SIGNATURE

DD FORM 1 SEP 72 1547 PREVIOUS EDITION OF THIS FORM IS OBSOLETE.

EXAMPLE 3

CONTRACTOR COST SHARE LESS THAN 30%

If for this FPI contract the PCO desires to negotiate a 90-10 cost sharing over the negotiated target cost he may feel it appropriate to reduce the capital index extropolated from the table as provided for an ASPR 3-808.7 for FPI contracts with a contractor share of less than 30%. Given the specifics of this contract he might elect to reduce the capital index by 5% - one-half the maximum latitude authorized. The resulting capital index would be 5.564% and his profit objective would be computed as follows:

CALCULATIONS

FPI Capital Index for 2.381 Turnover Rate	5.857%
PCO decides on a 5% reduction 100% - 5 % =	95%
5.857 X .95 = 5.564	
Adjusted Contract Capital Index (line 12)	5.564%

FPI contract with 90/10 share line over and under target cost

10. COST-BASED PROFIT/FEE OBJECTIVE (Lines 5 thru 9)		10.004	%
11. CONTRACT CAPITAL TURNOVER RATE	DD Form 1861	x 2.381	
12. CONTRACT CAPITAL INDEX	ASPR 3-808.7(1)	5.564	%
13. CAPITAL-ADJUSTED PROFIT OBJECTIVE	Line 12 + 80% of Line 10	10.566	%
14. SPECIAL PROFIT (Replaces line 9 if applicable)	ASPR 3-808.7(1)		%
15. TOTAL PROFIT OBJECTIVE	(Line 13 + Line 14)	10.566	%
DATE	PREPARED BY	SIGNATURE	

DD FORM 1 SEP 72 1547 PREVIOUS EDITION OF THIS FORM IS OBSOLETE.

EXAMPLE 4

CONTRACTOR COST SHARE MORE THAN 30%

Assume that the PCO desires to negotiate a 50-50 cost sharing over the negotiated target cost. Since ABC, Inc's. 50% share will exceed the 30% test for FPI contracts in ASPR 3-808.7(h), the PCO decides to increase the appropriate capital index by the maximum 10%. In addition the PCO finds that ABC efforts warrant a 1.5% Special Profit Consideration. He calculates his profit objective as follows:

CALCULATIONS

FPI Capital Index for 2.381 Capital Turnover Rate	5.857
Additional Profit for 50/50 share line + 10%	.586
Adjusted Contract Capital Index	6.443%

FPI Contract with 50/50 share line over and under target cost

10. COST-BASED PROFIT/FEE OBJECTIVE (Lines 5 thru 9)			10.004 %
11. CONTRACT CAPITAL TURNOVER RATE	DD Form 1861	x	2.381
12. CONTRACT CAPITAL INDEX	ASPR 3-808.7(i)		6.443 %
13. CAPITAL-ADJUSTED PROFIT OBJECTIVE	Line 12 + 50% of Line 10		11.445 %
14. SPECIAL PROFIT (Replaces line 9 if applicable)	ASPR 3-808.7(j)		1.500 %
15. TOTAL PROFIT OBJECTIVE	(Line 13 + Line 14)		12.945 %

DATE	PREPARED BY	SIGNATURE

DD FORM 1 SEPT 72 1547 PREVIOUS EDITION OF THIS FORM IS OBSOLETE.

EXAMPLE 5

DEFINITIZATION OF A MATURE LETTER CONTRACT AND
CONTRACTOR COST SHARE LESS THAN 30%

Assume ABC, Inc. proposal is to definitize a letter contract for which 40% of the work has been accomplished and 45% of the estimated cost has been incurred, and on which an 85/15 share line is being used. Both circumstances reduce the Contract Capital Index but the reductions together cannot reduce the Capital Index below the table entry for CPIF contracts. The PCO decides the circumstances surrounding the letter contract warrant reducing the FPI Capital Index by 3/4 of the interval between FPI and CPIF elements. In addition he feels a 5% reduction is justified for the 85/15 share line. Since these reductions push the Capital Index below the CPIF element, the Adjusted Contracted Capital Index becomes 5.048%.

CALCULATIONS

Letter Contract

FPI Contract Capital Index for 2.381 Capital Turnover	5.857%
CPIF Contract Capital Index for 2.381 Capital Turnover	5.048%
Interval	.809%

Reduction is 3/4 of interval or -.607%

Share Line

FPI Capital Index	=	5.857
Reduction of 5% for 85/15 share line X.		.050
	Reduction	.293%

Letter Contract Reduction	.607
Share line Reduction	.293
	.900%

5.857
- .900
4.957

4.957% is less than CPIF element of 5.048%
Adjusted Contract Capital Index is 5.048%

FPI contract with 85/15 share line over and under target cost

10. COST-BASED PROFIT/FEE OBJECTIVE (Lines 5 thru 9)			10.004 %
11. CONTRACT CAPITAL TURNOVER RATE	DD Form 1861	x	2.381
12. CONTRACT CAPITAL INDEX	ASPR 3-808.7(1)		5.048 %
13. CAPITAL-ADJUSTED PROFIT OBJECTIVE	Line 12 + 50% of Line 10		10.050 %
14. SPECIAL PROFIT (Replace line 9 if applicable)	ASPR 3-808.7(1)		- %
15. TOTAL PROFIT OBJECTIVE	(Line 13 + Line 14)		10.050 %

DATE	PREPARED BY	SIGNATURE

DD FORM 1 SEPT 72 1547 PREVIOUS EDITION OF THIS FORM IS OBSOLETE.

Note to DD Form 1499 (Revised)

1. The line number references make this form self explanatory with the exception of 14e.

2. Assuming the contractor and the negotiator split the difference between their proposals on direct material costs and total costs in the course of negotiation, the Profit for Additional Contractor Investment (Item II of this DPC - page 69) is determined as follows:

Total Direct Materials	1,050,000 X .8%	=	$8400
Total Cost	5,250,000 X .07%	=	3675
	TOTAL		$12075

This is calculated and added after all negotiations are completed. This is added only when all the criteria listed in ITEM II of this DPC are met.

REPORT OF INDIVIDUAL CONTRACT PROFIT PLAN

DEPARTMENT

1. REPORT NUMBER	2. CONTRACT NUMBER					3. ACTION	
	a. DEPT	b. ACTIVITY	c. FY	d. SERIAL NO.	(Army only) e. RQ	YEAR	MONTH
	N	00099	72	99999		72	02

4. PURCHASING OFFICE NAME — ITEM 4 CODE

5. TYPE OF ACTION — 5a. ORDER/MOD NO. — ITEM 5 CODE
A. INITIAL AWARD
B. SUBSEQUENT NEGOTIATION OF COST/PROFIT
A

6. CONTRACTOR IDENTIFICATION — ITEM 6 CODE
a. COMPANY NAME ABC, Inc.
b. DIVISION NAME (If applicable) Vehicles Division and Controls Division

7. PRINCIPAL PLACE OF PERFORMANCE (City-State) — ITEM 7 CODE — CITY — STATE

8. FEDERAL SUPPLY CLASS OR SERVICE CODE — ITEM 8 CODE

9. DEPARTMENT OF DEFENSE CLAIMANT PROGRAM NUMBER — ITEM 9 CODE

10. TYPE OF CONTRACT (ASPR Section III, Part 4) — ITEM 10 CODE
A. FIXED PRICE REDETERMINATION
J. FIRM FIXED PRICE
K. FIXED PRICE ESCALATION
L. FIXED PRICE INCENTIVE (All types)
R. COST PLUS AWARD FEE
U. COST PLUS FIXED FEE
V. COST PLUS INCENTIVE FEE
L

11. WEIGHTED GUIDELINES (ASPR 3-808) (If weighted guidelines are not used, omit a through e and make entry if f only)

a. COST INPUT TO TOTAL PERFORMANCE	DD Form 1547, Line 5	6.0	%
b. COST RISK	Line 6	3.0	%
c. PERFORMANCE	Line 7	1.0	%
d. SELECTED FACTORS	Line 8	0	%
e. SPECIAL PROFIT FACTOR	Line 9	0	%
f. COST-BASED PROFIT/FEE OBJECTIVE (Sum of a through e, if applicable)	Line 10	10.0	%

12. CONTRACT CAPITAL EMPLOYED (Use Section 12 only if capital employed method is applicable)

a. COMPOSITION			
(1) OPERATING	DD Form 1861, Line 7	$ 870	,000
(2) LAND	Line 6(a)	$ 45	,000
(3) BUILDINGS	Line 6(b)	$ 464	,000
(4) EQUIPMENT	Line 6(c)	$ 721	,000
(5) TOTAL CAPITAL EMPLOYED	Line 8	$ 2100	,000
b. CONTRACT CAPITAL TURNOVER RATE	DD Form 1547, Line 11	X 2.381	
c. SPECIAL PROFIT FACTOR	Line 14	0	%
d. TOTAL PROFIT OBJECTIVE	Line 15	10.9	%
13. CONTRACTOR'S PROPOSED PROFIT OR FEE OBJECTIVE		15.0	%

14. ESTIMATED AMOUNTS NEGOTIATED

a. TARGET OR COST (To nearest dollar - omit cents)	$	5,250,000
b. PROFIT OR FEE (To nearest dollar - omit cents) @13% = 682,500 + 12,075	$	694,575
c. PROFIT OR FEE AS A PCT. OF COST (14b ÷ 14a)		13.2 %
d. PROFIT OR FEE AS A PCT. OF CAPITAL (14b ÷ 12a(5))		33.1 %
e. PROFIT FOR ADDITIONAL CONTRACTOR INVESTMENT	$	12,075

NOTE: (1) Show all percentages to nearest tenth of a percent. (2) Indicate all negative amounts by a minus (-) sign before entry.

15. DATE SUBMITTED	16. TYPED NAME AND SIGNATURE OF PROCURING CONTRACTING OFFICER OR REPRESENTATIVE	17. TELEPHONE NUMBER

DD FORM 1 SEP 72 1499 PREVIOUS EDITIONS ARE OBSOLETE.

CALCULATION OF CONTRACT CAPITAL INDEX

When the contract capital turnover is not equal to any ratio shown in the Cost to Capital Ratio column of the Contract Capital Index Table (ASPR 3-808.7, (h)), the contracting officer must interpolate in order to extract the proper Contract Capital Index from the table. The methodology for interpolation from this table is as follows:

Contract Capital Index Table (extract)

Capital Turnover Rate	Capital Risk Level CPFF
1.9 (A)	5.3 (E)
2.0 (B)	5.0 (F)
"X"	"Y"
2.2 (C)	4.5 (G)
2.4 (D)	4.a (H)

X = actual Capital Turnover Rate for instant contract

Y = interpolated Contract Capital Index

Finding "Y" the interpolated Contract Capital Index requires the following steps:

Step 1 Compute Turnover Rate Interval (C-B) - the range between turnovers high and lower than the actual turnover for the instant contract.

Step 2 Compute Actual Turnover Interval (X-B) - the actual interval between the actual turnover and the lower turnover listed in the table.

Step 3 Compute the Contract Capital Index Interval (F-G) - the interval between the Capital indicies shown for turnover larger and smaller than the actual turnover

Step 4 Divide Contract Turnover Interval by Turnover Rate Interval $\frac{(X-B)}{(C-B)}$

Step 5 Multiply Contract Capital Index Interval by the result of calculation in step 4. $\frac{(X-B)}{(C-B)} \times (F-G) = N$

Step 6 Subtract Step 5 from the capital index shown for the lower than actual turnover to derive the actual Contract Capital Index, Y. F-N = Y.

For example, if the actual turnover on a CPFF contract is 2.1, the following intervals are computed:

Step 1: Turnover Range Interval C-B
2.2-2.0 = .2

Step 2: Actual Turnover Interval X-B
2.1-2.0 = .1

Step 3: Contract Capital Index Interval F-G
5.0-4.5 = .5

Once these intervals are determined, the following calculations are made:

Step 4: $\frac{X-B}{C-B}$ $\frac{.1}{.2} = .5$

Step 5: $\frac{(X-B)}{(C-B)} \times (F-G) = .5 \times .5 = .25$

Step 6: F - .25 = Y

5.0 - .25 = 4.75

The interpolated Contract Capital Index in this example is 4.75%.

Part 3—Report of Individual Contract Profit Plan (DD Form 1499)

21-300 Scope and Purpose of Parts. This Part prescribes the reporting on DD Form 1499 (set forth in F-200.1499) of cost and profit plans on contracts or contract changes of $200,000 or more negotiated by specified purchasing offices. The form provides a basis for analyzing profit patterns and weighted guidelines objectives on Defense contracts. As used in this Part, the term "cost" includes target cost as well as estimated cost, and the term "profit" includes fee as well as profit.

21-301 Applicability. DD Form 1499 shall be prepared by each purchasing office of (i) Army Materiel Command and Safeguard System Command; (ii) Air Force Logistics and Systems Commands; and (iii) Naval Air, Ship, Electronic and Ordnance Systems Commands. The form also shall be prepared by the following Navy activities of the Naval Supply Systems Command: Navy Aviation Supply Office, Philadelphia; Navy Ships Parts Control Center, Mechanicsburg; and Navy Purchasing Office in Los Angeles. Purchasing offices which are located outside the United States, its possessions, and Puerto Rico, and which are under the jurisdiction of the above-mentioned commands are exempt from this reporting requirement.

21-302 Coverage.

(a) A DD Form 1499 shall be prepared by the purchasing offices described in 21-301 above for each negotiation of a contractual agreement involving a separate cost and profit which together total $200,000 or more. This negotiated total may, but need not necessarily, agree with the amount obligated by the contractual instrument. The instrument may be a new definitive contract, an indefinite delivery type contract, the definitization of a letter contract, or order under a basic ordering agreement, a supplemental agreement, or any other action in which the contracting officer and contractor negotiate an estimated cost and profit. If in connection with a fixed price type contract or contract modification, the contracting officer requires the contractor to submit cost or pricing data pursuant to 3-807.3, a DD Form 1499 shall be prepared for such action showing the contracting officer's best estimate of cost and profit.

(b) If more than one profit rate applies to a negotiation, and the amount for each rate is $200,000 or more, a separate DD Form 1499 shall be used to report data for each rate. If the dollar amount for any profit rate of a multi-rate negotiation is less than $200,000, the data for the amount below $200,000 shall not be reported. If the separation of a contract into different rates produces no portion of $200,000 or more, a report on DD Form 1499 shall not be submitted.

(c) If any reportable negotiation includes a cost or cost-sharing portion or a firm fixed price portion not reportable pursuant to (a) above, such portion shall not be reported on DD Form 1499. If the application of this provision fragments an action so that an otherwise reportable portion is less than $200,000, that portion shall not be reported on DD Form 1499.

(d) A DD Form 1499 shall be submitted if the above conditions are met even though (i) price competition was used, (ii) weighted guidelines were not used, or (iii) a supplemental agreement involving cost and profit was executed without changing the profit rate applicable to the basic contract.

(e) If cost and profit are negotiated with the same contractor for two or more contracts as a package (*e.g.*, Air Force FPR aircraft engine contracts), a single DD Form 1499 may be submitted for all the contracts included in the package. One contract number shall be selected as the master for identification in Item 2 of the form, and the other contract numbers shall be listed in the "Remarks" section, Item 14.

21–303 Due Date and Distribution.

(a) Purchasing offices shall (i) prepare DD Form 1499 as soon as possible after the date of action, (ii) assemble the reports for the month of action, and (iii) forward such reports in duplicate within 10 days after the close of the month as follows:

(1) Army—Headquarters, U.S. Army Materiel Command, Attn: AMCRP-SC, Washington, D.C. 20315.

(2) Navy—Headquarters, Naval Material Command, Attn: MAT 0214, Washington, D.C. 20360.

(3) Air Force—Headquarters, Air Force Logistics Command (ACDPL), Wright-Patterson Air Force Base, Ohio 45433.

(b) Purchasing offices shall conduct sufficient review of the form and associated contract files prior to submission of DD Form 1499 to insure that all reportable transactions are reported, and that reports are complete and accurate. Such review, for example, should include examination by price analysts and by existing procurement review committees.

(c) DD Form 1499 shall be submitted as an unclassified document. Should the reporting office consider it necessary to apply a security classification to a DD Form 1499, a communication relating the reasons for such classification shall be submitted to the Office of the Assistant Secretary of Defense (Comptroller), Attn: Directorate for Information Operations, through the appropriate organization in 21–303(a) above. In no case shall security classification be considered a reason for not reporting on DD Form 1499.

(d) The reporting requirements of this part are assigned RCS-DD-I&L(M)1215.

21–304 Specific Entries on DD Form 1499.

(a) *Department.* Enter Army, Navy or Air Force, as appropriate.

(b) *Item 1, Report No.* Each purchasing office which is identified by a separate number in the Item 4 code block shall enter a four-digit number assigned consecutively starting with 0001 at the beginning of each fiscal year. This number shall be followed by the last two digits of the fiscal year. Numbers with less than four significant digits shall be preceded by zeros; *e.g.*, the fourth report in fiscal year 1973 would be numbered 0004-73. This number identifies a specific DD Form 1499 and is not related to any DD Form 350 number.

(c) *Item 2, Contract No.* Enter the contract number in the same manner as prescribed for DD Form 350 in 21-108.

(d) *Item 3, Date of Action.* Enter in numeric terms the year and month (*e.g.*, 73/03 for 1973March) when a mutually binding agreement was reached as to the estimated cost and profit. For example, this may be the date when (i) a new definitive contract was awarded, (ii) a letter contract was definitized, (iii) a supplemental agreement was executed, (iv) a change order was definitized, etc.

(e) *Item 4, Purchasing Office Name.* Enter the name of the purchasing office submitting the report, and enter in the Item 4 code space, the symbol or number assigned to that purchasing office in DOD Procurement Coding Manual, Volume III.

(f) *Item 5, Type of Action.* Enter Code A for the first reportable action pertaining to a contract, *i.e.*, the award of a new definitive contract, a definitive contract superseding a letter contract, or an indefinite delivery type contract. Enter Code B for all other types of actions including orders under basic ordering agreements. Enter in Item 5a order, supplemental agreement or other numbers that will assist in identifying a Code B subsequent profit negotiation.

(g) *Item 6, Contractor Identification.* Enter the complete name of the concern and, if applicable, the name of the division to which the award was made. Enter in the Item 6 code space the first six digits of the contractor code as shown in the DOD Procurement Coding Manual, Volume II. If the contractor is not listed in the manual, no code shall be entered by the purchasing office.

(h) *Item 7, Principal Place of Performance.* Enter the actual location of the plant or place of business where the items will be produced or the service rendered in accordance with instructions prescribed in 21-113 for DD Form 350. Also enter in the Item 7 code spaces the city and state codes shown for the contractor at the specified location in the DOD Procurement Coding Manual, Volume II. If the contractor's name is not listed in the manual, or is listed for a location or locations other than the one reported, no code shall be entered by the purchasing office.

(i) *Item 8, Federal Supply Class or Service Code.* Enter the appropriate Federal Supply Class or Service Code from the DOD Procurement Coding Manual, Volume I, Section I.

(j) *Item 9, DD Claimant Program No.* Enter the code from the DOD Procurement Coding Manual, Volume I, Section III, which describes the commodity or service called for by the contract.

(k) *Item 10, Type of Contract.* Enter only one of the codes, A, J, K, L, R, U, or V, to show the pricing provisions applicable to the reported action. If more than one type of pricing applies to a single negotiation, the provisions of 21-802(c) and (d) are applicable. That is, separate DD Forms 1499 shall be prepared for each type of pricing involving a cost and profit totaling $200,000 or more; DD Forms 1499 shall not be prepared for (i) types of pricing with less than aggregate cost and profit of $200,000, (ii) cost-no-fee or (iii) firm-fixed-price without a negotiated cost and profit.

(l) *Item 11, Weighted Guidelines.* (See 3-808.2.) If weighted guidelines are used, enter in the Item 11 space the percentages applicable to a. through e., and enter also the profit objective in Item 11f, which is the sum of a. through e.

If any of the factors is negative, enter a minus sign (-) before the percentage. If weighted guidelines are not used in arriving at the purchasing office profit objective, omit entries for Items 11a through 11e, but enter the profit objective as Item 11f. All percentages shall be entered to the nearest tenth of a point. For example, 12.25% shall be reported as 12.3%, and 12.24% shall be reported as 12.2%.

(m) Item 12, Contract Capital Employed. (See 3-808.7.) If the contractor capital employed method is used, enter in Item 12 the data called for by a. through d.. Items 12.a.(1) through (4) must total 12.a.(5). All data must agree with the preceding DD Forms 1861 and 1547.

(n) Item 13, Contractor's Proposed Profit/Fee Objective. Enter to the nearest tenth of a point the profit or fee percentage proposed by the contractor.

(o) Item 14, Estimated Amounts Negotiated.

(1) Enter in the Item 14 spaces the estimated cost as 14a and the estimated profit as 14b. These entries shall be to the nearest whole dollar; do not show cents, or make entries involving the cents positions. For example, $268,035.54 shall be entered at $268,036, and not as $268,036.00; $200,500.49 shall be entered as $200,500. Enter in the Item 14c space the percentage derived by (i) dividing the entry in 14b. by the entry in 14a. to four decimal places, (ii) multiplying the result by 100 and (iii) rounding to the nearest tenth of a point.

For example:

$\frac{\$\ 55,000\ \text{(Profit)}}{\$385,000\ \text{(Cost)}} \times 100 = 14.28\%$ which would be entered as 14.3%.

(2) If the capital-employed method was used, enter in Item 14d the percentage derived by dividing 14b by 12a(5) to four decimal places, multiplying the result by 100 and rounding to the nearest tenth of a point. For example:

$$\frac{\$\ 55{,}000\ \text{(profit)}}{\$130{,}000\ \text{(capital)}} \times 100 = 42.31\%$$

which would be entered as 42.3%.

(3) Enter in Item 14e, in nearest whole dollars, any 'Profit Factor for Additional Contractor Investment' included in Item 14b. See Item II of this DPC for an explanation of this factor.

(4) The cost and profit entries in Item 13 shall reflect the entire reportable amounts negotiated in the contractual agreement rather than merely the portions obligated. Thus, "total package" and other awards contemplating incremental funding shall be reported at total negotiated cost and profit at the time of initial award, rather than at the amounts initially obligated. However, amounts applicable to options for additional quantities, shall be excluded from the Item 13 entries unless and until the options are exercised. When options are exercised, a report shall be submitted on the action.

(5) For indefinite delivery type contracts, the amounts reported shall reflect the best estimate of the annual requirement.

(6) For CPAF contracts (Code R in Item 10), Items 13b and 13c shall not include any portion of the award fee to be determined at contract completion. Therefore, the profit/fee percentage in Item 13c should reflect the minimum percentage to be received by the contractor.

(p) Item 15, Date Submitted. Enter the date when the purchasing office submitted the DD Form 1499.

(q) Item 16, Type Name and Signature of Contracting Officer or Representative. Self-explanatory.

(r) Item 17, Telephone Extension. Enter the telephone extension of the person whose name appears in Item 16.

(s) Remarks. Asterisk any unusual entries, and explain on the back of the DD Form 1499. For example, a negotiated profit or fee (Item 14.c.) that is lower than the government objective (Item 11.f. or 12.e.) or higher than the contractor's proposal (Item 13) should always be explained.

(t) If any entries are made in Items 12 and 14d for capital-employed, see the additional reporting requirements of ASPR 3-808.7(1).

REPORT OF INDIVIDUAL CONTRACT PROFIT PLAN						DEPARTMENT	
1. REPORT NUMBER	2. CONTRACT NUMBER					3. ACTION	
	a. DEPT	b. ACTIVITY	c. FY	d. SERIAL NO.	(Army only) e. MO	YEAR	MONTH
4. PURCHASING OFFICE NAME						ITEM 4 CODE	
5. TYPE OF ACTION A. INITIAL AWARD B. SUBSEQUENT NEGOTIATION OF COST/PROFIT				5a. ORDER/MOD NO.		ITEM 5 CODE	
6. CONTRACTOR IDENTIFICATION a. COMPANY NAME b. DIVISION NAME (If applicable)						ITEM 6 CODE	
7. PRINCIPAL PLACE OF PERFORMANCE (City-State)						ITEM 7 CODE CITY	STATE
8. FEDERAL SUPPLY CLASS OR SERVICE CODE						ITEM 8 CODE	
9. DEPARTMENT OF DEFENSE CLAIMANT PROGRAM NUMBER						ITEM 9 CODE	
10. TYPE OF CONTRACT (ASPR Section III, Part 4) A. FIXED PRICE REDETERMINATION J. FIRM FIXED PRICE K. FIXED PRICE ESCALATION L. FIXED PRICE INCENTIVE (All types) R. COST PLUS AWARD FEE U. COST PLUS FIXED FEE V. COST PLUS INCENTIVE FEE						ITEM 10 CODE	
11. WEIGHTED GUIDELINES (ASPR 3-808) (If weighted guidelines are not used, omit a through e and make entry if 1 only)							
a. COST INPUT TO TOTAL PERFORMANCE				DD Form 1547, Line 5			%
b. COST RISK				Line 6			%
c. PERFORMANCE				Line 7			%
d. SELECTED FACTORS				Line 8			%
e. SPECIAL PROFIT FACTOR				Line 9			%
f. COST-BASED PROFIT/FEE OBJECTIVE (Sum of a through e, if applicable)				Line 10			%
12. CONTRACT CAPITAL EMPLOYED (Use Section 12 only if capital employed method is applicable)							
a. COMPOSITION							
(1) OPERATING				DD Form 1861, Line 7		$	,000
(2) LAND				Line 6(a)		$	,000
(3) BUILDINGS				Line 6(b)		$	,000
(4) EQUIPMENT				Line 6(c)		$	,000
(5) TOTAL CAPITAL EMPLOYED				Line 8		$	,000
b. CONTRACT CAPITAL TURNOVER RATE				DD Form 1547, Line 11		X	.
c. SPECIAL PROFIT FACTOR				Line 14			%
d. TOTAL PROFIT OBJECTIVE				Line 13			%
13. CONTRACTOR'S PROPOSED PROFIT OR FEE OBJECTIVE							%
14. ESTIMATED AMOUNTS NEGOTIATED							
a. TARGET OR COST (To nearest dollar - omit cents)						$	
b. PROFIT OR FEE (To nearest dollar - omit cents)						$	
c. PROFIT OR FEE AS A PCT. OF COST (14b ÷ 14a)							%
d. PROFIT OR FEE AS A PCT. OF CAPITAL (14b ÷ 12a(5))							%
e. PROFIT FOR ADDITIONAL CONTRACTOR INVESTMENT						$	
NOTE: (1) Show all percentages to nearest tenth of a percent. (2) Indicate all negative amounts by a minus (-) sign before entry.							
15. DATE SUBMITTED	16. TYPED NAME AND SIGNATURE OF PROCURING CONTRACTING OFFICER OR REPRESENTATIVE					17. TELEPHONE NUMBER	

DD FORM 1 SEP 72 1499 PREVIOUS EDITIONS ARE OBSOLETE.

ITEM II - PROFIT FACTOR FOR ADDITIONAL CONTRACTOR INVESTMENT

Item I of DPC 96 was published pending the development of the policy established by Item I of this DPC (3-808.7). This Item II supersedes Item I of DPC 96 and pen and ink changes thereto in DPCs 100 and 102.

The added profit factor for additional contractor investment shall continue to be used in the negotiation of certain contracts meeting the following criteria:

a. the contractor is not a small business concern (the costs of small business concerns were not increased by DPC 94);

b. the contract contains a revised payments clause as set forth in E510.1 -- Progress Payment for other than Small Business Concerns (1972 Jan); 7-203.4 -- Allowable Cost, Fixed Fee, and Payment (1972 Jan); 7-203.4 -- Allowable Cost, Incentive Fee, and Payment (1972 Jan); 7-802.4 -- Payments of Allowable Costs Prior to Definitization of Contract (1972 Jan); or 7-901.6 -- Payments (1972 Jan);

c. 3-808.7 is not applicable, or the historical data method of calculating operating capital (3-808.7(e)(2)a) is utilized; and

d. the contract is priced on the basis of cost analysis.

The added profit factor shall be reflected in line 14e of DD Form 1499.

INSTRUCTIONS TO CONTRACTING OFFICERS

1. Negotiate the contract price in the normal manner. For incentive contracts, however, do not negotiate the sharing arrangement until final target profit or fee is negotiated in step 4 below.

2. Calculate an offset for the contractor's costs created by the new cash disbursement payment policy. To do this, add the estimated costs for purchased parts, subcontracted items, and raw materials (including materials purchased for this contract by other divisions) and multiply the total by a factor of 0.8%.

3. Calculate an offset for contracts negotiated with contractors who have been receiving progress payments or cost reimbursements on a weekly or more frequent basis but now, as a result of the changes in contract financing policy, can be paid no more frequently than once every two weeks. To do this, multiply the total estimated contract cost by a factor of 0.07%.

4. Add the sums developed under paragraphs 2 and 3 above to the previously negotiated (i) price of firm-fixed-price, fixed-price with escalation and fixed-price redeterminable contracts, or (ii) target profit of fixed-price incentive contracts, or (iii) fee of cost type contracts (base fee of CPAF contracts).

ITEM V--RESTRICTION ON R&D CONTRACTING WITH FOREIGN SOURCES

Section 744 of the Defense Appropriations Act for FY 1973 (PL 92-570) provides that no funds appropriated for the Department of Defense are available for entering into any contract or agreement with any foreign corporation, organization, person, or other entity for the performance of research and development in connection with any weapon system or other military equipment for the Department of Defense when there is a United States corporation, organization, person, or other entity equally competent to carry out such research and development and willing to do so at a lower cost.

The above provision does not change the rules for the selection of research and development contractors set forth in Section IV, Part 1 of ASPR (see in particular 4-102 and 4-106). However, when a U.S. and a foreign source are considered equally competent, the contracting officer will make a determination as to which of the sources will provide the services required at the lowest estimated cost to the Government. Criteria for evaluating cost estimates are contained in ASPR 4-106.5.

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ITEM VI--PURCHASES FROM COMMUNIST AREAS

6-401.2 Delete Rumania from list of communist areas.

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ITEM VII--APPENDIX F200.1195 - CONTRACTOR'S REQUEST FOR PROGRESS PAYMENT

DD Form 1195. From item 20a of instructions delete "Unless a specific basis is prescribed by the Contracting Officer."

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Mr. SHILLITO. I would only conclude my remarks, Mr. Chairman, by saying that, as you know, appearing before this committee has not always been necessarily one of my more enjoyable experiences. At the same time, I have found that the opportunity to be with you. At least it has always been very stimulating. I am also proud of the people I have with me today.

I will make one other comment on the subject of profits, I have a chart that I would like to show you. The reason I present this chart is that this so-called "profiteering industry" has to be brought into perspective every now and then. The only reason that I think maybe this particular chart might be interesting is that Mr. Burress of the Renegotiation Board was kind enough to just give me their 1972 figures.

Chairman PROXMIRE. Is that the same chart we saw a year ago?

Mr. SHILLITO. No, sir; it is not the same chart, Mr. Chairman. It so happens that profits in 1972 have gone down to about half of what they were last year, so it is a "new indoor record," Mr. Chairman.

The total profits on the part of all companies that were profitable add up to something like $993 million and the total losses of all companies experiencing losses was $575 million. Total profits when you subtract the losses come out to something like $418 million. Again this is Renegotiation Board pre-tax data, so you can take half of the $418 million and you end up with an after-tax profit of about 0.65 percent. Pretax profit is 1.34 percent. Is that not correct, Mr. Malloy? I think that is what it is.

At any rate, I would only say that while our policy is not intended to raise profits, our policy is intended to bring about greater consideration for capital and motivations with regard to contractor as capital-related profits. Based on Renegotiation Board data, Mr. Chairman, this is not a profiteering industry. We can go into profits, the ECI and TCI and the rest.

I apologize for running past your gong, sir.

Chairman PROXMIRE. Not a bit, you had a great deal to cover and perhaps my letter was unfair in asking you to cover so much. You did a brilliant job and I think your statement is most helpful to us.

Mr. SHILLITO. Thank you.

[The prepared statement of Mr. Shillito follows:]

PREPARED STATEMENT OF HON. BARRY J. SHILLITO

Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear before the Joint Economic Committee once again. Your letter of 30 November 1972 indicated that the Committee is interested in discussing several of our procurement policies and practices as related to the acquisition of major defense systems. My statement will cover the items mentioned in your letter. Historically, most of the areas you would like to discuss have caused us problems. There have been problems in our handling some of these areas, and I am sure some problems will surface in the future in spite of our best efforts to prevent them. Nevertheless, we have moved vigorously to correct shortcomings revealed by our own internal reviews as well as those that are brought to our attention from outside the Department. It should be emphasized that most of our shortcomings are highlighted as a result of our own reviews. This includes several of the areas you will probably want to discuss. Conducting reviews and correcting deficiencies in an organization the size of the Department

of Defense (DOD) is a never ending task. Recognizing this fact, I want to assure the Committee that the Department of Defense has moved and will continue to move vigorously to improve our policies and their implementation.

Before discussing the several specific topics which you identified, I would like to cover briefly a few items that are often overlooked in connection with defense expenditures. As has been true for the past several years, the national defense budget continues to reflect the substantial shift in our priorities from defense to civilian pursuits. In current dollars, defense spending has risen $24.7 billion since 1964. Other Federal spending has risen $103 billion. State and local spending has risen $113 billion.

Defense spending as a per cent of the Gross National Product will amount to 6.5% in FY 1973 compared to 8.3% in the prewar year of 1964. This is the lowest per cent of GNP in the past two decades.

In addition, the per cent of our budget that is devoted to manpower costs has increased significantly, for example, in FY 1964 we spent 43% of our budget for these costs while in FY 1973 this will be 56%. We cannot afford to allow this shift to continue.

All of these changes have placed great pressure on the Department to make the most of the funds that are made available by the Congress for the acquisition of major defense systems. Many of the actions we are taking to improve our acquisition policies and their implementation are the result of this environment.

MAJOR DEFENSE SYSTEMS ACQUISITION

During the past four years, the Department of Defense has instituted substantial changes in its policies for the Acquisition of Major Defense Systems. These broad policy changes were formalized in DOD Directive 5000.1, issued in July 1971 after 2½ years of study. The major areas of change are the requirements for: prototype competition, reduction of concurrency, designing to cost, and increased operational test and evaluation prior to the production decisions.

Any objective look back over the past four years must conclude that substantial accomplishments have been made in our defense systems decision making process. Let me summarize a few highlights.

The *Development Concept Paper (DCP)* has been broadened and become the primary management tool for controlling the orderly development and acquisition of defense systems. For this reason, the DCP is now called the Decision Coordinating Paper. First. as a decision device, it identifies the major issues with their pros and cons, reflecting all the major challenges to the proposed program for review by the Secretary of Defense. Subsequent to the decision by the Secretary, the DCP becomes the "contract" between the Service and the Secretary of Defense. A breach of this "contract" is cause for review of the program, and possibly a revised decision.

The *Area Coordinating Paper (ACP)* furnishes a broad look at over-all areas, e.g., Fleet Air Defense, and examines the threat, problems, and solutions. Recommended solutions and over-all plans permit logical decisions on individual defense systems. Ultimately all DCPs will be in support of ACPs.

The *Defense Systems Acquisition Review Council (DSARC)*, now widely known as the DSARC, serves as an advisory body to the Secretary of Defense on major defense programs when program decisions are necessary. It also conducts management reviews on these programs. Reviews by the DSARC provide a forum for open discussion of issues and alternatives to ensure that the advice given to the Secretary of Defense is as complete and as objective as possible. Thus far, approximately 60 major defense systems have been reviewed by the DSARC.

The *Cost Analysis Improvement Group (CAIG)* was organized as a subgroup to the DSARC. This group is responsible for: (1) developing uniform criteria to be used by the Services in preparing program cost estimates; (2) monitoring and assisting the Services in establishing independent cost estimating capabilities, and (3) reviewing the program cost estimates of the Services so as to provide the DSARC with an assessment of the adequacy of the cost data submitted.

Adequate *Test and Evaluation (T&E)*, starting early in the acquisition process, insures that long-range commitments are not undertaken until concepts and hardware designs have been validated. Readiness to move forward at each subsequent milestone is required to be substantiated by Test and Evaluation.

These policies provide for a process of incremental acquisition. That is, decisions are made sequentially to permit each individual system to proceed through go no-go gates along the development path only when it has been established that the previous step has been completed successfully or that a high degree of technical confidence has been reached.

Total costs are a paramount concern from the inception of the program—in fact, cost has been made a design parameter. The initial decision to start development will be made only if estimated total costs of development, acquisition, investment and operation of the projected system are commensurate with the projected performance and also are affordable within realistic budget constraints. During the development process, cost will be the priority target for the designers.

In our incremental acquisition strategy, we have moved from the past practice of basing decisions on paper studies and analyses to basing them on hardware demonstrations. This demonstration is in the form of system and equipment prototypes, such as the AX, the lightweight fighter, the advanced attack helicopter, the surface effects ship and other recent programs. Largely, these are competitive hardware prototypes. Some cost reduction is achieved via the force of competition. There is an incentive to the participating contractors to keep costs down and performance at the highest level within the cost constraint in order to be selected as the source to proceed with the subsequent production contract.

Thus, through the use of the incremental approach, coupled with the increased use of prototypes and hardware demonstrations, we believe we will greatly reduce the degree of concurrency in system programs. This approach should provide a measure of cost control by reducing the potential for subsequent technical problems with their corresponding increases in cost.

I feel that the present policies are sound and they are enabling us to move forward successfully into areas that previously had been difficult to manage. Our future endeavors are being directed toward effective implementation of these policies.

I would like to turn now to an area that we are emphasizing to a much greater degree than heretofore. We call this the "Design-to-Cost" concept. DOD Directive 5000.1, mentioned earlier, states:

Cost parameters shall be established which consider the cost of acquisition and ownership; discrete cost elements (e.g., unit production cost, operating and support cost) shall be translated into 'design to' requirements. System development shall be continuously evaluated against these requirements with the same rigor as that applied to technical requirements. Practical trade-offs shall be made between system capability, cost and schedule. Traceability of estimates and costing factors, including those for economic escalation, shall be maintained.

This policy introduces two points—*design to* and *trade-offs*. The traditional roles of price and performance are reversed; production unit price is fixed while performance is made a variable. Performance and schedule will be subject to trade-offs in order to meet the design-to production costs. In the past the designers paramount consideration has been to meet performance requirements with insufficient regard to producibility or production costs. The objective of "design-to-cost" is to require the engineer to consider the impact of design alternatives on the production costs and the operating costs.

In implementing this policy, cost control is crucial. It is necessary, therefore, that advanced technology be used deliberately to hold costs down—not to add performance at any price. It is necessary also that techniques of estimating the unit procurement and lifetime costs of systems be improved. It is necessary to set realistic cost ceilings and attempt to stick to them.

All this, while difficult to execute, is reasonable. We are applying this approach to a few new development programs, and some are far enough along to give us confidence we are on the right track. Of course, one of the difficult but crucial elements in this new approach is how one sets cost ceilings.

One area of particular concern has been in the field of electronics with its high, and rising, unit costs with low field reliability. Among the answers to this problem has been designing to a price, standardization, and supplier responsibility for field reliability.

The Department of Defense has initiated a study for cost reduction, now being conducted as the first part of a two year plan for low cost electronics.

This study is being conducted by distinguished research corporations, selected industry participants, and Government agencies, under the coordination of one research agency. The program is being directed by a steering group chaired by Doctor Foster. This joint DOD and industry effort is tasked to examine the overall process of requirements, specifications, development and acquisition; determine the effect of R&D on production costs, installation costs, support costs, maintenance requirements and cost, and equipment availability; and recommend procedural and institutional changes that will reduce cost and increase effectiveness of DOD electronics.

Some of the specific areas of interest under consideration by this group are: the possibility of institutionalizing the process whereby requirements are traded off with capability and cost, parametric cost estimating—whether it will work and whether other methods are available; how to motivate systems developers to have equal concern for cost, reliability and performance; impact of design-to-cost and design trade-offs on avionics cost-of-ownership; and possible application of failure-free warranty as in commercial practice.

The military departments have several price-limited prototype development programs now in process. In addition, there are Army lab and field tests being conducted of functionally equivalent commercial and military specification avionics equipment.

The second year of the program envisions DOD coordination of the recommendations developed by the study for cost reduction. Prototypes will be initiated for the next generation equipment requirements to include a specification on production cost; and incentives to military and industry for low-ownership costs.

While the thrust of the "design-to-cost" policy is to reduce production cost and life cycle costs through the design to-tradeoff concept, it does not replace our other efforts to control costs. Cost reduction which can be achieved without degradation of performance will continue to be aggressively pursued. New manufacturing methods, labor saving devices, cheaper materials, simplified designs and other ideas all will be continuously considered and exploited. Contractors will continue to be encouraged to use their ingenuity to achieve cost reductions through value engineering and other contract incentives. In addition, we are making increased use of "should cost" techniques with which your Committee is quite familiar.

I have just described to you our current activities governing major defense system acquisition. the current decision making process, and some of the main areas in the acquisition process where we are attempting to apply incentives to control cost—not only in our contractual relationships with industry but internally within DOD as well.

One of our priority areas of concern for many years has been to find ways to cope with rising costs and to keep programs reasonably within a budget figure. When we think of incentives, I am sure most people have in mind incentive provisions in contracts, the objective of which is to induce the contractor to cut costs and correspondingly increase his profit. This is a rather narrow view. Incentivizing contractors is only a small part of the total DOD and Industry incentive picture. There is only a limited amount which a contractor can save. In fact, the amount available for defense hardware is directly affected by our ability to control our other more consequential costs. DOD, as the buyer, has an incentive, because of reduced budgets and rising internal costs to insure the control of all our costs, and, in fact, to eliminate our nonessential costs. If we can't do this job properly, our needed force size will suffer and we just can't allow this to happen. The things which I have discussed are the result of that incentivizing. We are still a long way from achieving a perfect system. There is much work yet to be done to improve the techniques I have described and to ensure that they are adequately implemented and properly applied. I am convinced that we are moving in the right direction and that the steps Defense is taking do face up to its responsibility to provide an adequate defense within reasonable cost limits.

PROGRESS PAYMENTS

Next, I want to discuss some of the particular areas you asked about, starting off with progress payments.

Progress Payments are an essential element of Defense procurement. It is a long-standing DOD policy to provide progress payments when reasonably

needed for the prompt and efficient performance of our contracts. Many defense contracts, in fact most contracts for complex hardware, involve extended periods of performance and large investments of funds before any deliveries and billings are made. Furthermore, interest is not an allowable expense under defense contracts. Thus, without progress payments, very few contractors would have the financial resources or working capital to perform defense work. Accordingly, it is in the government's interest to make progress payments. They are a useful working tool which broaden the base of companies able to compete for defense business, and make possible a volume of production that could not otherwise be accomplished. As you know, similar payments are sometimes used in other segments of our society for the procurement of major items involving significant cost or long time periods for production.

As you may know, the development of DOD progress payment policy is the responsibility of my office. I am assisted in this matter by the Contract Finance Committee, which is an inter-Departmental group composed of a procurement representative from my office, a finance representative from the Office of the Assistant Secretary of Defense (Comptroller), and two representatives (procurement and finance) from each of the Military Departments and DSA. The Committee, chaired by my delegate, also receives technical assistance from the Defense Contract Audit Agency and OSD General Counsel's office.

The Contract Finance Committee, created in 1950, formulates policy which is transmitted via Appendix E of the Armed Services Procurement Regulation to the operating agencies and Departments.

The responsibility for proper implementation and administration of progress payments policy rests with the Military Departments.

Changes in Progress Payment Policy

During the past year at least four major improvements have been made in our financing policy as it relates to the reimbursement of costs on cost-type contracts and the payment of progress payments on fixed-price-type contracts. These are: 1) payment only on the basis of cash disbursed by the contractor for purchased material and subcontracted items; 2) uniform biweekly payments; 3) elimination of the alternate method of recoupment or liquidation of progress payments until cost and profit trends are known; and 4) more accurate data-gathering on the status of progress payments. I believe the changes in contract financing policy will reduce some of the inequities of the past, decrease the level of government provided financing and ensure that all contractors have a greater cash investment in their work-in-process inventory.

These substantive changes, which apply to all contractors other than small business concerns, were made applicable to new contract solicitations issued on or after 1 January 1972. The details of the policy changes were described in Defense Procurement Circular No. 94 dated 22 November 1971, later incorporated in the Armed Services Procurement Regulation through Revision 11. Appropriate changes were also made to recognize the changes in the payment clauses for both cost and fixed-price-type contracts.

Foremost among the changes introduced in contract finance policy was a requirement that contractors (other than small business contractors) pay their vendors and subcontractors for direct material and subcontract cost prior to billing the government for these charges. The effect of this policy change in these cases is to require direct material and subcontract costs to be handled on a "cash disbursed" basis rather than on an "accrued cost" approach. There has been no change relative to small business companies which are still provided progress payments on the "cost incurred" basis.

The policy providing for uniform biweekly payment for all contractors standardizes the Department of Defense position and eliminates the varying payment practices which in the past have permitted paying some contractors more frequently than others. We believe the new approach will also reduce the administrative cost to DoD.

Looking at the other end of the cycle, several questions arise. How do you recoup progress payments and apply the amounts paid to the price of the units procured and delivered? Do you recover them over a specific time frame? Do you recover them on a proportional basis? Do you pay part or all of the profit due when the items are delivered, unit by unit? The intricacies of the various methods of recoupment are complex and not easily understood by the layman.

There have been several methods used over the years since no one method seemed entirely suitable for every case. The usual method employed to recoup progress payments closely parallels the basis on which payments are made. This method, referred to as the "Ordinary" method of liquidation, delays the payment of practically all profit until the final delivery of the last item on the contract. Another method, called the "Alternate" method, allows the contractor to be paid profit on each item as it is delivered to the Government. Our regulations have been changed to curtail the use of this latter method unless specific conditions are met. The effect of this change is to require contractors to establish actual cost and profit trends prior to recovering a portion of the profit on deliveries under the contract, rather than base recoupment on the negotiated rate of profit.

You recognize I'm sure that it is extremely difficult in an ongoing contract to determine the unit cost of each item delivered and the value of the work-in-process inventory every few days or weeks. As a matter of fact, it is inconveivable to me that any accounting system or technique can be sufficiently precise to reflect this data on a current unit basis. Where the contractor's accounting system uses either actual historical or standard costs, such costing can only be done, realistically on a "lot" basis. Start-up, preproduction, tooling, labor efficiency variances—are all heavy initial burdens in any weapon system program. This, coupled with development costs, must result in certain arbitrary allocations to develop unit costs. In these situations, contractors, using sound judgment, may allocate costs between delivered items and work-in-process items differently. In order to constrain this judgmental area, Defense regulations permitted the use of actual cost, actuals plus cost estimates, or target costs in determining the cost of delivered units. In some cases such as in a tightly priced contract, this last method may have provided a temporary financial advantage to a contractor. The eternal optimism of the American businessman is that the worst is always behind him and the best (i.e., the most profitable) lies directly ahead. In many major contracts, however, the contract costs and possibly losses are not known until the contract nears completion.

Our Internal Auditors questioned the use of the "target cost" method for handling recoupment of progress payments and recommended that it be deleted. We examined this matter very carefully and concluded that the recommendation was a sound one and that it should be adopted. When the DD 1195 Form was revised in April 1972, this method was removed.

An additional change was introduced to improve our data gathering mechanism for requesting and reporting the status of progress payments. Where two forms were previously required, we have been able to cut down the paperwork by consolidating the two forms into one modified version serving both purposes. We believe this consolidation will materially assist us in obtaining more accurate data on the status of progress payments.

OSD Internal Audit Report on Progress Payments

You recently requested copies of an internal audit report dealing with the subject of progress payments. As we stressed in our transmittal letter to you, such unbridled technical evaluations are essential if we are to continue to improve the management of this phase of Defense procurement. I believe that it is important to note that the audit report issued by the Office of the Deputy Assistant Secretary of Defense (Audit) reflects principally on the procedural matters of applying and administering progress payments. The report highlights the fact that the Auditors noted incorrect interpretations of regulatory guidance and faulty mathematical applications which tended to compound the errors discovered.

As I have explained, the subject of progress payments is a highly complex one involving sophisticated financial procedures. To completely understand and adequately administer this area requires training and experience. While I do not believe we should become involved here with the various complicated precedures and minute technical details of progress payments, I think it is vital to point out that the findings in the audit report should not be interpreted as indicating a loss of substantial funds to the U.S. Government. Unless we are careful, this misunderstanding can esaily be caused. In essence, it should be clearly understood that the deficiencies noted did not result in the payment of any significant amounts that would not have otherwise been paid at some future period to the contractor. In some cases payments were premature and in

other cases the amounts paid were the result of misinterpretations of administrative guidance. We have taken action to correct these situations and we will continue to stress the need for each Department and Agency to closely monitor this important aspect of procurement policy.

Over-all Decline in Progress Payments

During the past four years, we have seen a steady downward trend in the over-all amount of progress payments outstanding. The following table shows progress payments outstanding by Military Departments at the end of fiscal years 1969–1972:

TABLE 1.—PROGRESS PAYMENTS (COST BASED PLUS SHIPBUILDING) AMOUNT UNLIQUIDATED (OUTSTANDING)

[In millions of dollars]

	June 30, 1969	June 30, 1970	June 30, 1971	June 30, 1972
Army	875	943	718	494
Navy	2,386	2,370	2,169	2,040
Marine Corps	10	12	6	6
Air Force	4,027	4,613	2,516	1,845
DSA	9	9	13	10
Total cost based	7,307	8,027	5,422	4,395
Navy-shipbuilding	2,156	1,814	2,301	2,648
Total	9,463	9,841	7,723	7,043

You will note from this table that on June 30, 1969 the total amount of progress payments outstanding was $9.463 billion. By June 30, 1972 this sum had declined to $7.043 billion, a decrease in total dollars outstanding of approximately 25% during the three year period. The largest decrease during this period is attributed to decline in cost-based progress payments which on June 30, 1969 were $7.307 billion. By June 30, 1972 this category had been reduced to $4.395 billion, a decline of almost $3 billion during the above period. From 1969 to 1972, Navy shipbuilding progress payments outstanding rose from $2.156 to $2.648, reflecting the growth of the Navy's procurement program for ships. We anticipate that this figure will be reduced when deliveries begin on the major vessels presently under construction; then it should rapidly decline as ships are delivered to the fleet.

In summary, we believe that during the past few years significant progress has been made in the improvement of financial controls and the administration of progress payments. Technical audit evaluations such as that rendered by the Deputy Assistant Secretary of Defense for Audit have been valuable tools in helping us gain better control and improve our financial management of contract operations. We have been our own severest critics in this area.

As a closing comment on the subject of progress payments, I want to make it clear that we are talking here only about fixed price type contracts. Payments are made in a similar manner under cost-reimbursement type contracts, i.e., periodic payments on the basis of costs incurred. However, they are not considered unliquidated payments which are later liquidated by deliveries of hardware at a specified billing price. Payments under cost-reimbursement type contracts are considered as reimbursement for work performed as of each billing period. Progress under such contracts, by their very nature, is generally not measurable in terms of line items or discrete elements. Rather, it is measured only by costs incurred against an estimated total cost to achieve a contractual objective.

Industrial Plant Equipment

When I appeared before the Committee last year I was pleased to be able to tell you that we had been able to selectively reduce the amount of industrial production equipment in the possession of contractors by 25% in the last two years. I am again pleased to state that this reduction is continuing. By 30 June 1972 the acquisition value of industrial plant equipment in the possession of contractors was down by 37% when compared to 30 June 1968. We had actually expected to do better than this. The naval blockade of Haiphong

harbor and increased use of naval vessels to shell land bases in Southeast Asia as well as the increased aerial bombardment in North Vietnam required us to keep production of naval gun ammunition and air munitions at a high level. When this is no longer necessary we may be able in an orderly manner to make further significant reductions in the amount of Government-owned plant equipment in the possession of these type contractors.

In March of 1970 the Department of Defense instituted a program for the phase-out of Government-owned industrial facilities in the possession of contractors. This program was initiated at a time when we had to plan for indefinite continuation of support of our Armed Forces in Southeast Asia. It gave contractors three years to submit a phase-out plan and five more years to complete it. Last year I reported that, as of 31 December 1970, 111 phase-out plans had been submitted and approved and that approximately 700 more were in process of review. By 30 June 1972 a total of 461 phase-out plans had been approved. We have had to slow down this program for what I consider to be very valid reasons. First, with the phase-down of U.S troop support in Vietnam we no longer want to give contractors up to a total of eight years to return our equipment. We want it back much sooner than that. Most of the equipment in the 37% we have had returned since 1968 was recalled without a phase-out plan. Secondly, our industrial preparedness planning has resulted in the identification of instances where it is essential that the Government equipment remain in the contractor's plant to assure the capability for quick response in the event of a national emergency. For this latter reason, we have granted exemptions from phase-out plans to 20 contractors to retain in their plants a total of 66 items with an acquisition value of about $1.3 million.

In the past, you have expressed interest in the comparability of Government rental rates for plant equipment with those of commercial leasing firms. As you know, these rates were increased in 1968 to slightly exceed commercial rates. Nevertheless, in May of 1971 we requested the Office of Emergency Preparedness, which is responsible for setting the rates, to review them to determine whether they still were comparable to commercial rates. After a review of the matter, we were advised by OEP that the rates were still generally comparable to commercial lease rates. We are still not happy with our current system of charging rent which involves considerable bookkeeping and surveillance with attention being given to amount of utilization, commercial use of the equipment and similar factors. For this reason we are having a study made of the whole system to see if we can't find a better way to do it. This study is now underway.

A closely related matter is the number of Government plants owned by the Department of Defense. In 1954 we owned 288 plants. Last May I told you the number had been reduced to 189 and I am pleased that the number is currently down to 183. Twenty-two (22) of these are inactive. In view of recent economic conditions it has been difficult to sell these plants which are generally big and expensive. Negotiations are underway, however, to try to sell several more and we are hopeful that they will be successful.

An important consideration in removing our equipment from contractors' plants is the need to be able to get back into production quickly in the event of future demand for support of our armed forces. In some instances it is necessary that the equipment remain in place ready for use in such an emergency. Even under these circumstances it is not necessary, however, that the Government own the equipment if we could be assured that it would remain available for defense production. Under existing authority if we sell such equipment it must be by public sale and thus we have no assurance of its future availability. Last year I mentioned that legislation was pending in Congress which would authorize sales to the contractor possessing such equipment when availability of the equipment for future defense production would be assured. This legislation passed the House of Representatives but was not acted upon by the Senate prior to adjournment. We understand this legislation will be reintroduced in the next Congress. If it is enacted it will be of great assistance in our effort to reduce Government ownership of industrial plant equipment. It will also assit in reducing our problems of surveillance and management control.

In summary the management of our industrial plant equipment is difficult and complex. We must see that the items needed to support our armed forces as well as adequate war reserves to assure national security are available. Furthermore, we must do this at the lowest possible cost. We are attempting

to obtain these supplies in the fairest possible manner to both the taxpayers and to industry with due concern to such things as small business interests as well. Our overall objective remains to reduce the amount of Government-owned facilities in the possession of contractors without endangering the capability of the country to defend itself. I think the figures indicate that we are succeeding.

Industrial Preparedness

The Department of Defense, has long been concerned about the impact the downturn in Defense expenditures was having on defense-related industries. The disappearance of production capability for Defense in terms of skills and people has serious implications not only for industry and the economy as a whole but also for Defense readiness in terms of preparedness planning. In November 1970, we made a study of production curves on a national level before, during, and after the Vietnam buildup. We were able to depict those industries whose declining Defense expenditures do have a tremendous effect on employment and those industries that can maintain relative stability in the face of a declining Defense budget. The direct result of viewing and analyzing these trends led us to conduct an in-depth study of our plans and policies relating to industrial preparedness—that is, ensuring the availability of adequate U.S. industrial production capability to satisfy Defense mobilization requirements. As a consequence of this study, we are placing greater emphasis on industrial preparedness measures to assure retention of sufficient capacity, when possible, to serve as a springboard for recreating the production base necessary to meet emergency or mobilization requirements. These measures include planning with industry for mobilization production and the lay-way and maintenance of industrial facilities no longer needed to support current Defense procurement but required to meet DOD mobilization requirements. With respect to long leadtime, high unit-cost major weapon systems such as aircraft and ships, the decision to retain these type of facilities in stand-by is made on a case-by-case basis whenever current production is completed. These decisions take into account considerations such as: (1) estimated one-time and annual recurring costs to retain the facilities in question; (2) estimated time and cost, if disposed of, to reconstitute that production capacity in event of an emergency; and (3) proposed actions and related costs to insure adequate subcontractor support for the production facility being proposed for retention.

Government Policy Re Aerospace Industry

The long range implications of government policy with respect to the aerospace industry has not been an area of primary responsibility for the Department of Defense. At the same time, we naturally have been concerned with the health of the aerospace industry in that it is so closely tied to our Defense industrial base needs.

We appreciate that this industry has received more than its share of criticisms. At the same time, we were impressed with the manner in which this industry, under severe international competition, has been able to hold its own. As you know, it has exports today in excess of $4 billion and, in fact, is the single largest area on the positive side of our balance of payments ledger. We believe it is important that our country attempt to maintain this trade position. We are also concerned with the cost implications as regard this industry, in that to maintain the trade position that we presently enjoy on the commercial front, some serious consideration may have to be given to modifying the capital structuring for future commercial aircraft. Unlike the past, the risk capital in the commercial aircraft business is of such a magnitude that very few companies will be willing to take the required gamble.

I would urge, however, that in discussing this total subject, you call on others from the Executive Branch, i.e., Treasury, Commerce, Transportation, etc., to discuss this very important subject with the members of your Committee.

PROFIT

The last area I want to cover is profit. We have always considered that profit is a basic motivating force in a business enterprise, and our policy is to harness that motive to the greatest extent practicable in defense procurement. Thus, many of our procurement policies are developed with this in mind. Cer-

tainly, all of the things I have talked about here today can impact a contractors profit—things such as his ability to design and manufacture to a given cost, to meet performance requirements without overrunning costs, to be more efficient in his manufacturing operations, to take advantage of progress payments without abusing them, and so forth. So, I think it is fitting to conclude with a discussion of changes being made in our profit policy—changes intended to encourage greater capital investment by our contractors.

We have taken a number of steps directed at increasing the capital investment required of defense contractors. Modification of contract financing policy discussed earlier is one of those steps. Another is the gradual reduction in the amount of government industrial plant equipment provided to contractors. A further step has been examination and planned revision of DoD profit policy to make it consistent with the increased investment objective.

History

This Committee is familiar with many of the major milestones in our examination of profit policy. In 1965 the DoD studied the question of the allowability of interest as an expense. In 1967 a Logistics Management Institute study concluded, as did the 1965 study, that capital investment must be considered in the development of government profit objectives if there is to be sufficient encouragement for contractors to invest in the facilities needed for the performance of government negotiated contracts. In late 1967, we made the initial effort to identify contractor capital and relate it to specific contracts. This study revealed many fundamental problems of policy and mechanics. By 1969 various study groups had resolved the majority of these difficulties and DoD moved to develop a wider historical data base on which to test the improved methodology. The vehicle for doing this was a statistically representative sample of 165 contracts taken from the Fiscal Year 1970 negotiated procurement universe. Developing the sample, gathering data, and analyzing it took place throughout 1970 and 1971. During this same period the General Accounting Office study of defense industry profits was conducted and published, with recommendations for the consideration of contractor capital investments in the development of pre-negotiation profit objectives.

Profit and Investment

As background it is useful to discuss briefly the financial or economic motivation of contractors. While I do not think the profit motive is the single factor that makes certain companies seek defense contracts. I do feel that profit considerations often drive individual investment decisions in defense oriented companies equally as much as they do in non-defense oriented companies. Profit considerations may not be the only considerations in individual investment decisions faced by defense contractors, but I believe this consideration to be one of the most dominant ones.

If one accepts profitability as a dominant factor in individual investment decisions, it follows that contractors will seek defense business if it will favorably affect their profits.

I think that most will agree that while the fundamental profit motivation is to increase dollars of profit, most American corporations seek to maximize their profit on capital. I do not think it is an over-simplification to say that in making investment decisions, the defense industry, like non-defense industry, seeks to maximize profit on capital.

This basic profit motivation contrasts with the Department of Defense profit policy which historically has focused upon profit measured in relationship to costs. This is a marked difference. What is required to make these perspectives more comparable is for the Department of Defense to consider profit not only in relationship to costs but also in relationship to the capital investment of the contractor. Stated in an equation:

$$\text{Profit on Capital} = (\text{Profit/Cost}) \times (\text{Cost/Capital})$$

Industry seeks to maximize the left side of the equation and current Department of Defense policies focus only on the Profit/Cost portion on the right side of the equation. The missing link is the capital investment of the contractor.

Problems With Current Policy

The unsatisfactory results of this difference in perspective are twofold. The first is that the current policy may discourage investment in cost reducing

equipment by defense contractors. This has been pointed out several times in previous hearings of this Committee, and I shall not do more than summarize the problem. When the profit percentage is based on costs and does not reflect investment, the contractor can increase profit on capital one of two ways: first by minimizing investment, and second by increasing volume. In negotiated procurement, the ability to increase volume is only tangentially controllable by the contractor—the really important factor, the budget, is external. The only really controllable alternative is minimizing investment.

A second, and very important, problem which to my knowledge has not been described to the Committee is the matter of equity. Currently, the DOD develops pre-negotiation profit objectives by use of the weighted guidelines. In my view the guidelines are an excellent technique for considering most of the relevant factors that must be considered to decide upon a profit opportunity on a specific contract. The major consideration not presently included is the capital investment of the contractor. Its omission can have an adverse impact on the equity of pre-negotiation profit objectives. In ourstudy of 1970 negotiated procurement, we closely examined profitability as related to contract type. We found that, when measured as a percentage of costs, profits had a reasonable pattern that reflected the degree of risk among contract types. Firm fixed price (FFP) profit objectives were higher than fixed price incentive fee which in turn were higher than cost plus incentive fee (CPIF). Profit objectives on cost plus fixed fee (CPFF), the lowest risk contract type, were the lowest of all. Such an alignment of profits with risk demonstrates, in our view, an equitable relationship of profit opportunity.

However, when we expressed these same profits as a percentage of capital, the apparent alignment and equity disappear. We found that the profit opportunities for cost plus incentive fee contracts, one of the lower risk contract types, were higher than those for any other contract type. Profit opportunities for the highest risk contracts, firm fixed price, while higher than cost plus fixed fee on a profit to capital basis, were lower than several other types of contracts.

Examination of profit objectives by product line disclosed similar inequities in profit opportunity. The average profit objective was 8.7% of costs for combat vehicles and 10.4% of costs for electronics and communications equipment. When viewed as a percentage of capital, however, the profit objective for combat vehicles was 22.5% and for electronics and communications equipment, 21.4%.

It is our view that in most instances contracting officers have been lead to the right conclusions by using our present weighted guidelines policy. However, while the contracting officers may have reached the proper conclusion, they had no mechanism to translate this conclusion into the proper rates. They, unknowingly, may have awarded a high profit to the product line they concluded should have had the lower profit. This situation, as well as the counter intuitive alignment of profit and risk, is both unfair and counter to the goals of our DoD procurement policy.

I have just described the two major problems of the current Department of Defense profit policy for negotiated contracts. These problems are an outgrowth of our practice of not giving adequate recognition to the contractor capital investment. Identification of the problems is not difficult. The same cannot be said for their solution. Quite clearly the solution to the problems lies in the successful development of a mechanism to relate, either by a process of identification or allocation, that portion of a contractor's investment to be utilized for performance of the contract being negotiated. Such a mechanism will allow the contractor to share with the government the benefits of investment in cost reducing facilities. Additionally, it will give the contracting officer a better basis upon which to judge the appropriateness of his pre-negotiation profit objective. However, such a mechanism is extremely complex and difficult to develop for effective use by large and decentralized organizations such as the DoD procurement activities. Development requires making difficult decisions on many fundamental issues about which men can and often do disagree. Some of these decisions have made the Department of Defense profit on capital test plan a subject of some controversy within recent weeks.

The proposed profit on capital policy which we are testing focuses upon the uses of capital (operating capital, land, buildings and equipment) rather than

the sources of capital (debt and equity). This feature of the policy reflects the Department of Defense position that the assets supported by the financial structure of a company, rather than the financial structure itself is our concern. We view the decision regarding the method of financing as the prerogative of management.

The profit on capital policy allocates capital to contracts rather than specifically identifying each asset with the contract being negotiated. This decision reflects our view that a policy to consider contractor capital investment must conform to the realities of accepted industrial practice if it is to be effective. Cost accounting methods and management control systems do not account for assets on a contract by contract basis because there is no management need for such accounting. To require such identification, solely for the purposes of a profit on capital policy would be nonproductive and would increase overhead expenses to be paid for by the DoD. I mentioned last year that we cannot afford an "administrative nightmare." Our test plan has this in mind. The feasibility of allocation of capital to a contract is reinforced by the fact that allocation has many precedents. Depreciation, the consumption of an asset, is allocated to contracts through the use of the overhead rate. The next step, allocation of the asset being consumed, is not a revolutionary idea.

In developing the proposed profit on capital test plan we relied upon existing procedures to the maximum extent possible in developing allocation methodology. From the outset, we were determined to develop a policy that accomplished our objectives and avoided additional administrative costs without unnecessarily compounding the already voluminous documentation required of defense contractors. In addition, it became apparent that detailed prior resolution of all allocation questions was virtually impossible. Therefore, the only reasonable course has been to develop a procedure that is (1) flexible; (2) relatively simple for contractor and procurement contracting officer to use; and (3) lends itself to effective audit. The mechanics of the policy being developed satisfy these criteria. As a result, we have an allocation process that creates new procedures only where procedures do not now exist, and one that builds upon existing overhead allocation methodology rather than creating a parallel one that adds to the confusion of preparing for contract negotiations.

One of the most difficult aspects of developing the profit on capital policy was deciding how much importance to give to capital and how much to give to weighted guidelines or cost based considerations. There are two extremes, neither of which is acceptable. One is that capital be the sole determinant of pre-negotiation profit objectives; and the other is that capital be disregarded as a determinant of profit objectives. The latter is unsatisfactory for the reasons that I have discussed earlier, for it is basically our current policy. The former may have the effect of assuring an adequate return on an asset regardless of the potential utilization and doesn't recognize that in many instances capital required will be rather minor.

The policy in its present form strikes a balance between capital considerations and the weighted guidelines cost considerations, causing a contractor to consider his investment in terms of its potential utilization as well as cost.

This, in summary, is the proposed profit on capital policy. It derives 50% of the negotiated "going-in" profit from the uses of capital, or assets. These assets are allocated to contracts by a procedure that whenever possible relies upon established methods. Capital invested and weighted guideline considerations are weighed equally in developing the pre-negotiation profit objective.

Rates

To have a profit policy that explicitly recognizes a contractor's investment in performing the contract requires the establishment of a range of rates of return on capital for application to allocated capital. Establishing rates of return which we are testing, has been an extremely difficult task because, in so doing, one is implicitly stating that the rates selected are "proper" profits. If the rate in the policy is X, then it must be implicit that a rate greater than X is too high and a rate less than X is too low. The dilemma is that such precision about a rather judgmental issue is preposterous. It is interesting to note that the few major studies of profits in defense contracting have never made a judgment as to whether these profits were too high or too low. This has

always been studiously avoided even though many of our critics, often in a rather cavalier manner, have inferred that to do this would be rather simple. The in-depth studies on the other hand, have wisely been content to compare the profits in defense business to profits in other industrial sectors. To not come to grips with this issue in developing the profit on capital policy would make the policy unworkable.

In deciding upon the rates for usage in the proposed policy, we applied three criteria. The first that the rate be fair to both DOD and industry; the second that the rate development be administratively feasible; and the third that the rate be consistent with the objectives of the policy which I have outlined.

We felt the fairness criteria could be met by basing the numbers used on a broad, objective sample of the profits of industries comparable to the broad cross section of defense suppliers over a representative number of years.

Administrative feasibility virtually required that we search for an existing statistical base that meets the fairness criteria. Rediscovery of the wheel by developing our own sample would have been extremely time-consuming task and one for which we have no particular expertise. When developed, it too would probably be broadly criticized. Furthermore, existing statistical series offer the advantage of a great number of years of past data for study that can be updated as time passes. In addition, of course, the sample must be consistent in terminology and definition with the policy that we have developed to be administratively acceptable.

The Federal Trade Commission *Quarterly Financial Report* for manufacturing corporations satisfies the first two criteria admirably. It is a massive sample accounting for approximately 91% of the total assets of manufacturing corporations which, in turn, represent about 90% of all U.S. manufacturing, one-half of U.S. corporate profits, and more than a quarter of the national income. The Report, which is based upon uniform and confidential reports from corporations, has been compiled since 1947 and is therefore an established statistical series.

One must consider how investment dollars are allocated both within corporations and in capital markets in deciding how to meet the third criterion of effectiveness. Corporate managers allocate capital budgets based on the returns the capital is expected to earn. In many cases the current disincentives mean investments to perform defense contracts cannot compete with alternative investments. Therefore, if we are to remove the disincentive to investment, the potential return in defense negotiated contracts must be made more competitive with the alternative investments.

Correspondingly, if capital is to be attracted to the defense sector, the returns possible must be competitive with other sectors of the economy. In order to compete effectively in capital markets and, of equal importance, within corporations, for the investment dollar, the rates provided for in the DoD profit on capital policy must be taken from the returns of industry segments comparable to the defense sector. It is with comparable industries and products that the competition for investment dollars will primarily take place.

I should emphasize that the profit on capital policy applies only to certain negotiated defense contracts. These contracts are predominantly for the purchase of major hard goods. The following is a distribution of recent negotiated military prime contract awards.

TABLE 2

Negotiated procurement	Percent
Major hard goods	96
Services	1
All other	3
Total	100

Major hard goods is a defense term that includes aircraft, missiles and space, ships, tank and automotive products, weapons, ammunition, and elec-

tronics and communications epuipment. FY 1970 negotiated major hard goods contracts were distributed as follows:

TABLE 3.—DISTRIBUTION OF MAJOR HARD GOODS NEGOTIATED PROCUREMENT

[Fiscal year 1970]

	Percent
Aircraft	34
Missiles and space	22
Ships	11
Tank-automotive	3
Weapons	2
Ammunition	12
Electronics and communications equipment	16
Total	100

Given this distribution, which is likely to account for 80% or more of the potential business to which the profit on capital policy will ultimately apply, it seemed reasonable to us that by culling from the Quarterly Financial Report of the Federal Trade Commission those industries (such as mining process industries, soft goods like apparel, food) which were not comparable to the major hard goods we acquire, we could construct a sample that satisfied all criteria. In so doing, we developed what we have termed a "Selected Durable Goods" sample from the *Quarterly Financial Report.*

The selected durable goods sample includes aircraft and parts, electrical machinery, other machinery, motor vehicles and equipment, other fabricated metal products, instruments and related products, and manufacturing and ordnance. I think that this sample of manufacturing industry compares very closely with the cross section of major hard goods procurement conducted by the Department of Defense.

We have used an eight year average return on capital of selected durable goods manufacturing industries taken from the *Quarterly Financial Report* as the base for the return provided in the policy. This average (defined on a basis consistent with the profit on capital policy) is 20.2 percent.

Several adjustments to this average rate are required to insure that the rate is consistent with the objectives of the profit on capital policy. The first adjustment that is required is to account for unallowable costs, a phenomenon peculiar to defense contracting, which the Department of Defense does not allow as a charge to our contracts. These unallowable costs are deducted from the sample data because by definition total revenues are reduced by all costs incurred to arrive at profit. The profit on capital policy, on the other hand, is intended to be used in negotiating profit objectives which by DOD definition do not include unallowable costs. Therefore, it was necessary to add to the sample base a factor for unallowable costs. This factor, taken from average defense contract experience over past years, is 4.2 percent of capital. This adjustment does not take into account the unallowable costs associated with interest expense.

The next step in the process of developing a rate of return is to relate the return on capital to the risk of contract type. This was accomplished be reducing the return for cost plus fixed fee and cost plus incentive fee and raising the returns of the fixed price incentive fee and firm fixed price contracts by an offsetting amount. In making the adjustment in this fashion, the 24.4 percent average rate of return (after adjustment for unallowable costs other than interest) was held constant.

Having made adjustments for risk and for unallowable costs, the only remaining adjustment required to make the FTC base consistent with the profit on capital policy was to allow an adjustment for profit erosion. Profit erosion is an attempt to anticipate the difference between profit expected and profit earned. The profit on capital policy is used to develop a "going in" profit or profit objective figure while the sample data are earned "coming out" profits. Therefore, it is necessary to add to the FTC base figures an adjustment for the erosion of profit during the contract performance in order to make this base consistent with the policy. Based on data developed, the erosion factors

utilized were zero for cost plus fixed fee contracts, one percent for a cost plus incentive fee contracts, two percent for fixed price incentive fee contracts, and three percent for firm fixed price contracts.

The profit erosion factor for firm fixed price contracts is not as scientific as we would like. This is due, primarily, to our lack of information regarding earned profit on firm fixed price contracts. On the other hand, from Renegotiation Board data we know that the loss filings were the highest in the past eight years. Eighty-two percent of the dollar losses reported were incurred on firm fixed price contracts. In addition, based on Renegotiation Board data, average earnings on FFP contracts were only 0.23% of sales. *Exhibit one* illustrates the impact of adjustments to the base rates.

Definition of Capital and Profit

Now that I have introduced the issue of rates, I would like to discuss briefly the matter which I refer to as profit on capital rate games. Because of the large number of acceptable but different definitions of capital for use in the profit on capital rates, it is easy to unknowingly compare dissimilar profit on capital figures. I would like to illustrate this by showing how the numerical rates in the proposed profit on capital policy which have been the subject of some criticism, could have easily been made to appear lower without having the slightest impact on actual profitability.

Exhibit two shows a hypothetical balance sheet and income statement. While simple in the extreme and not necessarily representative of a specific defense contractor or group of defense contractors, I think these are reasonable financial statements. This exhibit illustrates that, given a fixed situation, the numerical rate can vary across a wide range depending upon the definition of capital chosen. In developing the profit on capital policy, we have used that definition of capital that yields the highest numerical rate of the three shown. We have made this decision, not because we want to overstate the profit rate, but because it is the most valid definition of profit on capital given our requirements. These requirements are that the data be readily obtainable, quickly understood by our work force, and easily audited. We also require that profit be defined in a way that is consistent with the DoD policy that interest is not an allowable cost. Therefore profit must be before interest, unallowables, and taxes. This further raises our numerical rates relative to alternative definitions. Comparison of our rates with rates not similarly defined is both invalid and not very informative.

Impact On Profits

I very much appreciate the concern of those who have attempted to assess the impact of the profit on capital policy when fully implemented by conducting various kinds of comparative analyses with earned profits. In my judgment the most valid way to make an assessment is by examining the impact of the policy upon the pre-negotiation profit objective of the government negotiators. This is the focal point of the policy. The policy provides a mechanism that will enable the contracting officer to consider capital when he develops his pre-negotiation profit objective, and therefore, will change directly only the pre-negotiation profit objective. Other factors remaining the same, however, one might fairly forecast that if the pre-negotiation objective moves down, on the average, then the negotiated profit objective and the earned profit will move in the same direction. The converse is, of course, also likely if pre-negotiation profit objectives are raised.

In order to make such a comparison we superimposed the profit on capital policy on the statistical model of the FY 1970 negotiated procurement universe. Based upon this analysis, the pre-negotiation profit objectives for fixed price incentive contracts move downward from 10.1 percent of costs to 10.0 percent of costs. Firm fixed price pre-negotiation objectives increased from 11.2 percent of costs to 11.9 percent of costs. Taking into account the dollar volume of these two contract types, there was an over-all increase in pre-negotiation profit objectives of two-tenths of one percent for the combined fixed price type contracts. Including all type contracts for FY 1970, we are convinced, as a result of this analysis, that the aggregate going-in profits will be about the same. We also learned that when the proposed policy was simulated on the FY 1970 model, pre-negotiation profit objectives for specific contracts changed in almost every instance. Thus, it is our conclusion that when the profit on capi-

tal policy is applied to all fixed price type contracts, a major redistribution of profits will take place, but the aggregate profits of all these contracts will increase only by a very small amount.

I would like to point out there are two very distinct phases of the impact of the implementation of the policy. The first and the one which we measured using our statistical model is characterized by a redistribution of profits reflecting the current investment of contractors in the performance of government contracts. Hopefully, the second stage of impact will take place as investment increases and results in decreased costs shared with contractors in the form of increased profits. We are able to forecast the first stage of the impact of the profit on capital policy with a high degree of confidence. The second stage is dependent upon the degree to which the current policy is successful in motivating contractors. At present this cannot be forecast. This is the reason for the planned continued test.

While the second stage cannot be forecast with any confidence at this time I would like to state that we are committed to accomplishing the task of measuring, after the fact, the impact of the policy. Even at this early date I would be remiss were I not to mention that measurement of results will be a difficult problem. One problem, which plagues us in many areas, is that of the baseline against which actual costs experienced should be compared in order to determine results. Another problem is that of the time, because result measurement must, of necessity, await substantial completion of a contract before the impact of investment upon cost can be ascertained. A final problem, one particular to the contracts negotiated during the evaluation period, is that of assessing the relationship between motivation, and policy permanence. If a contractor has no assurance that the policy will apply to other contracts then his sphere of consideration for investment will be limited only to investments that will be fully or substantially amortized on the specific contract to which the policy will apply. The tendency will be not to invest in long lived assets, or assets whose use will be spread over subsequent contracts or other contracts to which the policy may not apply. We expect that the motivational impact during the evaluation period will be less than when the policy is fully implemented for these reasons. Despite these recognized problems we think that we can effectively measure the after the fact impact of the policy.

Test Period Plans And Objectives

Introduction of the profit on capital policy has three phases. The first which we have recently completed was the basic development stage that began in earnest in 1968. The next phase evaluation and modification, will begin on 1 January 1973. We hope this can be completed by mid-1974. The final phase, implementation, is therefore, tentatively scheduled for the latter half of 1974.

The evaluation phase will be an extremely busy period. We are confident that considering capital in setting Defense prenegotiation profit objectives is a sound approach. Our desire for the best possible policy, both administratively and in theory, makes this evaluation period absolutely essential.

To gain maximum benefit from the evaluation, we have spelled out in some detail the objectives, mechanics, control system and uses of the test results. Much of the planned work is dependent upon and will be an outgrowth of the test negotiations; other work will proceed in parallel with these applications but independent of them. All effort is focused on having a strong, well substantiated profit policy which can be made mandatory without risk of unintended consequences.

Our first objective is to shake down the procedures we have established to insure they are functional and are not burdensome to the users. When introducing a policy which promises significant changes in contract pricing and practices (as this one does) the Defense Department must know the full impact of these procedures on the contracting process. The evaluation period will provide an opportunity for many contractors to assess first hand the impact of the policy on his particular operation. We hope to be able to clear up misunderstandings and have a well informed group of contractors when the policy is implemented.

In formulating a policy of this type, many assumptions and judgments are necessary to develop a workable policy and to bridge gaps in statistical knowledge. I have already described most of these assumptions and been candid in admitting that they are based on the best data and research available to us.

One of our objectives is to assess the validity of these assumptions by observation of actual usage.

The mechanics of the evaluation period are reasonably simple. We have issued a Defense Procurement Circular, (DPC #107), which includes comprehensive examples intended to cover most contingencies. The DPC is the basic statement of the planned evaluation period and an explanation of its usage. If the criteria for applicability are met, the contractor agreeing to participate in the test submits the required data for review and audit.

If that data is deemed adequate and if the procurement is within the internal guidance provided, the PCO will notify the contractor that he agrees to the usage of the profit on capital concept for the development of prenegotiation of profit objectives. The negotiations are then conducted using prenegotiation profit objectives developed through the profit on capital policy and documentation is forwarded through channels to OSD.

In the event the PCO does not agree to use the profit on capital policy in negotiation for reasons spelled out in the supplementary guidance, the PCO so notifies the contractor and negotiations are conducted using the normal weighted guideline procedures.

Because this is a test involving important matters, it is imperative for OSD to control the test in a manner adequate to insure proper gathering and use of necessary information. All future improvements and refinements require the control and information gathering activities be carried out in a thorough and responsible manner. Our control system includes two types of controls—direct or people oriented controls and indirect or procedureal control. Direct controls are the most effective. A policy coordinator will be designated within OSD(I&L) to coordinate the several activities underway during the test period and resolve operational problems quickly. To further smooth the operation of the test, a knowledgeable individual will be designated in the headquarters of each of the major buying commands in DoD to handle communications and problems in his activity. These representatives, along with the profit policy coordinator, will serve as a committee to communicate ideas and assure consistency and appropriateness of application of the policy during the evaluation phase.

To communicate the intent and purpose of the policy, OSD has undertaken a comprehensive training program to reach the procurement work force within the Department of Defense. This training began in November and is expected to be completed by mid-April. It encompasses both the conceptual and methodological aspects of the policy and includes hands-on experience in using the policy in the classroom.

By having a knowledgeable policy coordinator within OSD, active service participation within the DoD components and a comprehensive training program designed to reach the procurement personnel involved, we feel we have established top notch direct control for an effective evaluation.

Indirect or procedural controls will play a complementary role in assuring the reasonable use of the policy during the evaluation period. The first is the requirement that all documents submitted by the contractor and prepared by DoD personnel be forwarded to OSD for review. Having this information available for review will allow those monitoring the policy the flexibility of using source documents to resolve procedural and operational problems. These documents also provide data for a defense industry capital data bank. All information submitted by the contractor will be audited by the Defense Contract Audit Agency (DCAA) as part of its regular procedure on negotiated contracts.

Another procedural control is the DPC example. This example describes several instances of the policy's application and the manner in which we intend that it be used. This will provide more information to the user and prevent misuse in the field.

A control system is only as good as the people using it. Its objectives are to assure the appropriate use of the policy, and application in the manner intended so that we may acquire data and experience to permit further refinement in improvement of the policy. We expect this control system, relying on both people and procedures, will accomplish those objectives. We anticipate the result of the test period and the results of activities and studies carried on during that period to provide us with a firm basis for improving and refining

the policy and to give us the assurance that we are proceeding in a constructive manner to improve DoD procurement.

A key result will be an intangible one, but one very important to the long-run success to any DoD profit policy. This is to be a reorientation in the thinking of people about the adequacy and measure of profit in negotiated procurements. Profit has been thought of as a percentage of cost for a long, long time and a change in perspective will take some time, hopefully not too long. We hope to make the DoD workforce at ease with the concept of profit on capital and enthusiastic about its application.

Secondly, we expect the application of the policy in different situations to give us a very good indication of the effectiveness of the procedures and the ease of their application. We are sure there is room for improvement in these policies, but their repeated application will given us a better guide to those areas requiring attention and correction.

Thirdly, we expect to acquire a better knowledge of the Defense industry capital structure. Such information is essential when making policy changes that will impact upon our national security capability and also on this important segment of the economy. Possessing improved capital structure data will permit even more accurate assessment of policy impact.

Finally, we expect to gain more insight as to what rates of return must be possible in order to maintain a modern Defense industry and what methods are the best suited to provide the opportunity for such a return.

When we feel we have answered or satisifed the questions which now confront us, we shall use the knowledge to modify the profit on capital policy. This is the real payoff of the evaluation we are just starting.

Improvements will most likely occur in the following areas:

1. We expect the existing procedures to be modified and improved as necessary, including both the weighted guidelines procedures and profit on capital procedures.

2. We expect to revise as necessary the means and method for considering capital in Defense contracts. This could take several forms, including increasing or decreasing its relative importance from what we have.

3. The final step in our use of the output from the test will be to revise the DoD sponsored training to better convey the philosophy and procedures of these profit policy changes.

A policy can be best applied and implemented if the users of the policy are convinced of its good intentions, flexibility, workability and potential benefits to the government and taxpayers. Part of effective implementation of any profit policy change is to assure that the users of the policy have this kind of confidence. We accept that as part of our task and are vigorously pursuing it.

Summary

Evaluation is the next step in a lengthy process to develop a sound profit on capital policy. We are commencing on several projects and studies to enhance the quality of our measurements, prove out our assumptions, and strengthen the policy. At the conclusion of the test period we expect to have a policy sound enough to be implemented with confidence that it will accomplish its intended objectives without introducing new problems.

Mr. Chairman, I have gone into considerable detail on the subjects that you asked that we cover. I have done this in order that the record will be complete and to be sure there is no misunderstanding of these subjects. I appreciate the opportunity to provide this information to the Committee.

EXHIBIT 1.—PROFIT ON CAPITAL POLICY ADJUSTMENTS OF FTC-SELECTED DURABLE GOODS BASE

[Percentage]

	CPFF	CPIF	FPI	FFP
FTC/SEC base	20.2	20.2	20.2	20.2
Adjustment for unallowable costs	+4.2	+4.2	+4.2	+4.2
Risk differential	−4.4	−1.4	+1.6	+4.6
Adjustment for profit erosion		+1	+2	+3
Profit on capital rate	20	24	28	32

EXHIBIT 2.—HYPOTHETICAL BALANCE SHEET SITUATION

Assets		Liabilities and equity		Income statement	
		Liabilities			
(1) Cash	2	(7) Accounts payable	10	Sales	100
(2) Securities	8	(8) Debt	30	Costs	−90
(3) Accounts receivable	20	(9) Total liabilities	40	Profit	10
(4) Inventory	20	Equity			
(5) Fixed assets (net)	20	(10) Equity	30		
(6) Total assets	70	(11) Total liabilities and equity	70		

PROPOSED POLICY

$$\text{Profit on capital} = \frac{\text{Profit}}{\text{Total assets} - \text{Cash} - \text{Securities} - \text{Accounts payable}} = \frac{\text{Profit}}{(6)-(1)-(2)-(7)} = \frac{10}{50} = 20\%$$

OPTION No. 1:

$$\text{Profit on capital} = \frac{\text{Profit}}{\text{Total assets} - \text{Cash} - \text{Securities}} = \frac{\text{Profit}}{(6)-(1)-(2)} = \frac{10}{60} = 16.6\%$$

OPTION No. 2:

$$\text{Profit on capital} = \frac{\text{Profit}}{\text{Assets}} = \frac{\text{Profit}}{(6)} = \frac{10}{70} = 14.3\%$$

Chairman PROXMIRE. I want to get into the progress payments, the profit matter a little later on.

You may not be satisfied with the detail in which we get into the profit matter, I only have a couple of questions on it, but you certainly can expand in any way you wish when we get into this.

Mr. SHILLITO. Certainly.

Chairman PROXMIRE. I would like to start off the way you do.

IMPROVEMENTS IN PROCUREMENT

The first part of your prepared statement this morning discusses the many changes which have been made during the last few years to improve the weapons procurement process. You refer to more prototype competition, the reduction of concurrency, to a new "design to cost" philosophy, and to increased emphasis on operational test and evaluation prior to production decisions. You suggest that "substantial accomplishments" have been made during the past four years, and I must say in all candor that I agree with you.

Mr. SHILLITO. Thank you.

Chairman PROXMIRE. I think you have made substantial accomplishments. You have had some excellent people, you have done a good job, Mr. Packard and Mr. Laird have in this respect.

Mr. SHILLITO. Thank you.

Chairman PROXMIRE. As you know, I have myself advocated more prototyping and better operational testing, and I have supported the Defense Department in what are perhaps its first two "design to cost" projects—the A–X close support plane and the Light Weight Fighter program of the Air Force.

I often wonder, however, just how much progress we have made, where our reforms are really taking us. The defense budget is still rising, and the total amount of cost overruns we have experienced

still seems to grow with each General Accounting Office report on the subject. Sitting where I do, it is hard to project trends into the future, to see where the defense budget is likely to be in five or six years and what kind of force structure we are likely to have.

The Defense Department itself, I think you will admit, has been less than vocal in the past as to its own long-term plans.

For that reason, I would like this morning to evaluate the changes and progress which you cite in your prepared statement in light of a rather remarkable, perhaps unique, Defense Department presentation which has appeared in recent months.

SPEECH BY LEONARD SULLIVAN

I refer to a speech by Mr. Leonard Sullivan, Jr., Principal Deputy Director, Defense Research and Engineering, on August 16, 1972, to a symposium of defense industry representatives meeting here in Washington. Mr. Sullivan attempted in his speech to lay everything out right on the table. He tried, first, to project the likely size of the defense budget in 1980.

He made some assumptions that the size of the budget in real terms would be about the same, in physical terms and that we would see how well we would be able to live within that. It would grow, however, because, of course, of inflation.

He tried also to gauge the implications for our 1980 force structure if we continued with the procurement programs now in the pipeline.

I trust, Mr. Shillito, that you are at least generally familiar with the speech by Mr. Sullivan which I am referring to. Let me ask you just a few general questions about that speech.

First, and I would like to put that speech in the record at this point, it is a relatively brief speech.

[The speech referred to above follows:]

NEWS RELEASE
OFFICE OF ASSISTANT SECRETARY OF DEFENSE (PUBLIC AFFAIRS)
WASHINGTON, D.C. - 20301
PLEASE NOTE DATE

ADDRESS BY MR. LEONARD SULLIVAN, JR.
PRINCIPAL DEPUTY DIRECTOR, DEFENSE
RESEARCH AND ENGINEERING
BEFORE THE AFMA/NSIA SYMPOSIUM
SHERATON-PARK HOTEL
WASHINGTON, D.C., 16 AUGUST 1972

Thank you, Johnny. Good morning ladies and gentlemen. My assigned task this morning is to show you the results of a preliminary study. It was done in our office with a lot of help from Systems Analysis and Comptroller. It is our first attempt to quantify the problem of "designing to a cost." As Johnny has already mentioned, the big question is not how to design to a cost, but what cost to design to.

This study focuses on the overall problem of what we can afford to buy rather than on the problem many of you are concerned with -- what we'd like to buy. (FIRST SLIDE). We call this presentation "Designing to a Cost." We have given it some 30 or 40 times within the Defense Department as a means of stimulating thought. Let me state from the outset that it defines only the problem -- while only hinting at the solution. Hopefully it will sharpen your understanding of the future budgetary realities. There are three key assumptions: (1) that force levels stay generally constant at the currently planned levels; (2) that we try to keep a modern force whose average age is half the system lifetime; and (3) that inflation will be held to current levels.

(CHART 2). This next chart gives an outline of how we organized the effort. First, we made a projection of GNP, followed by a projection of government spending. From this we have made an allocation for the Defense budget based on past trends and projected pressures. We split the Defense portion into its parts by the usual budget categories of manpower, procurement, and O&M. Our initial efforts focused on trying to identify the total costs attributable to specific weapons systems. We soon found that much of the data for the manpower and O&M accounts did not allow a consistent analysis of costs. Consequently, we concentrated on just the procurement costs of specific items. As shown on the chart, we continued the separating

process until we arrived at an estimate of the funds available for specific classes of new weapons systems such as "tactical aircraft" or armored vehicles.

(CHART 3). This vugraph projects GNP and the components of Federal spending, based on historical trends and our very unofficial estimates of the future. We estimated a $2 Trillion GNP by 1980, a projection many economists appear to agree with. As a matter of fact, we also track the Brookings Institute projectures very closely. Regarding non-defense expenditures, we made a projection that the historic rate of growth would continue, generally paralleling the GNP curve. This projection, shown as the dotted green line, would result in about $400 Billion non-defense spending annually by 1980. The solid green lines indicate the result of a 25% higher or 25% lower annual rate of increase, resulting in possibly a $50 Billion change either way. Defense spending projections are depicted by the blue curve. Again the dotted line represents our best guesstimate of future expenditures, resulting in a $112 Billion budget by 1980. Using this hypothetical target for defense spending, we then began more detailed projections of defense budget allocations within that total.

(CHART 4). Breaking our projection into its components, we come up with this distribution of funds. First, we expect Military Personnel and Retirement costs will continue to increase, reaching 40% of the total budget by 1980. This assumes no change in force level. Operations and Maintenance will also show growth in dollars to about 20% of the defense budget. This will leave a maximum of only 40% for investment in Procurement, R&D, and "other" items -- such as Military Construction and MAP aid to other countries.

However, this graph and the preceding one should not be taken as sources of comfort. (CHART 5). As far as we can determine, the total estimated dollar increases between FY 73 and FY 1980 will be consumed by anticipated inflation. In other words, we believe a $112 Billion budget in 1980 will be identical in purchasing power to an $83 Billion budget now.

I wish to repeat this statement. Because of the pressures we believe will exist on the DoD budget, we see very little opportunity for growth in purchasing power in this decade. Better times for DoD are not around the corner. More likely, our "actuals" will be less than projected here if we are, as hoped, entering a generation of peace.

(CHART 6). As I mentioned previously, we were hoping next to get the total costs of operating specific weapons systems within these totals. We found that direct costs were obtainable, but indirect costs were not as clear

and vary in definition between Services. For this reason we have been forced to limit our analysis to an allocation of procurement funding to specific classes of systems as shown on the next chart.

(CHART 7). First, we split the procurement budget into its components based upon DoD mission areas, such as Strategic Forces and General Purpose Forces, and projected these categories through FY 1980. The second step was to allocate within each major mission area to specific classes of systems. We used FY 73 funds as a baseline for our projections by category because we have already concluded that no real growth will occur in the DoD budget. Hence we can project in terms of constant FY 73 dollars.

Let's take a look at the Tactical Aircraft portion of the General Purpose Forces slide since it is by far the largest single procurement category. On an annual basis, we estimate $5.6 Billion will be made available to support tactical air, of which $2.4 Billion could procure new tactical aircraft. Likewise, it appears that the budget can accept about $500 Million for procurement of other new aircraft for ASW, airlift, and training. However, a significant portion of the funding is needed to support the tacair inventory in the form of modifications, spares and support. This totals about $1.7 Billion of the $5.6 Billion total. Another billion will be required to buy and support air-launched missiles and ordnance.

As you can see, we went through similar analyses in the Naval and Land Warfare categories, as well as Offensive and Defensive Strategic Force categories. One might reflect a moment on what already appears to be an extraordinary expenditure for tacair, for instance, compared to that available for our ground forces. Anyway, using these budgetary allocations as a starting point, it is possible to estimate how much we can afford to buy annually in each equipment category.

Our next problem was to devise a simplified method of calculating an annual procurement level. (CHART 8). We made one big simplifying assumption. We know that production of specific items phase in and phase out in a bell-shaped curve. To simplify the problem of dealing with such variables, however, we have assumed instead that we would buy equipment at constant annual rates. These rates are determined by the life of each weapon system and the annual force attrition as shown by the expression on the chart. In short, we buy just enough every year to replace over-age equipment and operational losses, thus retaining a constant size, constant age force indefinitely. However, we use a production unit cost which assumes a more optimum production rate.

Weapons systems life is varied for different kinds of systems as shown by the chart. For example, we made the average life of tactical aircraft 15 years, but estimated ship life to be 30 years. Force attrition is based upon current peacetime experience.

The bar chart at the bottom also suggests what we believe is a serious flaw in our planning cycle. DoD financial planning is on a five-year cycle and force planning on an eight-year cycle. Most weapon systems last substantially longer than that when development and phase-out times are considered. Thus, we find that the official DoD planning cycle is too short for effective projections of affordable costs. When we start developments, there is no way to demonstrate that they will fit within future resource constraints, because the planning cycle is not long enough to cover their full introduction into inventory.

Anyway, using the simplifying assumptions of constant annual procurement rates, we looked at eight different categories of weapons systems. In each case, we looked at all present types of systems, chose their replacement systems and their currently projected procurement costs. Some categories contain as many as 20 different types of end items now in inventory. (CHART 9). This unclassified chart shows a summary of many classified charts, indicating "affordable" annual funding rates, plus the excess required by currently designed or planned systems. In the first category we found ASW Aircraft to be substantially over allowables, in that we estimate $300 Million annually is available whereas the total procurement of existing configuration aircraft will take about $600 Million. Armored Vehicles presents very much the same story -- about 85% over available allocation due to planned introduction of more expensive tanks and vehicles. Navy Ships comes very close to target -- they are only 10% over but only by assuming the Navy can in fact design to the costs established for destroyers and sea control ships. Army Aviation reflects the introduction of new and more expensive UTTAS and attack helicopters, but underestimates probable costs of the HLH. We estimate this category "should" absorb about 25% of the total Army procurement. Yet if it is allowed to continue on its current path, it would absorb about 50% of the total Army procurement. Airlift and Training Aircraft are also over by about 76%.

Tactical Aircraft represent the largest monetary difference, with about $4.2 Billion required annually, but only about $2.4 Billion available. The major reason for this out-of-balance situation is the introduction of the expensive F-14 and F-15. This category, however, is one where the introduction of the AX, which has been designed to a target cost of $1.4 Million, helps to balance the more expensive fighters. If it were not for the AX, the situation would be much worse than depicted here.

Offensive Strategic represents what we believe is a possible projection of the bomber fleet and improvements to TRIDENT and MINUTEMAN missile systems. Defensive Strategic represents the cost concerned with bomber defense of the U.S. as well as ABM defenses.

Within these 8 categories, we believe only about $8.5 Billion will be available annually, yet our analysis indicates that the price of weapons we now have options to buy would cause us to be short about $5 Billion annually if we are to maintain a constant size, constant age inventory of weapons. If we assume O&M to be proportional to initial procurement costs, we would have an equal sized shortage there.

In summary (CHART 10), we believe there is no way to reallocate resources within foreseen budget limitations to match the currently planned force levels with currently planned equipment costs and retain technological superiority in all of our forces at the same time. We are driven to this conclusion largely because the unit costs of available options are, in many cases, substantially above the amount we can afford to pay, and because there is insufficient flexibility to change program funds from one category to another without virtually eliminating a category. History shows that our weapon systems are increasing in cost by a factor of ten every twenty years. This cursory analysis indicates that we cannot allow this trend to continue.

There are, of course, alternative ways out of this dilemma. One alternative (CHART 11) is to reduce force levels. This alternative has occurred in the past, particularly as more modern, more cost effective equipment was developed and deployed. Part of the rationale has been that a few new, more effective equipments must be able to replace many less-effective, old units. We believe this total reliance on cost-effectiveness is no longer appropriate. We believe the force levels are now approaching the minimum size necessary to project our national policy. The alternative of continuing to reduce force levels is not very attractive.

Another alternative (CHART 12) is to expand and formalize the concept of a mixed force, which we have termed a high-low force mix. Under this notion we would consciously project a smaller high performance force, combined with a larger standard force designed for lower total cost. In the high performance force, we would seek technological superiority in a single mission. We would tend to design the item against the worst threat it would probably face and try to achieve a high readiness and mobility for this force. Other possible attributes are shown on the graph. In the standard force, we would try to stress multi-purpose characteristics, where desirable. The system would be designed against the largest numerical

threat, assuming that the higher performance forces could be made available to combat superior threat. Again, we have listed other possible attributes the standard force might have.

In fact, our present forces generally represent a "high-low" force mix of sorts, with higher performance in the newer machines and larger numbers of the older, poorer performing machines awaiting replacement. The difference here would be a plan to replace some high performance machines with better ones, and to replace others with cheaper ones. Variations in programmed mixes could then reflect annual defense budget variations.

However, this does not exhaust the possible alternatives for lowering costs. (CHART 13). This chart suggests two others. First, we need more stress on the continued product improvement of existing systems to avoid expensive start-up of new programs. The second possibility, we believe, is an all-out attempt to arrest the cost growth associated with continuously expanding "requirements."

(CHART 14). Let us look at the requirements a little closer. As I have already mentioned, several studies have indicated that in some classes of systems the difference between the cost of a 1960 system and a 1980 system is a factor of 10. The chart shows, for example, a new 1960 system as a reference point. We estimate it probably doubled in cost between the first and the last version. In this illustrative case, the initial estimate for the new 1980 system appears to be only 7 times as expensive as the 1960 system. But in reality -- and based on recent experience -- the true cost of the item has probably been underestimated for various reasons, including engineering changes, schedule changes, support changes, estimating changes, unforeseen problems, etc. This is currently causing substantial criticism of the Defense Department management because we really have been unable to accurately estimate the true costs of a weapons system at its inception. But better initial estimates do not, per se, reduce costs; they raise them. In reality, the true increased costs of weapons systems have been driven by demands for more performance. For example, we believe the components of increased cost -- payload, range, speed, avionics, accuracy, crew safety -- have been the dominant factors in causing weapons systems to increase in cost over any given time period. Of course, decreased production, increased paper work and inflation have also helped to drive costs upward. It is clear to us that alleged DoD mismanagement of weapons systems cost estimating has not been the dominant factor in cost increases. Abuse of the "requirements" process is the more likely culprit.

(CHART 15). This chart shows a declassified summary of performance growth characteristics taken over 13 major sets of new and old systems. On the average, R&D cost has gone up 5.4 times and unit cost 4.2 times over their predecessor systems. For these increases, very substantial performance growth has been obtained. For example, on the average, payload has more than doubled; range and speed have almost doubled; and other functions have about tripled. We believe these increases in performance adequately explain over half the increases in costs. It is clear that we are now running into a new constraint. We cannot afford to continue along the path of increased performance with its implicit higher cost across a wide range of systems. We must avoid new requirements which are "nice-to-have." New technology for newness' sake has got to go by the boards.

We believe it is possible to make substantial and meaningful reductions in cost by a serious review of the initial requirements. (CHART 16). For example, the nameless case depicted here indicates that in one weapon system it was possible to eliminate frills without changing the major system characteristics and reduce the cost by 13%. Review of the initially stated requirements in context of currently projected environment could lead to the reduction of another 22% from the unit costs. Overall, this would result in 35% savings without affecting the military effectiveness. If this much can be cut from several categories of weapons systems, it is quite possible that we will be able to live within our projections of DoD fund availability. If we find it impossible to make cost reductions either by changing requirements or mixing forces, it is quite likely that we will be forced to smaller forces.

In conclusion (CHART 17), the following recommendations fall out of this study and are presently rattling around in the Pentagon. First, we need to formalize the process of designing to a cost. We must encourage the OSD staff and the Military Departments to improve their capabilities to do this. Second, we need to dispel the myth of bigger defense budgets just around the corner. We think this is false optimism. Third, we need to revise our defense long-range planning to allow more extended budget forecasts and force level projections to be made which allow some flexibility for new programs. We need to revise our accounting and reporting systems to improve our ability to make and check lifetime cost studies. In particular, we need to get a better understanding of the potential for more efficient use of O&M funds, training and base support funds, as well as manpower allocation. Also, we need to consider the overall concept of the mixed force to accommodate the budgetary limitations and retain sufficient technological superiority as well as numerical sufficiency.

(CHART 18). Continuing these as yet unapproved recommendations, we need to revise the requirements process in the Military Departments to emphasize problems of cost. We need to undertake special cost reduction R&D programs to increase reliability, where appropriate, and provide standardized components as well as lower cost options. Together, these recommendations would represent a huge shift, if implemented. We think we need a change of approach within the industry and military to emphasize cost as an equal parameter with performance and schedule. Overall, we think this is a very large task and we shouldn't fool ourselves into underestimating its magnitude. Just getting "the word" to permeate "the system" could take years.

As you realize, it will be a big task and we will need to call on you for help. We think the nation's security depends upon effectively answering this challenge we now face. It isn't a job the Defense Department can do alone. As Mr. Rush said earlier, we realize that we in Defense have to make these changes. But you must help us change.

By now, many of you have probably felt pressures from the Services to reduce costs or design systems to a target cost. The AX program is a good example of this. Another example is the lightweight fighter which is now being built as prototype under a design goal of a $3 Million unit cost. In both these cases we already have indications of designs being changed to reduce production costs. Both present opportunities to move towards a conscious all modern, high-low force mix. I hope those of you who have been working on the B-1 program, particularly in the avionics, have felt pressures to hold avionics costs to an acceptable value. I am also sure that many of you who have worked on that program have been disappointed when your favorite gadget has not been used in the design. We can no longer afford to "require" your favorite gadgets unless we are very sure that the added complexity is absolutely essential -- not just cost-effective on one trumped-up scenario. Some of you may know that the F-15 characteristics have been modified to eliminate costly subsystems of questionable value. Some others of you may know what's happening to the Army's armed helicopter program. I believe another case of the new look is the UTTAS, where target costs have been provided for the airframe. Although a worthy start, I predict the UTTAS is still too expensive. The Navy's ship designers are feeling the pressure. Eventually, the Navy's air arm will also feel the squeeze -- as does the Army's SAM-D contractor, and as do the Air Force's contenders in the Medium STOL transport.

We simply cannot afford to repeat our unfortunate experience with the MBT and the AAFSS by allowing the cost of another system to rise too much. Congress has shown its willingness to eliminate programs that they believe

are too costly. We should not, by default, force them to exercise that willingness again. I would like to close by repeating some remarks by both Mr. Rush and Dr. Foster. The study I have presented was not made for industry consumption, nor intended to point the finger of blame at industry. American engineers are equally competent to design a LEM or a Pinto. We know that. The problem is for us to decide which we want, and then tell you so.

The problem, of course, is that industry aids and abets our establishment of requirements. We never establish totally unattainable requirements. We seldom ask for much more than you have said is possible. Unfortunately, we seldom ask for what's practical, and you seldom tell us. Our standards need revising -- on both sides. Unless we can get a better exchange of ideas for lower cost alternatives and establish a willingness for the Defense Department to reconsider "requirements" when they drive the cost, we will be unable to make the necessary improvements. I think the best opportunity for making cost-conscious designs lies in this area of exchange between the DoD and industry. I believe we must embark on this course together. There could be enormous satisfaction in providing more defense for less tax dollars. I assume you would agree. Thank you.

DESIGNING TO A COST:

-OR-

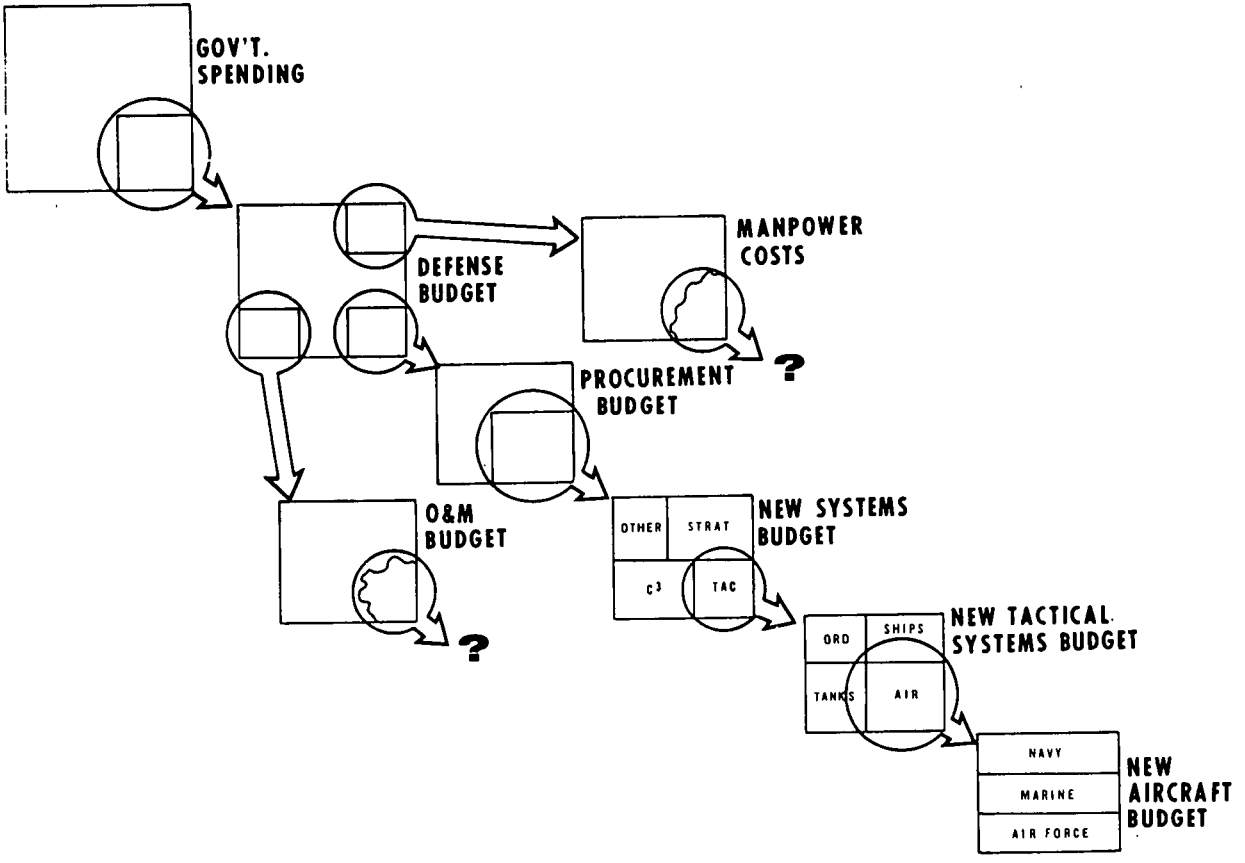
ASSESSING THE BUDGETARY REALITIES

2184

BASED ON
- REALISTIC BUDGET PROJECTIONS
- A RELATIVELY CONSTANT FORCE LEVEL
- REALISTIC INFLATION

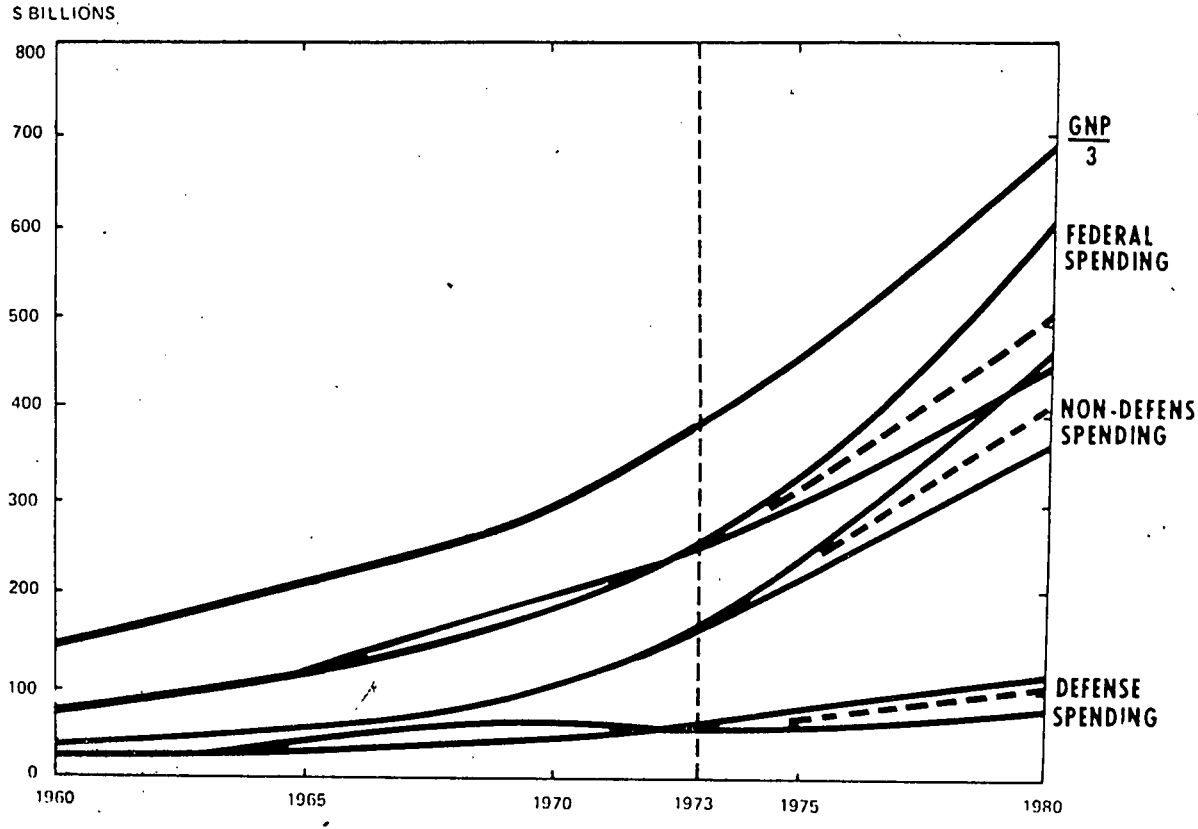
HOW MUCH CAN WE AFFORD TO SPEND TO BUY AND OPERATE VARIOUS WEAPON SYSTEMS?

METHOD OF DETERMINING "AFFORDABLE" COSTS



PROJECTED FEDERAL SPENDING

HYPOTHETICAL



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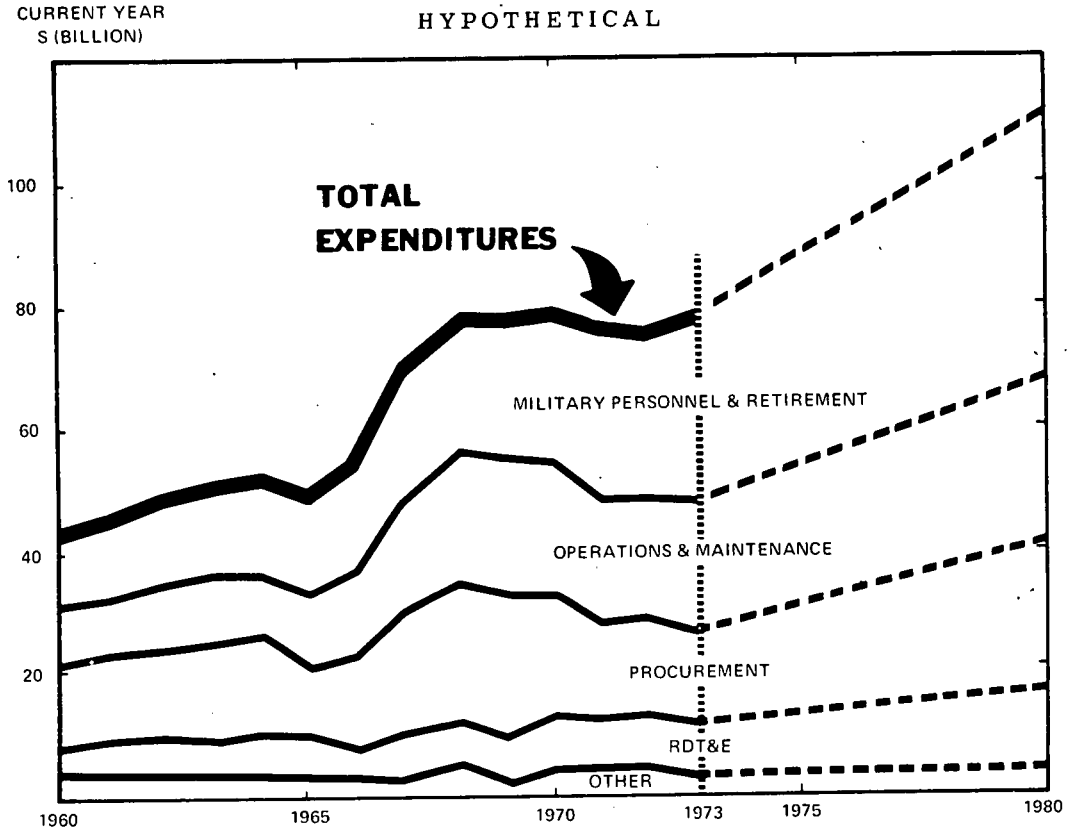
DEFENSE EXPENDITURES 1960-1980

HYPOTHETICAL



A $112 BILLION DOD BUDGET IN 1980 IS IDENTICAL TO AN $83 BILLION BUDGET NOW, ASSUMING NO FORCE LEVEL CHANGES.

WE SEE LITTLE OPPORTUNITY FOR GROWTH IN "PURCHASING POWER" BY 1980.

IN TRYING TO ALLOCATE TOTAL COSTS TO SPECIFIC SYSTEMS:

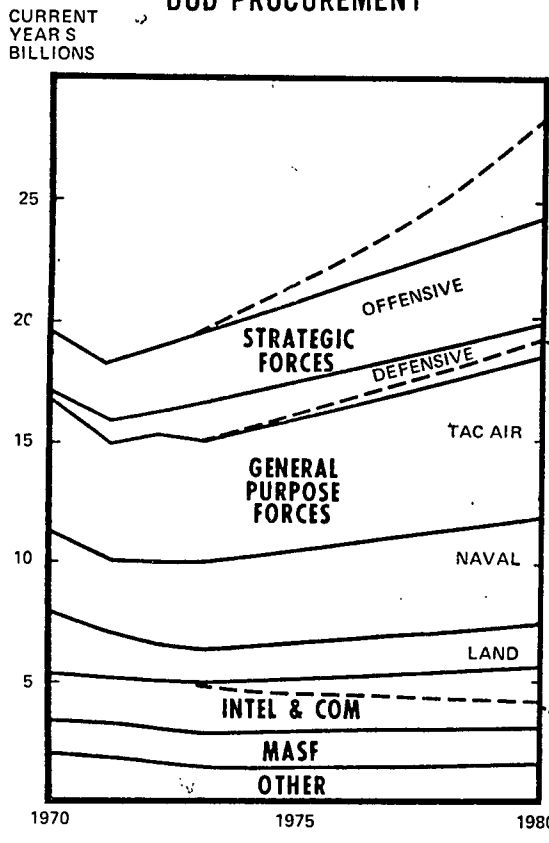
* WE CAN ALLOCATE DIRECT OPERATING COSTS ONLY TO MISSION AREAS AND SOME CLASSES OF SYSTEMS

* WE CANNOT ALLOCATE GENERAL SUPPLY, MAINTENANCE AND BASE OPERATING COSTS TO SPECIFIC SYSTEMS

* WE CAN ALLOCATE TOTAL PROCUREMENT COSTS TO SPECIFIC CLASSES OF SYSTEMS

. . . . As shown by example on the following pages:

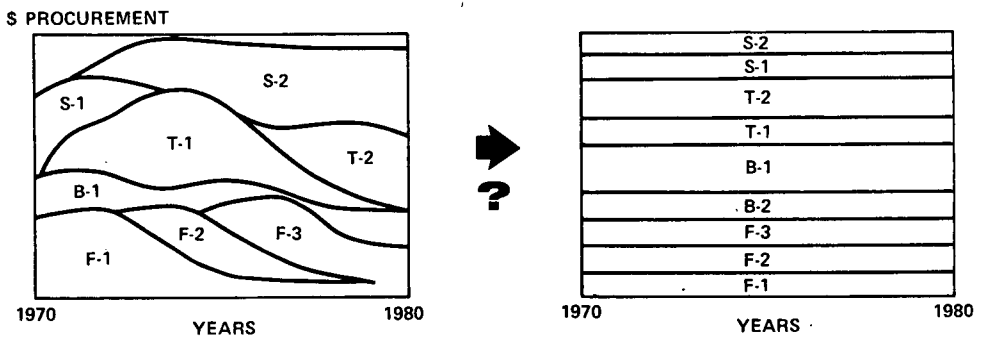
TOTAL OBLIGATIONAL AUTHORITY
DOD PROCUREMENT



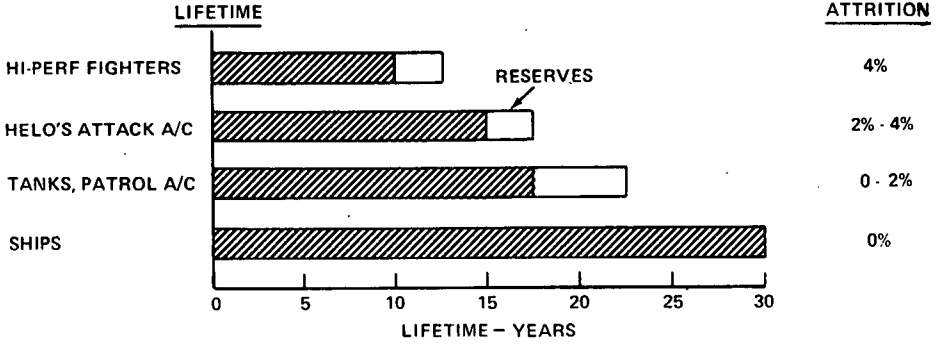
ESTIMATED AVERAGE FUNDS
(FY 73 DOLLARS)

STRATEGIC FORCES	OFFENSIVE		AIRCRAFT & SPARES	300	3200
			AIRCRAFT MISSILES	200	
			LAND BASED MSLS & SPARES	800	
			SUBMARINES & SPARES	1100	
			SUBMARINE MSLS & SPARES	800	
	DEFENSIVE		AIRCRAFT & SPARES	250	1000
			SURVEILLANCE	250	
			ABM OR BOMBER DEFENSE	500	
GENERAL PURPOSE FORCES	TAC AIR	AIRCRAFT	TAC A/C	2,400	5,600
			ASW	300	
			TRAIN & AIRLIFT	200	
			MODS	700	
			SPARES	600	
			SUPPORT	400	
		MIS & ORD	MISS PROC & SPARES	500	
			ORDNANCE	500	
	NAVAL	SHIPS	SHIPS	2,200	3,600
			SUPPORT	500	
		ORD	ORD & SUPT	500	
			C&E & OTHER	400	
	LAND & AMPHIB	USMC	ALL	200	1,600
		ARMY	A/C HELOS & SUPT	400	
			MISSILES & SPARES	400	
			COMB & SUPT VEHCLS & WN	400	
			AMMO	200	
			C&E & OTHER	200	

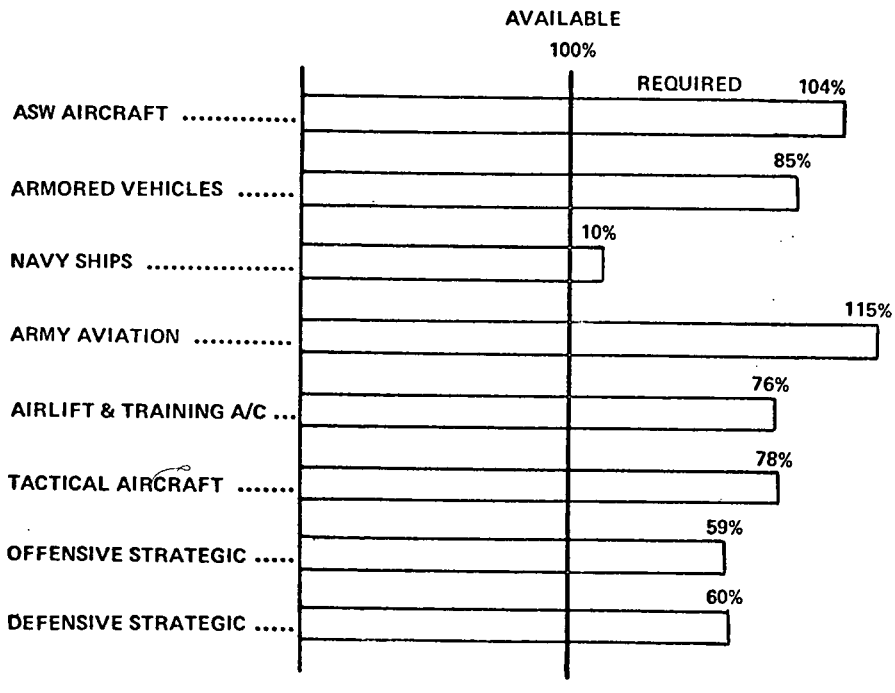
APPROXIMATION OF ANNUAL PROCUREMENT COSTS



$$\text{Annual Procurement} = \text{Unit Cost} \times \left[\frac{\text{Inventory}}{\text{Lifetime}} + \text{Annual Attrition}\right]$$



SUMMARY OF "AVAILABLE" AND "REQUIRED" ANNUAL PROCUREMENT FUNDS



	AVAILABLE $M	ADDITIONAL REQUIRED $M
ASW AIRCRAFT	300	313
ARMORED VEHICLES	250	211
NAVY SHIPS	2200	190
ARMY AVIATION	325	375
AIRLIFT & TRAINING A/C	200	152
TACTICAL AIRCRAFT	2400	1852
OFFENSIVE STRATEGIC	1900	1330
DEFENSIVE STRATEGIC	950	617
TOTAL	$8525	$5040

BASED ON THIS SAMPLE, WE BELIEVE:

THERE IS NO WAY TO RE-ALLOCATE RESOURCES WITHIN FORESEEN BUDGET LIMITATIONS TO:

- MATCH CURRENTLY PLANNED FORCE LEVELS WITH CURRENTLY PLANNED EQUIPMENT COSTS

AND

- RETAIN TECHNOLOGICAL SUPERIORITY IN ALL OUR FORCES

ONE ALTERNATIVE IS TO REDUCE FORCE LEVELS:

	FROM	TO
TACTICAL AIRCRAFT	5,483	3,140
ARMY AVIATION	7,405	3,420
NAVAL SHIPS	618	558
ARMORED VEHICLES	26,100	14,200
ASW AIRCRAFT	831	414

ANOTHER ALTERNATIVE IS TO ADOPT A HI-LO FORCE MIX:

A Small Elite Force with
HI PERFORMANCE:

- Technological Superiority
- Limited Versatility
- Worst Tech Threat
- High Self-Defense
- High Readiness
- Air Mobility?
- All-Weather?
- Shorter Life?
- US Unique?

A Larger Standard Force with
LO TOTAL COSTS:

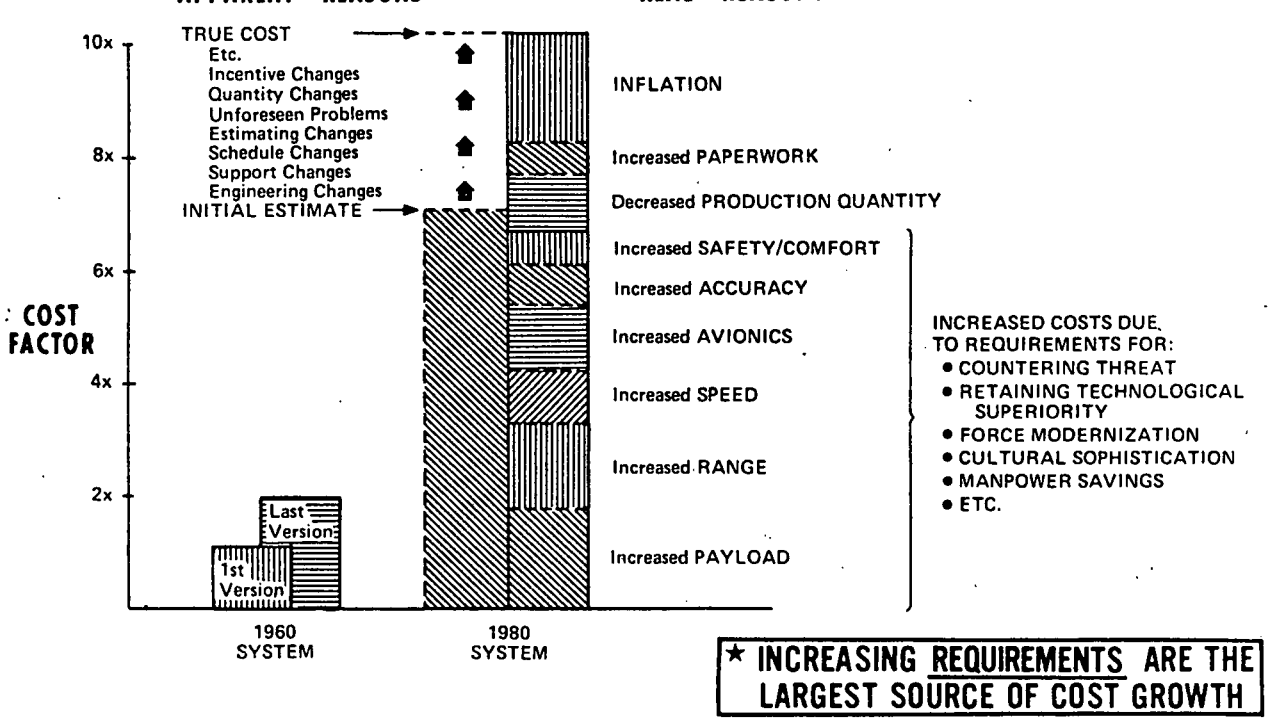
- Numerical Adequacy
- Multi-Purpose
- Largest Numerical Threat
- Lower Self-Defense
- High Reliability
- Ground/Sea Mobility?
- Clear Air Mass?
- Longer Life?
- NATO Common?

OTHER ALTERNATIVES INCLUDE:

* STRESSING CONTINUED PRODUCT IMPROVEMENT OF EXISTING TYPES TO AVOID COSTLY START-UP OF NEW PROGRAMS

* ARRESTING THE COST GROWTH ASSOCIATED WITH CONTINUOUSLY EXPANDING "REQUIREMENTS"

REASONS FOR "COST GROWTH" IN REPLACEMENT SYSTEMS



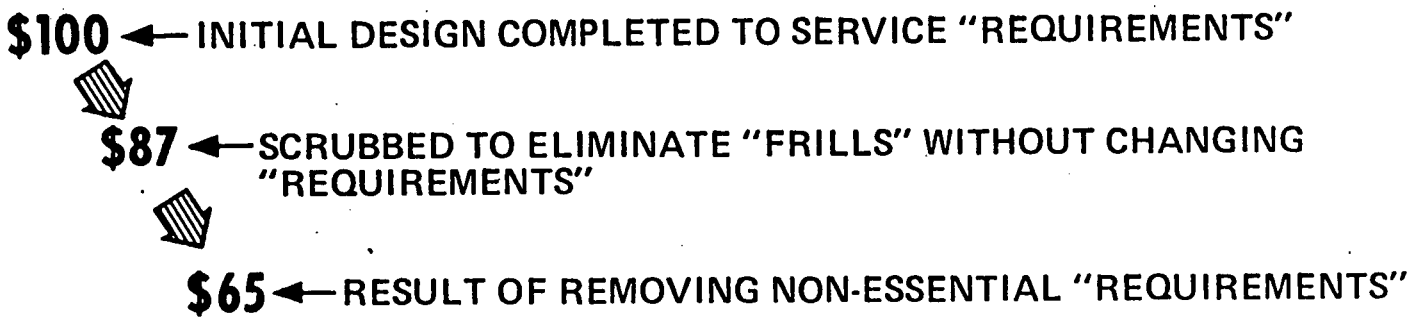
★ INCREASING REQUIREMENTS ARE THE LARGEST SOURCE OF COST GROWTH

AVERAGE GROWTH IN COST & PERFORMANCE

COST GROWTH		PERFORMANCE GROWTH					
R&D Cost	Unit Cost	Payload	Range or Endurance	Speed	Avionics Function	Crew Comfort or Safety	Delivery or Navigation Accuracy
5.4x	4.2x	2.3x	1.9x	1.8x	3x	3x	3x

THIS AVERAGE BASED ON 13 MAJOR SETS OF NEW AND OLD SYSTEMS.

ONE CASE HISTORY IN COST REDUCTION



RESULT: 35% SAVING IN UNIT COST WITHOUT AFFECTING REAL MILITARY EFFECTIVENESS

RECOMMENDATIONS

* We need to formalize the process of DESIGNING TO A COST and encourage the OSD staff and the Military Departments to improve their awareness and capabilities to assess the adequacy of the fiscal planning

* We need to DISPELL THE MYTH OF BIGGER DEFENSE BUDGETS "just around the corner" so that the Military Departments and Industry will take this problem seriously

* We need to revise our DEFENSE LONG RANGE PLANNING systems to include

  - realistic, authoritative Defense Budget Forecasts
  - 10-20 year budget and force level projections
  - inclusion of a "planning wedge" for as yet unauthorized programs

* We need to revise our ACCOUNTING AND REPORTING SYSTEMS to permit vastly greater visibility into

  - O&M Costs
  - Training Costs
  - Base Support Costs
  - Manpower Allocations

  before we can really understand what savings are potentially available

* We need to consider the overall concept of a "HI-LO FORCE MIX" to accommodate both BUDGETARY LIMITATIONS and DWINDLING TECHNOLOGICAL SUPERIORITY

RECOMMENDATIONS (con't)

* We need to revise the REQUIREMENTS process in the Military Departments to include an awareness of costs
* We need to undertake SPECIAL COST REDUCTION RDT&E Programs to increase reliability and/or decrease maintenance and to provide standardized components
* We need to establish an effective well-planned campaign throughout industry and the military, instigated from the highest levels, but PLANNED WITHIN DOD
* We need to TAKE TIME TO PLAN what is practically achievable and HOW TO DO IT

DO NOT UNDERESTIMATE THE MAGNITUDE OF THE TASK

..... OR THE NEED TO SELL IT TO ALL LEVELS

Chairman PROXMIRE. First, Mr. Sullivan said it was the best Defense Department "guestimate" that we would have a defense budget of approximately $112 billion by 1980, an increase of $29 billion over the present $83 billion fiscal 1973 budget. He also indicated that the entire $29 billion increase would be consumed by inflation, as I indicated, and that a $112 billion budget in 1980 would be identical in purchasing power to today's $83 billion budget.

Mr. Shillito, is the Defense Department convinced today that there is no prudent way in which we can reduce future defense budgets below current levels, and that we have no choice, absent a dramatic shift in world conditions, but to look forward to a budget which will rise steadily between $3 to $5 billion per year between now and 1980?

DEFENSE COSTS TO RISE

Mr. SHILLITO. Mr. Chairman, if we were to make the assumption that world conditions would be somewhat comparable to that which they are today, we would have to assume that, and if you were to make the assumptions that price escalations would be at a comparable level to what they are today, and that the gross national product would move at somewhat the rate it has today, and you tied all these assumptions together, you would have to assume that in order to just keep pace that the cost of this country's defense operations are going to increase. We cannot possibly expect everything else to increase, and the threat be at least comparable to that of today, and that defense in current dollars, then year dollars, would go down. In constant dollars defense costs would be comparable.

Chairman PROXMIRE. Yes, that is what I am talking about. I am talking about whether there are sufficient improvements, sufficient changes, modifications in our procurement, and in our manpower policies and other expensive policies which can give us encouragement maybe we can do this for somewhat less.

MANPOWER COSTS

Mr. SHILLITO. Well, I made a point in my brief introductory remarks, Mr. Chairman, that I think is vital as far as we are concerned in defense. These assumptions that I talked about, if they stay somewhat as I indicated in then year dollars, defense has to go up slightly. But the thing that really bothers me as much as anything else about our defense budget is this shift that has taken place within this defense budget.

You are looking at a situation as we go into fiscal year 1974 where about 60 percent of our defense budget is going to people. As I mentioned last year, Mr. Chairman, I think you voted for everyone of the pay increases that are tied to these people.

Chairman PROXMIRE. I did indeed. I do not think there is any economy in doing it any other way; I think you would agree with me.

Mr. SHILLITO. I am agreeing, but you helped us increase the budget.

Chairman PROXMIRE. But I also helped you decrease it.

Mr. SHILLITO. We were whipsawed.

Chairman PROXMIRE. No, one way is to provide adequate pay so you do not have an unjust system to draft people.

Mr. SHILLITO. You are right.

Chairman PROXMIRE. And have them in, and you and the Secretary of Defense agree with that.

Mr. SHILLITO. Yes, sir, completely.

Chairman PROXMIRE. What I am saying is that there are other areas where you can make cuts.

Mr. SHILLITO. Yes, but the point I am making, Mr. Chairman, is that you have been critical of our defense budget, but the vast majority of the even then year dollars in the defense budget, 1964 to 1972, 1974, ties into these increased costs of people.

Now we are looking again at 60 percent of our defense budget costs going to people. It was only 43 percent prior to Vietnam, and we have less people today in the Department of Defense than we had prior to Vietnam for something like $20 billion more in the way of people expenses. We have to get on top of this people situation, somewhere, somehow.

Chairman PROXMIRE. I am just asking how the factual situation looks to you.

Let me proceed a little further.

Mr. SHILLITO. Yes.

Chairman PROXMIRE. Is it the Defense Department's intention, in light of present and forseeable pressures on the overall Federal budget—we are very aware of those pressures, the President is putting a ceiling on.

Mr. SHILLITO. Sure.

Chairman PROXMIRE. I had a chance to talk with Mr. Shultz yesterday at some length along with some other Senators and I think that ceiling is going to surprise a lot of people, the one coming up for fiscal 1974; it is going to be very tight, indeed, which means a lot of pressure on you, that is the Defense Department, as well as the other departments in the Government.

Mr. SHILLITO. Yes, sir.

Chairman PROXMIRE. So that under these circumstances you just wonder, is the Defense Department intention to make whatever changes in the present policies may be necessary to at least limit future increases in defense spending to the amounts needed to maintain a constant purchasing power for the procurement dollar?

In other words, is $112 billion a relatively firm ceiling which the Department will enforce, or does it feel it could raise that figure even further if cost overruns continue, unit costs rise, and our force structure starts to fall?

Again, this is not meant to be an argumentative question.

Mr. SHILLITO. Yes, sir.

Chairman PROXMIRE. It recognizes we do have these pay increases, we are going to have them in the future, and we are likely to have these overruns and other increased costs.

What are you going to do about it, how can you get a ceiling, in other words, without cutting into the guts and strengths of your defense effort?

Mr. SHILLITO. Mr. Chairman, I am sure you would agree with this.

When unit costs rise with regard to a weapons system, and when we are faced with the kind of budgetary problems that we have today, and have had in the past few years, we are not looking at a situation where annual expenditures for major weapons systems go up. In fact, that is part of the problem. We generally end up with less in the way of major weapons systems, and that is the problem.

Chairman PROXMIRE. Right.

Mr. SHILLITO. So really, what happens is. when unit costs go up, force size suffers, and that too is the problem.

Now, I would like to hope that as we move forward, and as world conditions change, that the defense budget in toto will shrink and shrink significantly. But again you have to tie this entire situation to the need for strength as related to a given time frame.

Chairman PROXMIRE. Let me just proceed a little bit further.

Mr. SHILLITO. But I would like to say that, first of all, national security is paramount and we have to assure we have national security, and it has been made clear by, well I go back to Bernard Baruch—you know his comment was, if, first of all, you do not have national security, that which you have is really worthless, and I feel very much that way.

Chairman PROXMIRE. I agree with that. We have to have national security that is adequate.

Mr. SHILLITO. Sure.

DEFENSE COSTS-PROJECTIONS

Chairman PROXMIRE. But let's look at, next. what $112 billion would actually buy in 1980. and this is what really disturbs me. and this is the heart of Mr. Sullivan's presentation; I think it illustrates dramatically that the Defense Department has a lot of work ahead for it, even if it gets $112 billion in 1980, if it hopes to provide at that time the kind of force structure which a prudent defense posture may require.

Mr. Sullivan breaks out eight specific kinds of defense hardware, and he attempts to estimate for each how many dollars would be available in a $112-billion 1980 budget and how many dollars would be needed to maintain our present force structure in light of the projected costs of the specific new systems now in the pipeline.

I find his conclusions for these eight specific kinds of hardware quite staggering. He estimates that we will have $8.5 billion available for this hardware in 1980, but that we will need $13.5 billion, $5 billion more to maintain the present force structure which the $112 billion would cut into, given inflation and so forth. So without economics somewhere a $112 billion defense budget would cut into our present defense preparedness status.

For several years now, Mr. Shillito, not only I but the Senate Armed Services Committee and many other observers, have expressed concern over the skyrocketing unit costs of defense hardware and have suggested that we may be on the verge of pricing ourselves out of an effective defense. I have referred to the process as "gold-plated unilateral disarmament."

Does not Mr. Sullivan's analysis show that the basic thrust of these criticisms has been right and that major changes are needed and needed now in our present procurement policies?

Mr. SHILLITO. Mr. Sullivan's statement, by the way, which I am thoroughly familiar with, Mr. Chairman, and went over in some detail, is one that I, on balance, agree with. It is somewhat hypothetical in some ways. But he emphasizes just a few points that come through loud and clear, the points that I made in my proposed statement today in a little bit different way, points that tie into our necessity to reduce hardware costs, major weapons systems costs.

The philosophy of design to cost, I think, also comes through in his statements loud and clear, in the interest of trying to get on top of our hardware costs.

I have talked many times, about, the necessity for our getting on top of our initial operating requirements, which I think is something that we really have not gotten on top of adequately, Mr. Chairman.

We must do a much better job of determining what goes into these weapons systems in the interest of doing something about the total weapons systems costs.

The only other point I would like to make is where he talks about $5 billion more, as far as staying on top of our present force structure, really, Mr. Chairman, this is not much more than an extrapolation of that which has taken place from 1964 to 1972 as far as staying on top of that which is necessary to do the job required for our present force.

Chairman PROXMIRE. Well, this troubles me because I can see a tough problem for the Defense Department, the Congress, and the country here.

Sullivan does think we will be $5 billion short in the eight specific areas he discusses, that there may be another $2.5 billion shortfall in the operations and maintenance of this hardware, and he notes the historic tendency of current estimates to always rise over time. If this is right, and it costs more than now expected to maintain a voluntary army, it might take a $125 billion budget in 1980 to maintain something akin to our current force structure.

Is it not a fair statement, in light of Mr. Sullivan's analysis, to say that the continuing rise in the unit costs of defense hardware presents us with a problem of crisis proportions?

Mr. SHILLITO. Again the point that Mr. Sullivan is making is that we have to decrease the costs of major weapons systems. That is the single point that he is making and, Mr. Chairman, you agree with that, I agree with that and, Mr. Chairman, I also feel that we have a level of sophistication in many of our major weapons systems that is not necessary. I think we have to do more about getting numbers of weapons that will do the job effectively without concerning ourselves with some of the nice-to-have kind of things that have often been a part of these major weapons systems, and that is a point that Leonard Sullivan is emphasizing in his speech.

Chairman PROXMIRE. That is right. But I wonder if we are making anything like the kind of progress we have to make.

You refer to and, as you know, I support your reference to the AX, the lightweight fighter.

Mr. SHILLITO. Surely.

Chairman PROXMIRE. And also to an austere attack helicopter for the Army, and to the Navy's sea control ships and surface effects ships programs. But let's look for a moment at some of the eight specific areas cited by Mr. Sullivan, and see what's actually on the drawing board.

TACTICAL AIRCRAFT

Tactical air, in the first place: Mr. Sullivan notes that our tactical air needs constitute in dollar terms the largest single procurement requirement facing us in the years ahead. He estimates that we would have $2.4 billion available for tactical air procurement in his projected 1980 budget, but that we would need almost $4.3 billion to maintain our current force structure given the expensive new planes now in the pipeline. That is a shortfall of $1.9 billion; it indicates a need for 78 percent more tactical air procurement dollars than we are likely to have. And the problem would be much worse if we could not count on the AX coming into the inventory.

Now, some of this 78 percent shortfall could be eliminated if the Air Force formally adopted the concept of a "high low" force mix for the fighter part of its tactical air forces, if it bought only a limited number of expensive F–15's and a larger number of inexpensive light weight fighters. But the Air Force continues to speak of the light weight fighter as a technological development program and says it has no firm plans for lightweight fighter production.

In light of Mr. Sullivan's study, has the Defense Department now made a firm decision that some lightweight fighters will, in fact, be needed in the Air Force as a complement to the F–15?

Mr. SHILLITO. Mr. Chairman, I would like to furnish the answer to that question for the record.

So far as the Air Force's plans, relative to light weight fighters, AX's and so forth—numbers, et cetera—I don't think any of these terms are classified but I would prefer to give you this for the record.

[The following information was subsequently supplied for the record:]

The lightweight fighters will not be missionized aircraft, but advanced development prototypes to investigate promising new technology which could not be incorporated in production aircraft because of the risks involved. This prototype program will assess the performance improvements of this technology; evaluate the operational utility of a limited capability, lightweight, high performance fighter; and provide a means of accurately determining the cost of possible follow-on operational versions should such an aircraft prove feasible. With the current technical and cost uncertainties, the Air Force considers a lightweight fighter production decision to be premature at this time.

Chairman PROXMIRE. Do you see any way in which the Air Force will be able to maintain a viable fighter force structure unless it buys some light weight fighters in addition to the F–15.

Mr. SHILLITO. It is going to——

Chairman PROXMIRE. How can it maintain any kind of a viable fighter structure?

Mr. SHILLITO. It is going to have to acquire more in the way of aircraft and less per unit costs for aircraft.

F–15

Chairman PROXMIRE. There is no way the F–15 can get down below $6 million and probably the cost will be $10 million a copy.

Mr. SHILLITO. I am not going to comment on what the F–15 will end up being. I am very satisfied with the program of the F–15.

Chairman Proxmire. I think it is a terrific plane, I agree.

I have no quarrel about that. It is just the cost is so enormous.

Mr. SHILLITO. Again, it depends on the quantities.

Chairman PROXMIRE. Right.

Mr. SHILLITO. Really, Mr. Chairman, there are only a couple of fundamental things that tie to this whole subject that we are talking about here. Admittedly the budget and this sort of thing becomes terribly important, but you end up with the necessity for tying time and price and performance as the fundamental elements of every one of these major weapons that we get into. You have to relate that to the dollars available and the threat and, of course, on most of the major weapons systems we are talking about, you quite logically would have to assume that you are not really going to be quite sure as to what some of these weapons are going to end up costing you until you get fairly well downstream.

Chairman PROXMIRE. Well, we know perfectly well that the F–15 is going to cost, as I say, around $10 million a copy.

Mr. SHILLITO. I don't believe that, Mr. Chairman. Our parametric estimates in-house would not indicate that.

Chairman PROXMIRE. Substantially less?

Mr. SHILLITO. Yes, the procurement cost is substantially less.

Senator PROXMIRE. Enough so that you could have a viable AF structure without having lightweight fighters in addition?

Mr. SHILLITO. I am not going to answer your question specifically.

Chairman PROXMIRE. Let me then very briefly get into another area because I do want to get into progress payment and some of these other things.

Mr. SHILLITO. Certainly.

F–14

Chairman PROXMIRE. It seems to me the Navy is in even worse shape in Tac Air than the AF. Even for comparable force levels. The F–14 will cost over $16 million a copy. I think there is every reason to expect it can go to $20 million a copy—and that disparity would be greater in the event of a Grumman bailout.

If the DOD is really taking steps to solve its procurement cost crisis, what inexpensive complements to the F–14 are now on the Navy drawing boards?

Do you think we can realistically afford 300 F–14s at $20 million a copy?

Mr. SHILLITO. Well, again it depends on, as I say, the threat, Mr. Chairman, and the importance of the AW6–9—Phoenix weapons system which the F–14 carries.

Chairman PROXMIRE. It is simple arithmetic, you simply could not afford to have adequate force structure with a $16 or $20 million F–14 within the Navy with a reasonable budget. It is just not there.

Mr. SHILLITO. We will have to see how the F–14 negotiation works out. A lot of your colleagues on the Hill, of course, do appreciate the importance of that weapon. I too appreciate the importance of the weapon. I am not sure as to what the numbers of the weapons should be or have to be. At the same time strategy and tactics are not a responsibility fortunately, of I. & L. Everything sometimes seems to be. After the present negotiations are behind the Navy, I would like to suggest at that time you go into this in more detail.

Chairman PROXMIRE. I don't want to get into it too late. We are getting into a position where we are moving on these weapons and have to move and commit ourselves.

Mr. SHILLITO. Mr. Chairman, the Services involved and particularly in this case the Navy, in conjunction with the committees that they have to work with day in and day out for their authorizations and appropriations are not getting into these things, I don't think, too late. I mean they are constantly concerning with this sort of thing.

Chairman PROXMIRE. The questions on Army aviation I will skip and ask you to answer for the record when you correct your remarks.

Mr. SHILLITO. Yes, sir.

ARMY ATTACK HELICOPTER

Chairman PROXMIRE. Let's look at the related field of Army aviation. Mr. Sullivan estimates that there will be $325 million available in 1980 for Army aviation, but that we will need $700 million—over 100 percent more—to maintain our current force structure.

Now one of the reasons for this huge shortfall is the Army's insistence on having its own close support plane. The Cheyenne is dead, but the Army has already started work on what it hopes will be a cheaper replacement.

If the Army does face a 100 percent shortfall in its aviation budget, is there really any place for a new attack helicopter which is any more sophisticated or expensive than the present Cobra?

[The following information was subsequently supplied for the record by Mr. Shillito:]

The Army urgently needs an attack helicopter which is more capable than the Cobra. It needs a helicopter which can routinely operate in the nap-of-the-earth environment, at night, and during adverse weather. The planned advanced attack helicopter (AAH) will be smaller and less sophisticated than the Cheyenne. However, through experience gaind from the Cheyenne development program, the current state of the art will permit the vertical flight performance capabilities of the AAH and its flight agility to be greatly improved over those of the Cheyenne or any other existing attack helicopter. The reduction in sophistication and increased flight performance changes have evolved as a result of field experiments and computer analyses which have identified those areas of tactical benefit. The AAH characteristics have been patterned after these findings to achieve a more cost effective combat system. The present Cobra is performance-limited and has very limited night capability. When the AAH becomes operational, it will provide the "high" capability assets and the Cobra will provide the "low" capability assets for the planned "high-low" force concept described by Mr. Sullivan.

Chairman PROXMIRE. If the Army is still committed to a more complex helicopter, what change in its procurement policies can you point to that would seriously indicate it is on the way to solving its procurement crisis?

[The following information was subsequently supplied for the record by Mr. Shillito:]

During the past year the Department of the Army has made a number of significant changes in its procedures by which it acquires major weapon systems. These changes are set forth in Army Regulation 1000–1 titled "Basic Policies For Systems Acquisition By the Department of the Army." That AR was issued on 30 June 1972 and contains new policies which will shorten the requirements generation and system development time and will improve the Army's decision making process. One of the principal changes which has been implemented is a policy for establishing a "Design-to-Production Unit Cost" objective early in the acquisition cycle for a major weapon system. That estimate will be the basis on which system changes and trade-off analyses are made. The estimate will be included in development contracts so that contractors can design equipment which can be produced below the estimated amount and so that contractors will be placed on notice that if production costs exceed the amount the program may be cancelled. "Design-to-Production Unit Cost" estimates have been placed in contracts for the SAM–D and UTTAS systems and will be placed in all future major systems contracts.

STRATEGIC WEAPONS

Chairman PROXMIRE. I would like to get into one other area before getting into strategic weapons. Let me touch briefly on strategic weapons.

Mr. Sullivan suggests that we will have a shortfall of 59 percent in 1980 on strategic offensive weapons and a shortfall of 60 percent on strategic defensive weapons.

Can you point to one new "design-to-cost" system now on the drawing boards in the strategic field that is likely to eliminate this shortfall?

Mr. SHILLITO. We, of course, have gone into "Design to Cost" in some detail as far as elements on the Trident, Mr. Chairman, but, of course, that is such a significant percentage of the total that I do not think I have to go much further than that, but significant elements of the Trident are receiving that sort of attention, sir.

Chairman PROXMIRE. I am not sure you answered my question. I asked you if you could tell me just one new design-to-cost system now on the drawing boards that is likely to eliminate the shortfalls, in other words, come up with a less expensive weapon to do the job or enough of the job to satisfy it.

Mr. SHILLITO. I wouldn't suggest that would eliminate the shortfall, I would not want to suggest that.

Chairman PROXMIRE. Well, the Trident situation aggravates the shortfall, as I understand it: if we accelerate the new billion dollar Trident submarines then we are really in trouble.

Mr. SHILLITO. You are talking about designing to costs, you are talking about the result of this application of obtaining more in the way of defense hardware per dollar. Of course, we are trying to do this on virtually every one of our programs. A major portion of our strategic program, though, as you know, with the exception of the Trident, are well along, and, in many ways, fairly well behind us.

Chairman PROXMIRE. I won't pursue this line of questioning any further right now, but the subcommittee may wish to submit written questions on the Sullivan study and I would appreciate your replies to that.

I want to say, before turning to another subject, it's nice to talk in general ways about new philosophies in defense procurement and the legitimate progress which the DOD is making. But that is not enough. In my opinion, Mr. Sullivan's speech of August 16 is a remarkable presentation. It is remarkable both for its candor and, whatever weaknesses it may have, for the depth of its analysis. It defines both the nature and the magnitude of the procurement crisis which we face in the years ahead.

You say you are moving to solve that crisis, but I am not convinced. There is one way, however, that you can convince me. Would you will willing to go back to the Pentagon, put a team together, build on the Sullivan study, and report back to the subcommittee sometime next year with specific recommendations for each of the eight areas cited in the study showing how we can square the funds available and the funds needed to fulfill our force structure objectives in the 1980 period?

I wouldn't expect an iron-clad long-term program; I'd be content with options we might choose between in the different areas. I think you might want to include in that presentation of options some areas—perhaps number of aircraft carriers and the makeup of a new bomber defense system—where our force structure itself could realistically be cut.

I would appreciate it if you could give us something like that again, not this morning, but if you could put a team together and come back or have your successor, or have your successor come back, I understand, and I regret you are leaving us, I understand you are leaving us, I regret it, you have done a good job. Do you see any reason why such a team could not make such a study for options?

Mr. SHILLITO. Indeed such a study could be conducted. In many ways you have to realize that the Sullivan efforts tie in very much to just that.

Chairman PROXMIRE. Would you be willing to conduct such a study?

Mr. SHILLITO. I would like to suggest this, Mr. Chairman: I will indeed go back to the Pentagon and discuss this with Leonard Sullivan and others and then will advise you of what the outcome of this discussion is.

Chairman PROXMIRE. I hope you will, and I hope either in I. & L. or D.D.R. & E. it can be done, and you report back because, it seems, without this kind of a study, I do not know how the Defense Department can satisfy the Congress or the public that we are meeting a real crisis, a real crisis in costs that faces us.

Mr. SHILLITO. Mr. Chairman, I would make one comment. Of course, the output of such an effort does heavily tie into our discussions with the Armed Services and the Appropriations Committees, and we have to be doing these kinds of things and are doing these kinds of things as you suggest here constantly.

I will make one other comment, Mr. Chairman, and I do not mean

this in any facetious way or any incorrect way, but my historical relationship with this committee has been such that you really do not want anything unless it can be publicized.

Chairman PROXMIRE. That is right, that is absolutely right. That is the function of this committee, and a lot of people don't understand that.

We are not a committee that meets secretly and privately and does not reveal things. We have one function, it is not to recommend legislation directly to the floor of the Senate, we cannot do that. This is a factfinding, publicizing, dramaticizing committee. It was when Paul Douglas was chairman, Wright Patman and others, that is the nature of our committee. We do not have any effect unless we reach other members of the House and Senate. You cannot reach them in reports, let's face it, you cannot reach them in hearings. The one way we can reach them is if they watch television, which they do, and read newspapers which they do. That is the way we get to them, that is the way to reach them.

I do not want anything that is classified, that I can look at and be afraid to use in debate or any other time because if I use it——

Mr. SHILLITO. Okay. Let me finish——

Chairman PROXMIRE. That is the problem we have and I am glad you recognize it. I think you are wise to recognize it and I appreciate your stating it.

Mr. SHILLITO. Thank you, I am glad you say I am wise. [Laughter.]

Chairman PROXMIRE. You are.

Mr. SHILLITO. Anyway, Mr. Chairman, unless things are such that you can publicize them, you don't want them, and we don't quite look at national security that way, Mr. Chairman. We just don't quite feel that so far as our intelligence programs lead is down particular routes as to what we need, what we have to have, that these kinds of things can be publicized.

Chairman PROXMIRE. I do not think there is much difference between us.

Mr. SHILLITO. The point I am making if we come up with the kind of thing you are talking about, sir, this has to be a highly classified effort and we would be delighted to treat that kind of thing as such.

Chairman PROXMIRE. I do not understand why it has to be classified.

Mr. SHILLITO. Let's see how we come out as a result of our discussion. I mean it might be able to be sufficiently toned down and sufficiently innocuous that it will be meaningless.

Chairman PROXMIRE. No, no, I don't want that, Mr. Shillito. [Laughter.]

I think the American public has to know, the American Congress has to know about it. The Congress doesn't know about classified material, very few members of the House or Senate are going to take this classified material and study it. You know that. These decisions have to be primarily on the basis of what is not classified. The things I am asking this morning I think can be given to us, and the adversary, the Soviet Union, knows far more now than is likely to be disclosed in the kind of a study that you will give us.

They know what our problems are, economic problems and technological problems in great depth. I am not asking for anything new that would give them any comfort or knowledge, you know that.

Mr. SHILLITO. Well, again, I just want to make the point that the type thing you are talking about could lead us down this path and this is something I think you need to recognize and I think apparently have.

Chairman PROXMIRE. I just wanted to say it is called to my attention outside groups have done this, Brookings has done this kind of study, maybe they are completely wrong, way out in left field, but Brookings has done it. The Democratic candidate for the Congress——

[Laughter.]

Mr. SHILLITO. What was that again?

Chairman PROXMIRE. The Democratic candidate for the Presidency, George McGovern, made a study last year which was very deeply criticized but was fundamentally a good basis for debate. The Secretary of Defense made no bones about how bad he thought it was. I thought he was a little flamboyant in doing it.

Mr. SHILLITO. Pretty invigorating study.

Chairman PROXMIRE. I think you would have to agree that kind of thing is useful.

Mr. SHILLITO. Sure.

Chairman PROXMIRE. And this is the kind of thing I am asking of you gentlemen.

Mr. SHILLITO. Well, let's see. Let me see, what we can come out with or what the discussions in the Pentagon will lead to, Mr. Chairman. But I just wanted to call the security side of this to your attention. I am sure this is something that you fully appreciate, sir.

Chairman PROXMIRE. All right.

Now, you spoke in your prepared statement this morning about recent changes which have been made to improve Defense Department regulations governing progress payments on defense contracts. As you know, excess progress payments on the C–5A played an important role in forcing the DOD to bail out that program. Despite your assurances that improvements have now been made, I'm afraid that we're following the same old road with Grumman and the F–14.

EXCESS PROGRESS PAYMENTS ON F–14 CONTRACT

Are you familiar with the audit report of the Defense Contract Audit Agency, dated June 30, 1972, which concluded that Grumman has already received progress payments in excess of the amount provided for by its contract?

Mr. SHILLITO. I am familiar with the audit report, sir.

Chairman PROXMIRE. You are familiar with it.

Mr. SHILLITO. I am familiar with the audit report.

Chairman PROXMIRE. Would you try to locate a copy of that report and provide a copy to the subcommittee?

Mr. SHILLITO. Mr. Lynn is here, and I would like to have Mr. Lynn think about this for a moment and answer your question more specifically.

Mr. Lynn, can you respond to that question?
Mr. LYNN. We can provide you a copy of the report.[1]
Chairman PROXMIRE. Fine, very good.

ADVANCE PAYMENTS

I am less concerned right now about that, about the June 30 audit report than I am with the highly unusual "advance payment pool agreement" which was entered into subsequently, on August 8, 1972, by Grumman and the Navy. I've obtained a copy of that agreement from the GAO, and after summarizing it briefly, I'd like to ask you a few questions about it.

The agreement notes Grumman is now without and has been unable to obtain any short term bank financing from any source since its old line of credit was withdrawn on April 30th because of its projected losses on the F–14 program.

What the agreement does is to set up a special "advance payment pool account," a pool of money supplied by the Navy against which Grumman can draw to finance work not only on the F–14 program, but on 10 contracts in all, including its other major Navy programs. Grumman is to pay the Navy 6⅞ percent interest for the period these funds are on loan, and it is to pay them back by receiving credits against the loan when it delivers F–14's and other pieces of military hardware.

This agreement means, does it not, Mr. Shillito, that the Navy has become Grumman's private banker, that it is the only banker who will lend Grumman money at this time in its present financial condition?

Mr. SHILLITO. Well, Mr. Chairman, first of all, you are right that we do have an advance payment relationship with Grumman. Grumman, of course, originally requested "unusual progress payments." Grumman was advised by the Navy to seek bank financing. The banks reiterated their statements, as you have stated, that they were not willing to provide the financing to Grumman under the circumstances of today's environment, unless the Government would grant a 100 percent guarantee.

The Navy concluded that the advance payment was the most feasible means of financing because it provided a vehicle for imposing restrictions which the Navy considered to be very essential. It also provided a measure of the value of the money that would be furnished Grumman by the imposition of interest as you have also stated, sir.

Mr. Buehrle, as I mentioned earlier in my introductory statement, is here with us today, and I would like to ask Mr. Buehrle if he would care to elaborate on my comment or to answer your question more specifically.

Chairman PROXMIRE. Before he does, let me just put the question a little differently so that it is clear what I am trying to get at. It is my understanding that the Navy's authority to enter into this advance payments pool agreement comes from 10 U.S.C. 2307 as implemented by section E of the Armed Services Procurement Regulations. I have looked at this legal authority carefully and it gives rise to several questions in my mind.

[1] A copy of the requested audit report No. 517–10–2–0329, dated June 30, 1972, was furnished on Dec. 26, 1972. The report may be found in the subcommittee files.

First, section E-209 of the ASPR permits advance progress payments to defense contractors, but it clearly states that they should be used only as a last resort. Even 100 percent progress payments—compared to the 80 percent Grumman has received under the F-14 contract—and Government guaranteed loans are cited by the ASPR as preferable to the direct Government loans which advance payments represent.

Why, then, has this method of financing been chosen by the Navy?

Mr. SHILLITO. I think you sort of answered that yourself, Mr. Chairman, when you talked abou this being the last resort.

Mr. Buehrle.

Mr. BUEHRLE. The ASPR also says, sir, that the government may use advance payments when it considers it to be to its best advantage.

In reviewing the situation, we thought there were certain restrictions that should be imposed upon the company, which we could do more readily with an advance payment treatment than we could under other methods.

Also, if we would agree to their requirements with regard to unusual progress payments, it would be hard to measure what those values are or to what period of time they would extend.

We also recognized that in addition to the F-14, Grumman also had other important programs.

In an effort to provide them with the necessary financing to perform those programs, we decide the advance payments should be made.

Chairman PROXMIRE. What kind of restrictions does advance payments require on Grumman?

Mr. Shillito mentioned restrictions.

Mr. BUEHRLE. Yes, sir. You say you have a copy of the agreement. There is a whole section with regard to covenants and restrictions. I could read them.

Chairman PROXMIRE. You do not have to read them. Can you summarize them briefly?

Mr. BUEHRLE. Yes.

Among other things, it provides for restriction on dividends, disposition of property, guaranteeing other people's liabilities, control with regard to salaries of key employees, overseers and directors, the normal type of restrictions you will find in a loan agreement.

Chairman PROXMIRE. There is another section of the ASPR that again gives me some trouble; it specifies, and I quote section E-211 of the ASPR:

> Only with those * * * contractors * * * who have the financial capability or credit * * reasonably to assure their ability to perform their contracts in accordance with their terms.

Do you think Grumman meets this stipulation at the present time?

Mr. BUEHRLE. So far as we can determine, we expect that he will, sir.

Chairman PROXMIRE. Well, they have announced they will not, they would close their doors before they would meet their contract.

Mr. SHILLITO. We have analyzed their financial statement very thoroughly.

Chairman PROXMIRE. I think they can, I would agree with you they can, but they have announced they will not.

Mr. SHILLITO. I think again we border on a portion of negotiations here. If you want to talk about advance payments fine, but if you want to talk about what Grumman will or will not do, I would prefer to avoid that.

Chairman PROXMIRE. All right.

ADVANCE PAYMENT AGREEMENTS UNUSUAL FOR LARGEST CONTRACTORS

The General Accounting Office has assured me that advance payment pool agreements have been used very sparingly in the past, and always with small companies. Are you aware of any other time when such an agreement has been entered into with one of the 10 largest defense contractors?

Mr. SHILLITO. I can give you a complete listing of the occasions when we have used advance agreements, Mr. Chairman. As far as the 10 largest contractors, I would have to say this indeed has not applied.

Chairman PROXMIRE. So this is an unprecedented thing in that sense?

Mr. SHILLITO. It is indeed not a normal method of financing, Mr. Chairman.

Chairman PROXMIRE. Now when the advance payments pool agreement——

Mr. SHILLITO. We have about 65 instances of advanced payments I would guess.

Chairman PROXMIRE. Well, in the security areas.

Mr. SHILLITO. As compared to this one; yes, sir.

Chairman PROXMIRE. When the advance payments pool agreement was signed on August 8, it provided for a ceiling on the loans outstanding of $20 million. Are you aware of any other time when an advance payments pool agreement has been entered into for this large an amount?

Mr. SHILLITO. If you were to consider our international relationships and international economic needs of other countries and so forth, Mr. Chairman, we do have a few that are greater than this.

Chairman PROXMIRE. You do?

Mr. SHILLITO. Yes, sir.

Chairman PROXMIRE. Can you specify them?

Mr. SHILLITO. Yes.

We have an agreement with the United Kingdom——

Chairman PROXMIRE. Those are countries, not companies.

Mr. SHILLITO. That is right, that is what I said, countries, Mr. Chairman.

Chairman PROXMIRE. Yes.

Mr. SHILLITO. We do have one with Newport News here that I see in my notes.

Chairman PROXMIRE. Over $20 million?

Mr. SHILLITO. No, sir. None over $20 million; no, sir.

Chairman PROXMIRE. That is what I was getting at.

Now, that $20 million ceiling, it has turned out, has been very tem-

porary in nature. It was raised to $36 million on September 14, and Grumman has now requested another $10 million on top of this, which would raise the total to $46 million.

There certainly is no precedent, or are there any precedents for $46 million loans? I guess your answer has to be no, since there is no precedent for a $20 million loan.

Is it likely the ceiling of this agreement will continue to be raised in the future?

Mr. SHILLITO. I cannot answer that question.

Chairman PROXMIRE. I am sorry, I should not have asked that question because it does affect——

Mr. SHILLITO. Yes, it does.

Chairman PROXMIRE. Nevertheless, you see, on the one hand we are told that the Navy was tough, and I congratulated them on being tough, and insisting that Grumman stand by the contract.

On the other hand, it seems we are going through the back door with $46 million on the horizon, $36 million already, and another $10 million coming up, and we do not know how much more in the future. It is hard to say whether maybe this is a way of getting around the limitations which the Navy announced publicly that it is following with respect to Grumman.

Mr. SHILLITO. Well, you can infer that these type actions are in conflict, but indeed they are not.

When you get down to the necessity for insuring that dollars are available to meet the costs of a particular weapon, you find that financing sometimes is necessary to do just exactly that. I will not cite other programs, but this has been the case in the past in a few other programs at the same time, you can still be tough as far as that contract is concerned.

Chairman PROXMIRE. There is no case at all that has gone over $20 million and this is close to $46 million, or appears to be and, as I say, you cannot tell me that is the end, and it probably is not.

Mr. SHILLITO. No, I will not say one way or another.

At the same time, you know we have had loans many times over the years that ran well in excess of this, as you well know, sir.

TERMS OF AGREEMENT WITH GRUMMAN

Chairman PROXMIRE. Let's take a look at the fairness of the agreement from the commercial banking standpoint, how reasonable a rate of interest is 6.6 percent for a short-term loan at the present time.

Do you think any bank would loan at that rate with a prime or short-term rate approaching six percent of the soundest commercial risk?

Mr. SHILLITO. The Navy analyzed this, Mr. Chairman, and I would say that you have a point, a debatable point, but you indeed have a point.

Do you want to comment on this, Mr. Buehrle?

Mr. BUEHRLE. Yes, I would like to make one comment, and that is, we are geared to use the rate set by the Treasury Department for the Renegotiation Board. The Secretary of the Treasury sets the

going rate every 6 months and our rate of interest is geared to that rate which is set by the Secretary of Treasury.

Chairman PROXMIRE. It has no relationship whatsoever to the risk involved?

Mr. BUEHRLE. It is simply set on a mechanical basis with relationship to a matter which is not related to the risks of the borrower.

We do not have any sliding rate at all. We have a single rate or stated rate.

Chairman PROXMIRE. As I understand, the only basis for the borrowed money, in other words, is the company's work-in-progress inventory the government normally uses in situations. So it seems to me clear, and I would like any comment you would like to make on it, that a commercial banker would expect, at least some claim on the underlying assets of the company; is that not right?

Mr. SHILLITO. I think that is possibly a correct assumption but, at the same time, we have greater collateral than you have suggested. It does add up to a significantly greater amount than the advance payment as it now stands.

Chairman PROXMIRE. Now Grumman can use the funds deposited in this advance payments pool agreement. Can you tell me what part of the funds can be used in the program?

Mr. SHILLITO. Can you answer that, Mr. Buehrle?

Mr. BUEHRLE. Yes, sir.

In the advanced pool agreement, we use one of the contracts for what we call a designated pool contract. The money that goes into the accounts is the money that will be used under the F–14 contract, the money that the advanced payment is a self-liquidating arrangement whereby we would withhold funds under that contract and attempt to return the money to the Navy as the contract is completed.

Chairman PROXMIRE. From what fund again?

Mr. BUEHRLE. From the appropriations of the designated pool contract, which in this case is the F–14 contract.

Chairman PROXMIRE. Now, Mr. Shillito, are you aware that Litton Industries has been overpaid millions of dollars in progress payments on the ship contracts?

Mr. SHILLITO. I am indeed aware of the audit reports on Litton Industries, Mr. Chairman. I am indeed aware of the progress payments environment as regards Litton Industries.

NAVY INVESTIGATION OF LITTON SHIPBUILDING CLAIMS

Chairman PROXMIRE. Are you aware of the fact that a three-man team has been established within the Navy to investigate the possibility that Litton may have made fraudulent misrepresentations in its shipbuilding claims and that the Navy may also be inquiring into the possibility of fraud with regard to Litton's requests for progress payments on its ship contracts?

Mr. SHILLITO. Is this the Navy-Marad team that you are talking about, Mr. Chairman, wherein the Maritime Administration is involved?

Chairman PROXMIRE. No, sir.

Mr. SHILLITO. This is just the Navy team?

Chairman PROXMIRE. This is right.

Mr. SHILLITO. Yes, sir, I am aware of the various efforts we have had as regard Litton.

Chairman PROXMIRE. What can you tell us about this investigation?

Mr. SHILLITO. To my knowledge, I have not seen anything in any of these reports that would indicate anything of an indication of fraud, at least from the reports I have looked at, they do not give me that kind of information.

Chairman PROXMIRE. What can you tell us about the investigation?

Mr. SHILLITO. Let's see, can we get a response as far as the Navy is concerned here relative to this or, Joe, Bernie, do you have anything as far as——

Mr. LYNN. Not on the investigation, Mr. Shillito. I believe that was the question, it was directed to an investigation.

Mr. SHILLITO. Yes.

Mr. LYNN. We do not have any knowledge about that.

Mr. SHILLITO. Did you not have a Navy reply that tied into this particular subject, Mr. Chairman, so far as Litton is concerned?

I thought I saw something or heard about you receiving something.

Chairman PROXMIRE. Well, the Navy did reply, and they conceded the overpayments.

Mr. SHILLITO. Well, what I am really relating to is the recent letter that you received from the Navy Under Secretary, Mr. Sanders. I think this tied to a request from you for information with regard to this, and you asked a number of questions with regard to the Litton financial situation, and he made it clear that the Navy has reviewed Litton's financial position and that they routinely monitor the financial developments.

He stated, however, that as mentioned in his letter, or the Navy's letter to you of mid-1972, financing data was company confidential and it was inappropriate for the Navy to comment on Litton's financial condition, which is a matter that he felt should be addressed by the Litton corporate officers.

Chairman PROXMIRE. Let me just interrupt to say I wanted to know if any of the gentlemen with you, you say you do not know——

Mr. SHILLITO. No, sir.

Chairman PROXMIRE [continuing]. If any of the gentlemen with you know of any information with respect to the investigation of fraud involved in this.

Mr. SHILLITO. I cannot give you——

Chairman PROXMIRE. I know you cannot, but I wonder if any of the gentlemen with you can.

Mr. SHILLITO. I am not aware of anything that ties into that, Mr. Chairman.

Is there anyone else here that can respond?

Chairman PROXMIRE. There is no indication so far as that is concerned?

Mr. SHILLITO. No, sir.

Chairman PROXMIRE. Do you know the highest amount by which Litton was overpaid on a ship contract?

Mr. SHILLITO. Mr. Sanders' letter of 14 December might be introduced into the record, Mr. Chairman, because he says there that you asked for information concerning possible overpayment progress payments.

Chairman PROXMIRE. That is fine, yes, sir.

[The following information was subsequently supplied for the record:]

DEPARTMENT OF THE NAVY,
OFFICE OF THE SECRETARY,
Washington, D.C., December 14, 1972.

HON WILLIAM PROXMIRE,
Chairman, Subcommittee on Priorities and Economy in Government, Joint Economic Committee, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: I have your letter of November 30th in which you reiterated your belief that Litton Industries is having serious financial difficulties and requested further information concerning Navy Shipbuilding contracts with Litton.

You asked several questions about Litton's financial situation. Regarding your first two questions, which involve the Navy's assessment of Litton's financial capability to complete its Navy contracts, the Navy has reviewed Litton's financial position and routinely monitors financial developments. However, as mentioned in our letter to you of July 12, 1972, financial data is company-confidential, and it is considered inappropriate for the Navy to comment on Litton's financial condition, which is a matter that should be addressed by Litton's corporate officers.

You also asked for information concerning possible overpaid progress payments on the Navy's submarine contract with Ingalls Shipbuilding Division. In early September, 1972, a Navy review determined that the contractor was overpaid progress payments during the period June, 1968, through September 4, 1972. The cumulative overpayment at its maximum amount to $7,590,000 but had decreased to $1,678,010.54 by September 1972. Repayment was immediately requested, and the contractor fully refunded the outstanding $1,678,010.54 in repayment made on 6 and 13 September 1972. With respect to interest charges on the overpaid funds, the company made repayment within 30 days of demand. Therefore, under the terms of the contract no interest charge was applicable. Our reviews have not revealed any other overpaid progress payments on Litton's Navy contracts.

Your letter also addressed the six-month extension of the cost-incurred method of payments to Litton on the general-purpose amphibious-assault-ship (LMA) construction contract. The extension was based on the contractor's claim for changes and excusable delay. We are now reviewing the matter to determine what amount of excusable delay can be substantiated. If it is determined that the period of excusable delay is less than six months, the contractor will be required to repay the difference between cost incurred and actual physical progress payments, plus interest, for that time determined not excusable. Thus, deferring the changeover date of the method of payment does not provide the contractor with interest-free funds. At this time, there is no basis upon which to forecast what the cash effect on Litton might be, as this will be determined by several factors, including the amount of excusable delay allowed.

I trust that the foregoing will suffice for your purposes.

Sincerely yours,

FRANK SANDERS,
Under Secretary of the Navy.

Mr. SHILLITO. And he goes to say that the cumulative overpayment at its maximum amounted to $7.59 million, but it has decreased to $1.67 million by September 1972. He says the repayment was immediately requested and the contractor fully refunded the outstanding $1.678 million in repayment made on 6 and 13 September, 1972.

Then he goes on to talk about the interest charges and he says that:

"Our reviews have not revealed any other overpaid progress payments on Litton's Navy contract."

AUDIT REPORTS OF EXCESS PROGRESS PAYMENTS CONSIDERED CONFIDENTIAL

Chairman PROXMIRE. With respect to that letter from Secretary Sanders, the Pentagon insists the information in your reports are considered proprietary data and may not be made available to the public. What is so secret about these reports? Why can we not release them?

Mr. SHILLITO. Well, again, we touched on this at previous hearings. Of course, you know the entire financial structure of a contractor and maybe even these internal subjective reports can have an adverse effect on a contractor's financial situation.

Chairman PROXMIRE. Let me say why we need these reports, because these reports do indicate some conflict with what Mr. Sanders told us in his letter so far as the size of the overpayments is concerned.

Mr. SHILLITO. But, you know, the point that I made last year, as I recall, before this committee was very fundamental and that is that there have been questions as to our legal right to take action in regard to the disclosure of confidential business information. Now you can get into a subjective kind of evaluation as to what should or should not be——

Chairman PROXMIRE. That is exactly right You have to make the judgment, you make the judgment as to what is proprietary information.

Mr. SHILLITO. Of course, generally the company makes the judgment and we are not in agreement with the company, but we end up generally being put in a position where it is awkward legally if we disagree with the company and then release it.

Chairman PROXMIRE. We cannot release the entire reports. What about the numbers, why can we not disclose to the public the amount of the overpayment, what about the propriety of that?

Mr. SHILLITO. Mr. Chairman, I may be wrong, but I look at that letter from Secretary Sanders, and that just seems to——

Chairman PROXMIRE. That is exactly the point, you see. What he says, or what the overbilling is, does not agree with our knowledge of what the report shows; that is what we want to make public.

Mr. SHILLITO. I see. I think you have to say he is the No. 2 man in the Navy so we have to expect in his position he ought to be speaking with the full authority of the Navy.

CONTRACTOR'S COOPERATION WITH NAVY AUDITS

Chairman PROXMIRE. Let me ask you this: In your audits of Litton to determine the amounts of overbillings and overpayments, has the company been completely cooperative? Has it given the Government auditors complete access to its books and records of its Navy contracts?

Mr. SHILLITO. Well, you have to understand, Mr. Chairman, that,

as the Assistant Secretary for I&L, my involvement with specific contractors is very, very infrequent.

Chairman PROXMIRE. I understand Mr. Lynn's agency did the audit. Could Mr. Lynn answer that?

Mr. SHILLITO. Mr. Lynn, could you respond to that?

Mr. LYNN. Yes, I would say, Mr. Chairman, the information we have needed to audit progress payments has been furnished to us.

Chairman PROXMIRE. Then you would say they have been completely cooperative right along the line?

Mr. LYNN. Well, auditors never have a particularly easy time anywhere. [Laughter.]

Mr. SHILLITO. Even within the family, Mr. Chairman.

Chairman PROXMIRE. Mr. Lynn is a terrific diplomat, he would be a great ambassador.

Mr. LYNN. I would say within that environment we have been able to report without qualification.

Chairman PROXMIRE. Have you had complete access for progress payments?

Mr. LYNN. For progress payments, yes.

Chairman PROXMIRE. Why do you say progress payments?

Mr. LYNN. I was directing my reply to your question. Your question was progress payments.

Chairman PROXMIRE. You have had complete access to progress payments and you have implied you have not had complete access in other matters.

Mr. LYNN. I did not say that.

Chairman PROXMIRE. Do you not say you had complete access to the books?

Mr. LYNN. I suppose if we had attempted to make, to enter into examinations of other data of the contractors over all operations, I suspect there might have been problems. But what we needed for these audits of progress payments, we have gotten.

Chairman PROXMIRE. What is Litton's general ledger, what kind of information is contained in that ledger?

Mr. LYNN. The general ledger, as any general ledger, has assets, cash, inventory, accounts receivable, it has liabilities, accounts payable, that sort of thing; their net worth.

Chairman PROXMIRE. Has Litton ever refused your auditors access to its general ledger?

Mr. LYNN. This relates to the same point and to the same letter that Mr. Sanders wrote to you. On our initial try they did balk at the general ledger.

Chairman PROXMIRE. Why?

Mr. LYNN. They felt that we really did not need all of the things in a general ledger to do what we were doing.

Chairman PROXMIRE. What did you do about it?

Mr. LYNN. We went back to the Navy, and we told them we could not do the job without access to the general ledger. So with the assistance of the Navy, we then did obtain access to the general ledger and then were able to submit a report.

Chairman PROXMIRE. You say you did get access to the general ledger?

Mr. LYNN. We did.

Chairman PROXMIRE. Well, that is interesting, but once again we have information to the contrary. But you should know, you say you did get access to the general ledger.

Mr. LYNN. That is right, Mr. Chairman, you have several reports that we have given you——

Chairman PROXMIRE. That is right.

Mr. LYNN [continuing]. On Litton, and one of them, you will recall, states that we did not have access to the general ledger.

Chairman PROXMIRE. That is right.

Mr. LYNN. Then there is a supplemental report.

Chairman PROXMIRE. That came in later when you did get access?

Mr. LYNN. That is right.

Chairman PROXMIRE. That clears it up.

Mr. LYNN. Yes, sir.

DOD STUDY OF PROGRESS PAYMENTS ABUSES

Chairman PROXMIRE. Assistant Secretary of Defense Robert Moot had a study conducted into progress payments abuses which resulted in a report on the audit of selected aspects of the progress payment system. The Defense Department gave us a copy of this report at our request and I would like to ask a few questions about it.[1]

First, when was the investigation begun and how long did it last?

Mr. SHILLITO. Mr. Welsch, can you respond to this particular question? This was conducted under Mr. Welsch's organization, and I think that this internal audit effort can best be handled by Mr. Welsch. Would you care to respond to that?

Mr. WELSCH. Yes, Mr. Shillito.

The audit was started in the fall of 1970, approximately September, and it was completed and report issued in November 1971. We did preliminary survey work and rounded up the material necessary to develop the program and perform the field work and that was performed during the early part of 1971, with the wrap-up stages coming in the fall of 1971 and the report issued on November 3, 1971.

Chairman PROXMIRE. How many contractors were examined, what was the dollar amount of the contracts examined, and how were the contractors chosen to be examined?

Mr. WELSCH. We do not have the exact tabulation of the contractors examined because we selected contracts on the basis of systems evaluation. Our audit was devised to evaluate the total system rather than select individual contracts.

We tried to stratify our sample to provide a basis for evaluating the system of making progress payments.

Chairman PROXMIRE. So you do not know how many contractors were examined?

Mr. WELSCH. Yes; we had approximately 52 contractors involved, with about 233 contracts.

Chairman PROXMIRE. What was the dollar amount of the contracts examined?

Mr. WELSCH. About $10 billion in contracts involved.

[1] Excerpts from "Report on the Audit of Selected Aspects of the Progress Payment System" may be found on pp. 2530–2536. The full text of the report is in the files of the Joint Economic Committee.

Chairman PROXMIRE. $10 billion?

Mr. WELSCH. Yes, sir.

Chairman PROXMIRE. Will you give us a list of the contractors examined who were found to have obtained excess progress payments, the programs on which the payments were made, and the amounts involved?

Mr. WELSCH. We could probably supply this for the record. I do not have it with me. We have a list of contracts, as you know, in the report which we furnished.

Mr. SHILLITO. We will give you a list, Mr. Chairman, of the premature progress payments. So far as the specific contractors are concerned, we will give you such a list.

Chairman PROXMIRE. Fine.

[The following information was subsequently supplied for the record:]

LIST OF CONTRACTORS WHO OBTAINED EXCESS PROGRESS PAYMENTS

The following is a list of contracts examined with excess progress payments at the time of the audit. The list is a reproduction of Attachments A, B, D, and E of the audit report with the names of the contractors. Attachments C and F of the audit report are not included since they did not involve unauthorized payments at the time of the audit. Some contracts are listed on more than one attachment because more than one condition was noted for these contracts.

The audit report addresses the status of conditions at the time of the audit. However, no attempt has been made to verify the audit findings on individual contracts. Actions have already been taken, and are continuing, to correct conditions found during the audit and to improve over-all contract financing policy. These included revised procedures, recoupments from contractors, adjustments of contractual clauses, and special seminars and training courses to assure that operating personnel are fully aware of the philosophy, policy, controls and procedures on progress payments.

The term "Excess progress payments" does not mean that the government ultimately paid more for an item than required by the contract. It means that the contractor was provided working capital through progress payments to which he was not entitled at the time.

ATTACHMENT A

INCORRECT PERCENTAGES ON CONTRACTORS REQUEST FOR PROGRESS PAYMENTS WITH MONETARY EFFECT
CONTRACT CLAUSE INCORRECT

Contractor	Contract No.	DD-1195 Number	DD-1195 Date	Progress payment limit (percent) Rate used	Progress payment limit (percent) Proper rate	Excess progress payment
		Army				
Grumman Aerospace Corp	DAA-J01-67-C-0795	70	Aug. 15, 1970	80	72.0	$238,155
Teledyne Systems Co	DAA-B07-68-C-0255	26	May 23, 1969	80	71.8	1,522,452
Boeing Corp	DAA-J01-68-C-0577	47	May 4, 1970	80	72.3	[1] 1,427,393
Bell Aerospace Corp	DAA-J01-68-C-0566	14	July 14, 1969	80	72.8	64,062
United Aircraft Corp	DAA-J01-68-C-0827	36	Feb. 18, 1971	80	72.4	175,851
Boeing Corp	DAA-J01-68-C-1566	105	Aug. 21, 1970	80	70.1	1,350,414
Bell Helicopter Corp	DAA-J01-68-C-1928	43	Jan. 20, 1971	80	72.8	286,442
Conductron Corp	DAA-B03-69-C-0046	39	Jan. 22, 1971	80	72.1	181,717
Bell Aerospace Corp	DAA-J01-69-C-0085	42	Feb. 17, 1971	80	72.8	911,936
Hughes Tool Co	DAA-K02-69-C-0433	50	Oct. 6, 1970	80	70.8	166,445
Continental Motors	DAA-E07-70-C-3247	19	Aug. 24, 1970	80	73.4	[1] 273,189
General Dynamics Corp	A36039-05598	95	Oct. 5, 1970	85	79.2	1,826,339
Total						8,424,395

See footnote at end of table.

ATTACHMENT A—Continued

INCORRECT PERCENTAGES ON CONTRACTORS REQUEST FOR PROGRESS PAYMENTS WITH MONETARY EFFECT
CONTRACT CLAUSE CORRECT—Continued

Contractor	Contract No.	DD-1195 Number	DD-1195 Date	Progress payment limit (percent) [1] Rate used	Progress payment limit (percent) [1] Proper rate	Excess progress payment
Navy						
General Dynamics Corp	N00017-70-C-2205	3	Aug. 3, 1970	80	72.8	$85,893
McDonnell Douglas Corp	N00N0W-66-0606i	128	Dec. 16, 1970	80	74.6	912,315
LTV Aerospace Corp	N00019-67-C-0146	24	Oct. 9, 1969	80	72.5	[2 3] 1,288,178
McDonnell Douglas Corp	N00019-67-C-0170	184	July 29, 1970	80	70.8	[2] 236,210
Do	N00019-67-C-0550	96	Mar. 12, 1970	80	72.1	43,424
Lockheed Corp	N00019-68-C-0043	36	Jan. 19, 1971	80	72.8	81,154
General Dynamics Corp	N00019-68-C-0074	116	Oct. 30, 1970	80	74.3	1,086,991
LTV Aerospace Corp	N00019-68-C-0075	77	Dec. 10, 1970	80	72.4	[2 3] 3,165,524
Raytheon Corp	N00019-68-C-0386	114	Oct. 8, 1970	80	72.1	1,084,387
United Aircraft Corp	N00019-68-C-0471	41	Feb. 18, 1971	80	72.7	[2 3] 1,340,828
Litton Systems	N00039-68-C-0527	43	Aug. 3, 1970	80	71.7	[1] 421,548
United Aircraft Corp	N00019-69-C-0103	9	July 20, 1970	80	72.7	52,949
Westinghouse Corp	N00019-69-A-0153	3	Feb. 22, 1971	80	71.5	[1] 186,989
Raytheon Corp	N00019-69-C-0200	70	June 25, 1970	80	72.5	[2] 820,852
General Dynamics Corp	N00019-69-C-0336	AF-55	do	80	72.8	[2] 18,758
Do	N00019-69-C-0336	N-59	Jan. 23, 1970	80	72.8	[2] 471,249
United Aircraft Corp	N00019-69-C-0355	18	Feb. 18, 1971	80	72.7	11,720
Watts Manufacturing Co	N00156-69-C-0505	5	Nov. 20, 1970	80	76.7	14,246
Boeing Corp	N00019-69-C-0562	52	Jan. 26, 1971	80	70.8	3,181,965
McDonnell Douglas Corp	N00019-69-C-0616	31	Apr. 24, 1970	80	72.0	[2] 65,720
Boeing Corp	N00019-70-A-0008	8	Jan. 11, 1971	80	72.8	376,415
Grumman Aerospace Corp	N00019-70-C-0458	21	Feb. 28, 1971	80	72.8	[2] 405,907
General Dynamics Corp	N00019-70-C-0529	24	Feb. 4, 1971	80	72.8	[1] 864,000
Westinghouse Corp	N00383-69-D-1553	13	July 10, 1970	80	72.8	[2] 172,656
Link Division Singer Precision.	N61339-66-C-0021	47	Aug. 20, 1970	80	72.1	[2] 55,680
Singer Simulation Products	N61339-69-C-0200	16	Sept. 2, 1970	80	74.1	207,319
Total						16,652,877
Air Force						
Hughes Tool Co	F-04701-68-C-0175	45	Dec. 8, 1970	80	73.4	$349,545
Westinghouse Corp	F-04701-68-C-0269	23	Jan. 29, 1971	80	71.6	[1] 152,369
Litton Systems	F-33615-68-C-1548	11	June 11, 1969	80	70.0	[1] 8,390
Lockheed Corp	F-33657-69-C-0004	61	July 27, 1970	80	71.6	945,923
TRW Inc	F-04701-69-C-0091	95	Mar. 2, 1971	80	72.1	[2] 2,642,810
Barian Associates	F-33657-69-C-0420	4	May 1, 1969	80	73.1	53,327
Sperry Gyroscope Corp	F-33657-69-C-1362	13	Jan. 13, 1971	80	69.9	[2] 183,541
Radiation, Inc	F-19628-70-C-0005	14	Sept. 16, 1970	80	72.7	[2] 38,722
Total						4,374,627
Summary total (Army, $8,424,395; Navy, $16,652,877; Air Force, $4,374,627)						$29,451,899

[1] Appears also on attachment F.
[2] Appears also on attachment E.
[3] Appears also on attachment D.

ATTACHMENT B

INCORRECT PERCENTAGES ON CONTRACTORS REQUEST FOR PROGRESS PAYMENTS WITH MONETARY EFFECT
CONTRACT CLAUSE CORRECT

Contractor	Contract No.	DD-1195 Number	DD-1195 Date	Progress payment limit (percent) [1] Rate used	Progress payment limit (percent) [1] Proper rate	Excess Progress payment
Army						
Radiation, Inc	DAAB07-70-C-0074	15	Sept. 1, 1970	80	72.3	$172,057

See footnote at end of table.

ATTACHMENT B—Continued

INCORRECT PERCENTAGES ON CONTRACTORS REQUEST FOR PROGRESS PAYMENTS WITH MONETARY EFFECT CONTRACT CLAUSE CORRECT—Continued

Contractor	Contract No.	DD-1195 Number	DD-1195 Date	Progress payment limit (percent) [1] Rate used	Progress payment limit (percent) [1] Proper rate	Excess progress payment
Navy						
United Aircraft Corp	N-00019-69-C-0620	19	Feb. 28, 1971	80	72.7	$21,819
Do	N-00019-69-C-0621	20	Jan. 31, 1971	80	72.7	372,905
Total						394,724
Air Force						
RCA	F-33657-68-C-1230	25	Dec. 1, 1970	80	73.1	$133,182
Fairchild Hiller Corp	F-09603-68-C-1633	36	Mar. 12, 1971	80	73.0	333,744
Bordens Electric Manufacturing	F-09603-68-C-1786	53	Oct. 19, 1970	85	77.1	54,902
Hughes Tool Corp	F-33657-69-C-0669	40	Dec. 23, 1970	80	72.8	[2] 100,294
General Electric Corp	F-33657-70-C-0101	15	Jan. 15, 1971	80	72.6	18,464
Boeing Corp	F-33615-70-C-1025	14	Dec. 7, 1970	80	73.1	17,313
Hughes Tool Corp	F-33615-70-C-1393	13	Sept. 8, 1970	80	74.8	8,437
Do	F-33615-70-C-1556	11	Oct. 28, 1970	80	72.8	5,868
Total						672,204
Summary total						1,238,985

[1] Applies to (a)(3)(ii) or (a)(4) of Progress Payment Clause and Items 11b or 22b of DD-Form 1195
[2] Appears also on attachment F, not included in this report

ATTACHMENT D

INCORRECTLY PREPARED CONTRACTORS REQUEST FOR PROGRESS PAYMENTS THEREBY OVERSTATING MAXIMUM PERMISSIBLE UNLIQUIDATED PROGRESS PAYMENTS

Contractor	Contract No.	DD-1195 Number	DD-1195 Date	Amount of overstatement
Grumman Aerospace Corp	N-00N0W-61-0024	69	Apr. 30, 1968	[1] $2,022,703
Do	N-00N0W-63-0126i	101	Jan. 15, 1970	[1] 2,761,772
Do	N-00N0W-66-00058	95	Feb. 28, 1971	[1] 2,562,218
Do	N-00N0W-66-0229i	46	May 15, 1969	[1] 2,593,425
LTV Aerospace Corp	N-00019-67-C-0146	24	Oct. 9, 1969	[1 2] 1,608,878
McDonnell Douglas Corp	N-00019-67-C-0673	189	Feb. 17, 1971	1,117,591
LTV Aerospace Corp	N-00019-68-C-0075	77	Dec. 10, 1970	[1] 5,037,092
Do	N-00019-68-C-0130	19	May 28, 1970	[1] 21,341
Do	N-00019-68-C-0191	14	May 18, 1970	[1] 341,787
United Aircraft Corp	N-00019-68-C-0471	41	Feb. 18, 1971	[1 2] 1,083,683
Grumman Aerospace Corp	N-00019-69-C-0075	31	Mar. 15, 1971	[1 2] 745,681
Lockheed Corp	N-00019-69-C-0385	59	Sept. 29, 1970	[3] 2,690,836
Sperry Gyroscope Corp	N-00024-69-C-5290	20	Sept. 25, 1970	554,390
TRW, Inc	F-04701-69-C-0091	95	Mar. 2, 1971	[1 2] 1,538,850
Sperry Gyroscope Corp	F-33657-69-C-1362	13	Jan. 13, 1971	[1 2] 39,669
North American Rockwell Corp	F-33657-70-C-0336	48	Feb. 26, 1971	[1] 244,107
Total				24,964,023

[1] Appears also on attachment E.
[2] Appears also on attachment A.
[3] Used in narrative of report.

ATTACHMENT E

CONTRACTS WITH UNDERLIQUIDATIONS OF PROGRESS PAYMENTS

Contractor	Contract No.	Original (percent)		Revised (percent)		Billing price of deliveries	Liquidations based on		Under liquidation
		Profit	Liquidation rate	Profit	Liquidation rate		Original rate	Revised rate	
				ARMY					
Lockheed Corp	DAAE-11-66-C-3667	7.3	65.3	0	70.0	$77,112,080	$51,884,403	$53,978,456	$2,094,053
Boeing Corp	DAA-J01-68-A-0005	10.65	63.6	10.0	63.7	136,335,897	86,709,631	86,845,966	136,335
AVCO Lycoming	DAA-J01-68-A-1853	10.8	72.3	7.3	74.6	16,450,596	11,893,781	12,272,145	378,364
General Electric Corp	DAA-F03-69-C-0010	11.0	72.1	1.3	80.0	1,639,470	1,182,058	1,311,576	129,518
Do	DAA-F03-69-C-0027	10.1	72.7	8.9	73.5	5,876,869	4,272,484	4,319,499	47,015
Grumman Aerospace Corp	DAA-J01-69 A-0305	13.0	70.8	10.0	72.8	1,628,888	1,153,253	1,185,830	[3] 32,577
Radiation, Inc	DAA-B07-70-C-0074	10.7	72.3	0	80.0	69,800	50,465	55,840	5,375
Amron Orlando Co	DAA-A09-70-C-0103	11.2	72.0	2.5	79.1	3,250,367	2,340,263	2,542,656	202,393
Total									3,025,630
				NAVY					
Westinghouse Corp	N00383-69-D-1553	10.0	72.8	0	80.0	1,397,751	1,017,562	1,118,200	[1] 100,638
Grumman Aerospace Corp	N00N0W-61-0024	7.3	65.3	3.954	67.4	104,895,745	68,500,721	70,344,266	[2] 1,843,545
Do	N00N0W-63-0126	7.3	65.3	4.532	67.0	179,740,761	117,370,717	120,088,376	[2] 2,717,659
Do	N00N0W-66-0058	7.3	65.3	5.6245	66.3	313,600,593	205,268,735	207,917,193	[2] 2,648,458
Do	N00N0W-66-0229	7.3	65.3	0	70.0	11,554,021	7,551,393	8,031,815	[2] 543,509
Westinghouse Corp	N00017-67-C-1105	7.3	65.3	0	70.0	7,692,303	4,712,754	5,384,614	671,860
General Dynamics Corp	N00017-70-C-2205	10.0	72.8	0	80.0	403,131	237,847	327,304	29,457
LTV Aerospace Corp	N00019-67-C-0146	10.0	72.5	7.42	74.5	112,439,000	81,518,275	83,767,055	[1 2] 2,248,780
McDonnell Douglas Corp	N00019-67-C-0170	13.0	70.8	10.84	72.3	81,197,580	57,437,887	59,705,850	[1] 1,217,963
LTV Aerospace Corp	N00019-68-C-0075	10.6	72.4	7.70	74.2	527,939,000	332,264,036	391,767,838	[1 2] 9,503,802
Do	N00019-68-C-0130	10.2	72.6	9.89	72.8	12,577,000	9,130,902	9,156,056	[2] 25,154
Do	N00019-68-C-0191	9.7	73.0	8.63	73.7	65,337,000	47,674,110	48,131,259	[2] 457,149
United Aircraft Corp	N00019-68-C-0471	10.1	72.7	8.03	74.1	145,882,200	101,857,192	103,098,710	[1 2] 3,241,518
Command Corp	N00019-69-C-0066	12.0	71.5	10.9	72.2	6,754,514	4,829,478	4,876,759	47,281
Grumman Aerospace Corp	N00019-69-C-0075	11.7	71.7	10.333	72.6	92,707,512	66,471,286	67,305,654	[3] 834,368
Raytheon Aerospace Corp	N00019-69-C-0200	10.4	72.5	3.0	77.7	9,328,337	6,763,031	7,248,157	[1] 485,076
General Electric Corp	N00019-69-C-0270	10.6	72.4	10.0	72.8	14,475,035	10,479,962	10,537,862	57,900

General Dynamics Corp	N00019-69-C-0336	10.0	72.8	6.3	75.3	19,714,280	14,370,755	14,844,853	[1] 474,098
Lockheed Corp	N00019-69-C-0385	12.0	71.5	0	80.0	31,029,000	22,185,735	24,823,200	2,637,465
McDonnell Douglas Corp	N00019-69-C-0390	15.0	69.6	10.821	72.2	38,437,980	26,752,834	27,752,222	999,388
Do	N00019-69-C-0616	11.2	72.0	0	80.0	494,088	355,744	395,270	[1] 39,526
United Aircraft Corp	N00019-69-C-0621	10.1	72.7	2.69	78.0	17,798,877	12,859,062	13,883,124	[4] 1,024,062
McDonnell Douglas Corp	N00019-70-C-0236	14.0	70.0	10.75	72.3	5,426,910	3,798,837	3,923,655	124,818
Grumman Aerospace Corp	N00019-70-C-0458	10.0	72.8	9.47	73.1	9,440,098	6,872,390	6,900,712	[1] 28,322
United Aircraft Corp	N00019-71-C-0109	10.1	72.7	0	80.0	192,698	120,965	154,158	33,193
General Electric Corp	N00024-69-C-1055	13.0	70.8	7.6	74.4	5,079,478	3,596,270	3,779,132	182,862
Link Division, Singer Precision	N61339-66-C-0021	11.0	72.1	3.3	77.5	1,278,133	921,533	990,553	[1] 69,020
Do	N61339-68-C-0162	12.0	71.5	9.4	73.2	627,286	448,509	459,173	10,664
Total									32,297,535
				AIR FORCE					
Philco Ford Co	F04695-67-C-0133	10.2	65.3	0	70.0	6,282,642	4,102,565	4,397,849	295,284
Singer Co	F33657-68-C-1293	9.5	73.1	7.8	74.3	4,090,773	2,990,355	3,039,444	49,089
General Electric Corp	F33657-69-C-0008	10.7	72.4	4.1	76.9	15,721,341	11,382,251	12,089,711	707,460
TRW, Inc	F04701-69-C-0091	10.0	72.1	6.137	75.4	35,191,524	25,373,088	26,534,409	[1] 1,161,321
General Electric Corp	F33657-69-C-0124	10.7	72.3	5.5	76.2	1,871,912	1,353,392	1,426,397	[3] 73,005
Sperry Gyroscope Corp	F33657-69-C-1362	15.0	69.6	3.26	77.5	503,794	387,451	390,440	[1 2] 2,989
Radiation, Inc	F19628-70-C-0005	10.1	72.7	0	80.0	830,571	603,822	639,330	[1] 35,508
General Electric Corp	F33657-70-C-0101	10.2	72.6	7.6	74.4	2,262,249	1,642,393	1,683,113	40,720
North American Rockwell Corp	F33657-70-C-0336	9.6	73.0	5.522	75.9	8,676,008	6,333,485	6,585,090	[2] 251,605
Total									2,616,981
Summary total									37,940,146

[1] Appears also on attachment A.
[2] Appears also on attachment D.
[3] Appears also on attachment C, not included in this report.
[4] Appears also on attachment B.

Mr. SHILLITO. By the way, this ties back into my earlier point of the statement—excuse me, sir.

Chairman PROXMIRE. Go ahead.

Mr. SHILLITO. The point that does need emphasizing, and that is that in these premature progress payment situations this does not mean that a company is obtaining more dollars than it should obtain.

Chairman PROXMIRE. Not necessarily.

Mr. SHILLITO. It is obtaining its dollars too early, too soon.

Chairman PROXMIRE. And that can be very important, of course, as anybody who knows the time value of money knows, it means they have an interest-free loan.

Mr. SHILLITO. So far as that company's finances go it could be very important.

Chairman PROXMIRE. So far as the taxpayer is concerned, it means $400 million paid to one contractor, $500 million in advance, means the interest on that is lost.

Mr. SHILLITO. As far as the interest is concerned.

Chairman PROXMIRE. The Federal Government has to pay interest on that $500 million.

Mr. SHILLITO. As far as the interest is concerned that is correct. It is not a 400 million loss.

Chairman PROXMIRE. That is right.

Mr. SHILLITO. So many people get the wrong impression and that is the reason I emphasize this point.

TOTAL EXCESS PROGRESS PAYMENTS

Chairman PROXMIRE. I want to congratulate you for making that study, I plan to make it public today, at least I am making it available to the press—it's a rather lengthy document. Tell me this: What is the total amount of excess or unauthorized progress payments identified in this report?

Mr. SHILLITO. Can you answer that, Mr. Welsch?

Mr. WELSCH. We didn't stratify it so you cannot add it up. Some of the misinterpretations made which resulted in an inappropriate payment had several different situations involved so we did not attempt to aggregate the situations because we were evaluating the system and tried to home in on the various aspects of the system.

Chairman PROXMIRE. I have gone through it and was able to total up more than $200 million.

Mr. WELSCH. I think this would approximate that, if you did aggregate it. But as I say, it is difficult to add the findings into one total because of the various segments of the systems and the various procedures used.

Chairman PROXMIRE. Over what period of time were these excess payments made?

Mr. WELSCH. We had contracts involving 1968, 1969, and prior. We tried to select contracts for our systems evaluation which had been either complete or were in process long enough to give us a basis for evaluating the system.

Chairman PROXMIRE. Would you say that you can make any kind

of a projection, any kind of a guesstimate, as to what the total amount of excess progress payments would amount to if all defense contracts were gone into based on this study?

Mr. WELSCH. No, I do not.

Chairman PROXMIRE. Why wouldn't you say this was typical? You chose it carefully in order to get an understanding of this setup, I presume you picked not only sufficiently big contracts, and you did $10 billion, but sufficiently typical so you would have an understanding of it.

Why could you not project what excess progress payments from this?

Mr. WELSCH. Because there were so many varying provisions in each contract and type of contract. There are also so many varying stages in which contracts are at during any one particular period of time so far as production payment, et cetera, we didn't feel it was practical or proper to make a projection. We merely put down the sample we had as illustrative of the system.

TRUCK-LIFTS CONTRACT

Chairman PROXMIRE. At the bottom of page 22 of the report a specific abuse is discussed. Can you tell us which contract this was and who held it? Can you also explain the facts in the case?

Mr. WELSCH. Are you referring to the contract in paragraph 1 on the bottom of the page there?

Chairman PROXMIRE. That is right.

Mr. WELSCH. This is an AF contract. I don't know the contractor at this time.

We avoided listing the individual contractors for the purpose of, again as I say, providing an evaluation of the systems.

Chairman PROXMIRE. Can you explain the facts in that case?

Mr. SHILLITO. Why don't we provide this for the record, Mr. Chairman.

Chairman PROXMIRE. All right.

[The following information was subsequently supplied for the record:]

Contract F41608-69C-6899 is an Air Force contract with the Tar Heel Engineering and Manufacturing Co. of Springhope, N.C. for 114 Truck-Lifts. FSN 1730-606-5391 with a contract price of $801,054. The contractor went out of business and the contract is now under termination proceedings. There remains $13,000 unliquidated progress payments which will be used as part of the termination settlement. To assure that this condition does not recur in the future. all Administrative Contracting Officers were advised to give greater emphasis to a more adequate review of contractor requests for progress payments.

Chairman PROXMIRE. Let me proceed on this. There may be some others.

RAYTHEON CONTRACTS

At the top of page 23 a case is discussed where $82.6 million was paid to a contractor without any independent technical evaluation being done by the Government as to his actual work accomplished. At the time of the review in March 1971, according to the report, six of the eight contracts in question were in a delinquent status and

some progress payment requests were approved while the contracts were delinquent. Can you identify this contractor, I guess you cannot on the basis of what you have told me so far—can you tell me anything more about these contracts?

Mr. WELSCH. Not at this time. We can supply for the record though additional detail.

Chairman PROXMIRE. Aren't contractors required to certify their requests for progress payments, and doesn't he have to indicate on these requests his actual work accomplished?

Mr. WELSCH. This is, as I understand, yes, sir, on the form requesting progress payments.

Chairman PROXMIRE. In a case such as this, is the contractor guilty of giving the Government false or misleading information, or is it a case of Government officials failing to do their job by checking into actual work accomplished?

Mr. WELSCH. I would prefer to do a little more review of the case and supply it for the record because, as I say, we do not have all of the background on each case.

We have much material in the file on it but we can supply that for the record.

[The following information was subsequently supplied for the record:]

The contractor is the Raytheon Company and the eight contracts and information concerning progress payments at the time of the audit review are shown below:

Contract No.	Contract amount	Progress payments	Percent of delivery due	Percent of contract delivered
N00019-68C-0386	$24,874,592	$16,906,533	100	34
N00019-69C-0200	16,951,769	13,110,709	100	32
DAAB05-69C-1012	6,629,000	5,715,115	100	60
N00017-69C-2323	2,533,030	1,622,602	100	50
F19628-69C-0094	21,482,600	18,941,893	0	0
N00017-69C-2409	10,113,000	6,567,118	100	1
N00017-70C-4409	19,181,000	12,131,896	0	0
N00019-70C-0299	11,828,068	7,611,038	15	0
	113,593,059	82,606,904		

One cannot conclude, however, simply on the basis of this information what the amount of premature progress payments or the extent of delinquent performance was. Progress payments, in accordance with Appendix E of the Armed Services Procurement Regulation, were based on costs incurred and not on delivery of items or physical progress.

Chairman PROXMIRE. So a contractor gets his progress payments, you find out later he is delinquent—what do you do?

Mr. SHILLITO. You end up obtaining those progress payments back or you end up charging that off against his future billings, Mr. Chairman.

Chairman PROXMIRE. Supposing he has given you false information in getting progress payments and certified it. What happens then?

Mr. SHILLITO. That becomes another situation.

Chairman PROXMIRE. What do you do then?

Mr. SHILLITO. You end up undoubtedly with a potential legal case on your hands. But, to my knowledge, we have had very few instances where we have determined this to be the case.

NO ACTION TAKEN AGAINST GOVERNMENT OFFICIALS WHO ALLOW CONTRACTORS TO OBTAIN EXCESS PROGRESS PAYMENTS

Chairman PROXMIRE. Has a government official ever been reprimanded, disciplined or fired for allowing a contractor to obtain excess progress payments?

Mr. SHILLITO. Well, we have taken actions—but first of all, let me say that some of the things that you have touched on here are really the reasons that we asked for this in-house look on which our auditors, our internal auditors did a good job.

Chairman PROXMIRE. As I say, it is a good report.

Mr. SHILLITO. Yes, sir, and they did a great job in doing just exactly this and, of course, they operate totally independently and they are a very effective organization.

Now, at the same time, on the procurement side of our operations, on Mr. Malloy's side of our defense operations, I am sure that you would probably find that our procurement people are probably not in complete agreement with this audit report although they are in general concurrence. I am not sure what the positions of our procurement people are as related to that audit report.

But I would say this: That as a result of that report we have taken a number of actions. All of the services and the agencies were direct recipients of the report, and were requested to take immediate action to correct the issues involved in the cited contracts. Instructions were passed to the field in the form of letters, in the form of memos to our individual operating activities.

The Contract Finance Committee who works for me, by the way, headed up by Colonel Benefield, was the organization to specifically ask that this audit be conducted. They adopted a number of the recommendations that were made in that audit report, including the deletion of method C, as you recall, which I will not go into, but which my statement does go into. This change was introduced in the revised progress payment form that went out early this year, and a followup survey was started in November, last month, by the Departments and the DSA to take a look at the corrective actions that have been taken on all contracts that were cited before, and again our Contract Finance Committee has under study a revision to the financing procedures for paying our contractors operating under a loss type contract.

So a lot of things have happened, but it gets back to the same point we were talking about on major weapons systems, Mr. Chairman, the problem in an organization this large is often not the policies. The problem is the implementation of these policies.

Chairman PROXMIRE. That is right. That is why I ask, there are some really serious abuses.

Mr. SHILLITO. Yes, sir.

Chairman PROXMIRE. I am going to cite one in just a minute that I think is really outrageous and that is why I ask has a Government official ever been reprimanded, disciplined, or fired for allowing a contractor to obtain excess progress payments.

Mr. SHILLITO. I cannot give you his name, rank, serial number, and codespeed.

Chairman PROXMIRE. I am asking have there been any, not who they were.

Mr. SHILLITO. There have been a number of instances so far as the system is concerned, where we have indeed sent letters out saying we have got to get on top of this. We have a number of these things come up constantly at our Logistics Systems Council policy meetings.

Chairman PROXMIRE. You cannot cite instances where a man was disciplined, let alone reprimanded, or fired?

Can you, Mr. Malloy?

Mr. MALLOY. I think it is impossible, Mr. Chairman, to answer that question in an organization as large as the DOD. We reprimand people all the time. But to be able to answer off the top of our heads as to whether any reprimands came as a direct result of——

Chairman PROXMIRE. I can tell you people who have been reprimanded and fired for trying to save money. Ernie Fitzgerald, who is on the staff of this committee, was fired from the Staff of the Air Force because he tried to save money on the C–5A.

SONOBUOYS CONTRACT

Let me give you a shocking example and where it seems to me some action should have been taken:

In December 1968, according to the report, $4.2 million had been paid to a contractor. This was the maximum amount payable under the contract but at the time only 1.5 percent of the items to be produced had been delivered. Yet the delivery schedule required 100 percent of all items by the end of the same month. An earlier evaluation by the Government contract officer estimated physical progress to be 45–50 percent of completion. And to top it off by the end of January 1971, more than 2 years later, deliveries were still not completed and the contract was in a delinquent status for 14 months.

Now, under those circumstances, wouldn't you say that some kind of disciplinary action should have been taken to protect the taxpayer?

Mr. MALLOY. Mr. Chairman, I surely could not say one way or the other just given that amount of information.

Surely that indicates there were peculiar and special problems involved in that contract situation. I am not familiar——

Chairman PROXMIRE. It is your report, it is not our report that you furnished us.

Mr. MALLOY. That is correct, and I am sure that whatever service was involved in that contract has already looked at it in great detail and taken whatever corrective action was indicated.

Chairman PROXMIRE. But you cannot tell me the status of that today, you cannot tell me the official concerned.

Mr. SHILLITO. The best I can do is give you for the record the specific actions taken with regard to that contract, if that is what you want.

Chairman PROXMIRE. Well, we would like to know whether the government got its money back and so forth.

Mr. SHILLITO. Yes, sir.

Chairman PROXMIRE. We would also like to know whether the

contractor gave false and misleading information in his request for progress payments.

[The following information was subsequently supplied for the record:]

The item referred to is on page 23 of the November 3, 1971 audit report.

"3. The progress payment limitation of $4,191,455 on Contract NOW66–00727 was reached in December 1968. At that time only 1.5 percent of the contract value was delivered, whereas the delivery schedule required 100 percent of all items by December 31, 1968. The only technical evaluation obtained by the ACO in September 1968 estimated physical progress to be 45–50 percent of completion. As of January 31, 1971, deliveries were not completed and the contract was in a delinquent status for 14 months."

This was a contract for 13,500 sonobuoys, awarded in 1966 and calling for deliveries to be completed by December 31, 1968. The current obligated value of the contract is approximately $6.7 million. The contract called for first article approval and in the initial stages, only nominal progress payments were allowed commensurate with the ACO's first article value estimate ($35.000). Normally, when first article approval is required, any costs incurred in connection with later production items are at the contractor's risk until the first article has been approved. Apparently, because the contract contained liquidated damages provisions, the contractor assumed a certain risk by stocking up with materials beyond his immediate needs in order to be able to meet the delivery schedule. This was also in recognition of the long lead times involved in the acquisition of some of these materials.

The first article was approved by the Navy Department on July 19, 1968. The inventory of purchased material was then eligible for progress payments. On the same date, July 19, 1968, the contractor filed a request for progress payment in the amount of $3,085,103.42. Progress at this point was thus largely related to purchased materials. Subsequent to this payment, five additional progress payments were made bringing the outstanding total to $4,191,455 as indicated in the audit report. The implication that the contract was only 1.5% complete when progress payments of $4,191,455 were approved by the ACO is misleading. The status of contract deliveries is not the sole determinative of physical progress under a contract for the purpose of approving progress payments. ASPR recognizes that progress is measured by the acquisition of material as well as the incurrence of labor, production of tooling, etc. In this respect, the contract was, at that time, in excess of 50% complete.

Since the contractor was successful in having his first article approved, the Navy, the contractor, and the DCAS office were all confident that the contractor could produce a successful sonobuoy. Neither the ACO nor other DOD personnel had any reason to believe the contractor would run into technical difficulties on his production items. However, despite approval of the preproduction models, failures were subsequently encountered when making drop tests, and the contractor ran into unforeseen technical production problems. Thus, after the delivery dates called for by the contract, he was technically delinquent. No futher progress payments were made until 1970 except for one very small amount in 1969. In April 1970, the contractor submitted a progress payment request for approximately $233.000. This was thoroughly reviewed by the ACO, and was paid on July 17, 1970, three months later. This brought the total of progress payments to $4,425.000 which was 70% of the $6.322.035 face value of the contract at that time. The contractor had incurred costs of over $9 million at this time, of which material alone represented more than $4 million. The contractor's next request for progress payment, on February 2, 1971, was rejected by the ACO on the basis that the maximum allowable progress payment had been made. Thereafter, no further progress payments were made under this contract.

In view of the foregoing, the government did not consider it necessary to request a refund of progress payments which had been made to the contractor. There is no indication that the contractor gave false and misleading information in his requests for progress payments. Deliveries under this contract were approaching 50% when the last progress payment was made. There were approximately $2.3 million of unliquidated progress payments outstanding at

that point. Currently, the amount of unliquidated progress payments has been reduced to approximately $320,000, which is 58% of the $554,629 value of items remaining to be delivered.

Chairman PROXMIRE. On page 59 of the report there's a list of the contractors included in the review. Were excess progress payments identified with all of these contractors?

Mr. SHILLITO. Mr. Welsh, can you answer that again? Are you talking about the five contractors in that?

Chairman PROXMIRE. Yes, page 59.

Mr. SHILLITO. I think that there were unusual——

Chairman PROXMIRE. It is not five, it was a large number.

Mr. SHILLITO. Not five.

Chairman PROXMIRE. A large number.

Mr. SHILLITO. Because there was another portion of the report dealing with five that comes to mind.

Mr. WELSCH. There were 52 contractors, and I do not believe we had overpayments on all of these.

We did not use the names in the report so it cannot be readily reconciled, but I am quite sure if we reviewed our records it would show that several of these contractors were not in an overpaid status or receiving excess progress payments.

OVERPAYMENTS TO LOCKHEED

Chairman PROXMIRE. I notice Lockheed-Georgia is on the list. But the report does not specifically mention the $400 million in unauthorized progress payments reported by Mr. Lynn's agency. Was this one of the cases uncovered in the review or did this come to light independently of it?

Mr. WELSCH. I believe that was independent of our review, sir.

Chairman PROXMIRE. It was not included.

Mr. WELSCH. We included it in our review but not as an example because it was being handled as a separate issue during that period of time by the DCAA and the procurement people.

Chairman PROXMIRE. So that is over and above the $200 million reported in this report, that $200 million, another $400 million and in the case of Lockheed makes it $600 million that we know about.

Mr. SHILLITO. Mr. Chairman, most of that regarding Lockheed is pretty well behind us. But this would be in addition to that.

Chairman PROXMIRE. Can you briefly, and I don't——

Mr. SHILLITO. By the way, they were not unauthorized progress payments. These were not unauthorized, as far as the Lockheed payments are concerned. That is an important point. In fact, if you would like we might have Mr. Beuter talk to this particular point. This has been an issue of debate for some time, and I want to make it clear that they were not unauthorized. We will go into it in detail and furnish it for the record.

[The following information was subsequently supplied for the record:]

PROGRESS PAYMENTS

The Air Force position with respect to the alleged overpayment to Lockheed of $400M under the C-5A contract is as follows:

The Method C procedure (target cost for delivered items) used by Lockheed in requesting progress payments was allowable under the contract.

Because of outstanding contractual differences, the use of the Method C procedure was equitable to both the contractor and the taxpayer.

It would have been inequitable to enforce the collection of the computed $400 million *overpayment* of progress payments without recognizing the large *underpayment* for delivery billings which Lockheed regarded as completely offsetting.

The C–5A contract was a fixed price incentive contract with special repricing clauses. Government financing for fixed price incentive contracts is provided from two sources—progress payments and delivery payments. When actual costs overrun target costs on such conttracts, it is necessary to *decrease progress payments outstanding and increase delivery payments* as shown in the following illustration (in the interest of simplicity, profit adjustments have been omitted):

Contract data:	
Target cost	$400
Target billing price	$400
Ceiling price (130 percent of target cost)	$520
Progress payment rate (percent)	80
Liquidation rate (percent)	80
Progress payment data:	
Total costs incurred	$200
Delivered items:	
Target cost (method C)	$100
Estimated actual cost (method B)	$120
Target billing price	$100
Revised billing price	$120
Progress payments:	
Liquidation (80 percent of target billing price)	$80
Outstanding (total paid $160 less liquidated $80)	$80

Contract status	Contractor (1)	Auditor (2)	Contracting officer (3)
1. Total costs incurred	$200	$200	$200
2. Deduct cost of delivered items:			
Target cost (method C)	100		
Estimated actual cost (method B)		120	120
3. Cost of undelivered items	100	80	80
4. Maximum permissible progress payments (80 percent of line 3)	80	64	64
5. Progress payments outstanding	80	80	[1] 64
6. Progress payments due or (overpaid)	0	(16)	0
Total Government financing provideed by:			
Progress payments (line 4 above)	80	64	64
Delivery billings:			
Target price	100	100	
Revised price			[1] 120
Total financing	180	164	184

Note 1—In revising billing prices upward to $120, the contracting officer will deduct progress payment liquidation of 80% of $120 or $96. The $96 in liquidation will be deducted from total progress payments paid ($160) to arrive at progress payments outstanding of $64.

The above illustration discloses that, until revised billing prices are established by the contracting officer, the contractor and the Defense Contract Audit Agency (DCAA) auditor necessarily perceive the financing entitlement under the contract from different perspectives:

Contractor.—Column (1) discloses a condition in which the contractor has computed his progress payment limitation using target costs of $100 as the cost of delivered items. The total cash financing provided by the government at this point is $80 by progress payments and $100 for delivery billings or a total of $180 as shown in column (1). (As will be explained later, based on equity, the contractor is justified in using target cost until revised billing prices for delivered items are established.)

DCAA Auditor.—Column (2) displays the impact of the DCAA auditor's determination that the estimated actual cost of delivered items is $120 and the conclusion that progress payments are therefore overpaid by $16. In

fairness to the auditor, it should be recognized that the DCAA audit must be tied to the existing contract and no recognition can be given to revised billing prices until they become part of the formal contract. If procurement authorities enforced this asserted overpayment, the contractor would be required to refund $16 so that, as shown, government financing would drop to $164.

Contracting Officer.—But what are the equities of this situation? What is fair to both the contractor and the taxpayer? In the case of the example cited, under a fixed-price incentive contract, the government is obligated to pay the contractor for all cost overruns which exceed target costs but are under the ceiling price. Accordingly, as is shown in column (3), equity requires that *before reducing progress payments* by $16, the contracting officer should recognize the government's obligation to reimburse the contractor for costs in excess of target costs by *increasing the billing price of delivered items* by $20. If the government did not do this, it would be demanding a repayment of $16 for "excess" progress payments when in fact it owes the contractor an additional $4!

The simple illustration explained above, closely parallels the problem that Air Force procurement authorities faced when they received the DCAA report advising that, if computations were based on the estimated actual costs of delivered items, progress payments on the C–5A would be overpaid by $400 million. At that time procurement authorities recognized that the $400 million figure used in the audit report had no relationship to the *net* adjustment required in total contract financing because Lockheed (as in the case of the example described above) had been restricted to *target prices* for delivery billings. The C–5A contract's special repricing, termination and economic escalation clauses were designed to protect the contractor from catastrophic losses if actual costs exceeded provisional ceiling prices and the Air Force recognized an obligation to increase C–5A billing prices by several hundred million dollars. Lockheed asserted that it was entitled to full cost relief (see column (3) of above illustration) in the form of increased billing prices which would completely offset the computed overpayment of $400 million in progress payments. In contrast, the Air Force concluded that, while some of Lockheed's legal positions had merit, alternative interpretations of the contract required that the contractor absorb a portion of the cost overrun.

At the time of recipt of the DCAA audit the differences between the parties in interpreting the contract exceeded $500 million. It appeared that these differences would require resolution by the Armed Services Boaard of Contract Appeals (ASBCA) or the courts, and Lockheed had already docketed its case before ASBCA. The Air Force was reluctant to increase billing prices by a substantial amount because it believed this could prejudice the government's legal position in a possible future court case. On the other hand, if billing prices were maintained at the level of target prices and repayment of the progress payments of $400 million was enforced, it was recognized that this was not only inquitable but that this might be construed as a breach of contract. Accordingly, it was concluded that the best course of conduct was to defer the repricing of delivery billings and permit the contractor to continue to request progress payments by the use of Method C (target costs) *which was an allowable method under the terms of the contract.* This conclusion was reached on the basis of a rational analysis of the situation by Air Force procurement, financial management, and legal authorities at major command, Air Staff and Secretarial levels.

In September 1970 the Air Force changed the C–5A contract to authorize progress payments up to 100% of ceiling price. This action was taken because of concern that if the C–5A contract's ceiling price was increased above certain levels, the Air Force's legal case, which involved differences in contract interpretation, might be weakened. To provide Lockheed with progress payments without increasing the contract's ceiling price, the Air Force authorized progress payments up to 100% of a ceiling price which was always maintained at a figure which was lower than the projected outcome of a fair adjudication of the outstanding issues between the parties. It is emphasized that after this contract change, Lockheed's total progress payments continued to be limited to 90% of costs incurred. In fact, *Lockheed never received total progress payments in excess of 90% of total incurred costs during the entire fixed-price*

incentive contract until the day that the contract was restructured to a cost plus a fixed loss contract in June 1971. As a result, at the time the contract was restructured, Lockheed had incurred $113 million in allowable costs for which it had not been reimbursed.

Chairman PROXMIRE. Doesn't the Defense Department have the authority to suspend making progress payments if a contractor fails to make actual physical progress?

Mr. SHILLITO. Indeed.

Chairman PROXMIRE. Has this authority ever been exercised in connection with one of the giant defense firms?

If so, please tell us the instances and the facts surrounding them?

Mr. SHILLITO. I will have to give you the instances, but this is something which has come up several times.

Chairman PROXMIRE. It has been done, you can assure us, in the case of very large firms.

Mr. SHILLITO. Yes, it has been done, Mr. Chairman, on several occasions. Do you want to talk on this, Mr. Malloy?

Mr. MALLOY. I do not want to have the record be misleading on the point.

Your question had to do with a giant defense contractor?

Chairman PROXMIRE. Well, one of the five.

Mr. MALLOY. Our answer had to do with whether progress payments had ever been stopped as a result of lack of progress under the contract. We said we would have to give you the answer with respect to large contractors for the record but, as a general answer to the question, yes, there have been frequent instances where progress payments are stopped because of lack of accomplishment.

Chairman PROXMIRE. Can you cite one or two?

Mr. MALLOY. Not off the top of my head.

Mr. SHILLITO. We will give it to you.

[The following information was subsequently supplied for the record:]

Contractor	Contract No.	Progress payment No.	Date	Amount (thousands)	Reason
E—Systems, Inc., Greenville, Tex	F04606-68-C-0331	----------	July 1972	$245	Suspended to allow recoupment for reduction in contract amount.
Magnavox Corp., Ft. Wayne, Ind	F33657-71-C-1068	1	----------	131	Payments suspended since contract was delinquent, in a loss position, and had not made sufficient physical progress.
		2		69	Reduced to consider loss contract.
McDonnell-Douglas Electronics Co., division of McDonnell-Douglas Corp., St. Charles, Mo.	DAHC07-71-C-0328	17	December 1972	4	Progress was not commensurate with costs incurred.
	F33657-69-C-0628	100	April 1972	37	Contract ceiling price decreased thereby reducing progress payment limitation.
Electron Tube Division, ITT Corp., Roanoke, Va.	DAAB05-71-C-2604	3	September 1972	31	Suspend pending submission of additional data to support physical progress.
LTV Aerospace Corp., Sterling Heights, Mich.	DAAH01-71-A-0025	----------	March 1972	18	Progress not commensurate with costs incurred.
			May 1972	72	
			June 1972	8	
			August 1972	79	Progress payments suspended since costs included
			August 1972	15	materials diverted from other contracts without
			December 1972	7	contracting officer approval.
General Electric Co., Fitchburg, Mass.	N00024-71-C-5303	(1)	December 1971 to February 1972.	132	Contractor's accounting system did not accurately reflect costs for progress payment purposes. Payment made after accounting system accurately revised to satisfy contract auditor and administrative contracting officer.
Sanders Associates, Inc., Nashua, N. H.	N00019-70-C-0432	9	September 1972	173	Progress not commensurate with costs incurred.
		10	December 1972	209	
	N00019-69-C-0397	20	July 1972	662	Progress not commensurate with costs incurred.
	N00019-71-C-0441	31	June 1972	76	The unliquidated amount was in excess of the amount permitted by the contract.
		32-35	June to October 1972	236	Progress not commensurate with costs incurred.
	DAAH01-69-C-0749	120	December 1972	97	The unliquidated amount was in excess of the amount permitted by the contract.
	N00019-71-C-0118	10	January 1972	44	Progress not commensurate with costs incurred.
Raytheon Co., Wyland, Mass.	DAAB07-72-C-0075	4	May 1972	71	Do.
Raytheon Co., Lowell, Mass.	N00019-71-C-0024	29	January 1972	534	Do.
Hughes Tool Co., Aircraft Division	F08635-68-C-0079	10	----------	155	Delays in deliveries from subcontractors.
				534	Do.
Hughes Aircraft Co	F33-657-68-C-0829	10	November 1971	1,362	Failure to perform.
Do	N0017-70-C-1424	----------	November 1972	620	Do.
Boeing, Seattle	F04-701-71-C-0150	----------	February 1972	511	Lack of progress.

[1] Various.

Chairman PROXMIRE. The reason I ask is because such a situation recently occurred on a contract with the Tectron Corp. Tectron is apparently a small or medium size firm—it is not on the list of the largest 100 contractors. The Pentagon suspended its progress payments because it fell behind in physical progress and the Armed Services Board of Contract Appeals ruled in the Government's favor even though the action imperiled the contractor's financial position.

Do you believe the Government will take such a hard line with regard to Litton's LHA or Grumman's F–14 contracts?

Mr. SHILLITO. This is something, Mr. Chairman, that I would have to look at in light of all the facts, in light of the financial situation, in light of the Government's need, in light of many different things.

To just give you a yes or no would be nothing. It just would not be the right answer, as you well know, sir.

Chairman PROXMIRE. You have been in the Defense Department 5 years, you have been with two administrations, and you have an extraordinary experience in this area, so let me ask you this.

Mr. SHILLITO. Thank you very much. I like your term "extraordinary."

Chairman PROXMIRE. Well, extraordinary good experience. You know I am a friend of yours, Mr. Shillito.

Mr. SHILLITO. I hope so.

Chairman PROXMIRE. I do. I really try.

Mr. SHILLITO. Do you really?

Chairman PROXMIRE. I really try.

Mr. SHILLITO. By God, I do not need enemies. [Laughter.]

Chairman PROXMIRE. Come on now.

We detected a tendency among contractors and some Government officials to blame huge cost overruns and delays on the total package procurement concept. In fact we had the SEC coming in and saying, even they are saying no problems in the future because TPP is out of the way which, I think, of course, is ridiculous, even if we were one of the first critics of the program. Total package procurement has now been outlawed as I understand it.

Do you think some people may be going too far in using TPP as a scapegoat and thereby avoiding the central problems of mismanagement and inefficiency?

Mr. SHILLITO. Well, first of all, let me say categorically that total package procurement is not all bad. In many instances, and unfortunately those that have received just an awful lot of publicity, it indeed was the wrong type contract to go into.

I mentioned earlier what I consider to be some of the fundamentals of procurement, and I will not go into details with regard to your question. One of the fundamental problems, however, is the unknowns when you start a program if you have never bought a particular item before. If it is a new item to you, you are never really sure what it is going to cost until you get into the business and until you actually produce the item.

First of all, what is total package procurement, what does it mean? This is a situation where you are combining development and

experience production under a single contract wherein the production portion is priced either by a fully structured contract or by a priced option contract. So you are talking about buying something, potentially a major item, that has not been developed, that you really do not know what it is going to cost and tying this down so far as a production price is concerned.

Now, on many smaller programs for smaller items, where there is something that the item can be compared to, and when you know that the contractor can handle maybe a severe loss—several times the cost estimate should he have to—total package procurement can be applied.

But when you get into some of the major programs where you are talking about a few percentage points over-run being more than the company's entire net worth, Mr. Chairman, to go into a total package type procurement on a major weapons system is really sticking your neck out significantly. But to say all TPP contracts are bad is not correct.

Chairman PROXMIRE. What I was getting at is this: I think you state there what the fundamental problems are. We do not know what we are getting into in those programs, what the costs are, what we have to do to achieve a certain competence in our weapons systems, and those are basic conditions, no matter what kind of a contract you have. You are going to have very, very serious problems in many cases.

Mr. SHILLITO. That is right.

Chairman PROXMIRE. So that outlawing the total package procurement program for big contracts, the kinds you describe is a wise policy but that does not eliminate the likelihood that we are going to have overruns in the future. We are going to have incompetence, we are going to have to watch this very closely; is that not right?

Mr. SHILLITO. Yes, sir.

By the way, I would say one other thing. We will be glad to give you a listing of some of the total package procurement kind of programs that have been successful. Too many people in industry too often are inclined to blame total package procurement for all their ills, and I just feel that this is not correct, sir.

Chairman PROXMIRE. I am glad to hear that. I think you are right, although we were, I think, as I say, the first congressional committee to criticize this, and we criticized it very severely when the Defense Department was championing it.

One thing that bothers me about your generally excellent statement——

Mr. SHILLITO. Thank you.

Chairman PROXMIRE [continuing]. And I think it is about the best we have ever received from an official of your rank—but what bothers me are the references to recent changes, new studies, and new programs which are all expected to work wonders in the future.

Frankly, I have been hearing this song for a long time. I remember when your colleagues in the Pentagon heralded total package procurement as a miracle cure—Secretary Charles said it was the best conception for contract maladies that had ever come down the pike.

In 1969, the President's Economic Report singled out TPP as the thing that was going to straighten out Government contracting, and the Chairman of the Council of Economic Advisers boasted about it in hearings before this committee.

In your statement you talk about competitive prototyping as a way to keep intial prices down. I think that is great. In fact, I have recommended it. But what is to stop a contractor from buying in with a low price and then increasing costs after he gets the contract? Is that not the time tested method for getting money out of the Government?

Mr. SHILLITO. Well, you have asked a couple of questions, Mr. Chairman.

Chairman PROXMIRE. First of all, let's talk about changes and the future? Let me say what I would boil this down to is the importance of not crying "Uncle" when the crunch comes. In other words, just not giving in and backing down, and saying, "This is it, this is the contract, we are going to stick to it," and let the consequences fall where they may. We may lose a weapons systems. We may incur costs to the Government that are very great, we may have a contractor go under, but we will get a discipline then, an understanding, and an appreciation in the defense community that will pay dividends in the future.

Mr. SHILLITO. Yes, sir.

Chairman PROXMIRE. If we gave in, we are not going to get anything like that. We are going to get great costs.

Mr. SHILLITO. All right, sir, I will come to that point.

But, first of all, we believe strongly, as I tried to emphasize in the statement, that we are moving in the right direction. We do believe that the changes that we have made are such that for the first time, a lot of things are tied together.

You do feel sometimes in this environment that you have seen the merry-go-round go around before, you know, on some of these needed kinds of changes. But sincerely, Mr. Chairman, having been exposed to this environment for a long time in many different ways, since World War II, in fact, I would have to say that for the first time we do have things well tied together.

Our policies are good. Implementation of them is another thing. We have done quite a job of an in-house analysis of our problems.

You talked about Leonard Sullivan a few moments ago and his efforts. He has also led a fairly thorough in-house review of how we are progressing. Our progress is such that it does cause us to feel immeasurably better than we did a few years back. We have established a Cost Analysis Improvement Group that does look at our estimate for every major weapons system as we go through the hurdles at each decision point across the life cycle of these major weapons systems.

Now, back to your point of buying in and getting well. I would not want to suggest that this has gone away, and I would not want to suggest that there is any magic remedy to keep a contractor from buying in. I would not want to inform you that all at once all of our contractors have become realistic in their estimates and have lost their optimism that has tainted many of them and tainted us in many ways, and adversely affected our force size.

Chairman PROXMIRE. You have more buy-ins than ever, bigger buy-ins.

Mr. SHILLITO. You are looking now at historical programs; you are not looking at programs that have particularly come across the board in the last couple of years.

As far as the approach that we now have DOD Directive 5000.1, spells out the fly-before-you-buy approach, the idea of fully developing these major programs, and as best we can, knowing what it is that we have to have before we commit ourselves to the environment of firm fixed price. This is really the direction in which 5000.1 takes us; we should avoid, or minimize the situation of buying in on these major programs.

One other thing I should mention here, too, Mr. Chairman. I think we are moving in the direction that more and more we have to rely on our in-house estimates as to what programs should cost, and not be influenced by contractors' estimates, even when making our awards. Contractors' estimates, on balance I think, on many of these programs are not nearly as good as our own in-house estimates.

Chairman PROXMIRE. I think it is very, very constructive. But we still feel when you recognize the immense ability that we have had in the Defense Department—I think Secretary McNamara was as brilliant a man as I have ever seen.

Mr. SHILLITO. He was, yes, sir.

Chairman PROXMIRE. He had an enormous memory and tremendous insight, terribly hard-working. He was succeeded by another outstanding man, Clark Clifford; and Melvin Laird is as good as they come.

Mr. SHILLITO. Yes, sir.

Chairman PROXMIRE. I have great respect for them.

Mr. SHILLITO. And Dave Packard.

Chairman PROXMIRE. Yes, indeed, but you see, the kind of thing I am getting at is not a matter of intelligence that you apply as much as the will to stand up to a contractor under tough circumstances and take a position that the whole defense community is going to be very sad and unhappy about and is going to result perhaps in a bankruptcy, perhaps in a firm going under, at any rate an immense loss. This is the kind of an attitude that we, it seems to me, we have to have in addition, you say, to some skepticism about the bid that the contractor makes when he comes into the program.

We have to have a willingness, to stand up to contractors under the toughest kind of circumstances. I do not see that on the basis of the most recent developments, although we seem to be getting that in the Grumman case with respect to the F–14, but then we back away with the advance payments that seem to be coming in through the back door.

Mr. SHILLITO. Well, now, the point that you make, Mr. Chairman, is indeed sound. I think it ought to be elaborated on just a little bit though. What we really have to do is stand up early. We have to stand up before we get ourselves "wrapped up in our long underwear" as far as a program being well in production, a program involving a piece of hardware that we have to have for the security of this country. That is when it gets to be really awkward. Doggone it,

we have to stand up and stand up soon on these program in order to make these decisions right and early.

Once you find yourself too far gone, and you are in a situation where you know what you have to have the hardware that you are talking about, it becomes pretty tough to just say, "Well, we are going to turn our back on that needed hardware."

Admittedly we have Public Law 85–804, which gives us the vehicle when this applies. Fortunately, on 11 million procurements each year, this does not happen too often. It has happened on a few of our major weapons systems and these have been highly publicized. I can only say, Mr. Chairman, that we feel at least as bad about this as anyone else.

Chairman PROXMIRE. Well, let me just try this once more in a little different way and then I have a couple of other questions, we want to get into defense——

Mr. SHILLITO. The point I am making, excuse me, sir.

Chairman PROXMIRE. Yes, sir.

Mr. SHILLITO. We are really talking about the national interest and that is what you are really talking about, too.

Chairman PROXMIRE. That is right.

Mr. SHILLITO. Sometimes the position of one person versus another may be a little different on the national interest issue, but we have to decide what is in the national interest.

Chairman PROXMIRE. Yes, and here is the problem in representing the national interest. When the Government lets a contract, it should have an adversary relationship with the contractor.

On the other hand, the Defense Department has an interest in keeping alive a vital, effective, functioning defense industry.

You have to have good profit, you have to have a real incentive, the healthier it is, the better.

Mr. SHILLITO. Yes, sir.

INDEPENDENT PROCUREMENT AGENCY

Chairman PROXMIRE. Does this not mean the Government cannot exercise its adversary role, and does not exercise its adversary role, because of its close relationships?

Should we not have an independent agency for procurement so as to avoid this conflict?

Mr. SHILLITO. Mr. Chairman, I do not know whether you are suggesting that, but I would frankly be inclined to feel that, knowing you as well as I do, once you would fully analyze the situation you would not come to the conclusion that there needs to be an independent agency.

Chairman PROXMIRE. You ought to consider that option. I think we ought to consider it.

I should not say independent of the Government, it has to be a Government agency; I should say independent of the Defense Department.

Mr. SHILLITO. Well, I have spent quite a bit of time in countries where they have tried to use an agency independent from their Defense Department, to do their procurement job.

Chairman PROXMIRE. Does it not work well with the British in procuring aircraft?

Mr. SHILLITO. It does not work as well as ours.

Chairman PROXMIRE. That is hard to believe. [Laughter.]

Mr. SHILLITO. Well, it is really not—once you find yourself——

Chairman PROXMIRE. Is there any study or analysis that would show that?

Mr. SHILLITO. I think such a thing could be pulled together rather quickly.

Chairman PROXMIRE. I would like to see it.

[The following information was subsequently supplied for the record:]

A study of Defense procurement in Britain was ordered by the British Government in October 1970. The Study Group headed by Mr. Derek Rayner completed the study in April 1971 and submitted its report "Government Organisation for Defence Procurement and Civil Aerospace" to Parliament. As a result of the recommendations of this study, the procurement of aircraft, which had until then been conducted by an independent agency, viz., the Ministry of Aviation Supply, was transferred to the Ministry of Defence.

Mr. SHILLITO. Most of these countries are envious of ours.

I would like to make this comment: We do have an adversary relationship, I do not care how you cut it; there is indeed an adversary relationship between our contractors and the Department of Defense, a sound adversary relationship. Sometimes it can be better, but it indeed is an adversary relationship.

Chairman PROXMIRE. How can you have that when Mr. Ash threatens to go to the President over a matter like the *Litton* case?

Mr. SHILLITO. I do not know——

Chairman PROXMIRE. LHA.

Mr. SHILLITO. I do not believe that, Mr. Chairman, and I——

Chairman PROXMIRE. You do not believe what?

Mr. SHILLITO. I do not believe that he made that statement, Mr. Chairman. I happen——

Chairman PROXMIRE. As I understand it, he admitted it.

Mr. SHILLITO. I frankly am not aware of that. If he did, fine, but I do not believe that he did.

I have known Mr. Ash for a long time, and Mr. Ash is a very competent guy. I have been on the opposite side of the negotiating table from Mr. Ash many times. We have never been a part of the same organization at the same time, and we have not seen eye to eye on many many things at times. But Mr. Ash is a very capable, tough-minded, and hard-working guy.

Chairman PROXMIRE. No question about his being a good negotiator, when you see what he had been able to get out of the Government with the very badly managed shipyard he has got down there.

Mr. SHILLITO. Well, again, I won't quarrel with the problems that have gone on at Pascagoula. I indeed would be the first to admit that things could have worked out a lot better at Pascagoula, but I cannot envision the point that you make as being correct, Mr. Chairman.

DEFENSE PROFITS

Chairman PROXMIRE. Now, I would like to get into the profits thing, unfortunately rather briefly, the hour is late. I think you

have made some excellent points on the profit picture and I think this chart is a chart that is not entirely persuasive because what you do is you take the contract price dollar. If you take return on investments that is something else.

Mr. SHILLITO. Would you like to talk about that, Mr. Chairman?

Chairman PROXMIRE. Let me say, the difference, of course, let me say this before I get to the question I have for you, the difference is in many of these cases, many of these cases the contractor is working with the Government's money.

Mr. SHILLITO. And still making only that kind of profit.

Chairman PROXMIRE. Well, regardless, the important thing is the return on investment.

Mr. SHILLITO. Indeed, Mr. Chairman.

Chairman PROXMIRE. You know that, I know that, you know that as one who has been in industry for a long time, very successfully.

Mr. SHILLITO. And, by the way, I would not want to suggest that these charts——

Chairman PROXMIRE. How about that chart.

Mr. SHILLITO. That is profit as a percent of total capital investment, I think you would prefer return related to equity capital—total capital does not really make your point as well as you would like it to.

Chairman PROXMIRE. I am sure you want to make my point on that. [Laughter.]

Mr. SHILLITO. But the only point I would like to make, the GAO study you are familiar with. You are familiar with the FTC–SEC data and, of course, with the LMI study. What this does—chart on profit on ECI—here is to take 41 companies which are predominantly defense contractors, and compares their return to their equity capital. The previous LMI study stopped as of the end of 1968, as you recall, so we did not have the financial data related to defense sales and profit for these companies, broken down by defense and nondefense. We have used their total corporate financial data.

I would urge that you not come to the conclusion that this chart is completely right for defense data for the last 3 years.

I would also say that if you look at a company's total business without segregating defense from nondefense, that based on history you would have to estimate that defense profits would probably be a little lower than nondefense profits.

Chairman PROXMIRE. But what you are talking about there is return on equity as calculated by the Logistics Management Institute.

Mr. SHILLITO. That is right.

Would you like to talk about the GAO?

Chairman PROXMIRE. Yes; but the one that is lowest is the LMI.

Mr. SHILLITO. Yes, that is right.

Chairman PROXMIRE. And that was not a matter of getting a sample based on picking a number of firms and getting what their actual profits were on defense contracts, as I understand it. What it was, was a matter of those firms that would volunteer their profit returns, isn't that right?

Mr. SHILLITO. It so happens that every company that was talked to that did business with DOD, over $200 million a year, agreed to

participate. About 65 percent of all the companies solicited between $25 and $200 million a year agreed to participate. We are talking about a sample which represents about 85 percent in dollars of the universe of durable goods, manufacturing companies having more than $25 million defense sales, and whose sales were more than 10 percent to defense.

Chairman PROXMIRE. That were in the sample but not in the firms that reported.

Mr. SHILLITO. Excuse me, 85 percent of the dollars are reflected by that line over those years.

Chairman PROXMIRE. Reflected because you picked a sample of those.

Mr. SHILLITO. The 85 percent relates to the total defense dollars in the sample. Only about 15 percent were not there, in there. So I would say on balance, it reflects a pretty good picture as to what the equity capital situation really is.

Chairman PROXMIRE. The trouble I have with it——

Mr. SHILLITO. By the way, there is a big turnover in here.

Chairman PROXMIRE. I understand that. The LMI was not derived on the basis of a GAO independent auditor going in and determining whether the bookkeeping procedures were correct and calculating what the profits were. It depends on how you allocate the overhead and it depends on all kinds of things.

Mr. SHILLITO. That ties in our profit on capital policy. By the way, GAO and LMI conclusions were the same.

Chairman PROXMIRE. You have not got the GAO.

Mr. SHILLITO. I am not talking about lines, the numbers. I am talking about the conclusions. One of them dealt with profit on capital which is something you were interested in.

Chairman PROXMIRE. As I recall, the return on capital study by GAO indicated the return on capital was reasonably substantial for defense firms, it was not a low profit.

Mr. SHILLITO. But mean average less than the SEC data.

Chairman PROXMIRE. Well, the audit indicated they were much higher.

Mr. SHILLITO. The review of 146 contracts indicated that they were much higher.

Chairman PROXMIRE. That is right.

Mr. SHILLITO. But that did not reflect a representative sample.

Chairman PROXMIRE. And many didn't show what the audits showed.

Mr. SHILLITO. Those were 146 selected contracts.

Chairman PROXMIRE. But what do the audits show?

The initial reports not audited showed they were much lower than they should have been.

Mr. SHILLITO. The audits showed there were many contracts where the profit to equity was staggering.

Chairman PROXMIRE. That is right.

Mr. SHILLITO. But the audit also shows the mean average profits were indeed lower than the FTC–SEC data. The audit really reflected a distribution curve resembling the distribution curve for a roulette wheel.

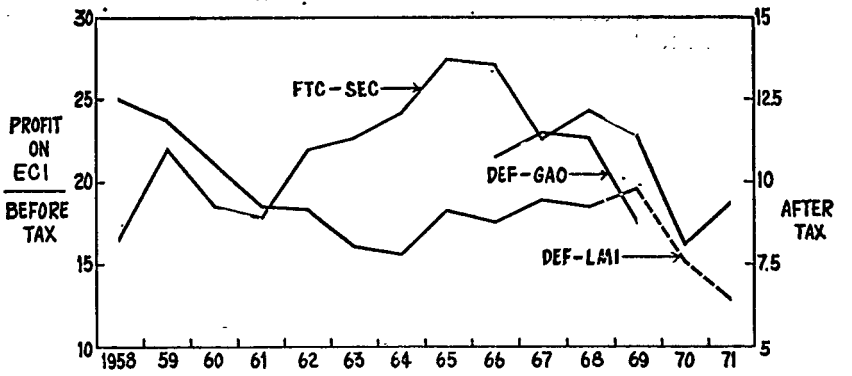
Chairman PROXMIRE. I understand that, but there is no reason to go over.

Mr. SHILLITO. All right.

[The following charts were subsequently supplied for the record by Mr. Shillito:]

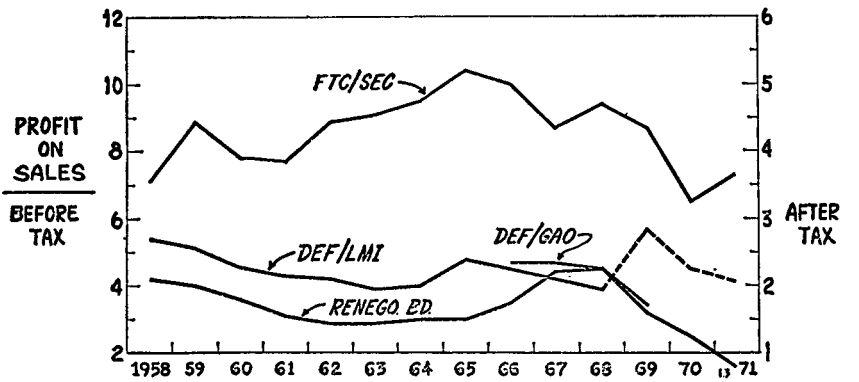
PROFIT ON ECI

HIGH AND MEDIUM VOLUME COMPANIES



FTC/SEC	16.5	21.9	18.5	17.8	21.9	22.6	24.1	27.4	27.1	22.5	24.4	22.8	16.1	18.6
DEF-GAO									21.4	22.9	22.6	17.4		
DEF-LMI	25.0	23.7	21.1	18.5	18.3	16.1	15.6	18.2	17.4	16.9	18.5	19.6	15.2	12.9

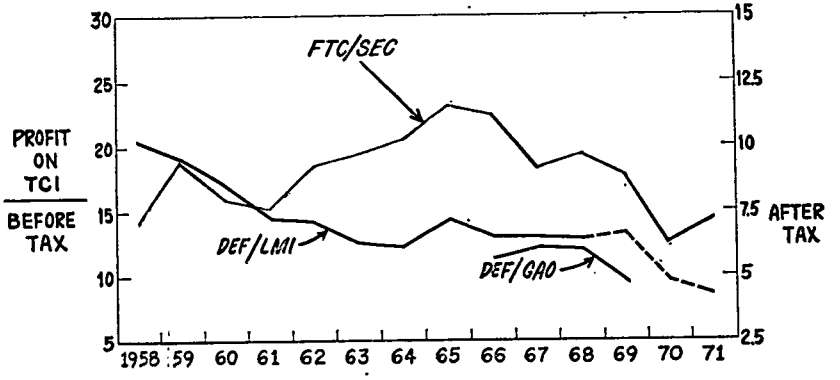
PROFIT ON SALES



FTC/SEC	7.1	8.9	7.8	7.7	8.9	9.1	9.5	10.4	10.0	8.7	9.4	8.7	6.5	7.3
RENEGO BD	4.2	4.0	3.6	3.1	2.9	2.9	3.0	3.0	3.5	4.4	4.5	3.2	2.5	1.3
DEF/GAO									4.7	4.7	4.5	3.4		
DEF/LMI	5.4	5.1	4.5	4.3	4.2	3.9	4.0	4.8	4.5	4.2	3.9	5.7	4.5	4.1

PROFIT ON TCI

HIGH AND MEDIUM VOLUME COMPANIES



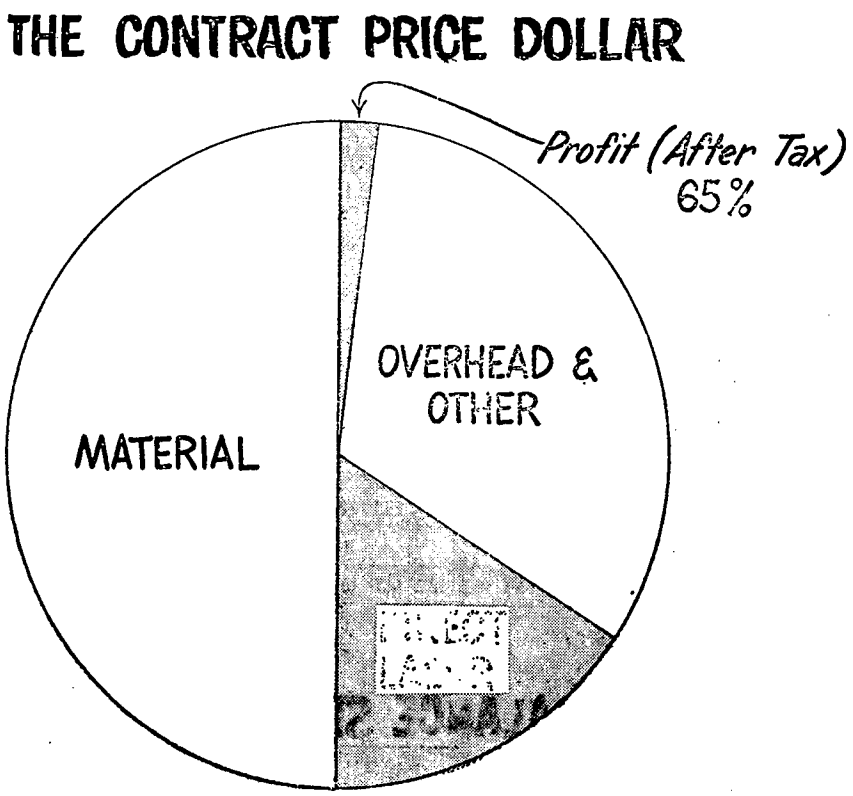
FTC/SEC	14.1	18.8	15.9	15.1	18.5	19.2	20.4	23.1	22.6	18.2	19.5	17.9	12.4	14.2
DEF/GAO									11.3	12.1	11.9	9.5		
DEF/LMI	20.4	19.1	17.0	14.6	14.3	12.5	12.2	14.3	13.0	13.0	12.8	13.1	9.6	8.6

BALANCE SHEET

ASSETS		LIABILITIES AND CAPITAL	
CURRENT ASSETS:		**CURRENT LIABILITIES:**	
CASH AND MARKETABLE SECURITIES	$ 200	ACCOUNTS PAYABLE	$ 200
ACCOUNTS RECEIVABLE	100	OTHER ACCRUALS	100
INVENTORIES	300		300
	600		
FIXED ASSETS	1,300	LONG-TERM DEBT	500
OTHER ASSETS	100	STOCKHOLDER'S EQUITY	1,200
TOTAL ASSETS	$2,000	TOTAL LIABILITIES AND CAPITAL	$2,000

TOTAL CAPITAL EMPLOYED

GAO - TOTAL ASSETS			$ 2,000
LMI - NET ASSETS	TOTAL ASSETS	$2,000	
	LESS CURRENT LIABILITIES	− 300	$ 1,700
DOD - CAPITAL EMPLOYED:			
OPERATING CAPITAL (A/R+INV-A/P)		$ 200	
FACILITIES CAPITAL		1,300	$ 1,500



EXPERIMENTAL PROJECT

Chairman PROXMIRE. Let me ask you this, isn't the new experimental program, which you talked about, and I am glad to see you are getting into it, biased towards increasing profits by giving contractors on option to elect to come under it?

Don't you believe there will be a tendency for contractors to elect to come under it only if it is likely to increase their profits?

Mr. SHILLITO. Well, first of all, I sure am happy to hear that you now feel that we are wise to go ahead with this experimental program. And, second——

Chairman PROXMIRE. I wouldn't say that you are wise to go ahead with a particular experimental program, but what I say is I think you are wise in looking around for new programs and to experiment with them.

Mr. SHILLITO. Thank you.

Second, I would say that this will not, as a test, insure that the contractors will only see an increase in their profits.

The Defense Procurement Circular gives ourselves and the contractor the option to go or no-go on this.

We hope that we are going to end up with about two hundred plus contracts over the next year——

Chairman PROXMIRE. But the contractor gets the first option. He won't come in unless he is going to increase his profits.

Mr. SHILLITO. And we, of course, feel quite strongly that most of these contractors are going to want to get involved in this test just to see how it works.

By the way, it is not contractor first and defense second, it is a mutual situation. That is what this test says. It is a mutually agreed to plan to negotiate our contracts, heavily considering profit on capital, not all, but 50 percent.

RETURN ON CAPITAL INVESTMENT

Chairman PROXMIRE. Let me ask why doesn't the Defense Department require contractors to submit data on actual profits realized as a return on capital investment? Shouldn't you have this information on negotiated contracts in order to tell whether the profit incentive is being properly employed?

It might not be enough, in some cases it is not perhaps enough, Secretary McNamara made that point and I think he was right when he made it, but it also may be excessive especially in certain categories—why shouldn't we get it and make it public?

Mr. SHILLITO. If I understand your question correctly, as we move into our planned approach, we will have data with regard to contractors' capital in a way that has not been the case historically.

Chairman PROXMIRE. What I am asking is can't you check it now? Does it have to be somewhere down the pike? That data is available now and you can check it and reveal it to the public.

Mr. SHILLITO. Well, you are going to see some of it, a lot of it, come through this test. If you are going to do it that way you are going to see the same approach that LMI took so far as the larger contractors are concerned and I think that going the route we are going will take us very much in the direction you are talking about.

Chairman PROXMIRE. For years and years we have been asking you to collect the data and disclose it.

I cannot understand why you cannot do that.

Mr. SHILLITO. We do not have all the data.

Chairman PROXMIRE. Why don't you ask for it?

Mr. SHILLITO. We would have to go out and solicit. That is what we are doing. Colonel Benefield, do you want to talk to this?

Colonel BENEFIELD. That is exactly what we are doing at this point.

Chairman PROXMIRE. I want to know how much profit with every contract.

Mr. SHILLITO. You are just saying do it faster, and we are saying——

Chairman PROXMIRE. We have been asking for this since 1968, as you know, so we are not asking for this with any great speed, that is 4 years.

Mr. SHILLITO. Well, I see there we are in disagreement again. To me that is 5 years. [Laughter.]

Mr. SHILLITO. But at any rate, I think that we are moving in the direction that you have urged us, Mr. Chairman, and we appreciate

your urging. If this test shows the kind of thing that I feel it will show we are going to be broadening this significantly, and we will have the kind of data bank that you are talking about.

Chairman PROXMIRE. Will you give us the data from that test?

Mr. SHILLITO. I will have to see what the reaction of the DOD is after this is pulled together.

Chairman PROXMIRE. See what the data shows first before you decide whether Proxmire can have it.

Mr. SHILLITO. You said that, I didn't say it, Mr. Chairman. [Laughter.]

Chairman PROXMIRE. You did not deny it. [Laughter.]

Mr. SHILLITO. That is right.

I didn't deny it.

Chairman PROXMIRE. Well, I want to say, Mr. Shillito, I hope this is not your last appearance. I understand you are going to leave the Defense Department in the near future, which I think is too bad, but I understand you served your Government very, very well.

DEFENSE BUDGET TRENDS

I do want to stress once again what I have stressed at the very beginning how vital it is, how important it is, for us to get an understanding of where we are going on the defense budget——

Mr. SHILLITO. Yes, sir.

Chairman PROXMIRE [continuing.] Much more clearly than we have now. Whether it is possible to live within $112 billion budget——

Mr. SHILLITO. Yes, sir, I appreciate it.

Chairman PROXMIRE. Whether we have to go to $125 billion or more, and I think the argument Mr. Sullivan and others have made on the impact of these immensely expensive weapons systems and our force levels is an extremely important one. If Congress does not understand that, you will have a couple of very bad consequences: One, we will probably have to have money spent but even more important than that we may have a grossly inadequate defense.

Mr. SHILLITO. Yes, sir.

Chairman PROXMIRE. For that reason I think it is very vital that you give us a report on your views on the Sullivan study in as great detail as you can just as soon as possible.

Mr. SHILLITO. I agree with your point, sir. It is necessary that we know what these out years are going to look like as best we can.

There is a point that comes through in the Sullivan study which you have touched on here. It comes through when you understand as much about this business as you do, and that is that that which we refer to as the FYDP, the 5 year defense plan, is rather inadequate, and that in this business as regards major weapons systems when you look at this total picture, we have to think in terms of more than 5 years.

Chairman PROXMIRE. We cannot even get the 5 years unclassified.

Mr. SHILLITO. Well, I would expect that is right. Sure, I would expect that is right. It is classified.

Chairman PROXMIRE. I am sorry. Well, again thank you very much

The subcommittee will stand adjourned subject to the call of the Chair. This concludes this series of hearings as of this time.

We will have other hearings on the SST beginning on next Wednesday, December 27.

Mr. SHILLITO. Fine, thank you.

[Whereupon, at 12:15 p.m., the subcommittee adjourned, subject to the call of the Chair.]

THE ACQUISITION OF WEAPONS SYSTEMS

DEMOTION OF GORDON W. RULE

WEDNESDAY, JANUARY 10, 1973

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 11 a.m., in room 1202, Dirksen Senate Office Building, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire and Representative Griffiths.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Ross F. Hamachek, Richard F. Kaufman, and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; George D. Krumbhaar, Jr., minority counsel; Leslie J. Bander, minority economist; Walter B. Laessig, minority counsel; and Michael J. Runde, administrative assistant.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The subcommittee will come to order.

Our hearing this morning is concerned with the harassment of an able, dedicted and courageous public servant. I refer to the demotion by the Navy Department of Gordon Rule, formerly Director, Procurement Control and Clearance Division, Naval Material Command, as retribution for his candid testimony before this subcommittee.

The significance of this episode goes far beyond the issue of shabby, unjust treatment of one outstanding employee. It goes to the very heart of the legislative process and the ability of the Congress to obtain information on the activities of the executive branch—activities which involve the expenditure of some $250 billion a year—and which, in addition, affects all aspects of our national welfare.

It is painfully obvious that actions by the administration to intimidate, harass, downgrade and fire public servants as punishment for giving honest information to the Congress are prejudicial to effective government.

This subcommittee invited Admiral Kidd to testify on December 19th. He sent Gordon Rule in his place. Mr. Rule answered our questions candidly and with obvious competence. Among other things, he responded to a specific question. I want to make it clear that he did not volunteer. I asked him whether or not he considered the appointment of Roy Ash as Director of the Office of Manage-

ment and Budget a mistake. He replied that he did. I asked him to explain why and he did.

It should be stressed that this reply was in response to a direct question and in the context of a discussion of Navy negotiations with Litton Industries that of course was headed by Roy Ash, and he also indicated that the problem might be overcome if the OMB Director were subject to Senate confirmation.

Ostensibly it was this that led to his summary demotion and one of the crudest acts of retribution since the Ernest Fitzgerald affair. In Mr. Rule's case, the vengeance was even more preemptory. He was reassigned to the job of updating the curriculum of the Navy training school in Anacostia.

This proceeding bears a dismal parallel to the treatment of Ernest Fitzgerald and other able Defense Department public servants who felt the vengeance of the military hierarchy for their candid testimony on military procurement before this subcommittee.

These episodes are tips of the iceberg that lurks ominously below the surface. High public officials of unquestioned ability, dedication, and experience are being fired or demoted in droves. Heads roll daily as the administration continues to tighten the screws of control and exclude the Congress and the public from basic governmental decisionmaking.

It is no wonder that the Congress is in an anxious mood as our prerogatives are eroded and vital information is withheld. Operating personnel are becoming too frightened to speak up and tell us the facts we need to know—unless they have the high courage of people like Ernie Fitzgerald and Gordon Rule.

It is most ironic to note that President Nixon in 1951 introduced a bill—this was the Nixon bill—that made it a criminal offense for any government official to intimidate public employees from testifying before the Houses of Congress.

Without objection, I will place that bill in the record at this point.

[The bill referred to follows:]

82D CONGRESS
1ST SESSION

S. 1390

IN THE SENATE OF THE UNITED STATES

APRIL 26 (legislative day, APRIL 17), 1951

Mr. NIXON (for himself, Mr. TAFT, Mr. MCCARRAN, and Mr. WHERRY) introduced the following bill; which was read twice and referred to the Committee on the Judiciary

A BILL

To amend sections 1505 and 3486 of title 18 of the United States Code relating to congressional investigations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 1505 of title 18 of the United States Code is amended by inserting "(a)" before "Whoever" at the beginning thereof and by adding at the end thereof the following new subsection:

"(b) Whoever as an officer of the United States or of any department or agency thereof causes or attempts to cause a witness, who is a member of the Armed Forces of the United States or an officer or employee of the United States or of any department or agency thereof, to be de-

moted, dismissed, retired, or otherwise disciplined on account of his attending or having attended any inquiry or investigation being had by either House, or any committee of either House, or any joint committee of the Congress, or on account of his testifying or having testified to any matter pending therein, or on account of his testimony on any matter pending therein, unless such testimony discloses misfeasance, malfeasance, dereliction of duty, or past reprehensible conduct on the part of such witness, shall be fined not more than $5,000 or imprisoned not more than five years, or both.

"The demotion, dismissal, or retirement (other than voluntary or for physical disability) of such witness within one year after attending or testifying in such inquiry or investigation, unless such testimony discloses misfeasance, malfeasance, dereliction of duty, or past reprehensible conduct on the part of such witness, shall be considered prima facie evidence that such witness was demoted, dismissed, or retired because of such attendance or such testimony."

SEC. 2. Section 3486 of title 18 of the United States Code is amended by inserting "(a)" before "No" at the beginning thereof and by adding at the end thereof the following new subsection:

"(b) No witness, who is a member of the Armed Forces of the United States or an officer or employee of the United States or of any department or agency thereof, shall be de-

moted, dismissed, retired, or otherwise disciplined on account of testimony given or official papers or records produced by such witness before either House, or before any committee of either House, or before any joint committee established by a joint or concurrent resolution of the two Houses of Congress, unless such testimony is given or such official papers or records are produced in violation of law, or unless such testimony or the production of such papers or records discloses misfeasance, malfeasance, dereliction of duty, or reprehensible conduct on the part of such witness."

Chairman PROXMIRE. The bill was passed by the Senate but was not reported out in the House. However, there are other laws relating to this same kind of malfeasance. Title 18 of the U.S. Code provides for 5 years' imprisonment and/or up to $5,000 in fines for intimidation of witnesses and obstruction of the power of inquiry of a committee of Congress.

In view of his earlier interest, I ask Mr. Nixon now to personally look into the circumstances of Gordon Rule's demotion.

As chairman of this subcommittee, I intend to get to the bottom of this matter not only because of its own merits, but because it is a symptom of a serious distortion in the process of our democratic government.

Mr. Rule, will you come forward and will you begin by telling us exactly what happened with respect to your job after your testimony of December 19th?

TESTIMONY OF GORDON W. RULE, FORMER DIRECTOR, PROCUREMENT CONTROL AND CLEARANCE DIVISION, NAVAL MATERIAL COMMAND

Mr. RULE. Good morning, Senator. I want to first say that when I testified before you and the other members of the Subcommittee on the 19th of December, I made a statement that has been characterized as crude and rude and very poor judgment with respect to a remark I made about General and former President Eisenhower. I want to publicly apologize for that remark. I meant no disrespect, but it has been so construed and the least I can do is apologize for it.

Chairman PROXMIRE. Well, I think we all appreciate that. I did not think it was in bad taste, but perhaps you do on reconsideration. I think this is a statement that we often make that a distinguished statesman would turn in his grave. You did not mean any disrespect but I think it has been very much an element in this matter and I appreciate your comment.

Mr. RULE. I think if I had said the General, the former President, would turn over in his grave, that would have been a statement people would have understood. But I was guilty of a verbal excess and I do apologize.

What was it you wanted me to do?

SEQUENCE OF EVENTS

Chairman PROXMIRE. I wanted you to state exactly what happened with respect to your job after your testimony of December 19th. You testified here and the record was clear that you answered a number of questions, but the critical question seemed to me—maybe my judgment was wrong—the critical question seemed to be with respect to Mr. Ash and your position on it.

The following day, I understand that you were visited by Admiral Kidd. Would you describe the situation?

Mr. RULE. That is right, Senator. After the testimony on the 19th, I lost my voice. I got laryngitis and I was home in bed the next day with a cold and laryngitis and Mrs. Rule said that Admiral Kidd

was at the door and wanted to see me, and came into my bedroom. I was in bed. I did not get up.

The Admiral, it being a Wednesday, was in uniform and he sat beside my bed. He had a piece of paper which was on his own letterhead. It was addressed to himself. It was dated the 20th of December, which was that day. He told me that he had to have that piece of paper signed by the close of business that day. The piece of paper of which I kept the original, was addressed to the Chief of Naval Material: "I hereby request retirement from my Civil Service position. My performance and submissions for accrued leave and designation of the Old Age and Survivors benefits will be filled out and submitted promptly by me."

He wanted me to sign that. He also said that if I did not like that language, I could sign a blank piece of paper—he had a couple of those with him—and date it and he would fill in the rest.

Well, I hate to say this, because I sort of think I have good health, but I was in lousy shape that day. I started to get emotional, as I think the Admiral will tell you. I started going back over my Naval career and finally, he sat there—and it was about an hour. He sat there and I finally sat up in bed and started to get a little sense and started to get irked. It was then that I told him that I had no intention of signing that piece of paper or resigning.

He asked me to reconsider several times and said that he would be glad to come back at 3 o'clock in the afternoon that day and pick up the paper and I said, "There is no need for that, I am not going to sign it."

When he left, Mrs. Rule took him to the door and he again urged on her the importance of getting me to sign that retirement paper.

That, Senator, is what happened. Now, why it happened, I can't tell you. It was within about 24 hours from the time I had testified.

BIOGRAPHICAL SKETCH

Chairman PROXMIRE. Now, prior to the time that you testified, what was your status as you understood it with the Navy and with the Defense Department? I ask this in light of the fact that you have been decorated or recognized, commended in the past year. You had a rating that preceded your testimony by about one week. Would you describe that so we have a picture of the view which you, wish anybody, any prudent person, would feel was your position prior to your testimony?

Mr. RULE. Well, I outlined that in a letter, Senator, to the Civil Service Commission, and at the expense of seeming to blow my own horn, I would like to tell you about it.

Chairman PROXMIRE. I wish you would.

Mr. RULE. I would first like to restate that when I was in uniform, I entered the Navy as Lt. (jg.) and four and a half years later, I was a Captain on active duty. I am pretty proud of that military feat, because that is pretty fast promotion.

I retired. Now, I then went back to practicing law——

Chairman PROXMIRE. Would you give us the dates on that? When did you enter and when did you retire?

Mr. RULE. 1942. I entered in early 1942 and five years later, I went back to inactive duty. I was a reservist. But I had gone through the grades from Lt. jg. to Captain.

Now, I have to say that in going through those steps, I believe that I acted exactly the same way about active duty as a civilian by calling the shots just exactly as I see them. It was respectful and as I say, I got the promotions in grade and on active duty.

Then I went to practice law and then I was asked to come back and take this job as Director of the Procurement Control and Clearance Division in the Office of Naval Material. I took that job on July 9, 1963.

Four years later, in 1967, I received a superior civilian service award, which is the highest award that can be given by the head of an agency. The head of the agency in that case was Admiral Gallatin, one of Admiral Kidd's predecessors.

Four years after that, in 1971, I got the highest Navy award, the Distinguished Service Award, from the Secretary of the Navy. That was in February 1971.

That, in capsule, is my record. It was interesting to me that the same day that I had a conversation with Admiral Kidd and Secretary Warner; namely, on 12 December, I was also given a satisfactory efficiency rating through the end of 1972. I have a photostatic copy of that signed by my immediate bosses.

So I think that brings it up to date by way of background.

REQUEST FOR RESIGNATION

Chairman PROXMIRE. Could I ask you, when Admiral Kidd came to your home on 20 December, 24 hours after you testified, did he give you any reason for asking for your resignation?

Mr. RULE. The good of the service.

Chairman PROXMIRE. Did he expand on that at all?

Mr. RULE. No: not really. I asked him specifically if Mr. Warner, the Secretary, knew that he was there seeking my retirement. He would not answer that question directly. He said he had been in touch with Mr. Warner, had talked with him the previous evening, and that Mr. Warner was leaving town that day at 5 o'clock. I subsequently asked Admiral Kidd in his office that same question, if the Secretary knew that he, Admiral Kidd, was going to, trying to get me to sign a retirement paper. And again he was evasive. He would not answer that question, saying only that he had talked to the Secretary.

So I do not know to this day whether Mr. Warner knew it or not.

Chairman PROXMIRE. Am I right or wrong in assuming that there was a rating which you received as late as approximately December 12 or 13, 1 week before the visit of Admiral Kidd asking for your resignation, in which you received a rating which was as high as you could get. Is that correct or not?

Mr. RULE. It is partially correct. There is a photostatic copy of it signed by Mr. Cruden and Admiral Freeman for the rating period ending December 29, 1972. It is a satisfactory performance rating. The only three ratings that a civil servant can get are unsatisfactory, outstanding, or satisfactory. Normally, you get a satisfactory rating. I got that.

Chairman PROXMIRE. The only reason I ask about this particular rating is because of the time limit. It was one week before. Did you

make any statement or take any action or have any incident at all that occurred between the time that rating was determined and the time Admiral Kidd visited, other than your appearance before this subcommittee?

Mr. RULE. Not that I am aware of, sir.

Chairman PROXMIRE. Nothing?

Mr. RULE. Not that I am aware of.

Chairman PROXMIRE. Before I yield to Mrs. Griffiths, let me just put into the record, and I will read quickly one paragraph of it, the bill—bill S. 1390 that I placed in the record—which applies, seems to apply in this case, part of the bill. This is on page 2, line 23 of the bill.

No witness, who is a member of the Armed Forces of the United States or an officer or employee of the United States or of any department or agency thereof, shall be demoted, dismissed, retired, or otherwise disciplined on account of testimony given or official papers or records produced by such witness before either House, or before any committee of either House, or before any joint committee established by a joint or concurrent resolution of the two Houses of Congress, unless such testimony is given or such official papers or records are produced in violation of law, or unless such testimony or the production of such papers or records discloses misfeasance, malfeasance, dereliction of duty, or reprehensible conduct on the part of such witness.

There is a provision for a $5,000 fine or not more than five years imprisonment, or both. Of course, one of the issues before the subcommittee is whether or not that law has been violated.

I am going to ask Admiral Kidd to come forward in a minute, after I yield to Mrs. Griffiths. Before I do that, however, I would like to put into the record also, and for Mrs. Griffiths information and the information of those who were not present at the last hearing, precisely the testimony which, in my view, had an effect on this. I am going to ask Admiral Kidd to indicate if there was anything else in the testimony that might have affected his position.

You testified as follows:

Senator PROXMIRE. * * * Now, as you know, Mr. Roy Ash, the former President of Litton, and he was the chief executive officer of this company at the time that this situation had developed, he is the man who has been designated by the President of the United States as the new head of the Office of Management and Budget. Do you have any views on that appointment? [Laughter.]

Mr. RULE. I sure do.

Senator PROXMIRE. We would surely like to hear them.

Mr. RULE. Well, I think, first, that old General Eisenhower must be twitching in his grave. He was the one who first called attention to the so-called military-industrial complex, and I frankly think we have added a new dimension to the military-industrial complex. I think it is a military—this may not be the proper order—but I think it is almost a military-industrial-executive department complex. I think it is a mistake for the President to nominate Mr. Ash, whom I have never met. I think it is worse mistake for him to accept the job. I just—that is the way I feel about it.

Senator PROXMIRE. Why is it a mistake? Why is it a mistake, first, for him to be nominated?

Mr. RULE. I am saying this strictly from his background and his efforts on behalf of Litton during the negotiations that have been going on.

Senator PROXMIRE. It is a mistake, on the basis of his record as a business manager, to bring a man with this kind of a record in as head of the Budget Bureau?

Mr. RULE. Insofar as the LHA is concerned, yes; and of course, Senator, his job is probably——

Senator PROXMIRE. Let me ask you what Ash did in the negotiations on the LHA contract.

Mr. RULE. Well, let me just finish what I was going to say.

Senator PROXMIRE. Yes, sir.

Mr. RULE. And I forgot it; you interrupted me.

Well, there was an article in the paper the other day by Orr Kelly which quoted, he was quoting from, some minutes of a meeting, and these minutes, according to the article, said that Mr. Ash had talked to Mr. Connally about a program of the magnitude of one to two billion dollars to help companies like his and other shipyards, and the statement was made by Mr. Connally apparently, "Well, if you are going to present that to Congress, make it bigger than the Congress." Now he has that background.

All I say is that from where I sit now I have got to think it is a mistake. But I think my thoughts on whether it is a mistake could easily be or could be overcome if he were subject to confirmation and going before a committee to be confirmed where he could be questioned about, I do not know, any number of things. But he has probably the most important job in this Government, next to the President, but he is not subject to confirmation; he is not subject to questioning; and he enjoys the same executive privilege, I guess, that Mr. Kissinger does. He does not have to go up to any committee, and be questioned throughout the year, and I just think this is wrong.

Senator PROXMIRE. Well, he does come before committees, certainly previous budget directors have, in their capacity, but I agree he certainly does not need any confirmation.

Will you give me your interpretation, I read that column by Mr. Kelly too, and I was a little puzzled by that reference in the conversation with Mr. Ash and Mr. Connally, in which he said, "Make it bigger than the Congress." What was your interpretation of that? You would go to the President for—

Mr. RULE. Well, he wrote two columns. In one column, he said that Mr. Ash had told, in this meeting that he was quoting the minutes, that he was quoting form, he had told the people in that meeting that he was going next to see Mr. Warner, Mr. Sanders, and then to the White House with his problem. Now, that was in one column.

Then in the second column, he talked about this program of a billion to two billion dollars to be presented to Congress and, so far as I am concerned, sitting here right now, I think you will see that program presented to Congress. I think you will see it presented to Congress with the aid of the Grummans and the Lockheeds and others, I think you will see it.

Senator PROXMIRE. You mean a program simply to wipe out all of the claims by paying them in full?

Mr. RULE. I do not know how ingenious the program will be. I do not know what it will try to do, but it will try to get a billion or two dollars to help out some companies in trouble.

Senator PROXMIRE. Help out Litton. Lockheed, Grumman, and so forth. * * *

That is the pertinent part, in my view, of the testimony. As I say, I will ask Mrs. Griffiths if she wishes to inquire.

Representative GRIFFITHS. Thank you; I want to ask some questions which do not relate particularly to this testimony, but I would appreciate the answers.

You are head of the Procurement Division, is that right?

Mr. RULE. The exact title is Director of the Procurement Control and Clearance Division in Admiral Kidd's office.

NAVY SHIP PROCUREMENT

Representative GRIFFITHS. I see. When the Navy purchases a ship, do you simply go down and buy a ship, make a contract with somebody to build it, or do you make contracts with the——

Mr. RULE. Both.

Representative GRIFFITHS. Pardon.

Mr. RULE. Both.

Representative GRIFFITHS. When you make those contracts, does the purchaser have before him the blueprints for whatever it is he is buying?

Mr. RULE. Again, he may have if the Government furnishes the design and the blueprint to build that ship. But sometimes, we give a company a contract to design the ship itself. That was the case with the LHA and Litton.

Representative GRIFFITHS. I see. When he makes the purchase and he does have the blueprint before him, does he have also the prices paid for every component item in previous purchases? That is, could he look at that design and say, well, so many nuts at so much, so many bolts at so much, so many screws, and here is the cheapest prices available?

Mr. RULE. Yes, he is supposed to have what is called a bill of material for the material that he buys that goes in the ship.

Representative GRIFFITHS. But does he have the price list on every item?

Mr. RULE. He certainly should, because when we make the contract with him, when we make our contract with the ship builder, we have to, in order to look at a proposal and try to determine whether it is reasonable, the material is usually 50 percent of the cost of whatever we buy, all our hardware.

Representative GRIFFITHS. How long has the Navy had such information available, do you know?

Mr. RULE. In general?

Representative GRIFFITHS. Yes, in general.

Mr. RULE. That has been available to us, a requirement, for as long as I have been here.

Representative GRIFFITHS. And how long have you been here?

Mr. RULE. At least 15 years. I do not know how we could price anything without that information.

Representative GRIFFITHS. Have you ever used the catalog at Battle Creek?

Mr. RULE. No, ma'am, we have not. But they do have some catalog prices of standard components. Some of these things are priced in catalogs so you can just flip over it and see what this gadget, usually off the shelf, and its component's cost. Ordinarily, we are supposed to get quotations and estimates of prices from the contractors who supply these things and we are supposed to check them. First we check to see whether the prices are gained through competition. If they were, almost ipso facto, they are reasonable. If they were sole source subcontractors, we may have to do some more checking.

Representative GRIFFITHS. But if you have purchasing agents that are capable of doing this, then why do we ever buy an overpriced item?

Mr. RULE. I am sorry, why what?

Representative GRIFFITHS. If you have purchasing agents that are capable of doing this, why do we ever buy an overpriced item?

Mr. RULE. Why do we ever buy an overpriced item?

Representative GRIFFITHS. An overpriced item.

Mr. RULE. The term "overpriced" means different things. If it is a sole source component being bought from manufacturer "A", it may very well be overpriced. If, as I said a moment ago, we get competition, competitive bids——

Representative GRIFFITHS. Well, if it is a sole source on a large complex item, does not that purchasing agent still look through there at every individual item and say, how much are you paying for that and what are you paying for that and why don't you buy it cheaper?

Mr. RULE. Yes, ma'am.

Representative GRIFFITHS. Well, then, why do you let them run it up too high? How can they?

Mr. RULE. Well, there again, it depends on what type of contract he has. If he has a fixed-price contract, we never know how much profit he really makes and whether he ran these prices up too high or not. That is why the emphasis is on the congressional mandate that we get competition if possible.

Representative GRIFFITHS. Oh, I understand. You are now suggesting that when they bid, if a contractor has the lowest bid, you let him make the thing without any further negotiation. Is that it?

Mr. RULE. Mrs. Griffiths, unfortunately, that is the way it works a great many times, but the very fact that we have competition is sometimes hurting us and with the excess capacity in the aerospace industry and that sort of thing, when we compete for large contracts, the thing that we have to watch for today is too low a price, that somebody isn't buying in, as indeed I testified that Grumman did to the same tune of about $500 million. It is not whether we are going to get a fair price out of competitive procurement, it is that somebody may buy in and that is the root of bailouts later.

Representative GRIFFITHS. I understand. I would like to say to you that I am the only person up here, as far as I know, that does not believe that competitive bidding necessarily means the lowest price. In my opinion, the lowest prices we are paying are obtained by trained negotiators with all the information at their hands as to exactly what each item costs.

Mr. RULE. I agree with you.

Representative GRIFFITHS. I agree with you, too, that we ought to be able to stop this buying by the Government contractors, the idea that you ought to be able to kill off a competitor by buying in someplace else.

DISPUTE WITH ADMIRAL KIDD

Chairman PROXMIRE. Now I will ask Admiral Kidd to come up.

Mr. RULE. I want to add something, Senator Proxmire.

Chairman PROXMIRE. Go right ahead.

Mr. RULE. The Admiral's nose is quite out of joint with me because of my last testimony because I did not clearly and categoricaly say to you that I was testifying as an individual and not as a representative of the Navy. Now, I thought that I had covered that point when the very first thing I said at the hearing was "Thank you for letting me appear without a statement. The reason I do that is because, as you know, if I wrote one, I would have to get it cleared in the Navy and I do not think they would clear it."

Now, I thought that statement went to that point, but the Admiral does not think so. But I know that he thought I should have been more clear and I want to make it clear today.

Chairman PROXMIRE. Let me say that it was very clear in my mind. I felt very definitely that you were speaking for yourself and that there was no other reason in your explaining the fact that you did not have a prepared statement.

Mr. RULE. Precisely.

Chairman PROXMIRE. There is something to be said for those prepared statements wherever it would be appropriate. This morning it would not be appropriate, because you have come, as I understand you and Admiral Kidd, to answer questions.

We appreciate your deciding to come, Admiral Kidd. I would appreciate it if you would proceed to answer questions to the extent that you can with respect to the situation.

Is there anything in Mr. Rule's testimony that you believe is not factual or with which you disagree?

TESTIMONY OF ADM. I. C. KIDD, CHIEF, NAVAL MATERIAL COMMAND

Admiral KIDD. You would like me to start with Mr. Rule's rather than yours?

Chairman PROXMIRE. All right, start with mine. That is fine. Then get to Mr. Rule's.

Admiral KIDD. If I may.

Chairman PROXMIRE. Yes, sir.

Admiral KIDD. Going through your opening remarks, Mr. Chairman, I respectfully would like to clarify some points here. In the top line I would like to just clarify a few points going through here.

RULE NOT DEMOTED

Hearing on the demotion of Mr. Rule—perhaps this is an exercise in semantics, but truthfully, I did not demote him. He has not been demoted. He is still a GS–17.

The next point down in the third paragraph, where you observe that it is obvious that actions to intimidate, harass, downgrade and fire as punishment—he has not been fired, sir. And I would take issue with the intimidation, harassment, and downgrading, because I do not believe they are appropriate terms.

In the next paragraph you state, contrary to your agreement with Mr. Rule just now, that I sent Mr. Rule in my place. That is quite wide of the mark, sir. I did not.

Chairman PROXMIRE. Will you restate that?

Admiral KIDD. The statement here, sir, in your opening statement that I sent Mr. Rule in my place. That is not the way it was at all. As a matter of fact, I took it upon myself personally to go up to his office on the Wednesday preceding his appearance to go over with him the specific reasons why the other gentlemen whom you had invited, Secretary Warner, Admiral Sonenshein, Admiral Snead, and myself, would not be able to appear at that time because of the

ongoing negotiations with Litton and Grumman. It was judged an inappropriate time to air bedding, as it were, publicly on these negotiations where we had been trying almighty hard to get these contracts at the advertised price.

RULE'S APPEARANCE AS WITNESS

Now, on the occasion of that visit, Mr. Rule took the opportunity to applaud the Navy's hard-line position. That was the day after Grumman had come out with that full page ad of theirs, in effect protesting our hard-line position. And after running through the reasons why we did not feel it appropriate to come, I told him that in view of his unique status up here as a witness before your subcommittee, I was not going to tell him no, but at the same time, I did not think it would be too good an idea, but if he came, he was to avoid addressing those two ongoing negotiations. And in Mr. Rule's letter to the Civil Service Commission, he makes this point, that Mr. Warner called me, tracked me down in Mr. Rule's office on that occasion, and then asked to speak to Mr. Rule and told him that if he wanted to come up, that was fine with him.

So I would take vigorous exception to this implication that I sent Mr. Rule. I did no such thing.

ARTICLES BY ORR KELLY

To go a step further, if you please, sir, on Friday of that same week, after the first of Mr. Kelly's articles appeared in the Evening Star and Washington Daily News on the memorandum that he had gotten hold of, I asked Mr. Rule to come down on that occasion. Now, this was the Friday preceding the day he appeared. And I told him again that I did not want him addressing either the Grumman or the Litton negotiations because of the delicacy thereof and if he came up, he was to come up and make it abundantly clear that he was up here on his own.

He acknowledged those instructions but sort of waived his hand and said, oh, those instructions do not really mean anything. It was on that occasion that he undertook to hold school on me philosophically on leaks of documents—this particular one—and he acknowledged at that time that this is where he and I parted company on matters of moral principle, that he felt that the leaking of documents like that was good for the country and that really, I was too young and naive to understand the inner workings of Washington and that I should really take this as a matter of course. I could not debate that point. But I still think it is wrong and it certainly does not help our ongoing negotiations.

STATEMENT CONCERNING ROY ASH

It might be worth while here to introduce really one of the principal contributing factors to my great loss of confidence in Mr. Rule. It was sort of the straw that broke the camel's back, Mr. Proxmire, that prompted me to take him up on his earlier offer to retire. That is a very important point. Because when he and I had first come into head-on collision back in February, why, I told him at that time that there was no question in my mind that he was prob-

ably the most competent gentleman we had in matters of procurement—and in that area, he is indeed superb—but once policy decisions had been made, they had to be abided by. At that time he offered to retire. I said no, I did not want him to retire because we needed his competence in procurement too badly and that I did not want to lose him because I certainly have no corner on the market in brains.

Moving on down in your remarks:

It should be stressed that his reply was in response to a direct question and in the context of a discussion of Navy negotiations with Litton Industries that of course was headed by Roy Ash, he also indicated that the problem might be overcome if the OMB Director was subject to Senate confirmation.

I have no objection to a man stating his private views up here. That is what you gentlemen are here for. I am sure that you keep proper controls. But to have observations like that made, Mr. Chairman, and made in the frame of reference as reflecting the opinion of an official U.S. Navy representative, I just do not think it is fitting, and this was the atmosphere in which Mr. Rule allowed his appearance to be conducted.

The opening statement, sir, speaks of demotion and there has been none.

SCHOOL IN ANACOSTIA

In the opening statement, the Navy Training School is identified. Mr. Rule has made the point to me many times that his long suit is in procurement, and indeed it is. He is among the very finest in government employ. We have a school in Anacostia to fill a very definite gap and need for the training of young officers and young civilians in procurement matters, in matters of logistics. It has been ongoing for sometime. We bring in gentlemen to lecture. It is in effect a seminar course and it is to capitalize on his avowed strength in procurement matters that I decided to detail him to that school to bring the curriculum up to date and to insure that the students over there have the benefit of tapping his great wisdom and experience in this area.

Going on to the section of your opening statement where you state, sir:

It is no wonder that the Congress is in an anxious mood as our prerogatives are eroded and vital information is withheld.

I could not agree more that you must have everything you ask for. I suppose there are certain areas of sensitive military information, but I fully applaud the intent there. However, sir, I would respectfully invite your attention to our, the Navy's testimony, my personal testimony before the House Armed Service Committee over three lengthy and difficult sessions several months ago in executive session on just this subject of our contractural difficulties with Litton, and I will stand on what I said before this subcommittee and I think that you will find my views and others in the Navy as strong, perhaps more so than Mr. Rule's.

In the opening statement the word demotion is identified. There has been none.

REQUESTED RULE'S RETIREMENT

You went into this bill, the 1951 bill which you identified as Mr. Nixon's bill. I think that is pretty fine reading. I think that it needs to be made clear that on the matter of my requesting Mr. Rule's retirement, it was indeed a request to take him up on his previous offer. I think that is a very important point, a request to take him up on his previous offer. We sort of went over very quickly that part in that same section of that bill which speaks to misfeasance, malfeasance, dereliction, and questionable conduct.

Now, to go into Mr. Rule's opening remarks——

Chairman PROXMIRE. Before you do that, admiral, let me just respond to your criticism of my opening statement. I think you are right that it is clear that you did not send Mr. Rule up in your place. That was made clear by Mr. Rule. He just said so and I think that is correct and that was an error in my opening statement. But I cannot accept any of the rest. We will get into that, I would prefer, if you would permit us to get into that when we discuss what is a demotion, what is a firing, what is an intimidation, what is downgrading. I think that I can explain my position; you can explain yours, but we will just have to leave the record for those who wish to do so to judge it.

I think also that your remarks that Mr. Rule seemed to give the impression that he was speaking as a Navy official once again is one that Mr. Rule, as he pointed out just before you came up, made pains to avoid. I understood it that way. You may wish that it had been made clearer, but I think he made an effort to make it clear that he was speaking as an individual.

NAVY OFFICIALS REFUSE TO TESTIFY

Then you said that you believe very strongly that we should have everything that you can give us. It is very hard for me to accept that with a straight face when you refused to come up, Admiral Sonenshein refused to come up, and Secretary Warner refused to come. You are all capable men, experienced men. You could have come up and responded and said that you simply did not want to discuss the Grumman care or the Litton case and yet give us a great deal of information that would be most valuable to this committee and to the Congress. You simply refused to come at all.

And, finally, when you indicate in your remarks that was the straw that broke the camel's back in reference to Rule's testimony—having said that, it seems to me that you are conceding that the reason Mr. Rule has been transferred is because of his testimony before a congressional committee. I do not see how you can say with a straight face than an assignment to Anacostia in the capacity to which you assigned him is not a demotion.

Now, you can respond to that if you wish or go on to Mr. Rule's and let me get into these interpretations with specific questions.

TEMPORARY ASSIGNMENT

Admiral KIDD. You made several observations there wherein you used words "demotion, assignment, transfer." Mr. Rule, I am in-

formed by the gentleman at the Civil Service Commission, has been detailed. Now, I do not profess to be an expert on civil service language or technical detail, but I think that as we proceed, there are probably going to be occasions when I may well misspeak and use the wrong words. He has been detailed on a temporary assignment. The letter back to him yesterday from Civil Service Commission, the receipt of which letter made it possible for me to appear today—because that meant the Commission no longer had this before them—so I would just like to touch on that question of proper words, and in these other areas, sir, where you disagree, I think we will just have to agree to disagree.

TESTIMONY CONCERNING GRUMMAN AND LITTON

Chairman PROXMIRE. All right. Now, would you just go ahead and comment briefly on Mr. Rule's response to my question?

Admiral KIDD. Yes, sir. Mr. Rule opened by touching on my visit to him. I did indeed go to tell him that I wanted to take him up on his earlier offer to retire. I told him that it was going to be necessary to move him—not so much because he apparently found it impossible to stay within the outfield fence of the ballpark that I laid out for him before he went up. And as I mentioned, that was the straw that broke the camel's back.

Chairman PROXMIRE. Would you be specific on that? Where did Mr. Rule go beyond the ballpark?

Admiral KIDD. He felt constrained to get into Litton matters, into Grumman matters, lashed out quite vigorously on both companies, which contributed nothing to the atmosphere of ongoing negotiations which have been and remain difficult at best. He did not, in my judgment, make it clear that he was up here on his own rather than the official——

Chairman PROXMIRE. That latter I think we have discussed.

Admiral KIDD. We have.

Chairman PROXMIRE. In what way, Admiral Kidd, did he make it difficult? Give me a specific basis for your charge that Gordon Rule's testimony here is in any way a handicap to your negotiations with Grumman or Litton?

Admiral KIDD. To go into the specifics, when he speaks to the buy-in at Grumman. There may have been; I do not know.

He speaks to Litton in general terms, with comment on their management, their administration, which have already been addressed in detail up here by more experienced and knowledgeable people. He was in an area in which he had no firsthand knowledge. He was in an area in which he was not current, and yet, he felt constrained to speak for the U.S. Navy in detail, depth, and with objectives which have not helped our negotiation.

Chairman PROXMIRE. Admiral, that was not my question. My question was in what way has the Government's position been injured or have been adversely affected by what Mr. Gordon Rule said on December 19?

Admiral KIDD. I have answered the question to the best of my ability, Mr. Chairman.

Chairman PROXMIRE. What you told me was that he got into an area in which he was not directly informed.

Admiral KIDD. Yes, sir.

Chairman PROXMIRE. But you have not showed me that that did any damage.

Admiral KIDD. That would be a bit difficult to measure and quantify.

Chairman PROXMIRE. I am sure it would.

Admiral Kidd. Very difficult. Here is a judgment problem and I just lost confidence in him, sir, and that it what I told him when I went to see him the day after he testified.

Chairman PROXMIRE. In other words, the Navy considered any discussion of any kind about Litton or Grumman as taboo?

Admiral KIDD. That is what I told him, Mr. Proxmire; yes, sir. On Wednesday——

Chairman PROXMIRE. Should we be kept in the dark on this even in matters that would not affect and you cannot show that this in any way affected negotiations?

Admiral KIDD. I think the outcome of negotiations will be the first time we see this.

Chairman PROXMIRE. I could understand your position if you could explain how anything Mr. Rule said could affect negotiation in any way. Certainly we have a right to inquire and he has a right, it seems to me, to respond to the extent that he feels and we feel that his response will not prejudice in any way your negotiations. Otherwise, you are simply preventing the Congress from getting information we have a right to know. We have hundreds of millions of dollars at stake with both companies, as you know.

Admiral KIDD. There is a time and a proper place for everything, sir, and to have such a gentleman is just like in a jury, it seems to me, having one juror who does not have to go to the hotel with the rest of them and he can run out and communicate with the press while the court action is still ongoing, we do not need that kind of help. And I told him that.

Chairman PROXMIRE. Yes; but you see, the Navy is deciding what the Congress has a right to know about.

Admiral KIDD. Oh, no.

Chairman PROXMIRE. I do not think the Navy has any business doing that, especially when you cannot show that that has in any way injured, damaged, or affected adversely the negotiation.

Admiral KIDD. I think it would be inappropriate for me to go into this further because these negotiations are still ongoing.

Chairman PROXMIRE. Now, Mr. Rule was not involved in the negotiations?

Admiral KIDD. Right.

Chairman PROXMIRE. We did not ask him about ongoing negotiations. How could Rule have hurt the negotiations under those circumstances? He had nothing to do with it. This is one area in which he had been excluded, one of the very rare areas of important procurement, as you know.

Admiral KIDD. We are dealing with human beings, Mr. Chairman, on both sides of the negotiating table. I think that should be kept in mind in all of our contractual negotiations, and to have a self-

appointed Navy spokesman get up and lash out, this affects mental attitudes, judgments, reactions. I would say again that I do not need that kind of help.

Chairman PROXMIRE. Assistant Secretary Barry Shilito testified in the same hearings, I think the day after Mr. Rule was up here, 2 days after Mr. Rule was up, and talked specifically about the Grumman case. Was he out of bounds, too?

Admiral KIDD. No, sir.

Chairman PROXMIRE. Why not? What is the difference?

Admiral KIDD. Because he is the gentleman who has kept current and speaks with authority, and was well aware of the bounds of propriety within which he was obliged to stay.

Chairman PROXMIRE. So you are telling me that Mr. Rule, whom you have just said is a superb expert in procurement, is not able to testify——

Admiral KIDD. On things he knows nothing about.

Chairman PROXMIRE. I did not ask him about the negotiations. He said he was not in on the negotiations, you and I agreed to that. But I asked him as one who is an expert in procurement, particularly an expert in the procurement of ships, to give us as good an understanding as he could have on the Litton situation.

VISIT TO RULE'S HOME

Let me proceed. I understand that you did in fact visit Mr. Rule's home the day after, 24 hours after he appeared before this subcommittee, is that correct?

Admiral KIDD. Correct.

Chairman PROXMIRE. And you spent about an hour in his bedroom with his wife present—Mr. Rule was sick in bed at the time, is that right?

Admiral KIDD. He was. I talked to him on the phone before going over and asked him how he felt. He said he did not feel very well, that it sounded like laryngitis but it probably was nerves. He said he had had similar attacks after previous appearances.

I said it was very important that I see him that day, so I called from the office and from the hotel—he lives very close to the office—and asked if I might come up.

Mrs. Rule met me at the door, was most cordial, and when I came in, Mr. Rule smiled and said, "You are here to do a job, aren't you?"

I said, "Yes, sir, I have come to accept your earlier offer to retire."

He smiled and he said, "I have seen it coming."

I said, "Well, I feel very badly about it, but apparently, you made your own decision that you weren't going to stay within the confines of the ball park," and I told him what I wanted.

He said, "Fine, I will sign whatever you want."

Then he started to talk and as he described it very well, the more he talked the more agitated he became, and this was certainly understandable. He asked me if the Secretary knew of my visit and I said I had talked to the Secretary the night before and that morning before coming over.

Mr. Rule smiled and said, "I understand."

Chairman PROXMIRE. So it was the appearance by Mr. Rule before this subcommittee and your reaction and Secretary Warner's reaction that resulted in your going to Mr. Rule's house and asking that he submit his resignation. Is that right?

Admiral KIDD. Well, the way you put it, it is kind of hard to answer yes or no. You are damned if you do and damned if you do not.

Chairman PROXMIRE. Well, just tell what was the reason.

Admiral KIDD. In my heart, it was what he did not do and what he did do while here. I do not think it was the appearance, because you know, he and I were up here together before you——

Chairman PROXMIRE. Of course it was the appearance! It was what he said when he appeared before the subcommittee and what he did not say.

Admiral KIDD. It was but one more and in this case, as far as I am concerned, since I am in charge of that ball club over there, the last log on the fire. He just can't—and as I said, he smiled and said, "Well, I just had to do it and I hope it was not in vain."

Chairman PROXMIRE. Now, you have told me that you talked this over with Secretary Warner the night before and the day you came over. Did you talk to any other official about this? Was this a decision entirely made by Secretary of the Navy Warner and yourself?

Admiral KIDD. I do not think I could give you a precise answer to that. There were many gentlemen with whom it was discussed. The decision was made among the many alternatives that he would be accorded the opportunity to retire as he previously had offered.

Chairman PROXMIRE. Who were the gentlemen? Who were the principal people with whom you discused this? This was a decision of considerable importance. You have told us that he is a superb procurement expert and I think that was an honest response, and I think it is right, and to take what is perhaps your top expert; certainly one of your top experts, and transfer him under these circumstances is a very great decision. You have told us you discussed this with the Secretary of the Navy. Who else?

Admiral KIDD. I think he was the top man. It was indeed a grave decision, but I just never know what he is going to do next and I just finally made up my mind that I was not going to put up with it any longer. This had been going on for about 13 months now.

Chairman PROXMIRE. Have you ever discussed the resignation or the possible resignation of Mr. Rule prior to this? You have said that he offered his resignation.

Admiral KIDD. Retirement.

Chairman PROXMIRE. And you have testified this morning that on the night of the 19th and the morning of the 20th you discussed the resignation with Mr. Warner and you say others subordinate to Mr. Warner, is that correct?

Admiral KIDD. Yes.

Chairman PROXMIRE. Did you at any other time discuss this?

Admiral KIDD. Yes, sir. Correction, if you please, Mr. Chairman.

Chairman PROXMIRE. Yes, sir.

Admiral KIDD. Retirement rather than resignation.

Chairman PROXMIRE. I beg your pardon.

Admiral KIDD. Apparently, there is a difference—I think there is. Yesterday, I had—going back, when I first got to this job 13 months ago, I was told by advisers far and wide that I was going to have three problems—Litton, Grumman, and Mr. Rule. And I do.

Chairman PROXMIRE. I am sure you have other problems. What do you mean by that?

Admiral KIDD. Many other problems. These are probably as, or more, time consuming than most of the others put together.

Chairman PROXMIRE. I can see a distinction right here. Grumman and Litton have cost the taxpayers hundreds of millions of dollars. Mr. Rule has saved the taxpayers hundreds of millions of dollars. What other connection is there?

Admiral KIDD. I just made that comment that I was told I was going to have three problems.

But this is not a new thing. You must understand that. It is not a new thing. Mr. Rule is a loner, and a pretty good one on some occasions.

Chairman PROXMIRE. Boy, we need them, people who will stand up under these pressures.

Admiral KIDD. But when you make a decision, you have to expect and be able to depend upon performance. You cannot have the whole doggone team going to the right and one player out there to the left all by himself. You just can't do it and win very often.

BLOWING THE WHISTLE

Chairman PROXMIRE. Well, when that man out in the left is blowing the whistle and informing the Congress and simply responding to Congress, it seems to me he is serving a very vital, central purpose in a democratic government.

Let me ask Mr. Rule to comment.

You have not had a chance to comment for sometime, Mr. Rule, on the testimony of the Admiral.

Mr. RULE. Well, I would just like to say that if he has three problems, Litton, Grumman and Rule, I hope he is not as screwed up in the negotiations with Litton and Grumman as he is with me. [Laughter.]

Chairman PROXMIRE. Admiral, have you ever discussed the decision to seek Mr. Rule's resignation or anything having to do with his testimony before this subcommittee with anybody in the White House?

Admiral KIDD. I missed about the first three words.

Chairman PROXMIRE. Have you ever discussed the decision to seek Mr. Rule's resignation or anything having to do with his testimany before this subcommittee with anyone employed in the White House?

Admiral KIDD. No to resignation and no to the question.

Chairman PROXMIRE. In the Office of the Secretary of Defense?

Admiral KIDD. Well, there have been many gentlemen interested down there. I would not attempt to begin to name them.

Chairman PROXMIRE. But you have discused it with the Secretary, Mr. Laird?

Admiral KIDD. I have kept him informed, Mr. Chairman.

Chairman PROXMIRE. You have kept him informed? Did you discuss—let them know what you intended to do before you confronted Mr. Rule? Did you let Secretary Laird know?

Admiral KIDD. No, sir.

Chairman PROXMIRE. Did you let any Under Secretary or anybody at the Assistant Secretary level know at the Department of Defense?

Admiral KIDD. No, sir; I worked through Navy channels. You might be interested to know, just as an aside, after turning over in my mind Mr. Rule's visit with me the Friday afternoon preceding the Tuesday he was up here, when he told me how important it was to have leaks, I told him I just could not understand that philosophy and I thought about that real hard over the weekend and I recommended again on Monday morning to my advisers and other gentlemen that he be denied permission to appear before you that next day, because I did not know what he was going to say. And he did. He did it. He just blew it.

Chairman PROXMIRE. What did he blow? You have not been able to point to a single part of the negotiations that have been prejudiced. What he did was he responded to a question I asked him specifically about the appointment of Mr. Ash. Now, how did that blow anything?

Admiral KIDD. I think the answer to that lies in Mr. Rule's statement to me when I went to see him at home when he smiled and he said, "I had to do it." So he knew exactly wherein he found it impossible to conform.

RULE'S JOB IS TO CHALLENGE

Chairman PROXMIRE. Mr. Rule, what did you have in mind when you say you had to do it?

Mr. RULE. Senator, let's go back just a little. The Admiral talks about 13 months of not knowing what I am going to say or do, and I guess he is right. I happen to have a job description that is in the record describing my job; it is to challenge. That is the basic nature of my job, to challenge business aspects of contractural arrangements or negotiations that I do not think are in the best interest of the Government. That is what I am getting paid for. That is what is in the record. A copy is attached to the letter I sent to the Commission, the Civil Service Commission, and I reserve the right to do that.

Now, I see this situation, the Litton and the Grumman situation, as a perpetuation of what I previously testified is dead wrong in the Navy. You know that Admiral Sonenshein took it upon himself as Chief of the Naval Ship Systems Command to negotiate the Avondale and Lockheed settlement and I have testified that I thought that was wrong.

Now, here is Admiral Kidd——

Chairman PROXMIRE. What that did was to cut you out, cut the challenge out?

Mr. RULE. It cut me out. I will get to that. It cut out the people on the operating level who know much more about negotiations—they are professionals—much more about how to handle the companies. But the contractors, you see, always want to come in and start at the top. They do not want to start at the bottom and have a proper decision staffed up if necessary.

NEGOTIATIONS WITH CONTRACTORS

Now, here is Admiral Kidd negotiating personally with Grumman and Litton. It is a repeat performance of what Admiral Sonenshein did and I think it is wrong.

Chairman PROXMIRE. What you are saying is that it cuts out the challenge, it cuts out the criticism, it cuts out the opportunity for the Government's case on a bid basis to be presented effectively. Is that right?

Mr. RULE. Yes, sir. The working level people, the professionals down there ought to have a chance to sift these cases, make a tentative decision, and if necessary, check it out topside. But these contractors do not want that.

I can tell you that the people in the Naval Ships Systems Command, if left alone, they will handle the Litton situation a hell of a lot better than it will get handled in Admiral Kidd's office.

Chairman PROXMIRE. Why?

Mr. RULE. Because they are professionals and they know what they are doing. This man has been in procurement 12 months, 13 months. All of a sudden he is an instant expert.

Admiral KIDD. May I respond?

Chairman PROXMIRE. What is your answer to that, Admiral Kidd?

Admiral KIDD. He is right. He is right. I have no corner on the market in brains.

Chairman PROXMIRE. Wait a minute. Is he right in protesting the challenge having been eliminated?

Admiral KIDD. He has been, as he often describes it, a conscience, and in that, he has done a pretty fine job. He is right in the need for contractors dealing with professionals, no question about it. When I was designated as the negotiator, the first thing I did was surround myself with a team of these gentlemen, experts, whose names Mr. Rule recommended to me, and they are the ones making the decisions, whose advice I have taken completely. There has been no overriding. To reassure you, because I have heard often and read that you feel that the civilians must be the gentlemen, because of their continuity, their age and experience, they are in the majority in each case.

Chairman PROXMIRE. Yes, but in this case, what effect did it have, psychological effect, direct? They are human beings, as you have indicated—when you knock out Mr. Rule, whose function it is to challenge this, who has the expertise and the professionalism to do it in a proper and effective way. To take him out of the picture, then you leave it up to the people in your office, what kind of a message do they get? Take it easy. Soften up.

Admiral KIDD. No, no.

Chairman PROXMIRE. Why do not they get that message? I would if I were in your office.

Admiral KIDD. No, there are many other very competent senior experienced civilian gentlemen like Mr. Rule who are, I am sure, as good as he, perhaps better, and there are others there to carry on.

Chairman PROXMIRE. Admiral, I am sure that there are senior, competent men perhaps as good as Mr. Rule technically, but I doubt very much if you have any other loners who will stand up against the position taken by the administration—any administration. I am not talking in a partisan way—Johnson, Nixon, it does not matter; we have had problems in procurement with both of them—to stand up against this kind of tough pressure, or pressure the Navy gets from Congress as we have had so often in these settlements. Mr. Rule has shown he has the guts and the heart to stand up. It is that kind of rare capacity which we need and which is being destroyed when you make him a consultant or a teacher instead of letting him exercise the authority he has exercised with such distinction.

Admiral KIDD. No, there you and I differ. There are just as many gentlemen who have this intestinal fortitude to stand up and be counted and they do a very fine job at it. I do not believe that it is necessary to have as an ancillary capability the determination to circumnavigate the system, go outside the system to present your views once decisions have been made contrary thereto. This we do not need, Mr. Chairman.

Chairman PROXMIRE. Admiral, if we can't get people who will go outside the system once in a while, there is no possibility of Congressional control or civilian control.

It seems to me the problem with Mr. Rule—as you have indicated, he is very capable, he is a man who deserved the award that he received—do you not really mean Mr. Rule is the problem because he had the habit of telling his superiors the truth?

Admiral KIDD. Absolutely not. No, sir. He has come down and told me wherein I have been in error on many occasions and where I have been able to take his advice, I have. He has identified one area here just now that, instead of negotiating claims for agonizingly long periods, we do the best we can, we send them into the courts, if the contractor declines to accept our offer.

Chairman PROXMIRE. Well, how has he been a problem?

Admiral KIDD. Sir.

Chairman PROXMIRE. How has be been a problem?

MEMORANDUM OF MEETING WITH ROY ASH

Admiral KIDD. Well, we have not touched on one area here, on the matter of my not being able to count on the preciseness of his responses. This sort of thing shakes an individual's confidence. This came about last summer. This is just one more piece of the puzzle, where he came down to my office and indicated that he had a document which was exceedingly sensitive and would be a bomb, as he described it. I asked if I might see it. He showed it to me. I said, where did you get it?

He told me. I said, this thing should not be on the loose, it ought to be classified.

The next morning I asked my Vice Commander, because I was

going to be out of town the next day, to get him down and track down this document.

Chairman PROXMIRE. Why should it be classified? Was it giving aid and comfort to the enemy?

ADMIRAL KIDD. It was the same document that Mr. Kelly got hold of that was reported on in two parts here, beginning Friday of the week before you had your hearing.

Chairman PROXMIRE. Why should that be classified?

Admiral KIDD. Sir.

Chairman PROXMIRE. Why should that be classified?

Admiral KIDD. Because it reflected confidences by a contractor which I do not believe the contractor wanted or felt should be put in the public domain at that time.

Mr. RULE. Which is just exactly where I think it should be. The contents of this document—it is unclassified and I took it as soon as I saw it to Admiral Kidd and asked him if he knew about it. They are minutes of a meeting with Mr. Ash. And he did say, how about classifying it, and he did have his deputy call me.

Chairman PROXMIRE. Who said that? Admiral Kidd said how about classifying it?

Mr. RULE. Admiral Kidd did not say it at that time. His deputy called the next day and said he wanted to classify it. I said I am not going to classify it, it is not my document.

Chairman PROXMIRE. If you will be just a little more clear in explaining what this is. It is now in the public domain, as you say; Orr Kelly has had a column on it.

Mr. RULE. It is a memorandum, minutes of a meeting on June 6, 1972, with Mr. Ash, president of Litton, Assistant Secretary of the Navy Ill, Admiral Kidd and Admiral Woodfin from Ships. And it is not classified. And boy, I do not think there is a thing in there that the public should not know. This is a company——

Chairman PROXMIRE. What is the substance of the memorandum?

Mr. RULE. Do you want to put the memorandum in the record?

Admiral KIDD. Do you have it?

Chairman PROXMIRE. Will you put that in the record? Can we make that part of our record, Admiral Kidd?

Admiral KIDD. Since it has been written about, I suppose it would not do too much harm.

Chairman PROXMIRE. All right, then, it is part of the record.

Mr. RULE. Offered by Admiral Kidd.

Admiral KIDD. No, you are the one who had it.

We are getting wide of the mark here, Mr. Chairman.

Chairman PROXMIRE. What is that, sir?

Admiral KIDD. We are getting wide of the mark. The document itself becomes academic at this point in time.

[The above referred to memorandum follows:]

MEMO FOR FILE

Subject: 6 June 1972 Meeting among Mr. Roy L. Ash, President, Litton Industries Inc., ASN(I&L), MAT 00 and SHIPS 02.

1. At the request of Mr. Ash subject meeting was held between 1030-1200 on 6 June to discuss Litton's analysis of alternative solutions to performance of

the LHA contract. Mr. Ash indicated that based on consultation with his lawyers, the following alternatives appear to be available to the parties:

a. Navy continue cost reimbursement payment basis beyond the 40 month current contract limit.

b. Navy terminate the contract.

c. Navy order work stopped.

d. Litton stop work.

e. Parties agree to reformation of the contract.

f. Parties agree to reduce contract quantity from 5 to 3 LHAs.

g. Litton could sell the West Bank facility to the Navy.

h. Litton could sell or spin-off the West Bank facility to absolve Litton Industries of the guarantee responsibility.

2. A general discussion among the participants ensued to achieve a better understanding of the Litton alternatives. In this discussion Mr. Ash indicated the extreme seriousness of this LHA matter to Litton, particularly if Litton were required to convert to a physical progress payment basis in September 1972. Should that occur, Litton would be unable to perform due to the impact on an already tenuous cash flow position Litton had presented on 2 June 1972. Mr. Ash also explained that reformation meant a cost type contract for at least the lead ship.

3. Mr. Ash also recommended that the Navy consider presenting this type contract problem along with other similar shipyard problems to Congress. This presentation would be in the form of a procurement policy change and would perhaps require $1 to $2 Billion. Mr. Ash indicated that he had discussed such an approach with Mr. Connally. Mr. Connally was quoted as saying such a program should be positively presented, on a grand program scale—make it bigger than the Congress.

4. Admiral Kidd then indicated his general reaction to the alternative presented:

a. Continue cost funding—Navy not likely to agree since it would be an acknowledgement of Navy responsibility for delay.

b. Termination—the Navy is considering its termination rights but this would not get the Navy the 5 LHAs it needs.

c. Stop work—would undoubtedly cost both parties money but would not yield any ships.

d. Litton stop work—if so, the Navy would resort to litigation to protect its interests.

e. Reformation—the retroactive application of 5000.1 to the LHA contract does not appear feasible or reasonable.

f. Reduction from 5 to 3—while accomodating Litton, the Navy would not get the 5 LHAs needed.

g. Sale to Navy—No comment is considered appropriate except to consider it impracticable for a myriad of reasons.

h. Spin off—no reason to believe that the Navy would give up it guarantee rights against the parent Litton Corp.

5. Mr. Ash again explained that the Litton in its financial planning assumes that the Navy will continue payments on a cost basis (as opposed to physical progress). Mr. Ash also indicated that he considered payments should continue until the Request for Equitable Adjustment is resolved.

6. Adm. Kidd queried Mr. Ash as to whether Litton had considered requesting relief under PL 85-804. Mr. Ash said he was not fully aware of the implications, but doubted that Litton would do so.

7. Mr. Ash indicated that Litton would not request an advance payment loan (this possibility was discussed in 2 June meeting).

8. Admiral Kidd indicated in summary that the Navy will have to require Litton to abide with the contract and it appears to be within the law to oblige performance under the contract. Mr. Ash indicated in LITTON's view, the Navy had failed to perform under the contract.

9. RADM. Woodfin indicated that in any event Navy owed Litton answers to 2 letters—one requested extension of reset from 34 to 54 months, the second requested extension of cost type progress payments from 40 to 60 months. RADM Woodfin indicated that the extension of either would require Litton to provide factual substantiation of the time related portion of Litton's request for Equitable Adjustment—as yet Litton has not provided any such basis. RADM Woodfin indicated that since Litton had indicated the availability of such infor-

mation in July, the Navy would give this information every consideration at that time.

10. Mr. Ash indicated that it appears that some in the Navy have a built-in sense of self-righteousness concerning Litton's performance, and that the Navy would have to relax this view if Litton is expected to proceed with the contract. Mr. Ash indicated that he intended to meet with Secretaries Sanders and Warner and then on to the White House to explain the problem.

11. The meeting was closed by the Navy indicating it would respond to Litton's letter requests in the future.

Admiral KIDD. Mr. Rule told me that night that he had gotten it from Officer A. This disturbed me, because in the first place, he had no business having it.In the second place, it was a direct indictment of Officer A's ability to keep things properly secured.

The next morning, Mr. Rule changed his story with my vice commander and said he did not get it from Officer A. When the article appeared first in the Evening Star and Washington Daily News, indicating that this document was on the loose, I had Mr. Rule down again and this time, he told me he had gotten it from still a third place.

Now, this, to me, is tampering with the truth and I cannot have people in positions of great responsibility and authority on whom I cannot depend to give me a straight answer.

Chairman PROXMIRE. Mr. Rule.

Mr. RULE. Senator, I could not have said that I got it from Officer A, because Officer A did not give it to me and I never said it. I did say that it came from his office and it did come from his office. And one of the peculiar positions, and unfortunate position, that I find myself in, being completely cut out by Admiral Kidd and his subordinates from these negotiations, is that people that are in the negotiation who do not like what is going on in the negotiations for some reason or other come to me. They either cry on my shoulder personally or I find documents on my desk.

Now, this is the result of the way these things are being handled and this is what Admiral Kidd does not like and I guess I would not like it either if I were in his place. But I would be conducting the negotiations in a way that this would not have to happen.

Chairman PROXMIRE. Mr. Rule, would you read that document that has now been made a part of the record that Admiral Kidd agreed could go into the record in view of the fact that it has already been written about?

It is very short, as I understand it, one page, one and a half pages?

Admiral KIDD. May I withdraw my concurrence on that properly?

Chairman PROXMIRE. Why do you want to withdraw it? You said it is already in the record. We already have information on it.

Admiral KIDD. Well, I just do not think it is fitting.

Chairman PROXMIRE. Why isn't it fitting?

Admiral KIDD. I feel a burden to anybody that I do business with to conduct myself properly. You have a law of the land here some place that I am looking for that makes it a Federal offense to have proprietary contractual information floating around loose. And while I might not agree with the contractor or I might get furious over his intransigeance or what not, I still have a legal burden from laws of the land that gentlemen like you pass to protect it.

Chairman PROXMIRE. What laws?

Admiral KIDD. Well, I will find it here in a minute.

Why don't you just go ahead, sir, and I will come up with it.

Mr. RULE. Senator, while the admiral is looking for something, just let me say on this point that he now raises of lack of confidence, I would like to make the point on behalf of a lot of other civil servants that this lack of confidence bit works both ways. It does not work just from the top down. There are a lot of competent, long in grade, or, rather, in their job, personnel who can just as easily lose confidence in some of their superiors, military and civilian—in other words, it is a two-way street. Again, this may sound egotistical, but it goes to the point and I have to do it.

Here is the Distinguished Civilian Service Award that I got from the Secretary of the Navy. And it says, Mr. Rule has consistently demonstrated extraordinary acumen, judgment, initiative and integrity," et cetera. But it specifically mentions judgment that Admiral Kidd now says he hasn't got any of.

I know what is going on just as well as a lot of other people do. And I will just say this: Ever since I rejected the Avondale claim in July 1971, there have been efforts made—they have changed my job sheet, they have taken duties away from me, and I know what is going on. And I know that Admiral Kidd probably thinks I am a burr up his ass and he wants me out. [Laughter.]

But this letter, Senator, from Assistant Secretary of the Navy Warner to get me that award says, "His is the responsibility to challenge, to question, and to disapprove when such action is necessary, regardless of other considerations or consequences."

Now, that is my job, and believe me I have been doing it so well that it does become a burr.

Chairman PROXMIRE. Thank you very much, Mr. Rule.

What I am going to do in this case—I think Admiral Kidd's initial reaction was competent and correct and made sense. The memorandum has been disclosed to the press, it has been in the hands of the press, but I think in order to make this discussion comprehensible, it is necessary for me as chairman to read two paragraphs from the letter which are the principal issues involved here. This was a meeting held on June 6, 1972, including Mr. Ash, Admiral Kidd, and others. At this meeting, paragraph 3, which is one of the two paragraphs I will read:

> Mr. Ash also recommended that the Navy consider presenting this type contract problem along with other similar shipyard problems to Congress. This presentation would be in the form of a procurement policy change and would perhaps require $1 to $2 billion. Mr. Ash indicated that he discussed such an approach with Mr. Connally. Mr. Connally was quoted as saying such a program should be positively presented on a grand program scale—make it bigger than the Congress.

Then in item 10 of the memorandum, Mr. Ash indicated that:

> It appears that some in the Navy have a built-in sense of self-righteousness concerning Litton's performance and that the Navy would have to relax this view if Litton is expected to proceed with the contract. Mr. Ash indicated that he intended to meet with Secretaries Sanders and Warner and then on to the White House to explain the problem.

INTERPRETATION OF ACTIONS TOWARD RULE

Now, Admiral Kidd, would you agree that under the circumstances, your behavior could reasonably be interpreted as an effort to badger a subordinate into leaving the Government services and as a disciplinary measure for making improper and unwise statements in public?

Admiral KIDD. No, Mr. Chairman, I would not.

Chairman PROXMIRE. Why would that not be a reasonable interpretation in view of Mr. Rule's clear resistance to this, his desire to remain in his present position, his feeling that this transfer is exile to Siberia, in effect, and certainly the general feeling that this takes him out of the action. He no longer can protect the public interest.

Admiral KIDD. Mr. Chairman, on the surface of the thing and the voluminous material that has been written in the newspapers thus far, I can certainly understand that sort of a conclusion. But I will tell you from the bottom of my heart, when I went over there to see him, it was to earnestly take him up on a previous offer to retire because I did not particularly want to see him get hurt.

Chairman PROXMIRE. Well, now, so that we clearly understand just what the situation is, you have referred to his new assignment. I would like you to state what action has been taken with regard to Mr. Rule since his testimony on December 19. There is some confusion in press reports and in explanations offered by various members of the Administration. Tell us precisely what Mr. Rule's status is and how it has changed since December 19?

Admiral KIDD. Aye, aye, sir.

He has been detailed, and here I must choose the words carefully because I understand there is a fine point here—he has been detailed temporarily to be the consultant at this school whose mission and purpose I earlier described. At the present time, sir, he is on leave at his request. He is still on the payroll, still drawing full pay and emolluments for his GS–17 rating. And that is where we stand.

Chairman PROXMIRE. You have said that you did not consider the new assignment a demotion. Do you consider it an increase or a reduction in his responsibilities?

A LATERAL MOVE

Admiral KIDD. Well, sir; I would say a lateral move.

Chairman PROXMIRE. A lateral move. Right off the field.

Any comments, Mr. Rule?

Mr. RULE. Senator, I think this question can be answered very easily, because in the letter dated 9 January, just yesterday, from the Chairman of the Civil Service Commission, he laid this to bed. He said 'Officially, you are still the incubent of the position of head, Procurement Control and Clearance Division, GS–17."

Now, that lays that one to bed, at least for the time being.

Chairman PROXMIRE. So you are officially head of the Procurement Control and Clearance Division; is that right?

Mr. RULE. That is what this letter from the Civil Service Commission, signed by the Chairman, says, and that must have come as some

news to Admiral Kidd, because he had given me a memorandum about 2 hours before I got this, that talks about my old office and my new office, and 2 days ago, I was in the office, on leave, working and he sent his deputy, a vice admiral up to tell me to get out of the building, that if I was going to work for the Navy, my office was in Anacostia.

Now, when the civil service tells me that I am officially still the incumbent of the position of head, Procurement Control and Clearance Division, I submit that I still have an office there and I still have a secretary and I still have a right to use it.

Chairman PROXMIRE. How do you answer that, Admiral Kidd? It seems that Mr. Rule has been told by the Civil Service Commission that he is still head of the Procurement Control and Clearance Division. At the same time, Admiral Moore, your deputy, as I understand it, yesterday told Mr. Rule that you wanted Mr. Rule out of his office, and that seems to me to be more than a lateral move.

Admiral KIDD. No. Mr. Chairman, I think there is a very reasonable answer to that—at least in my mind, and I did it. I told the gentleman that he was going to be detailed to this job over to do the curriculum update and review at the school in procurement matters, which he said is where he was strongest and for which he had been hired. He then came to see me and said he wanted to go on leave. This was, I think, the day after Christmas. And I said, fine. He said he had some thinking to do. I said that would be just fine, you let me know when you are going to come back.

I asked Admiral Moore a few days later how long Mr. Rule was going to be on leave and when he would take up his duties over at the school, because I had had the school prepare office space for him over there. And here the other day somebody—I have forgotten now who it was—came down and said that Mr. Rule was in his office. I said, well, by George, to myself, he is back from leave and he is over here and I told him to go over there to the school. And I just wanted to make sure that he understood that I wanted him where I want him.

Then I found that he was still on leave and was using his old office in the frame of reference that the Commission described it which he just read.

Chairman PROXMIRE. Well, Admiral Kidd, with all due respect, I think you are asking this subcommittee and the public to believe something that is impossible to believe. Mr. Rule has an excellent and outstanding record of service and accomplishment. Everybody agrees to that. He was given a satisfactory performance rating on December 12. A week later he appears before a congressional committee after receiving permission from the Navy to appear. He testifies, and one day later, you are at his sick bed demanding his resignation before the end of the business day. Later you transfer him to a Navy school as consultant and he is stripped of his authority as head of the Procurement Control and Clearance Division. Yesterday your deputy tells him you want him out of his office and out of the building. Yet you maintain that he is not being punished because of his testimony before this subcommittee. Surely you must concede that his treatment has something to do with what has happened to him since he testified.

Admiral KIDD. I have spoken to all those points already, sir. You have summarized them, I believe, without taking into account the testimony that has been given completely.

Indeed, that which occurred up here, errors of omission and commission, inability to stay within the frames of reference that were laid out for him—that, as I said, sir, was the straw that broke the camel's back.

Chairman PROXMIRE. And you feel, then, that it is perfectly proper and within the law—I have read the law aloud at this hearing once; I do not think I have to read it again—within the law to kick a man out of his office, take away his authority and responsibility, to transfer him to a job that he does not want, that he has made very emphatically clear he does not want, and you do not call that harassment, you do not feel that is anything but, as you say, a lateral movement.

Admiral KIDD. Correct, sir.

Mr. RULE. May I make a statement, sir?

Chairman PROXMIRE. Yes sir.

Mr. RULE. I want to change it if I said I did not want that job. I will be glad to take that job. If they want a consultant on procurement matters and if they want the course updated, I will update it on Saturday. I can take that job on and do it in addition to the one I have already, the one the Commission says I have. I do not have any objection to helping the school, I will be glad to.

I asked Admiral Kidd if this could not be done from my office in his building. I had previously gone and talked to the expert in CNM on training, school training matters. I had asked them if it was necessary to be physically located at that school that has five personnel, and they said, hell, you could do it in your living room after breakfast.

So I then wrote a memorandum to Admiral Kidd and I asked him if I could do the job from my office in his building. And he wrote back and said, oh, no, it is too important. You have to be co-located in Anacostia.

Now, the fact is he wants me out of the building. He does not want my friends, who are in these negotiations, to be crying on my shoulder. Again, I just wish he would—well, it is perfectly obvious that—to me it is perfectly obvious, and I so told the Commission—that this reassignment or detail was an afterthought. It came after I refused in my bedroom that day to sign a retirement piece of paper. It obviously is a punitive action.

Now I understand that it is the result of several things I have done over a period of 13 months that has made him lose confidence. Well, in this letter from the Commission, it says categorically that if you want to discipline anybody, you have to give them, the Commission regulations require that the agency must give the employees 30 days advance notice of proposed adverse action, stating specifically and in detail the reasons for the proposed action, offer him opportunity to reply, consider his reply, and give him a final decision.

Now, none of this has been done and I submit to you that the very fact that the Admiral sits here this morning and details in a public meeting these things which he should have done in detail and in

writing by the Commission regulation is all the proof you need that he is not following the Commission regulations and he has violated that very regulation of notice and detailed information by coming in and making that statement.

Chairman PROXMIRE. As I understand, Admiral Kidd's position that you have not been demoted, you have not been disciplined in any way, you are simply being transferred. You are not being harassed or punished in any way, shape, or form for your appearance here. He did not like your appearance, he said so, but you are being transferred to another job which he thinks has equal dignity, equal significance and importance, and you are being physically removed to another position.

Mr. RULE. Well, I think he has a great deal more to do to sell that point of view than he has done here this morning. And Senator, you read two paragraphs from that letter.

Chairman PROXMIRE. Yes.

LITTON PROPOSALS

Mr. RULE. You missed the most important paragraph. The most important paragraph starts off at the top. I am talking about the Ash and Litton——

Chairman PROXMIRE. Yes, we have it here.

The first paragraph:

At the request of Mr. Ash subject meeting was held between 1030–1200 on 6 June to discuss Litton's analysis of alternative solutions to performance of the LHA contract.

Mr. RULE. Get this, their alternative solution. This is what Litton is telling the Navy in the form of Admiral Kidd, that after talking to their lawyers, here are the following alternatives. Now, read those.

Chairman PROXMIRE [continues reading]:

Mr. Ash indicated that based on consultation with his lawyers, the following alternatives appear to be available to the parties:

a. Navy continue cost reimbursement payment basis beyond the 40-month current contract limit;

b. Navy terminate the contract;

c. Navy order work stopped;

d. Litton stop work;

e. Parties agree to reformation of contract.

f. Parties agree to reduce contract quantity from quantity from 5 to 3 LHAs;

g. Litton could sell the West Bank facility to the Navy; or

h. Litton could sell or spin-off the West Bank facility to absolve Litton Industries of the guarantee responsibility.

Mr. RULE. Now, it is my contention that the public has the right to know that those are the alternatives that this company, with a billion dollars LHA contract, has come in and laid on the doorstep of the Navy. Individually or cumulatively, all those alternatives spell bailout.

Admiral KIDD. May I speak to that?

Chairman PROXMIRE. Yes, sir.

Admiral KIDD. The Congress needs to know that sort of thing. The Congress knows. This was made clear in testimony when I appeared some months back. There has never been, and I would underline this again, any question in my mind of the need, the correctness, and the

propriety of the Congress being made knowledgeable of things like this at an appropriate time and place.

I would also for the record want to underline the fact that the Navy rejected those proposals as being quite unacceptable. So I think we are getting a little bit wide of the mark here if you push them.

PROPRIETARY INFORMATION

On the matter of that law, Mr. Chairman, I have a copy of it here before me, Title 1, Crimes of Procedure, Article 1905, where it covers proprietary information with the contractor.

Mr. RULE. I do not know whether the inference is that there is something proprietary in that memorandum, but if there is, I fail to see it.

Chairman PROXMIRE. If there is, why was not it labeled proprietary, why was not it classified, why was it unclassified?

Admiral KIDD. Through oversight in my own offices. It was written by one of the gentlemen in attendance, put in his personal files, and how Mr. Rule came by it I do not know. The first time I saw it was when he brought it into my office some weeks after the meeting and that was when I asked him where he got it. I told him at the time that it was a sensitive piece of paper and should be classified.

Now, the man tells one thing one evening to his boss, he tells something else the next morning to the Vice Commander, he tells his boss a third story, on the Friday before he comes up here to see you. I would respectfully submit, Mr. Chairman, my confidence in this case reached its elastic limit.

Chairman PROXMIRE. Let me say, of course, that Mr. Rule has denied that, so this is in dispute. You assert that he told you that it came from Officer A, and Mr. Rule has denied that he said that.

NEGOTIATIONS WITH ROY ASH

Isn't it correct, Admiral Kidd, that you have negotiated personally with Roy Ash on several occasions on several contracts awarded to Litton including the LHA and several nuclear submarines?

Admiral Kidd. That is correct.

Chairman PROXMIRE. Isn't it also true that on at least one occasion, Mr. Ash brought up the name of the then Secretary of the Treasury, John Connally, and said in your presence that Connally was in favor of presenting a $1 billion to $2 billion program to the Congress to solve the problem of the shipyards facing the Navy?

Admiral KIDD. I do not think it is quite the way you put it, Mr. Chairman. As I recall that discussion, he indeed said he had been in discussion where Mr. Connally had been present and that this proposal had come up. But I do not recall it being precisely identified whose idea it was.

Chairman PROXMIRE. Well, the memorandum said:

Mr. Ash indicated that he had discussed such an approach with Mr. Connally. Mr. Connally was quoted as saying such a program should be positively presented on a grand scale—make it bigger than the Congress.

Admiral KIDD. I would not dispute the memorandum, Mr. Chairman. I just do not remember whose idea it was in that event.

Chairman PROXMIRE. Didn't Roy Ash tell you at this meeting that this refers to that and he intended to go to the White House to explain the problem he was having with respect to the shipyard claims against the Navy?

Admiral KIDD. Yes, sir, he did.

Chairman PROXMIRE. In light of Mr. Ash's closeness to the President and his appointment as head of OMB, I can see how the Navy might feel somewhat jeopardized when Mr. Rule expressed his opinion about Mr. Ash's appointment. After all, Mr. Ash is going to be one of the most powerful men in Government, perhaps second only to the President. Is it possible that you have felt a failure on the Navy's part to take action against Mr. Rule after his testimony on the Ash appointment might be interpreted as a Navy endorsement of Rule's view and therefore it was incumbent upon you to do something?

Admiral KIDD. Oh, no. No, that thought never crossed by mind. I was embarrassed.

Chairman PROXMIRE. That was the first thought that crossed my mind.

Admiral KIDD. Well, I guess we think a little differently, sir.

No, that thought never crossed my mind. I was embarrassed when I read his testimony, not so much for what he said but the fact that, by George, he represented himself up here as a spokesman for the Navy. You yourself, in a letter to me, said, "I sent Mr. Rule."

I did not send Mr. Rule.

Chairman PROXMIRE. You permitted Mr. Rule to appear, you and your superiors permitted Mr. Rule to appear.

Admiral KIDD. I suppose.

Chairman PROXMIRE. The Secretary did.

Admiral KIDD. The Secretary did. And at the same time, as a subordinate, an employee of the United States, I told him what to stay away from. He found it impossible to comply.

Chairman PROXMIRE. You have had personal dealings with Mr. Ash. What is your opinion as to his appointment and his apparent intensions not to refrain from involving himself in budgetary matters concerning Litton's claims against the Navy?

Admiral KIDD. I would not presume to comment on that.

Chairman PROXMIRE. Why not?

Admiral KIDD. Because I do not know. He is a pretty good businessman.

Chairman PROXMIRE. What do you think? Sure, he is a pretty good businessman. He went to Harvard Business School, was No. 1 in his class. He has made millions of dollars, is one of the most artful negotiators with the Government. Now he wants to press his claim with the Navy. He says he won't let up on it and he is in this very, very powerful position. Do you think that makes sense, that that is ethical, that that does not represent a distinct, clear conflict of interest?

Admiral KIDD. No, I certainly do not. You take a look at the cross section of every civilian we have in a position of responsibility in the Government; he came from civilian life. That does not make them all crooks.

Chairman PROXMIRE. Oh, I am not saying he is a crook. What I am saying is this man has hundreds of thousands of shares, millions of dollars, that have to be liquidated over a period of time, invested in Litton and he says he is going to press this claim and he is in a position to press it with enormous force.

Admiral KIDD. Well, I think that is overstating it.

Chairman PROXMIRE. How is it overstating it?

Admiral KIDD. Because I do not know that you are correct.

Chairman PROXMIRE. Well, we have a memorandum that you said——

Admiral KIDD. I think we are pretty doggone fortunate, pretty doggone fortunate in having the gentlemen of integrity and honor and competence, business competence, and acumen that we do in appointed positions in these United States; very, very fortunate.

Chairman PROXMIRE. Well, I think we have some fine people, splendid people. I have great respect for Mr. Packard, Mr. Laird, many others. They are able people. But here you have a case where there is an explicit, direct conflict of interest affecting your own branch, the Navy, and affecting the claims of the Navy. If these claims are all granted, the Navy's capability of providing adequate security is going to be jeopardized, in my view. One billion dollars, 2 billion— you can't spare that, you know it. You need every penny you can get from the Congress to provide the kind of defense that I am sure you would like us to have.

Admiral KIDD. You are extrapolating now, I gather, sir, that Mr. Ash would put forward some such proposition and I do not think that is a proper assumption.

Chairman PROXMIRE. I do not know how else I can read this paragraph. What Mr. Ash indicated that he intended to meet with Secretaries Sanders and Warner and then on to the White House to deal with the problem. Now, of course, he is in the White House.

RULE INVITED TO TESTIFY

Let me ask you. As you know, we originally invited you to appear on December 19 on the costs and other economic implications of the Litton ship programs, especially the LHA and DD 963 and the F–14 aircraft. You declined to come, Admiral Kidd, on the grounds that you were involved in sensitive negotiations on the LHA and F–14 contracts. Mr. Rule was then asked to testify on general Navy procurement matters. Isn't it correct that you did not object to his appearance in any way, directly or indirectly, and that the Secretary of the Navy did not object to his appearance publicly?

Admiral KIDD. No, sir, that is not so.

Chairman PROXMIRE. Did you make any kind of public statement that you did not object?

Admiral KIDD. Pardon.

Chairman PROXMIRE. You made a public statement?

Admiral KIDD. No, I do not quite follow. I mentioned earlier, you will recall, that when I found out earlier that Mr. Rule had been invited personally by you, I think on Wednesday the week preceding when he was to come, after the decision had been made that Mr.

Warner, Rear Admiral Sonenshein, and the rest of us would not appropriately appear at that time, that is when I went up to see Mr. Rule and spelled out for him in words of one syllable the things that it would be inappropriate to address up here. So I do not think it is proper to say that I had no reservations.

Chairman PROXMIRE. But you did not tell him not to come. You accepted the permission granted by the Secretary of the Navy. You did not—that was it?

Admiral KIDD. Yes, sir.

INSTRUCTIONS ABOUT TESTIMONY

Chairman PROXMIRE. Then you told him that you wanted him not to comment on certain areas.

Admiral KIDD. Pardon.

Chairman PROXMIRE. Then you told him that you wanted him not to comment or respond in certain areas that you thought were sensitive.

Admiral KIDD. I told him that before he talked to Mr. Warner.

REQUEST FOR ADDITIONAL NAVY TESTIMONY

Chairman PROXMIRE. Admiral, I have attempted on several occasions to get the Navy to appear on the Litton and F–14 contracts. Each time the Navy says they will be glad to come but at a later time. I am afraid that your appearance will be so delayed that all important decisions will have been made and it will be too late for Congress to do anything but stand by and watch millions of dollars being wasted on mismanaged, inefficiently operated, gold-plated weapons program. I would like you to agree to come back to this subcommittee on a date certain in the near future and testify on the programs I have mentioned.

Can you specify a date?

Admiral KIDD. No, and I take, respectfully, issue with the sweeping implications of your statement, that we keep Congress in the dark, because by jingo, we have been up here testifying before other committees in the greatest of detail.

Chairman PROXMIRE. Well, you have testified before this committee and you have been very helpful to us on occasion. On this particular area, these are programs that it seems to me do involve enormous sums.

Admiral KIDD. I am talking about these programs, Senator Proxmire. These same programs, sir. We have been up here hours on end on both of these programs.

Chairman PROXMIRE. In public testimony?

Admiral KIDD. Yes, sir, before the House and Senate Armed Services and Appropriations Committees.

Chairman PROXMIRE. Well, you will not appear before our committee. You will appear before those committees, but not this committee?

Admiral KIDD. That is my understanding, yes, sir.

Chairman PROXMIRE. Why is that? Are we too critical?

Admiral KIDD. No, sir.

Chairman PROXMIRE. You will appear before the hawks but not the doves?

Admiral KIDD. No, sir, I think Mr. Warner's situation, I happened to be in the office when Secretary Warner talked to Mr. Kaufman, and he agreed that we would be most willing to come up before your subcommittee at an appropriate time.

Chairman PROXMIRE. But you will not tell us when. You will appear before the other committees, but not before this one.

Admiral KIDD. Those committees hold closed hearings in order to protect the proprietary interests of the contractor in accordance with those laws that I mentioned. I certainly subscribe to the impropriety of airing bedding on contractual fiscal situations and like matters.

Chairman PROXMIRE. I understand that and of course, nobody can, nobody would force you to answer questions that you feel are proprietary. But you could still come before this committee in open, public sessions. This committee does not have any function privately. To meet privately would serve no function whatever. This committee is a fact finding committee, the committee tries to get information to the Congress so they can act. Other committees meet privately. I think in many cases they are wrong to do it, but in many cases they markup legislation and they proceed in that way. Our responsibility is broader. If you cannot come up publicly, it seems to me it does not serve any purpose.

I understand there are some cases where you could come up publicly—I think there should be—and then restrict your responses and not respond in areas that you think proprietary information is involved in.

Admiral KIDD. Could I ask your advice on a matter in this regard?

Chairman PROXMIRE. Yes, sir.

Admiral KIDD. Let's take the Grumman situation, where we held the line to the everlasting discomfort of the contractor, made a public statement to that effect——

Chairman PROXMIRE. And I commended you when you made that statement.

Admiral KIDD. And that was very much appreciated, sir. Then these big ads in the newspaper and all. How much more public would you like us to get, sir?

Chairman PROXMIRE. Well, I would like you to get public to the extent of coming up and submitting to cross examination. These ads in the newspapers were by Grumman.

Admiral KIDD. That is correct.

Mr. RULE. Which was exactly, Senator, the point that I made and the reason I felt at liberty to jump off as I did and talk about their buy-in. I said in the record, "The reason I mention Grumman, and I have not been a participant in any of the negotiations." I made that very clear. But I certainly felt that I had a right to respond and at least comment on and talk about that full-page ad that Grumman put in the paper, not knowing anything about the negotiations. That is what I thought the Admiral was talking about, that you can't talk about negotiations. I could not talk about them anyhow.

And the same thing with Litton. "I would like to make a couple of comments about Litton. I have had no part in the negotiations

with Litton, either. But the fundamental point is that again I think the public and the taxpayer should know about Litton," et cetera.

Now, I am sorry if those statements got the Admiral's nose out of joint and made him "lose confidence in my judgment."

Chairman PROXMIRE. Mr. Rule, I understand you to make statements emphatically backing the Navy's position in ringing terms. It seems to me you should be commended by the Navy for being loyal to their position.

Admiral KIDD. It did not stop soon enough, Mr. Chairman.

Chairman PROXMIRE. He did not stop soon enough? He can say so much and then stop.

I have only a couple more questions. Then we have Mr. Mondello.

I want to apologize to Mr. Mondello, the General Counsel of the Civil Service Commission.

KIDD CALLS THE SHOTS

Are you disciplining Mr. Rule, Admiral Kidd, by detailing him to Anacostia or not? If not, then why can't Mr. Rule do what he said he is capable of doing—that is, do both jobs, the one he has and the new detail?

Admiral KIDD. The answer to the first question is a flat out no, Mr. Chairman. The answer to the second question is because I do not think he can and as long as I am the boss, I am calling the shots.

Chairman PROXMIRE. Well, have you considered the evidence that Mr. Rule has given this subcommittee this morning, in which he says that he has talked to the people over there and they feel he could do it easily?

Admiral KIDD. Quite thoroughly.

Chairman PROXMIRE. You think it can't be done without his leaving his office, going over there physically, not coming back to any of his present functions, being taken out of the act entirely as far as action and procurement is concerned?

Admiral KIDD. That is correct, Mr. Chairman.

Chairman PROXMIRE. Well, how long will it take Mr. Rule to do this job?

Admiral KIDD. I do not know, Mr. Chairman.

Chairman PROXMIRE. Well, can you find out and let us know?

Admiral KIDD. I would be happy to let you know when he starts.

Mr. RULE. I asked the Admiral that question. I asked him specifically how long this detail would last. He said he did not know, that it was open-ended and that after I finished that, he had other temporary assignments in mind.

Chairman PROXMIRE. How about that, Admiral?

Admiral KIDD. He is right.

Chairman PROXMIRE. So that if he finishes this job quickly, you will assign him to some other temporary job so that he will not come back to his responsibilities he has discharged so brilliantly that he has been cited for it?

Admiral KIDD. I am going to keep my options open on that, Mr. Chairman.

Chairman PROXMIRE. How can you say you are not disciplining him under these conditions?

Admiral KIDD. Because I did.

Chairman PROXMIRE. You did, but how do you justify that when you have a situation where you will not let this man even know how long this job will take? That would be very easy to determine, it would seem to me.

Then you furthermore say that when he finishes it, you have a few other things in mind, maybe a bowling alley to——

Admiral KIDD. I tell you what, Mr. Chairman. When I was sent back here from something that I really knew how to do, command of the Sixth Fleet, I sort of felt I was being disciplined. Mr. Rule has suffered no loss in pay, there has been no punitive action. I think really what we are talking about here maybe is a matter of personal pride. But there has been——

Chairman PROXMIRE. Admiral, reconsider your response there. You said when you were brought back here, you were considering that a demotion. You were given a promotion, in fact. You are the second highest ranking officer in the U.S. Navy, is that not so?

Admiral KIDD. No, sir, not quite, number five.

Chairman PROXMIRE. That is pretty high. How could you consider that to be a demotion?

Admiral KIDD. I was speaking in jest, Mr. Chairman.

Chairman PROXMIRE. Well, I am sure, especially in contrast to what has happened to Mr. Rule.

Mr. RULE. If I may say something, also in jest, it would have made about as much sense for somebody to give me a set of orders to go out and relieve the Admiral and run the Sixth Fleet as it made to give him a set of orders to come back and run Procurement.

Chairman PROXMIRE. Aren't you in effect putting Mr. Rule in permanent exile, sending him to Siberia for good?

Admiral KIDD. No, sir.

Chairman PROXMIRE. In a subtle and——

Admiral KIDD. No.

Chairman PROXMIRE. Well, you have open-ended the job he considers an exile. You have indicated that when he finishes it, no matter how well he does, you have other temporary assignments in mind.

Mr. RULE. And Senator, this is the last time I will interrupt. All I am asking is that Admiral Kidd abide by what the Civil Service Commission said yesterday: "Officially, you are still the incumbent of that job." Now, I am offering to do this other work and I can do it. If I could not as a GS–17, I ought to be fired, not retired if I could not do that job of upgrading the curriculum in the capacity of consultant. And the Admiral says that he is the boss and that is it. And that is where we stand. I will be happy to take on this other work, but I want that job just exactly the way the commission says it is. That is my official job.

Chairman PROXMIRE. That is the job in which Admiral Kidd testified earlier you did superb work?

Mr. RULE. That's right and I want that job back just the same as the commission says I have it today and I want to perform the job just as I always did.

Chairman PROXMIRE. Admiral, I want to say to you that I have great respect for you and you have performed here this morning

with considerable distinction in a tough role. It is not easy to do what you have to do, but with all due deference, I think you are insulting the intelligence of this subcommittee and the public to tell us with a straight face that this is not disciplining Gordon Rule when you take him out of his office, kick him out of his office in effect, refuse to let him stay in his office, transfer him to Anacostia to upgrade the curriculum, a job which he says he can do easily on any weekend, and then say when he finishes that, you have something else in mind.

One other question. Admiral Kidd, Secretary Warner agreed to allow you to testify on this question of Grumman and Litton. All I am trying to do is get a date. Can't you tell me when you will come?

Admiral KIDD. No, sir, because I would not even hazard a guess as to when these negotiations will be finished, Mr. Chairman.

Chairman PROXMIRE. You will not come before they are finished?

Admiral KIDD. That is my understanding.

Chairman PROXMIRE. You will appear before the other committees but not before this one on these issues?

Admiral KIDD. That is my understanding, sir. Not on the contractual part, Mr. Chairman. Not on the contractual part.

Chairman PROXMIRE. As I say, we are asking you to appear on procurement matters in general. This morning, it was, as I think it should have been, directed at what I think was the disciplining of Mr. Rule.

Thank you, Admiral, thank you very much.

Mr. Rule, did you want to make a concluding statement?

Mr. RULE. If you wait for Admiral Kidd to settle all these contractual problems with Litton, he will be long gone, because we will not settle those problems with Litton for many years to come on the contracts they have, I am sorry to say.

Chairman PROXMIRE. I think you are right and I think I will be long gone, too.

Mr. RULE. I know I will be.

Chairman PROXMIRE. Admiral, do you want to conclude with anything? I do not want to cut you off.

Admiral KIDD. Just thank you very much for your courtesy and the opportunity to come up.

Chairman PROXMIRE. Thank you, sir.

Our final witness is Mr. Anthony L. Mondello, General Counsel, Civil Service Commission.

Mr. Mondello, did you want to make any kind of opening statement or just respond to questions?

TESTIMONY OF ANTHONY L. MONDELLO, GENERAL COUNSEL, CIVIL SERVICE COMMISSION

Mr. MONDELLO. I have no statement, Mr. Chairman.

Chairman PROXMIRE. All right, sir, will you first explain your position with the Civil Service Commission, your responsibility and your qualifications to explain what recourse is open to civil servants?

Mr. MONDELLO. Yes, sir, I am the General Counsel of the Civil Service Commission and I have——

Chairman PROXMIRE. You are the General Counsel of the Civil Service Commission?

Mr. MONDELLO. Yes, sir, and I have a fair amount of familiarity with our regulations. As we change them, I have to comment on them and so I learn of their content.

Chairman PROXMIRE. How long have you been with the Civil Service Commission?

Mr. MONDELLO. I have been General Counsel of the Commission since March or April of 1968. I was formerly with the Department of Justice since 1948.

Chairman PROXMIRE. So for almost 5 years, you have been with the Civil Service Commission; before that, you were with the Department of Justice?

Mr. MONDELLO. Yes, sir.

Chairman PROXMIRE. And you have been the General Counsel, you say, for almost 5 years?

Mr. MONDELLO. About 5 years.

Chairman PROXMIRE. Will you explain the exact series of steps that must be taken in an appeal to the Civil Service Commission. What time period is involved, the length of time for each step, and what governs the length of time for each step?

APPEALS TO THE CIVIL SERVICE COMMISSION

Mr. MONDELLO. There are a good many different appeals to the Civil Service Commission, depending on the matter you are involved with. Maybe it will help serve your purpose if I say this: The Congress has structured the areas in which we can entertain appeals. We handle appeals under the Classification Act. We do so also as a result of adverse actions which are taken initially under the Veterans Preference Act, but we have broadened out Veterans Preference rights to the entire membership of the competitive service, so that anybody who is a member of the competitive service against whom adverse action is taken has the right of appeal to the Commission.

The Congress has defined "adverse action" for us in section 7511 of title V of the United State Code. Reading from 7511, subsection 2, "Adverse action means a removal, suspension for more than 30 days, furlough without pay, or reduction in rank or pay." The only one that seems to require explanation is reduction in rank.

Chairman PROXMIRE. Where you have a case where you have a man who is still the same rating—a GS–17, for example—so there is no reduction in pay and where his superiors say one thing—they say that it is not a demotion when they transfer him and he feels very strongly and very deeply aggrieved that he is being moved out of the function that he has the capability of performing, is there any grounds under any circumstances for the aggrieved party to appeal effectively?

Mr. MONDELLO. Yes, there are a number of things that such an aggrieved party can do. While I do not really feel free to disclose the content of the Commission's letter to Mr. Rule, which I have read, we have suggested to him what was wrong about some of the things the Navy apparently had done; but we have not conducted a

proper investigation of the facts in order to make a decision in the case.

Chairman PROXMIRE. Well, we have that letter. We are disclosing it.

Mr. MONDELLO. Well, then, let me talk to it.

Chairman PROXMIRE. So you can comment on it. We will make it a part of the record at this point.

[The letter referred to follows:]

U.S. CIVIL SERVICE COMMISSION,
Washington, D.C., January 9, 1973.

Mr. GORDON W. RULE,
Arlington, Va.

DEAR MR. RULE: This is in reply to your letter of January 3, 1973. Rather than respond to the specific questions you raised I believe that the best way I can assist you at this point in time is to describe your status as I understand it and advise you as fully as possible as to your rights in the situation.

In your letter you state that Admiral I. C. Kidd visited your home on December 20 for the express purpose of pressuring you to retire. There are circumstances under which a manager can suggest retirement as a choice to an employee, but under no circumstances can a manager coerce an employee's retirement, and if this is what occurred, your refusal to agree to sign a request to retire was entirely within your rights. Federal Personnel Manual Supplement 752–1 paragraph S–1–2 a (3) speaks to this, and we are calling this allegation to the attention of appropriate Navy officials to insure that the letter and spirit of these instructions are complied with.

We understand from officials of the Department that in accord with your request annual leave has been approved for you until January 15, 1973. We also have been advised that Admiral Kidd has orally assigned you to perform the task of reviewing and up-dating the curriculum of the Navy Logistics Management School. Navy has assured us that this is a legitimate task and one that you are well qualified to perform. We are also advised that the nature of this temporary assignment is an *informal detail* and that you continue to be officially assigned to your regular position.

The Federal Personnel Manual Chapter 300–19 defines a detail as "the temporary assignment of an employee to a different position for a specified period, with the employee returning to his regular duties at the end of the detail. Technically, a position is not filled by a detail, as the employee continues to be the incumbent of the position from which detailed." The Commission regulation requires that when a detail will exceed 30 days it must be reported on a Standard Form 52 or other standard form considered appropriate by the agency and maintained as a permanent record in the Official Personnel Folder. If it is found that the detail will exceed 120 days the agency must request prior approval of the Commission for any extension.

Normally it is within the authority of an agency to deail employees as necessary to accomplish the agency's assigned mission. However, you state that you believe this assignment to be a reprisal because of the answers you gave to questions during a Congressional hearing. The proper way to get a review of this action would be for you to present a grievance in accord with the procedures set forth in Department of the Navy's Civilian Manpower Management Instruction 771.S, Employee Grievances and Appeals. It is our suggestion, therefore, that you accept the assignment under such protest as you care to make while seeking redress through the Navy's grievance system.

We have not been informed as to whether Navy is planning to take any further action with respect to your employment. However, officially you are still the incumbent of the position of Head, Procurement Control and Clearance Division GS–17.

If the Department proposes to reassign you to a position that results in reduction in rank or compensation or to take any other adverse personnel action this must be processed in accord with the procedures set forth in Federal Personnel Manual Chapter 752 and Supplement 752–1. Adverse actions are listed in the regulations as "disciplinary and nondisciplinary removals, suspensions, furloughs

without pay, and reduction in rank or pay." The Commission regulations require that the agency must give the employee thirty days advance notice of the proposed adverse action, stating specifically and in detail the reasons for the proposed action, offer him an opportunity to reply, consider his reply, and give him a final decision. The employee then has the right to appeal to the agency, and then to the Civil Service Commission or directly to the Commission.

We have been assured by officials of the Navy that it intends to comply fully with the spirit and intent of the law, as well as both Commission and Navy rules and regulations in any actions they may take with respect to you. If any action should be taken which is in violation of your rights under law and CSC regulations, I assure you that the Commission will give these thorough and objective review at the proper time.

We hope this explains your rights and the avenues available to you to seek redress on the matters of concern to you.

Sincerely yours,

ROBERT E. HAMPTON, *Chairman.*

Chairman PROXMIRE. Explain what you mean by errors that the Navy may have made?

Mr. MONDELLO. I am speaking of the second paragraph of the letter to Mr. Rule.

Chairman PROXMIRE. That paragraph reads and I quote:

In your letter you stated that Admiral Kidd visited your home on December 20 for the express purposes of requesting you to retire. Under no circumstances can a manager coerce an employee's retirement and if this is what occurred, your refusal to agree to sign the request to retire was entirely within your rights, Federal Personnel Manual and so forth.

You are calling this allegation to the attention of the appropriate Navy officials to assure that the appropriate action is taken?

Mr. MONDELLO. That is right. What we say in the Personnel Manual and in our regulations with respect to involuntary retirement is that the circumstances surrounding any separation from the force, or any adverse action, are designed to see that people get treated decently and in the event that they are treated in the kind of way that Congress has described as adverse, they have a right of appeal to the Commission where, in connection with that appeal, there will be a hearing. At the hearing there will be an appeal examiner who will sit and objectively determine, in spite of conflict in the statements of the two parties, what indeed the facts were. This procedure has the virtue of being reviewed by the courts.

Chairman PROXMIRE. It may be the fault of the Congress, may be a fault of the law, may be a fault of the Civil Service Commission or a combination of these things, but the difficulty in these appeals take forever and meanwhile the man is destroyed as an effective civil servant in his capacity. We have the case of Ernie Fitzgerald which has been going on now for 3 or 4 years.

Mr. MONDELLO. Yes, but there are things about the Fitzgerald case, of course which should be understood. That case should have been over by now.

APPEALS DELAYS

Chairman PROXMIRE. Maybe it should have, but let me ask you what is the excuse for such things taking 3 or 4 years. If there is no legal requirement for a 2- or 3- year review process, is it not simply a case of red tape and administrative paperwork?

Mr. MONDELLO. A good critique of the Civil Service Commission system for handling appeals, particularly that part of it which is called the Agency Appeals System, has been written by a professor named Richard Merrill for the Administrative Conference of the United States which has just recently conducted a study. I happen to be a member of the Administrative Conference. The Conference has already adopted a proposal to see to the change in these procedures. Internally, I have been seeking changes in these procedures and the Commission has separately studied the matter.

But I think it is great that this independent entity, a separate agency of the United States set up by Congress just to do this kind of procedural study, has studied us to death and come up with some real procedural changes. There has been too much delay in the way things are handled, there has been too much duplication of hearings, too much of other trappings that I do not think has gotten us anywhere.

Chairman PROXMIRE. So now you have a study that has been undertaken to see how things could be speeded up, right?

Mr. MONDELLO. I am certain that they will be speeded up.

Chairman PROXMIRE. When will that study be available?

Mr. MONDELLO. I think within a day or so.

Chairman PROXMIRE. Oh, really?

Mr. MONDELLO. I think the conference is ready to send it to the Civil Service Commission in report form. It is a recommendation by the Administrative Conference of the United States to the Civil Service saying to the Commission, "We think you ought to change your present procedures in these and these and these ways." I happen personally to have voted for that in the conference and I am eagerly pushing it in the Commission. But I think we are that close.

Chairman PROXMIRE. That is good to hear and I want very much to see that, because I think that is the problem, the first problem, at least, that a civil servant runs into. He may have an excellent case, he may win his case hands down.

Mr. MONDELLO. But it takes too long.

Chairman PROXMIRE. But the first thing he has to do is present his case to the agency that has aggrieved him and that can always take a long time. Then he has to go to the Civil Service Commission and there the procedures can take a long, long time. You take Gordon Rule out of action for 2 or 3 years and he is destroyed.

Mr. MONDELLO. I do not see anything in the circumstances that I heard about this morning that would require a period of years to conclude.

Chairman PROXMIRE. First he has to go to the Navy.

Mr. MONDELLO. Yes, but I think that is a very quick procedure. It is a rather shortened and relatively informal grievance procedure. Since you were openly talking today about interbranch problems and whether Mr. Rule was indeed disciplined for what he said, I think you raised a very significant First Amendment question. Those questions, because they are constitutional and might affect his rights, are perhaps the only kind of question coming out of a grievance, as distinguished from an appeal procedure, that a court would be willing to accept jurisdiction on.

MEMBERSHIP OF CIVIL SERVICE COMMISSION

Chairman PROXMIRE. The Civil Service Commission, as I understand it, has three members, right?

Mr. MONDELLO. Yes, sir.

Chairman PROXMIRE. And one of those members is a director of the Litton Company?

Mr. MONDELLO. That is correct.

Chairman PROXMIRE. Receives pay from the Litton Company, $7,500 a year, as a director?

Mr. MONDELLO. That is correct.

Chairman PROXMIRE. That member is a woman?

Mr. MONDELLO. Yes, it is, Mrs. Jane Spayne.

Chairman PROXMIRE. Right, and she has not given any indication whether she will disqualify herself or not.

Mr. MONDELLO. I think she has.

Chairman PROXMIRE. The newspapers indicated that she had not so far. Perhaps she has.

Mr. MONDELLO. No, I read Orr Kelly's article of about a week or so ago when she was first contacted about it and she said obviously she would disqualify herself if anything came before her that involved Litton.

Chairman PROXMIRE. I read that same article, but I didn't get that interpretation from it.

Go ahead.

Mr. MONDELLO. Well, as of this morning, I understand Congressman Aspin had written to Mrs. Spayne and she has prepared a response—I assisted her with the response, as a matter of fact, although she changed it and it is her's. I suspect that has been mailed and what she says is that she has no intention of sitting on a matter that will raise either the actuality of a conflict of interest or the appearance of one, and she has already told the Chairman—I think she did yesterday—that she would not have anything to do with the Rule case if it came before the Commission.

Obviously, we don't know that it ever will, but I think she has made her position clear.

Chairman PROXMIRE. Is there any kind of custom or rule on members of the Civil Service Commission receiving outside compensation?

Mr. MONDELLO. There is more than that. There is an entire program in the executive branch that begins with Executive Order 11222. There is a set of umbrella regulations in Part 735 of Title 5 of the Code of Federal Regulations which we put there because the Civil Service Commission has a large part of the responsibility for conduct, ethics, and conflict of interest in the executive branch. The program anticipates that people will have private financial arrangements and that they might indeed get in the way of their official duties. So we have a program of disclosure and anyone who is responsible directly to the President, for example, under the Executive order, has to file a financial statement with the Chairman of the Civil Service Commission.

Mrs. Spayne, merely because she is subordinate to the Chairman of the Commission, also must file with him, and I happen to be the individual who reviews those statements in conjunction with the chairman and checks out what the duties of an individual are as compared with what his financial interests are. Whenever I see any sign of danger, I consult with the chairman and we try to see that people divest themselves of one thing or another. Sometimes this means that the people can't serve in a particular position.

Chairman PROXMIRE. Well, in this case, the opportunity would be available only for a two-man review. If the Commission is split, then I take it he wouldn't have any recourse, he wouldn't have any basis for having his job restored.

Mr. MONDELLO. Not at all. It all depends on how the facts ultimately come out. If adverse action is taken against Mr. Rule or if the matter gets to the Commission by virtue of the Classification Act—for example, I understood from your discussion with Admiral Kidd and Mr. Rule that there has been something going on with respect to his job duties. Well, we have rules about that on the books and a person's job description has to coincide with what his duties in fact are, because his pay depends on that and we do not let people lightly fool around with that. There is a separate classification appeal if somebody has misclassified his duties, so that if this danger approaches, we will know it in relatively short order.

I presume Mr. Rule will keep us informed, and if his actual duties do not correspond with his grade, there will be one or another avenue through which he can approach this. If he wants my counsel, he can have it. He obviously can have private counsel, too. But there are a number of ways in which he can come and get this business before the Commission.

ADVERSE ACTIONS AGAINST CONGRESSIONAL WITNESSES

Chairman PROXMIRE. Of course, the problem here and I think in most cases is not a clearcut situation where somebody appears before a congressional committee and the next day they are fired. It happened to Ernie Fitzgerald, it has not happened to Gordon Rule. There is a situation where Admiral Kidd is willing to come before a congressional committee with the public present and call it a lateral movement. I suppose a lateral movement is something that is very hard for the Civil Service Commission to appeal. He is just in a position where he has pretty much had it.

Mr. MONDELLO. No, I appreciate Mr. Rule's current difficulties as I heard him describe them this morning. The Admiral is correct when he described Mr. Rule's current assignment as a detail. We have regulations about details. The fact of the matter is that that detail can't run for as much as 30 days without the Navy preparing a document, a form 52 or the equivalent, which must be placed in his official personnel folder, and he will inform us, I am sure, whether this has been done.

Chairman PROXMIRE. As I understand what will happen in this case is Mr. Rule has to move over physically to Anacostia for 30 days before any kind of action can begin, is that right?

RESPONSIBILITY OF MANAGERS

Mr. MONDELLO. Well, let me back up just a little bit. Just as the Congress has given the Commission for which I work certain ways of getting into agencies to move toward correction of the grosser things that are done, and overall to see that personnel management is effective and decent, so the Congress has also placed the power to appoint people in the heads of agencies. It has given them the power to assign individuals to specific duties and I would move slowly, if I were you, before I would circumscribe the ability of agency managers to do with people what the mission accomplishment seems to require.

Now, I appreciate the attitude I heard expressed from the Chair this morning and I am not unsympathetic with it at all. But you place the responsibility on managers. You tell them to get a job done, you give them the money to do it. Then I think it ill behooves you to take a commission like our own—obviously, we need far more resources to do it—to second-guess personnel actions before they have gotten to a stage that is so serious they can't be ignored.

Now, the measure of the gravity that should trigger our action is already laid out for us by Congress. It might be that there is some closing of the gap you might want to do and if that is what you wish to consider, why, we will help you consider it.

ACTIONS AGAINST RULE

Chairman PROXMIRE. That is it. You know, here we have a situation which seems just to be prima facie to me. I am a very prejudiced party in this case, I suppose, but it just seems so clear. Here is a man who was decorated, received the highest award anybody can get, only one civilian a year receives this decoration by the Navy. The day after he appears before a congressional committee he is given this lateral transfer, they say. He is kicked out of his office, he is assigned to a job which he feels and I think many people feel is a nothing job. He is told that job is open ended, that when that job is ended, they can move him someplace else any time. This is a different situation from an employee who comes up and says, I think I am doing the best job I can do in this area, my boss does not agree.

You are dead right, a boss must be given a lot of discretion to move inefficient people out and put efficient people in who can do the job. This is absolutely essential. But where the facts are clear that you have an extremely efficient man, when his boss comes up and tells this subcommittee he is doing a superb job or has done a superb job, but that he is a loner, a whistle blower, it would seem there ought to be some way that you could act rather promptly——

Mr. MONDELLO. More quickly. Well, I think we are in about the same position that a Federal district court is in when a Federal employee goes to court and says, "look what they are doing to me. Enjoin them. Make them stop it right now." The court ordinarily requires him to show that he has some prospect of success on the merits.

Chairman PROXMIRE. You can do that? Could you move in with an injunction and require the Navy to keep Mr. Rule in his office?

Mr. MONDELLO. I was hoping you would not ask me that. The Circuit Court of Appeals for the District of Columbia has said flatly in one case that the Commission lacks that power. I would prefer to think that whether we can do so on the basis of sheer power, having the authority given by the Congress to do it, or whether we do it by general persuasion—which is the way our presence in most cases causes informal resolution of these matters—the court has said that. So I think in all fairness, I should tell you that that is what the court has said.

CASES WHERE COMMISSION HAS ASSISTED EMPLOYEES

Chairman PROXMIRE. I think more important than what the court has said is what you have actually done. Can you supply a list of specific cases where the Civil Service Commission has supported the claims of a Government employee and has moved to assist such an employee in his dispute with the Government?[1] Has this ever happened with the Defense Department, ever?

Mr. MONDELLO. I am sure it does.

Chairman PROXMIRE. Can you give me some specific cases, not some minor——

Mr. MONDELLO. They are not minor. To an employee caught up in something like this, it is not minor. This is his life.

Chairman PROXMIRE. I understand that. I did not mean it in that sense. I mean something that is in the public domain in such a big way that you have testimony before a congressional committee, that you have a man who can affect hundreds of millions of dollars in procurement. I am sure that at times, the Civil Service Commission has assisted somebody that in a way to them is the difference between life and death as far as their job is concerned, very important. But I am not talking about that entirely. I am talking about the big cases that affect the public treasury in the kind of way that the Rule case would.

Can you give us any instances?

FITZGERALD CASE

Mr. MONDELLO. Well, in spite of what you may say, I am going to suggest to you that the Fitzgerald case is such a case. I cannot really get to the merits of it, because the Commission may have to decide the merits of it——

Chairman PROXMIRE. Mr. Mondello, if you are citing the Fitzgerald case to me, I am really discouraged. Here is a case where this fellow was kicked out, fired from his job, everybody knows that. I asked the Justice Department to prosecute the Defense Department—I did not expect them to do it right away. But I asked them to do it. We have been waiting for years now, no action has been taken by the Justice Department. You have had hearings.

Mr. MONDELLO. We started them but they were aborted by Mr.

[1] See Mr. Mondello's letter, dated Feb. 7, 1973, pp. 2256–2261.

Fitzgerald because there was an issue in the case which he felt——

Chairman PROXMIRE. That issue was he wanted them public.

Mr. MONDELLO. That is right and the issue has been litigated and we are back to hearings. Here is a case where the Defense Department, according to Mr. Fitzgerald's representations to us, used the reduction-in-force regulations as a cloak for discharging him. There was a period when we litigated this other issue as to public hearings and I have nothing to say about that, it is done. But we are going to get to the mat on his issue, and if the Commission finds his allegation is supported, there is no doubt in my mind that they will order the Air Force to restore him.

Chairman PROXMIRE. In this case, the court ruled that Mr. Fitzgerald was entitled to a public hearing.

Mr. MONDELLO. Yes. I think that issue was a matter of sufficient doubt and respectability as an issue that it should have been litigated.

Chairman PROXMIRE. So the Commission caused the delay by not giving it to him in the first place.

Mr. MONDELLO. He caused the delay by asking——

Chairman PROXMIRE. Because of his asking for rights given him by the court.

Mr. MONDELLO. We have to find out what the facts are in the case yet. But we offered him a hearing and we are determined to find out what the facts are.

Chairman PROXMIRE. Will you give me for the record the cases big and small, all the cases, in which the Civil Service Commission has supported the claims of a Government employee and has moved to assist him in his dispute with the Government?[1] I particularly want those cases involving the Defense Department. All right?

Mr. MONDELLO. I hate to hesitate about this, but we have a complaint office in the Commission which handles I do not know how many thousand cases over a period of a year or 16 months. I do not want to list all those cases for you. I am sure a good many of them are from Army, Navy, and Air Force. Now, they are not all of the gravity you are suggesting. So let me offer this in return: I understand your question and I will go back and see what listing there is of cases that would be of the kind of importance you want.

Chairman PROXMIRE. I have great respect for you, you are obviously a man of competence, and for the commissioners, but I have a feeling——I would like to have it put to rest—that there are not many cases. There may be a few, but I would like to see a hundred at least. Don't give me the details, but just give me the names of people who have been assisted by the Civil Service Commission in getting their jobs. More than a hundred, or just go to a hundred. Can you do that over the last few years?

Mr. MONDELLO. Okay, but I like to think that one of the functions of the Commission is to assist not only employees but applicants in getting their jobs, getting assistance and——

WORKLOAD OF COMMISSION

Chairman PROXMIRE. I agree. How many cases do you process each year?

[1] See Mr. Mondello's letter, dated Feb. 7, 1973, pp. 2256–2261.

Mr. MONDELLO. I think there are something in the neighborhood of 2,500 adverse action cases.

Chairman PROXMIRE. How many Civil Service personnel are involved in the review process?

Mr. MONDELLO. I guess on the Board of Appeals and Review, which is the highest level of appeal at the Commission, I think there are six or seven board members and probably the entire staff does not exceed 60 or 70.

There are Appeals Examining Offices below that level. There is one in every region. There is one locally here in Washington. They have some staff, some 5 to 10 people each.

Chairman PROXMIRE. Can you supply the subcommittee with a list of Civil Service Commissioners and a breakdown of their personal financial or advisory relationships with Defense contractors? We know about this one relationship Mrs. Spayne has. I would like to know about the other two Commissioners, whether or not they have any relationship whatsoever with Defense contractors?

Mr. MONDELLO. I will do that to the extent that I can do so under that Executive order and without violating their privacy; yes, sir.

Chairman PROXMIRE. What does that mean? If it is of public record——you say they are required——

Mr. MONDELLO. It is not of public record; no, sir.

Chairman PROXMIRE. I thought you required disclosure and that was the protection.

Mr. MONDELLO. The disclosure is made to the Chairman of the Civil Service Commission. I told you I assisted in reviewing those things for the purpose of consulting with those people on what they ought to get rid of.

Chairman PROXMIRE. So it is not available to the public and to Members of Congress.

Mr. MONDELLO. It is not available to the public. I do not know that we have ever been asked for them by Members of Congress.

Chairman PROXMIRE. So the only way we can get the information is to get the Commissioners up here to testify.

Mr. MONDELLO. Much of the information comes out in confirmation hearings as a matter of course. I noticed the other day on Mrs. Spayne that the White House issued an announcement, when they announced they were about to nominate her, and that announcement said she was on the board of Litton Industries.

Chairman PROXMIRE. I am mystified. What do these Commissioners have to hide? After all, this is a very sensitive quasi-judicial function of greatest importance. Their integrity and their objectivity is immensely important. I know they want to be——

Mr. MONDELLO. Yes, sir, and I do not understand you questioning their integrity.

Chairman PROXMIRE. Why would this not be serving their interest as well as the public interest to let people know just what the situation is?

Mr. MONDELLO. It might be, but I am not going to engage to give you those documents when I do not know what the Commissioners personally want.

Chairman PROXMIRE. I am asking you to request the Commissioners to give them to the commission and if they will not give them to us, I would like to know about that.

Mr. MONDELLO. No problem.

Chairman PROXMIRE. Has there ever been a case before the Civil Service Commission where you have supported the right of a government employee to answer questions before the Congress or to speak critically about any Government practices?[1]

Mr. MONDELLO. Yes, sir—well, before Congress, no. I do not know of any case that raises, in first amendment or other terms, the prerogatives of an individual who comes up here, as I am here this morning, and is asked questions that he either does not want to talk about or questions that he does want to talk about and somebody else thinks he should not. There are cases in the courts—first amendments cases—including the Supreme Court, particularly a decision in the Supreme Court. The *Meehan* case, the case of a policeman and a union official in Panama who spoke out at a time when things were terribly restless down there and who was ultimately disciplined for it. That case got to the court of appeals three times.

Chairman PROXMIRE. This has a double effect. I am not only concerned about the right of Government employees to speak out, speak their mind under the first amendment. But there is another consideration which Members of Congress might feel is important. That is the right of the Congress to know, our right to find out, our duty, in fact, to inquire of civil servants to understand what is going on to speak their mind.

Mr. MONDELLO. There is a provision in the code——

Chairman PROXMIRE. A provision in the code. I am asking you if you have ever done anything about it, if the Civil Service Commission has ever gone to bat for an employee testifying before Congress. All the years the Civil Service has been in operation and the executive branch has appeared and there are many instances where they have made statements that their bosses feel are indiscreet, if you can name any instances where the Civil Service has gone to bat for them.[1]

Mr. MONDELLO. If you can cite cases that you know of where somebody has been discomfited by this or——

Chairman PROXMIRE. I understood you to previously answer that there were not any cases that you could cite.

Mr. MONDELLO. I am telling you about the cases I know that I have read in court decisions or that have come before the Commission where this issue is presented. I am hard pressed to discover them. I know a first amendment case that took place at Warner Robbins Air Force base where an individual kept writing letters to editors and was chided by his superiors for doing so. I think he was critical of the war in Vietnam, and he insisted on signing his name and identifying who he was and where he was from. His supervisor cautioned him not to do that, telling him, "I don't care what you say, but don't tie it to me, because I run a different kind of shop." I understand he was dismissed and if I recollect right, I think that case is somewhere in the district court down in Georgia.

Chairman PROXMIRE. How long has that taken?

Mr. MONDELLO. I don't know.

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[1] See Mr. Mondello's letter, dated Feb. 7, 1973, pp. 2256–2261.

Chairman PROXMIRE. He is dismissed and it has taken months or years? And it is still not resolved?

Mr. MONDELLO. This could be months, but I really do not know where the case is, at what stage, or whether there is a decision.

Chairman PROXMIRE. Your description is too brief to make any judgment on what you say. Any time you can't sign your name, that is pretty important.

Mr. MONDELLO. He could sign his name, but his supervisors objected to his indicating his connection with the Air Force, the Air Force taking part in this war.

You know, first amendment problems are very serious problems. When you consider that you have the supervisor-employee relationship at issue before you now in this episode, and then you have the overriding consideration of constitutional rights, you have some very serious business; and I think it would be only appropriate to look at what the courts are doing about these things. There are perhaps 8 or 10 cases I could get for you where Federal or other public employees have had difficulty with being told they could not say something, and the question arises as to whether they can be disciplined or removed. I think the cases are very instructive and I suppose if the rule matter ever does get to the Commission in adverse action form, the Commission is going to have to get busy and look at those cases itself and decide what they mean.

Chairman PROXMIRE. I appreciate very much your testimony, Mr. Mondello. I hope you will submit, No. 1, the study you talk about which you say will be available in a day or so, which will tell us how this can be speeded up; No. 2, the cases that I have asked for which indicate what the Civil Service Commission has done in the past. It seems to me the Civil Service Commission has no more important task—it has many important tasks but no more important task—than protecting the right of people to speak their mind and the right in this free country of ours and the right of Congress to listen to testimony of people who have the courage to speak out critically about what is going on in the Government. This is just absolutely essential and I will be very interested in seeing the extent to which the Civil Service Commission has acted.

But I very much appreciate your appearance here this morning. It has been most helpful to us. And the court case you just cited, we would like to have that.

Mr. MONDELLO. Yes, sir.

Chairman PROXMIRE. Thank you very much.

The subcommittee will stand adjourned, subject to the call of the Chair.

[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 by Mr. Mondello:]

U.S. CIVIL SERVICE COMMISSION,
OFFICE OF THE GENERAL COUNSEL,
Washington, D.C., February 7, 1973

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee, U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: In my testimony before your Committee on January 10, 1973, we arranged that I should furnish the Committee with a number of items of additional material to supplement my testimony. This letter is in-

tended to satisfy all of the requests that were made at the time. If, in your judgment, I have failed to furnish something you expected, or if you desire something additional to what is discussed or enclosed herein, you, of course, have only to let me know.

First, I have enclosed a copy of the Recommendation of the Administrative Conference of the United States which is entitled "Recommendation 72–8: Adverse Actions Against Federal Employees." This relatively brief document consists of the recommendations made by the Conference to this Commission on the procedural changes which it considers desirable to ensure that the processing of adverse actions is fair and expeditious and not unduly expensive.

Closely related to the Conference recommendation is the report of the Conference Consultant, Professor Richard Merrill of the University of Virginia Law School, Charlottesville, Virginia. I commend this to you as the best study of our adverse action procedures that I have ever seen. You will note that it is not a sterile piece of legal documentation but a paper which reflects what to me are keen and accurate insights into the operations of the program as it is used by the various contending parties who normally deal with it. Perhaps of greatest importance is the fact that this document was in the hands of each member of the Conference who voted in a plenary session of the Administrative Conference of the United States and approved Recommendation 72–8.

I must confess to having had a good deal of difficulty working out a response to your request for cases which begins at page 94 of the transcript of my testimony. As a kind of *pro forma* response I am attaching two lists of appellate cases. The first is a list composed of 100 employees whose appeals from adverse actions by agencies were sustained by the Commission. You will note that this list is not in alphabetical order but instead is made up in order of date of decision of the Board of Appeals and Review, which, within this Commission, is responsible for decision of such cases. The second list, similarly made up, contains identifying data on 100 reduction-in-force appeals in which the employee was sustained. We have not had each case reviewed to see what determination was made on the merits or what the issues in each case were. That would obviously constitute an extensive work project that I would like to avoid. Taken as a random sampling, it is my judgment that any conclusions based merely on such a number of cases drawn from such a narrow period would be relatively worthless as an effective study of our adverse action procedures.

Also, there is no way for you to determine from merely such a sampling of cases the ways in which the Commission "has supported the claims of the Government employee and has moved to assist him in his dispute with the Government." (Tr. p. 94) So let me step back and give you a little background which will help put these matters into the perspective from which I view them.

The work of the Commission consists of literally millions of personnel matters that are generated by maintaining a work force of approximately 2.6 million people in civilian positions. Each year the Commission processes approximately 1.7 million applications for employment, which lead approximately 200,000 new hires. We also facilitate thousands of transfers, reinstatements, and such matters. Nationwide, our offices handled about six million inquiries of many sorts during the past year.

Without going into extensive detail you can appreciate the problems that rise from a work force where individuals are arrayed in groups having different characteristics in terms of rights, benefits, and obligations. For example, approximately 90 percent of this work force is in the competitive service, the balance being in one or another of the subgroups into which the excepted service breaks down. Cutting across such lines of division are rights which flow from being a veteran. Additional special considerations attach depending on level of position, such as the so-called supergrade components. Cutting across many of these groupings are the effects of the classification and pay statutes which have to do with levels of difficulty and responsibility of work and the pay grades applicable to such levels.

The more basic and generalized requirements for the Federal service are laid out for us in the Civil Service Rules which are ordered by the President through power derived in part from the Civil Service Act. Subordinate to, and implementing, these rules (which are found at 5 CFR 1 through 9) are

the regulations of the Civil Service Commission which cover about 350 pages and constitute the principal balance of title 5 of the Code of Federal Regulations. These regulations cover the detailed implementation of statutes and Executive orders concerning status, veterans preference, the competitive service, the expected service, recruitment, selection, reductions in force, training, performance evaluation, incentive awards, pay administration, leave, suitability, political activity (Hatch Act), ethics and conduct, adverse actions, retirement, life insurance, and health benefits.

With respect to each of these areas, the central and field offices of the Commission are under constant bombardment by employees and agencies who desire advice and assistance concerning what are sometimes problems and sometimes outright complaints. Some of these are received in letter form, but many are not. Many, if not most, of them are matters which are resolved satisfactorily without any permanent record. It is thus virtually impossible to maintain a statistical box score which will reflect the handling of all of these matters *en gross.*

No one in the Commission is immune to the handling of such matters, and they reach the Commissioners as well as employees on the general staff. Our reaction to such requests in whatever form received is probably similar to the reaction your staff makes when your office is approached by its constituents. We first try to determine whether it is a matter that is at all within our jurisdiction. If it is, we then attempt to determine, usually directly from the agency in which the problem arose, a decently rounded view of precisely what occurred. If the matter can be informally resolved, we seek its resolution. If it cannot be informally resolved and is subject to an established appeal or grievance procedure, we advise the employee accordingly. If the employee's complaint indicates that there may have been a violation of civil service regulations, we make sufficient inquiry to establish those facts.. We do not invariably rely on any statement of facts received from either the employee or the agency but use our own judgment as to whether the situation requires that we send our own staff into the agency to investigate the matter.

In this fashion, we use our good offices and the authority we have to resolve all manner of problems. In situations where the facts establish a violation of regulations where we have the statutory power to direct that appropriate corrective action be taken, we issue such directions. We are sometimes brought into a matter before an improper action occurs when the employee knows that the improper action is threatened, and we have acted many times with such effectiveness as to prevent the action being taken at all. This may occur when we believe an action would violate law or our regulations, or merely when an action would violate our notions of what is called for by good personnel management practice. Upon occasion, an agency may disagree with our view of the situation, and decide to take an action which we think unwarranted. If it is of a kind where we have no authority to direct corrective action, we still advise the employee of whatever appeal rights are available and some of these matters come to the Commission in the appellate cases we handle. In that area there is no doubt that we have the power to direct action and to restore employees who have unwarrantably been made the subject of adverse action.

I do not mean to suggest by this recitation that the Commission plays the role of "good guy" and the agency "bad guy" in the working-out of these problems. Obviously, with a work force as large as ours and a set of regulatory and other materials of undoubted complexity, one should expect to find differing understandings of the rights, benefits, and obligations of both employees and agencies. Our focus is on constant improvement and simplification of the process in a systemic way so that managers and subordinate employees alike will understand both their rights and obligations—all to the end of seeing that people in the system are treated decently and the effective management of personnel will accomplish Government missions as efficiently and effectively as possible. In that march we do a lot better today, in my judgment, than we have ever done before. No one need tell us that our task has not been completed. Given the shifts and changes that take place in society generally, and in Government operations specifically, the task is one which will never end and which will require eternal vigilance.

We think that as a result of processing these many variety of problems and complaints, both formally and informally, we gain far greater therapeutic

effect than one would anticipate would arise from handling of any specific case. For example, in my own office I receive requests for assistance with respect to which I communicate with the General Counsel of another agency since I ordinarily feel more comfortable dealing with him than with the managers or even the personnel directors of other agencies. Whatever the situation that has caused me to call him, its resolution depends on that General Counsel offering advice, usually to a high-level agency manager or personnelist, which sets a pattern for future agency activity in the same area. My office fields a good many matters of this kind in which members of my staff and I have occasion to call counterparts in other agencies. But I generally see problems of a miscellaneous nature which do not seem to fit within anyone else's particular jurisdiction. The fact is that the major Bureaus and offices within this Commission which have special competence to deal with particular matters (such as pay, leave, retirement, etc.) get far more business of this kind than I do. Also, a few years ago in order to assure ourselves that we had an adequate "feel" for the kinds of problems that were troubling employees and which they might think did not fit within the jurisdictional boundaries of one or another Bureau or office of this Commission, we announced the opening of an Office of Complaints in the central office of the Commission so that anyone in this geographic area would have an avenue of complaint open to him. I enclose for your review a copy of the annual report of the Office of Complaints covering the period July 1, 1971 through June 30, 1972 which reflects the nature of complaints received, the manner of receipt (telephone, visit, letter) and a chart breaking down the number and types of complaints by agency and manner of reception. We also receive many requests for assistance from Members of Congress which we treat in the manner I have described above.

Your letter dated January 24, 1973 to Chairman Hampton raised the question whether sanctions exist against persons who violate the rights of Government employees. They certainly do. Even in the simplest case of one employee assaulting another while on the worksite, there is no doubt that the assaulting employee can be disciplined. In the situation where a supervisor violates the rights of those who are subordinate to him, that supervisor may be disciplined. In addition, without regarding the matter as at all involving discipline, it should certainly be a matter of managerial concern that a given supervisor is violating his subordinates' rights. If this is characteristic of his supervisory efforts, the ordinary routines concerning the evaluation of his performance as a supervisor should result in counseling, training (if necessary), and ultimately either reassignment or discipline if the other measures do not result in improvement of performance. Such a person would apparently not be a useful supervisor no matter how good he might be as a technician in a particular subject matter.

Obviously you have a much more difficult problem when a supervisor's performance is not so clearly bad as just described. Take the case, for example, of a good supervisory technician or a good supervisory professional who holds a pre-eminent position as a subject-matter specialist and only occasionally is given to managerial lapses of varying degrees of severity in their impact upon his subordinates. While the counseling-training-reassignment-discipline process may be useful even with respect to such an individual, the working-out of what should be done with respect to him is principally a mission-oriented managerial concern. The ordinary role of the Civil Service Commission in such matters is one of inquiry and monitorship in cases brought to our attention; and it is difficult, if not impossible, to make the case for absolute direction by the Commission, that is to say, that the Commission should be empowered to substitute its judgment for the judgment of agency managers in all such matters. Our oversight role is effective on matters in which we have competence and some authority. There is some parallel here to Congressional oversight which generally works best when it is done through committees which have adequate knowledge of specific agency operations or which have appropriation power over an agency's budget. Perhaps all I am suggesting is that accountability and authority should go hand in hand, whether you deal directly with agency operations or with oversight of those operations. As I indicated in my testimony Congress seems to have had such considerations in mind when you examine the care with which it has delineated those areas in which its grants of authority permit this Commission to have

directory power over agency personnel relationships—such as in the adverse action area covered by the Veterans Preference Act.

We have thus far noted problem areas of significance about which few people complain, but which are basic to the system, ordinarily because they touch on constitutional issues. The courts are faced with these problems, and as you can appreciate, it takes only a single complainant to bring such a matter before a court. What I have in mind are questions related to Government employment, such as suitability in terms of personal or behavioral characteristics, restrictions on political activity, and the identification of Federal employees with various forms and subjects of protest and dissent. These are all areas in which the adequacy of former solutions is under heavy challenge, and we grapple with them in the hope of discovering more acceptable current accommodations which also make sense in the personnel management milieu. I mention these matters because you have raised with me a specific problem which is narrower than those I have mentioned when it is viewed from the vantage point of the Bill of Rights, but broad when viewed in the separation of powers context you seem to put it in.

I refer, of course, to your request for cases where we have supported the right of a Government employee to answer questions before the Congress or to speak critically about any government practices (Tr. p. 100), and to your letter dated January 24, 1973 requesting to known whether any of the Commission's rules and regulations refer or apply specifically to the Federal statute, 18 U. S. C. 1505, in the general area of the rights of employees as Congressional withnesses. In responding to this set of questions I note that your letter speaks of "repeated violations of the Federal law protecting the rights of Congressional witnesses." When you approached this same question while I was testifying you spoke of the "many instances where they have made statements that their bosses feel are indiscreet," (Tr. p. 101), and I began to put to you the burden of citing cases that you knew about of this kind. My difficulty with responding to this line of questioning is that I do not know the cases which you know. Certainly you have been treating the Fitzgerald and Rule cases as fitting that mold, but beyond those two, I wonder about the existence of "many others.

If you wish to hold this Commission responsible for doing something, or alternatively, failing to do something, the minimum requirement is that we be permitted to know about the case. I therefore offer you what the Commission has offered to the various Members of Congress who have had occasion to deal with us with respect to specific cases. Identify the case to us and we will make inquiry into the facts and report back to you with respect both to those facts and to whatever responsibility the Commission has for action.

On the merits of the question which underlies discussion of such cases there are a number of ingredients that have to be taken into account. 5 U.S.C. 7102 constitutes Congressional implementation of the First Amendment "right of employees, individually or collectively, to Petition Congress or a Member of Congress, or to furnish information to either House of Congress, or to a committee or Member thereof,". That section concludes that the right so described "may not be interfered with or denied." This says nothing of course about whether individuals are free to fulfill those rights through the median of being witnesses before Congressional committees.

The area of First Amendment rights of Federal employees is complex. To assist you in knowing some of the considerations we have had in mind in dealing with the impact of the First Amendment on personnel management affairs, I have enclosed a copy of each of two articles. Each appeared in the Civil Service Journal. The first was written by me, and the second by William H. Rehnquist when he was an Assistant Attorney General in the Department of Justice. They contain discussion and citation of the cases I promised your staff I would furnish.

It is worth noting that at least one element of the problem you are analyzing is not mentioned in these articles; and that is the question of the effect, on one's rights, of the fact that he acts or appears to act in a representative capacity—as do many witnesses who appear before Congressional committees. The legal profession has relatively fixed notions about the burdens which can be properly placed upon those who represent others, many of which are crystallized in its Code of Professional Conduct. And Congress itself has accepted certain principles concerning representation in the restrictions incorporated in

the conflict of interest provisions of the criminal code. I cannot presume to suggest how this feature bears on the matter concerning Mr. Rule, but I note that the capacity in which he appeared before you at an earlier time than the day I appeared was apparently a matter of controversy between Mr. Rule and Admiral Kidd. This same matter of representative capacity may bear as well on anyone's appreciation of the terms used in 18 U.S.C. 1505.

Concerning 18 U.S.C. 1505, I understand the Chairman of this Commission has suggested to you in a recent letter that any comment concerning interpretation of that criminal provision or prosecution under it should be sought from the Department of Justice. You asked of us in your letter dated January 24, 1973 whether any of the Commission's rules and regulations refer or apply specifically to that Federal statute. I have found no such references and I know of no regulatory treatment by this Commission of the general matter concerning appearance of Federal employees as witnesses before Congressional committees either as individuals or as representatives of the agencies in which they are employed. Our regulations do contain prohibitions against retaliation or reprisal as to witnesses in agency and Commission proceedings, but not in proceedings before the Congress.

Finally, on your request to know of the private finances of the three Commissioners, I have been asked to furnish you the following information. Their submission of this information has occurred under the program established by Executive Order 11222 which I discussed at pages 89-90 of the transcript. A much fuller statement, furnished in connection with inquiries about Vice Chairman Spain, is found in the enclosed letter to Congressman Jack Brooks dated February 2, 1973. This program has been of great service in the executive branch, and to a large extent its effectiveness is a result of the complete candor which has been prompted by its promised confidentiality. The aim of the program is to avoid conflicts or the appearance of conflicts by the advance consultation which prevents their occurrence. And section 405 of the Executive order states that the financial statements required to be filed under the Order "shall be held in confidence" and not be disclosed except "for good cause shown."

The Commissioners are anxious to avoid taking action which might be regarded as a signal that confidence will not attach to the submission of financial statements either to he Chairman of the Civil Service Commission by Presidential appointees, or to agency heads by their subordinates. They are also aware that as a result of disclosure of Mrs. Spain's recent voluntary disqualification from a single matter there has been public discussion of the desirability of restricting the Commissioners, and perhaps other officials, in their capacity to earn income outside of their Federal salaries. On this question, with respect to which they are unaware of any specific Administration position, they feel they have obligations to other Committees of the Congress within the jurisdiction of which such matters principally lie, and they are not disposed to predetermine or distort the effectiveness of any subsequent inquiry by such Committees.

Since I was unable from your brief request to inform them acceptably of what legislative or other purpose it was intended to serve, and because such disclosures involve what are essentially private personal matters, they have asked me to convey their declination to you, subject, of course, to reconsideration when they know more about it.

Sincerely yours,

ANTHONY L. MONDELLO,
General Counsel.

Enclosures.

RECOMMENDATION 72-8: ADVERSE ACTIONS AGAINST FEDERAL EMPLOYEES—ADOPTED DECEMBER 15, 1972

A critical part of the mission of the Administrative Conference is to study the processes of government to assure the full protection of the rights of private citizens, including the rights of federal employees. At the same time, the Conference is equally concerned about assisting government agencies to devise and implement efficient administrative procedures that will facilitate accomplishment of their varied programs.

The Civil Service Commission and other government agencies each year conduct a large number of formal personnel action proceedings that involve charges of personal misconduct, poor job performance, or other behavior which reflects adversely on the individual employee. Each year several thousand adverse personnel action appeals are decided throughout the Government; the Civil Service Commission alone adjudicates well over 1200 appeals annually. The nature of these cases and the size of the caseload make it imperative both that proceedings be conducted with scrupulous fairness, and that procedures be neither too costly nor time-consuming. While existing adverse action procedures have attempted to meet these objectives, the Conference believes that implementation of this recommendation will yield substantial improvements in many highly significant respects.

This recommendation is intended to apply only to those classes of federal civilian employment currently entitled to adverse action procedures, as identified in Subchapter S2 of Federal Personnel Manual Supplement 752–1.

A. DEFINITIONS AND STANDARDS

1. *Adverse Action.*—In all cases in which an employing agency takes a personnel action adversely affecting an employee on the basis of his conduct or performance, the employee should be afforded an opportunity for an evidentiary hearing and his case should be decided on the basis of the record made at the hearing.

Such procedures are inappropriate, however, for use in situations in which an agency action made on the basis of broad managerial considerations of agency structure or resource allocation (*e.g.*, change in job classification, reduction in force) has incidental adverse effects on certain agency employees. The Civil Service Commission should seek legislation redefining the category of "adverse action" to exclude therefrom personnel actions not based on the individual employee's conduct or performance. However, in any proceeding to effect a personnel action assertedly based on managerial considerations, the employee should retain the right to challenge the bona fides of the agency's action.

2. *Efficiency of the Service.*—The Civil Service Commission should publish regulations or interpretive rules elaborating in as much detail as practicable the statutory standard of "efficiency of the service."

B. PROCEDURES FOR AGENCY HEARINGS

1. All employing agencies should establish procedures for personally advising an employee who has received a letter of proposed adverse action about the consequences of the action proposed and the procedures available for contesting it, which should continue to include the right to respond to the employing agency's charges prior to an evidentiary hearing.

2. An employee against whom an adverse action is proposed should have an opportunity for a prompt evidentiary hearing before the action becomes effective. However, if the employing agency determines that retention of the employee in his current duty assignment will adversely affect the ability of his office or installation to perform its functions, the employing agency should be able, pending its final decision (a) to reassign the employee; (b) to place the employee on administrative leave with pay; and (c) if, for a cause attributable to the employee, the hearing is not commenced within 30 days after the agency notifies him of its readiness to proceed or has not resulted in a final agency decision within 60 days after such notification, to place the employee on leave without pay.

3. Except in extremely rare cases where an employing agency can establish good cause for keeping the hearing closed, an employee subject to adverse action should have a right to elect a hearing that is open to the public. An employee is entitled to a private hearing, however, at which he may be accompanied by an observer of his choosing, in addition to any representative. This recommendation is not intended to limit the hearing officer's traditional authority to exclude other witnesses during the taking of testimony, or to maintain order and decorum.

4. The Civil Service Commission should assign the hearing officers to conduct hearings before employing agencies. A hearing officer should be suitably equipped

by training and experience to conduct such personnel hearings, and, unless he is an administrative law judge, should not be an employee of the charging agency. Ordinarily, hearing officers should be drawn from a pool established and employed by the Civil Service Commission, but when appropriate the Commission should be able to assign as hearing officers other persons with the prescribed qualifications.

5. Civil Service Commission regulations should make clear that at any hearing the employing agency has both the burden of coming forward with evidence and the burden of persuasion.

6. The hearing officer should use a pre-hearing conference or other means to identify and limit the hearing to the trial of material issues of fact as to which the parties genuinely disagree. The hearing officer should also be authorized to resolve summarily those material issues of fact as to which he is satisfied there is no genuine disagreement.

7. The hearing officer should be authorized to order an employing agency to produce witnesses in its employ or documentary evidence that he believes may be relevant to an employee's case. He should be free to call witnesses himself, to question witnesses for both parties, and to provide guidance to employees who are not represented. With the completion of the hearing, the evidentiary record should be considered closed for purposes of the employing agency's decision and any appeal by the employee to the Civil Service Commission.

8. The hearing officer should make factual findings and prepare a proposed decision, which would be submitted to the official designated by the employing agency to make the agency decision and made available to the parties along with the transcript of the hearing. The parties should have an opportunity (*e.g.*, ten days) in which to submit written argument, including objections to the proposed decision, to the deciding agency official. If the deciding official does not accept the hearing officer's proposed decision, he should prepare a formal agency decision that, among other things, states specifically the reasons for rejecting the hearing officer's findings or recommended disposition. The employing agency should be able to make its personnel action fully effective upon the issuance of its decision, and any subsequent appeal should not have the effect of postponing such effectiveness unless the employing agency otherwise directs.

C. PROCEDURE FOR APPEALS FROM AGENCY DECISIONS

1. Employing agency appeals systems, apart from that required by paragraph B(8) (*i.e.*, a final agency decision following the hearing at a level higher than that proposing the action) should be abolished.

2. An employee against whom adverse action is taken should have an opportunity for a single appeal outside his agency, to a central appellate authority within the Civil Service Commission.

3. The Civil Service Commission's appellate authority should customarily be limited in its review to the record compiled at the employing agency. Upon the motion of an employee, however, the authority should be able to admit, or remand to the hearing officer for the admission of, evidence that the employee could not reasonably have produced at the original hearing, subject to the employing agency's right to respond or rebut.

4. The Commission's appellate authority should have authority to affirm, or to reverse, or to modify the employing agency's disciplinary action in any appeal.

5. The Commission's appellate authority should assign cases for decision by lot or by rotation so far as practicable, and permit announcement of dissenting and concurring views.

6. The Civil Service Commissioners should retain discretionary authority to reopen and decide exceptional cases upon the petition of either the employing agency or the employee.

7. Employing agency and Commission decisions in adverse action cases should be publicly available after minimum editing necessary to protect employee privacy.

D. EX PARTE COMMUNICATIONS

1. (a) At no time should officials of the Civil Service Commission who participate in or are responsible for the disposition of employee appeals provide advice to either party or to the hearing officer on the initiation, processing, or disposition of any adverse action.

(b) Other Civil Service Commission officials should not advise or consult with either party, or their representatives, regarding the merits of any case that has been formalized by the issuance of a letter of proposed adverse action.

2. Hearing officers who conduct agency hearings and Civil Service Commission officials who participate in or are responsible for deciding employee appeals should be free from all *ex parte* influence or advice—including communications from employing agencies, employee representatives, and other Commission employees—relating to the factual issues or appropriate disposition of any adverse action or appeal. Expert professional advice on the facts or disposition of a case (such as the evaluation of a job classification specialist) should only be received on the record, subject to the right of both parties to respond.

E. ROLE OF THE CIVIL SERVICE COMMISSION

With the additional safeguards of the independence of the Civil Service Commission's appellate authority, proposed under C and D, above, it is not necessary to establish a new, independent agency to adjudicate adverse action appeals.

F. EFFECT ON EMPLOYEE GRIEVANCE PROCEDURES

The provisions of this recommendation are not intended to supplant or preclude provision for employee grievance procedures in existing or future collective bargaining agreements.

COMMITTEE ON AGENCY ORGANIZATION AND PERSONNEL—PROCEDURES FOR EFFECTING AND ADJUDICATING ADVERSE ACTIONS AGAINST FEDERAL EMPLOYEES

By Richard A. Merril, Professor of Law, University of Virginia School of Law

This report was prepared to support recommendations of the Committee on Agency Organization and Personnel of the Administrative Conference of the United States. It represents only the views of its author. The recommendations it supports have been approved by the Committee, but neither the report nor the recommendations have been considered by the Administrative Conference of the United States.

ACKNOWLEDGMENTS

No serious study of any facet of the administrative process could be completed without aid and cooperation from participants and many others. I am deeply in the debt of Anthony Mondello, General Counsel of the U.S. Civil Service Commission, who made certain that no doors in that agency were closed to me. I also owe special appreciation to John Murtha, of the Commission's staff, who has provided help and advice and generously shared the statistical data and other information produced by the Commission's own study of the Adverse Action Process. Neither of them, however, should be blamed for any errors in this report, or taxed with its conclusions, for both of which I assume full responsibility.

At the invitation of Roger Cramston, former Chairman of the Conference, I have made use of his notes for a study of judicial review of adverse actions. In addition, I have borrowed heavily from the excellent staff report on that subject by John Trezise, a 1971 graduate of the University of Michigan Law School, which was prepared under the supervision of the then-Chairman as an aid to further study and discussion.

Finally, I owe thanks to two members of the 1973 class of the University of Virginia School of Law, Earl Collier and Cameron Smith, who provided valuable assistance in preparing this report.

RICHARD A. MERRILL.

I. INTRODUCTION

Since its birth in 1833, the federal civil service system has developed into a modern and viable personnel service.[1] In 1883, competitive service protection extended to only 14,000 employees, just over 10 percent of the total federal payroll. Today approximately 2.5 million employees—more than 85 percent of

a now vastly larger federal workforce—are within the competitive service.[2] Originally, the duties of the Civil Service Commission consisted largely of screening applicants for federal employment,[3] but in the intervening years the Commission's jurisdiction has expanded greatly.[4] Its principal responsibilities involve affirmative aspects of personnel management. The Commission now supervises a system of position classification and administers federal pay scales and operates both a recruitment program and a pension system and oversees many employee training operations. Policies and procedures for probation, transfers, promotions, attendance, leave and relations with employee organizations are also part of its job. In addition, the Civil Service Commission exercises final authority over the discipline and removal of employees.

Despite the dramatic changes in and improvement of the civil service system, many aspects of federal employment practice have been subject to criticism.[5] Recent controversies have ranged from dispute over the proper role for federal employee unions [6] to the government's response to homosexuality among employees [7] to the extent of official encroachment on the privacy of federal workers. A persistent subject of concern has been the conduct and disposition of employee discharge and discipline cases, or "adverse actions." [8] Technically defined, an "adverse action" is any personnel action in which an employee in the classified service or eligible for veterans preference is removed, furloughed without pay, suspended for more than 30 days, or reduced in rank or pay.[9]

Approximately 93 per cent of the federal civilian workforce—nearly 3 million employees—are potentially subject to "adverse action" and entitled to the procedural safeguards Congress and the Civil Servic Commission have prescribed for such proceedings. Data about the number of adverse actions initiated each year are unreliable.[10] Extrapolating from what is ostensibly a 10 per cent of all adverse actions initiated by government agencies,[11] one obtains estimates of 11,600, 12,700,[12] and 15,700 actions for fiscal years 1969, 1970, and 1971. Each year perhaps one-quarter of these personnel actions are contested by the affected employees, either within their agencies or in appeals to the Civil Service Commission. Reductions in rank or pay, i.e., demotions, account for more than half of all adverse actions. Removals make up the second largest category of actions taken, and amount to well over half of the actions that are contested by employees. Furloughs and suspensions for more than 30 days represent a comparatively insignificant part of the actual caseload.

Adverse actions not only involve several thousand employees in the federal service each year as well as virtually every government agency; with growing frequency federal personnel cases reach court, often with accompanying discussion in the press. Until little more than a decade ago, federal courts were reluctant to play any significant role in supervising administrative decisions adverse to federal employees.[13] Meaningful judicial review of employee dismissals was, for practical purposes, unavailable.[14] Unless presented with allegations of specific violations of statute or regulation, most courts flatly rejected attempts by discharged employees to obtain judicial redress. The due process clause was considered inapplicable to government management decision,[15] and dismissals were routinely upheld on the theory that the hiring and firing of employees was an area of executive discretion [16] or on the closely related theory that government employment is not a right, but a privilege.[17] As late as 1950 in *Bailey* v. *Richardson*,[18] affirmed by an equally divided Supreme Court, the D.C. Circuit Court of Appeals stated that: "In terms the due process clause does not apply to the holding of Government office." [19] And even when employees were ostensibly protected by statute or executive regulation, the courts usually required only paper compliance,[20] and entirely rejected allegations of bad faith [21] and insufficiency of evidence.[22]

However, since the late 1950's the role of the courts in federal personnel disputes has changed dramatically.[23] Although one commentator has argued that *Bailey* v. *Richardson* has never been squarely repudiated,[24] the implication is at best dubious.[25] The companion concepts of employee privilege and management discretion have worn badly,[26] and it is now clear that federal employees are entitled to at least limited due process protections. Rather than rejecting employee complaints of arbitrary or discriminatory action out of hand, the courts have become willing to entertain such suits seriously.[27] The current attitude is reflected in *Norton* v. *Macy*,[28] a decision, like Bailey, from the D.C. Circuit. Reversing the dismissal of a National Aeronautics and Space

Administration employee who had been charged with homosexual conduct, the court stated that "[t]he Government's obigation to accord due process sets at least minimal substantive limits on its prerogative to dismiss it employees: it forbids all dismissals which are arbitrary and capricious." [29] The court have also given increasingly vigilant enforcement effect to statutes and regulations designed to protect employees (which have themselves been considerably expanded). Furthermore, the scope of judicial review of agency judgments in personnel cases is now significantly broader in most federal courts than a decade ago.[30]

A. The Nature of the Process

Both government managers and employee representatives are accustomed to distinguishing between two stages of what this report refers to as "the adverse action process." To insiders, "adverse action procedures" are those an agency must observe in effecting a decision to remove or discipline an employee. Described more fully in Part III of this report, these procedures consist essentially of notice of proposed action; an opportunity for the employee to reply orally and/or in writing, ordinarily within 15 days; and the agency's decision which may become effective 30 days after issuance of the notice. The procedures for taking adverse action thus do not include any opportunity for a trial-type hearing, presentation of witnesses, or confrontation and cross-examination, or provide any mechanism for appellate review. The second stage of the process is the more elaborate, more protracted "appeals process," in which the burden is on the employee to initiate review. An employee who appeals from the employing agency's action has an opportunity for one and possibly two trial-type hearings, and may obtain review of the agency's adverse decision at as many as three different administrative levels.

This report treats the two stages as parts of a single process. Because the procedures for effecting adverse personnel actions are comparatively expeditious and afford employees very meager protection against unjust action,[31] the appeals process is really the tail that wags the dog. The appeals process is the heart of the procedures for implementing removals and effecting discipline. It consumes most of the time required for decision and simultaneously provides the significant protections available to employees. Moreover, it is in the appeals procedures that the competing interests of management and employes conflict most sharply.

The visible portion of the adverse action process—the appeals process—is already highly adversary in character, notwithstanding government supervisors who prefer to emphasize its informal, administrative features.[32] The charges against an employee typically allege conduct that reflects adversely on his character or integrity. Relatively few cases deal with an employee's *ability* to do the work. Charges that are performance-related are more likely to focus on an employee's attendance record or his ability to work with others. The most common charge is "misconduct," which ranges from destruction of government property, to failure to pay creditors, to the commission of a criminal offense.

Ordinarily, by the time an employing agency decides to initiate removal proceedings, the relationship between supervisor and employee has deteriorated so badly that accommodation is not possible. Feelings run high on both sides. Although the employee may initially view the matter as a misunderstanding, once he contests the agency's action he no longer believes that the dispute can be resolved amicably. Thus it is not surprising that the system for handling such cases has evolved into a process of adjudication in which, more often than not, both sides are represented. Moreover, because employees usually lose,[33] and because compromise is difficult when an agency wants an employee removed, the process is not conducive to settlement.

The reader should be cautioned, however, that this description of the process is drawn largely from contested adverse actions. Most of our information comes from cases in which employees sought review of actions against them, thus bringing into play the adjudicatory procedures of the appeals process. We have only a general idea of what proportion of employees against whom action is initiated appeal, and very little information about unappealed cases. We do not know, for example, how many involve charges of misconduct, rather than inefficiency, or are directed against low-ranking employees. We only know that the majority of disciplinary actions do not now become "cases" at all. The

failure of so many employees to appeal could indicate that they do not dispute the charges against them or the penalty imposed. With so little information about these actions, however, it is hazardous to draw any inferences.

Another characteristic of adverse actions should be noted. Unlike other adjudicatory systems, the adverse action process involves adversaries who have been, and for some time will continue to be, in close proximity. Supervisor and employee have had time to cultivate their resentments, increasing the possibility that emotion rather than judgment may influence an employee's conduct or his supervisor's decision to initiate action. Such hostility may make it more difficult to retain an employee on the job during disposition of his case than, for example, to permit the continued operation of a motor carrier charged with exceeding its certificated authority.

Finally, one must acknowledge what seems to be an accepted, if regrettable, fact of life: Removal from government employment for cause carries a stigma that is probably impossible to outlive. Agency personnel officers are generally prepared to concede, as employee spokesmen claim, that it is difficult for the fired government worker to find employment in the private sector. The impression that it is difficult to fire government employees is widely shared—perhaps itself a product of the procedures that must be observed—and contributes to the belief that anyone who gets fired by the government is probably unemployable. This may exaggerate the consequences of removal. The acquiescence of so many employees suggests that alternative employment may not be impossible to find. One cannot escape the conclusion, however, that the government employee who is removed from his job loses something of tremendous value that in a market of declining demand for many skills may not be replaceable.

Three major charges have been leveled at the existing administrative system for processing adverse actions. The first is that it permits employees to be disciplined or removed on the basis of illegitimate and unsubstantiated charges. Second, it is claimed that the system embodies insufficient safeguards against unfairness and thus fails to command the confidence of employees. Finally, the accusation is made that system is complicated, duplicative, and takes too long to dispose of cases.

Although one encounters cases in which the government's action seems wrong on both procedural and substantive grounds, I am not persuaded that the adverse action process regularly *produces* unfair results. "The Spoiled System," the recent Nader Task Force study of the Civil Service Commission,[34] describes several examples of outrageous government action against employees, from which the author apparently infers that most employees are mistreated. I do not. The data we have assembled do not betray any systematic unfairness that the suspicious critic might expect to find: not young, or low-ranking, or female employees, not even those without representation seem to fare worse (or better) than employees generally.[35] The fact that employees usually fail to upset the action against them by itself neither confirms nor rebuts the integrity of the process.[36]

Neither, however, do the data establish that justice is rarely miscarried. The system lacks many features that would substantially reduce the risk of arbirariness and thereby support confidence that employees are likely to be treated fairly. The opinions of persons who are involved in the process, as one might expect, are largely determined by the role each plays. Lawyers who represent employees, union spokesmen, and former appellants believe the system inadequate to ensure fair decisions—and can cite examples to support their impressions. Agency personnel officers, government lawyers, and those who bear decisional responsibility in the Civil Service Commission defend its integrity, and point to the infrequency with which management decisions are upset in court.[37]

Notwithstanding the confidence of government managers, the adverse action system possesses an uncanny capacity to generate suspicion, and not only among employees or those who represent them. A principal cause of this "image" problem has been the secrecy shrouding the disposition of individual cases. Cases that reach court after involve sympathetic employees whose claims depict the process at its worst. Cases in which employees are removed for blatant inefficiency, or demonstrable incapality to get along with fellow workers, or unquestioned disregard for public property rarely surface. External observers have thus come to judge the process by cases that *probably* are not representative. However, self-righteous assertions that such cases are the exceptions, and

that the vast majority of adverse actions are properly initiated and fairly adjudicated cannot by themselves dispel the suspicion.

There is considerably broader agreement respecting the efficiency of the process, or lack of it. Most participants agree that cases take too long; and very few agency or employee spokesmen are prepared to argue that interminable delay is the price of assuring fairness. But delay there is, most of it at the agency level, although the Commission's processes are no model of expedition. More than 75 per cent of actions contested within employing agencies require longer to decide than the 60 days prescribed by Commission regulations. More than 50 per cent take more than three months, and 5 per cent are in process for longer than a year! If an employee appears beyond his agency, another two months will elapse at one of the Commission's regional offices, and yet another three months will be required before a final decision from its Board of Appeals and Review. It is important to realize that, in most agencies, the employee is off the rolls throughout the appeals process.[38]

Several factors contribute to this delay. There is a striking correlation between employee representation, whether by an attorney or union, and the time required for decision. Cases in which hearings are held routinely take longer, principally because of scheduling difficulties, not because the hearings are protracted. The potential availability of three appellate levels and the opportunity for a second hearing at the Commissoin manifestly invite delay. Many employing agencies anquish over or ignore appeals for weeks on end, or prolong the process by erecting multiple levels of internal review.

It is hardly surprising that the adverse action process is characterized by uncertainty and delay, or that many observers believe that it is unfair. At the Civil Service Commission cases are handled by officials whose primary responsibililty is to adjudicate appeals. No other department or agency, however, regards the disposition of adverse actions as anything other than an unavoidable incident of operating with a large work force. The process is not a part of, let alone integral to, any agency's primary mission. Employees against whom adverse action is taken, by definition, are obstacles to the accomplishment of that mission, and it is difficult for agencies to be concerned about the fairness or even efficiency with which they carry out a responsibility they wish they did not have.

The removal or demotion of a government employee involves a clash of competing interests: the interest of the employee in avoiding unfair or groundless action, and that of the employing agency in expeditious decision so it can get on with its primary mission. At a more fundamental level, the employee's interest in retaining his job or rank conflicts with the agency's desire to get the best performance from its workforce. The public shares ambivalent interests, on the one hand, in efficient and economical operation of government programs and, on the other, in fair and decent government treatment of private interests. It probably is impossible fully to protect any of these interests without jeopardizing the others. A system that guaranteed no employee would ever be deprived of his job because of some supervisor's malice would be too costly for the government to run or taxpayers to support. On the other hand, a system that allowed agency managers to implement disciplinary action immediately whenever, in their judgment, the needs of the agency required it would unjustly deprive many competent and dedicated civil servants of their jobs or benefits.

Any system for processing adverse personnel actions must necessarily seek a compromise between these competing interests. The recommendations supported by this report are precisely that, an attempt to achieve a balance between expeditious procedures and fairness to employees.[39] The recommendations rest on the central finding that the present system is complicated and inefficient and lacks essential safeguards of fairness. Because the competing interests are not easily reconciled, the recommendations may reflect a certain ambivalence. Nonetheless, if approved by the Conference and adopted by the Civil Service Commission and employing agencies, they would facilitate fairer as well as faster disposition of contested adverse actions.

II. METHOD AND SCOPE OF STUDY

A. *Sources and Statistical Data*

The Committee's recommendations and this supporting report are based on information obtained primarily from four sources: (1) interviews with persons involved in or familiar with the adverse action process, both in government and

out; (2) formal comments on reforms of the process submitted to the Civil Service Commission by employing agencies, employee unions, and other interested organizations in March and April of 1972, and in 1969, when the Commission was recently considering and eventually adopted several changes; (3) personal observations of the process in operation, including study of the files of more than fifty adverse action cases appealed to the Civil Service Commission; and (4) statistical data assembles from cases adjudicated in fiscal year 1970 by both employing agencies and the Civil Service Commission. In addition, of course, published and otherwise available secondary sources have been consulted.

Although the statistical data do not provide the primary basis for the recommendations, a brief statement about their source and limitations is in order. The data cover only contested adverse actions, i.e., actions that were appealed by the employees, and do not necessarily support any inferences about the universe of disciplined or removed employees who did not appeal. Available information about this larger group, as noted earlier, is based upon a 10 per cent sample of personnel actions retained by the Civil Service Commission, as well as the personal experience of participants.

A further caveat is in order. In assembling data about fiscal year 1970, employing agencies and the Commission's regional offices were asked to prepare case reports on all adverse action appeals they adjudicated during that year. The total number of reports received (over 1500), however, fell short of the total of adjudicated appeals previously reported; the disparity ran as high as 20 per cent in some agencies. The principal reason for this shortfall was the transfer of case files by agencies and regional offices in connection with remands and further appeals, employee reassignments, and for storage. The case reports received—605 from employing agencies and 899 from the Commission's regional offices—are believed to be a representative sampling of cases decided during 1970.[1] We have no reason to suspect that the under-reporting significantly distorts the picture of appellate activities at either level.

Finally, it should be noted that the employing agencies and Commission regional offices were asked to provide only information they were known to have available about individual cases. The Civil Service Commission for several years has required each employing agency and regional office to submit an annual report about the appeals it decided. Each agency and regional office had thus previously reported its appeals caseload for fiscal year 1970, including composite data about employee sex, age, grade, and representation, hearings, average time in process, and outcome. For this study and for the Commission's own current study of adverse actions, the agencies and regional offices supplied essentially the same information on a case-by-case basis. The attached case report form indicates the range of information provided.

B. *Scope and Assumptions of the Report*

The report makes a number of assumptions about the adverse action process. It also avoids discussion of several important related issues, whose resolution is beyond the scope of this study or outside the proper competence of the Administrative Conference.

1. *Postal Service.*—The United States Postal Service has not provided information or data for this study, although appeals from Post Office employees are included among the cases for which reports were submitted by the Commission's regional offices. The recommendations proposed below are not intended necessarily to apply to it.

2. *Criteria for adverse action.*—The report does not squarely address the difficult question of what employee conduct or performance should be grounds for discipline or removal. It is not intended to support any inference respecting the legitimacy of particular behavior as a basis for adverse action, or to explore the delicate relationship between management needs and employee privacy. These are troublesome issues that deserve in-depth study, but they are essentially beyond the scope of this report.

The report assumes that the government may legitimately discipline or remove employees for performance or conduct that undermines its ability to carry out its functions. In addition, the report begins with the tentative conclusion—based on available data—that most adverse actions are initiated for reasons that, if true, would be a legitimate basis for some disciplinary action. The recommendations for assuring fair truth-determining procedures, however, would make it easier for an employee to raise the legitimacy question, and thus in the long run might facilitate resolution of that issue as well.

CASE WORKSHEET

SURVEY OF ADVERSE ACTION APPEALS DECIDED IN FY 1970

1. Name of Appellant (Last, First, Middle Initial) CC-1-25 (Print in Full)				2. Agency Identification CC26-29	
3. Grade CC 30-31	Pay Plan CC 32-33	Series CC 34-38	4. Veteran Preference (Circle) 1–None 2–5 Pt 3–10 Pt CC-39	5. Sex (Circle) M F CC 40	6. Yr. of Birth CC 41-42
7. Service Comp. Yr. CC 43-44					

8. CSC Region of Duty Location: (Circle)
1. Atlanta
2. Boston
3. Chicago
4. Dallas
5. Denver
6. New York
7. Philadelphia
8. Seattle
9. San Francisco
10. St. Louis
11. Wash. D.C.
CC 45-46

9. Action Appealed: (Circle)
1. Removal
2. Reduction in Grade or Pay
3. Reassignment Involving Reduction in Rank
4. Suspension For More Than 30 Days
5. Furlough (NTE 30 Days)
CC 47

10. Personnel Action Code
CC 48-50

11. Reason For Action (Circle)
1. On-Duty Misconduct
2. Off-Duty Misconduct
3. Declination of Relocation or Assignment
4. Inefficiency
5. Disability
6. Position Reclassification
7. Pre-Appointment Factors
8. Other
CC 51

12. Representation (Circle)
1. Self
2. Private Attorney
3. Labor Union
4. Veterans Organization
5. Other Person or Organization
CC 52

13. Hearing Held (Circle)
1. Yes
2. No
CC 53

14. Decision on Appeal (Circle)
1. Action Upheld
2. Reversed on Merits
3. Reversed on Procedures
4. Modified on Merits
5. Other
CC 54

15. Days in Process
CC 55-57

16. Further Appeal (Circle)
1. None
2. To Agency (This Entry Applicable Only To Agencies With Two-Level Appeals Systems.) (If Circled Complete Block 17).
3. To CSC First Appellate Level. (If Circled Complete Block 18).
CC 58

17. Decision on Further Appeal To Agency (Circle)
1. Initial Decision Sustained
2. Initial Decision Reversed on Merits
3. Initial Decision Reversed on Procedures
4. Initial Decision Modifed on Merits
5. Case Remanded To First Level
6. Pending or In Process
CC 59

18. Decision on Further Appeal To CSC (Circle)
1. Initial Decision Sustained
2. Initial Decision Reversed on Merits
3. Initial Decision Reversed on Procedures
4. Initial Decision Modified on Merits
5. Case Remanded To First Level
6. Pending or In Process
CC 60

(SEE REVERSE FOR INSTRUCTIONS) PD 5 JANUARY 1972

Instructions for Completion of Worksheet

General: One copy of this form is to be completed for each adverse action appeal from actions subject to Part 752-B of the Commissions's regulations (see item seven on the form for a listing of the adverse actions included) decided at one or more appellate levels in agencies during fiscal year 1970. This includes decisions on appeals from actions originating prior to FY 1970 so long as the agency decision falls within that year. Do not include appeals cancelled or withdrawn without a decision.

This form may be completed by hand. Typewritten entries are not necessary. Additional instructions on items not self-explanatory are as follows:

Item

1. *Name of Appellant*—Up to 25 letters may be used for this entry. Print last name in full and continue with first name and middle initial up to a maximum of 25 letters. Leave unneeded spaces blank.

2. *Agency Identification*—Enter the assigned 4-digit submitting office number for the organizational element in which the appeal arose, as used in item 33 of SF 50.

3. *Grade*—Self-explanatory. Precede one-digit grades with a zero.

Pay Plan—Enter GS, WG, WS, or PF as appropriate.

Series—Use Classification Act series designation for GS positions, the *Handbook of Blue Collar Occupational Families and Series* for WG and WS positions, and the Postal Service series structure in Chapter E-1 of Handbook P-1 for PF positions. Precede 3- or 4- digit code with a zero or zeroes to fill in the 5-digit field. Leave blank for classification systems other than General Schedule, Wage, or Postal Field Service.

4. *Veteran Preference*—Circle appropriately. Item 5 of SF 50 contains this information.

6. *Year of Birth*—Enter last two digits of year of birth.

7. *Service Computation Year*—Enter last two digits of year of service computation date.

9. *Action Appealed*—Circle appropriate item corresponding to "Nature of Action" terminology in item 12 of SF 50.

10. *Personnel Action Code*—Insert code as used in item 12 of SF 50.

11. *Reason for Action*—Circle appropriate entry. The term "off-duty misconduct" is intended to apply to misconduct not related to the employee's job or work environment, such as failure to pay just debts or conviction for a crime committed off the premises and not associated with his official duties. The term "on-duty misconduct" applies to misconduct occurring in the work environment or related to the employee's duties, such as AWOL, insubordination, accepting bribes, assaulting a co-worker, etc. If the action was taken for a combination of off-duty and on-duty misconduct, count as on-duty misconduct unless the off-duty misconduct was clearly the primary reason for the action.

12. *Reprcsentation*—Circle appropriate item. The term "private attorney" refers to practicing legal counsel retained by or for the appellant. If the appellant is represented by a labor organization or a veterans organization and if that organization supplies an attorney, circle the entry for the organization supplying the attorney.

15. *Days in Process*—Count calendar days from date appeal received until date of first appellate decision. Precede 2-digit numbers with a zero to fill the field if appeal is processed in 99 days or less. If appeal is still pending decision, enter the number of calendar days from date of reecipt to date this worksheet is completed.

16. *Further Appeal*—If item one is circled, no further items on the worksheet need be completed. Item two applies only to agencies with 2-level appeals systems. If item two is circled, continue to field 17, after which the worksheet is completed. If item three is circled in field 16, skip field 17 and go on to field 18 to complete the form.

The report obliquely addresses the criteria for adverse action in one recommendation, which calls on the Civil Service Commission to clarify and amplify the statutory standard of "efficiency of the service." This recommendation, however, is not directed at the substance of that standard but at its vagueness. The objective is to make it easier for employees to know what sort of performance is demanded and what kinds of conduct are forbidden, and to narrow the unfettered discretion the statutory language gives deciding officials.

3. *The tenure classification.*—The report accepts the legitimacy, constitutional and administrative, or *some* distinction between tenured and non-tenured public employees that may justify differences in protections afforded against dismissal. The recommendations are addressed to the procedures the government makes available to tenured employes, i.e., those for whom the Constitution would require maximum safeguards. In the federal civil service, as previously noted, these currently include all non-probationary employees in the classified service and all non-probationary employees in the classified service and all preference-eligibles who have completed one year of service, and comprise well over 90 per cent of the civilian workforce.[2]

The recommendations do not suggest where the line between tenured and other employees [and] should be drawn. That is essentially a matter of sub-

stantive personnel policy beyond the primary competence of the Conference. Possibly the present line should be moved. It is also quite possible that in the long run the Civil Service Commission will be unable to resist pressures to make equivalent protections available to all employees, whether tenured or not. But the constitutional legitimacy of some such distinction at the present time seems incontestable.[3]

4. *Unionization of government employees.*—The increasing strength of public employee unions has put pressure on government to enlarge the scope of collective bargaining. Among the many issues now excluded about which unions would like to bargain, matters of employee discipline and removal rank high. Employee unions derive some support from the present system for processing adverse actions, since they can provide members with representation which may not otherwise be available. Without purporting to describe the views of all unions, however, most would support two fundamental changes: (1) procedures for discipline and removal should be subject to negotiation; and (2) the result of negotiation should be arbitration in place of existing adjudication.[4]

Many observers have reservations about whether arbitration would work in an employment context that involves a third interest, that of the public in efficient operation, which both the parties and outside arbitrators may undervalue. Yet arbitration apparently functions satisfactorily in similar settings in private industry. And it may be well-suited for the settlement of disputes over the appropriate consequences of undisputed behavior, which many adverse actions are. The assertedly lower costs of achieving settlement that may be possible through arbitration may outweigh the costs of retaining inefficient or obstreperous employees who would simply be separated under the present system.

The Administrative Conference should not recommend that binding arbitration be substituted for adjudication, however, although management might wish to consider arbitration as an optional alternative in individual agencies. The Commission probably would not accept arbitration as a mean for processing adverse action without Congressional approval. The Commission's General Counsel has previously taken the position that such action would be an invalid delegation of the Commission's responsibility under the Veterans Preference Act.[5] In any case, arbitration could not be made the exclusive avenue of relief without amendment of the Act's provision entitling all preference-eligibles to a hearing before the Commission on adverse action.[6] Acceptance of arbitration is likely to come, if at all, only as part of larger reforms of the government's policies respecting collective bargaining in the public sector. It is a fair assumption, therefore, that for some time to come employing agencies and the Civil Service Commission will continue to adjudicate contested adverse actions. The proposed recommendations are premised on that assumption.

5. *Judicial review of adverse actions.*—The availability and scope of judicial review of administrative decisions to remove or discipline federal employees are matters of considerable uncertainty and debate.[7] An employee can now obtain court review along two avenues—by suit in a district court or in the Court of Claims—with resulting differences in possible remedies and variations in the scope of factual inquiry. Although recent decisions announce disparate standards for review of agency and Commission decisions, the federal courts display an increasing willingness to scrutinize adverse actions with care, perhaps even with suspicion.[8]

Two major issues involved in judicial review of adverse actions—the route of review and its scope—are closely related to the problems addressed in this report. Their proper resolution depends significantly on the reception given the recommendations made here. If administrative hearing procedures were improved in accordance with the recommendations, one might willingly accept a scheme of review that confined the court to the administrative record. In a very real sense, therefore, the question of judicial review hinges on the issues discussed here. It is beyond the immediate scope of this report and recommendations, but a logical next subject of analysis and resolution.

III. THE ADVERSE ACTION PROCESS IN OPERATION

A. *Historical Development of Adverse Action Protections*

The key protections of federal civil servants against arbitrary removal or discipline are currently found in the Lloyd-LaFollete Act,[1] the Veterans' Prefer-

ence Act,[2] and Executive Order 11491.[3] The Lloyd-LaFollette Act prohibits the removal of an employee in the classified service "except for such cause as will promote the efficiency of the service," [4] and prescribes certain minimal procedural requirements for processing dismissals. Specifically, the act requires that an employee be given advance notice and a written statement of the charges on which his removal is based.[5] The Veterans' Preference Act imposes additional procedural requirements,[6] including the opportunity to respond to charges orally and in writing, and authorizes employee appeals to the Civil Service Commission from adverse agency decisions.[7] The statute, of course, applies only to veterans of military service,[8] but Executive Order 11391 extends its protections to all non-preference eligible employees in the classified service.[9]

Although the civil service concept is today commonly associated with safeguards against removal of the type contained in the Lloyd-LaFollette and Veterans' Preference Acts,[10] these protections are of comparatively recent vintage. The Lloyd-LaFollette Act became law in 1912, but the Veterans' Preference Act—which first prescribed the procedural safeguards necessary effectively to implement the substantive guarantees of the earlier law—was enacted only in 1944. Non-veterans worked largely without procedural protection until 1962 when President Kennedy issued Executive Order 10988, whose provisions have since been incorporated in Executive Order 11491.[11]

As noted earlier,[12] the original civil service law, the Pendleton Act of 1883,[13] dealt primarily with screening of applicants for federal employment. Except for barring removal or other prejudicial action against employees for refusal to contribute to a political party or render other political services, the Pendleton Act afforded no protection against arbitrary demotion or dismissal.[14] It was not until 1897 that any official action was taken to provide across-the-board protection against arbitrary removal.[15] Civil Service Rule 8, promulgated in that year by President McKinley,[16] provided that no employee in the classified service should be removed except for "just cause" and for reasons given in writing. The Rule also required that an employee facing discharge "shall have notice and be furnished a copy of such reasons, and be allowed a reasonable time for personally answering the same in writing." In practice, Rule 8 provided only a shadow of protection. It did not accord employees the right to a hearing or to confrontation, or provide for any external appeal frm agency removals. Moreover, the limited protections the Rule did accord proved unenforceable in the courts. Treating it as a an expression of executive grace that created no legal interest in employees, "the courts declined to take cognizance of this provision and held that punishment for its violation rested solely with the President. . . ." [17]

Shortly after taking office Theodore Roosevelt, a former civil service commissioner,[18] revoked Rule 8.[19] Although the Rule was subsequently revived by President Taft, the executive made no effort to strengthen its provisions.[20] The controversy over Roosevelt's action, however, finally provoked congressional action to protect federal civil servants from arbitrary removal. Apparently fearing that future Chief Executive might again revoke Rule 8, Congress wrote its substance into statutory law in the Lloyd-LaFollette Act.[21]

The Key provision of the Lloyd-LaFollette Act prohibited removal of classified employees from the civil service "except for such cause as will promote the efficiency of the service...." [22] Like Rule 8, the Act also prescribed the minimal requirements of notice, service of a copy of charges, and an opportunity to answer in writing with supporting affidavits.[23] But the Act likewise did not require that an employee facing discharge be accorded a hearing of any kind. Indeed, it expressly provided that "no examinaiton of witnesses nor any trial or hearing shall be required except in the discretion of the officer making the removal." [24] Nor did the statute authorize any appeal outside the employing agency which, as before 1912, retained final authority to remove.[25]

Since the Lloyd-LaFollette Act failed to go much beyond Rule 8's protections against dismissal, one may infer that Congress was generally satisfied with the modest safeguards it had accorded. At least in theory, the Act did strengthen the position of federal civil servants. The adoption of statutory restrictions on the removal power afforded a new opportunity for judicial review of removals alleged to violate these restrictions; and the courts interpreted the Act as granting employees a legal interest in being free from arbitrary dismissal.[26] As has been noted,[27] however, their inclination was to

require no more than pro forma compliance with its provisions. The additional protection accorded employee interests was thus very limited. As late as 1938, an informed commentator concluded that the Act "seeems never to have resulted in a successful effort by an employee to enforce his rights in the courts although employees have repeatedly resorted to litigation." [28]

In retrospect, the early service reformers' lack of concern about potential abuses of the removal power is puzzling.[29] Dismissal of political opponents would seem to be as routine a part of an effective spoils system as the appointment of political cronies. From the very first the civil service laws barred discharges for political reasons, but without broader restrictions on removals and a strong enforcement mechanism, no one could reasonably have believed that political removals would not be effected *sub rosa*. Perhaps early reformers were afraid that more effective restrictions on discharges might hamper removal of incompetent or corrupt workers.[30] An equally plausible explanation was advanced by the Court of Appeals for the District of Columbia in *United States ex rel. Taylor* v. *Taft*:[31] "The entire policy of civil service has been to restrict the power of appointment, not removal, because, once the right to appoint is restricted within certain defined classifications, the reason for political removals has ceased. . . ." [32]

Whatever the reasons for these early failures to curb dismissals, some 30 years elapsed after enactment of Lloyd-LaFollette before the Veterans' Preference Act established significant procedural safeguards against arbitrary removal. Even then, the motivation for the legislation was not high-minded concern over the tenure of civil servants. Veterans returning from World War I had experienced considerable difficulty in resuming their old positions or finding any work at all. Well into the 1930's popular movies depicted veterans forced into lives of crime because of their inability to obtain employment.[33] As World War II drew to a close poltical pressures mounted to avoid a replay of the post-World War I experience. The result was a range of laws designed to ease the transition of veterans back into peacetime society, among them the Veterans' Preference Act.

The Act's primary objective was to accord veterans preferential treatment in civil service hiring and related employment decisions.[34] Almost incidentally, Section 14 added provisions making it more difficult to remove veterans from federal positions.[35] Although it did not guarantee a trial-type hearing at the agency level, Section 14 required the employing agency, at least 30 days in advance, to furnish written notice stating in detail the resasons for a contemplated discharge, and provided that the employee could answer personally, as well as in writing.[36] More significantly, Section 14 authorized a preference eligible employee to appeal his removal to the Civil Service Commission, which we required to investigate, grant a hearing, and submit its findings and recommendations to the agency.[37] A 1948 amendment to the Act required employing agencies to follow the Commission's recommendations, which many had initially regarded as advisory only.[38] The original Act also extended the "efficiency of the service" standard to other major disciplinary actions such as reductions in rank or compensation, which had not been covered by Lloyd-LaFollette, and required that such actions comply with the full range of procedural protection applicable to removal.[39]

B. Current Administrative Procedures For Adverse Actions

To implement the provisions of the Lloyd-LaFollette and Veterans' Preference Act and Executive Order 11491, the Civil Service Commission has promulgated detailed regulations governing procedures for adverse actions.[40] A case may proceed through as many as three major stages: (1) agency procedures prior to "adverse action," often referred to, in the case of removals as separation procedures; (2) administrative appeal from the action within the employing agency; and (3) appeal to the Civil Service Commission. This section describes the process at each of these stages.[41]

Three preliminary observations are necessary. First, the Administrative Procedure Act does not apply to adverse action cases, for section 5 specifically exempts "the selection or tenure of an employee" from the Act's requirements.[42] Second, adverse action procedures in recent years have undergone continuing change.[43] As recently as 1970, the Commission significantly revised these procedures [44] and currently has additional changes under consideration.[45]

Finally, as the following description will make clear, existing procedures are already elaborate and complex, comprising an administrative process that possesses many trademarks of a refined, formal system.

C. Agency Pre-Action Procedures

Employing agencies have traditionally exercised initial jurisdiction in the adverse action area. The Pendleton Act gave the Civil Service Commission appellate jurisdiction only over removals for refusal to pay political assessments.[46] At first, the Commission read this provision as denying it even informal authority to investigate non-political removals,[47] but later gradually assumed an advisory appellate function. Shortly after the promulgation of Rule 8, the Commission requested that agencies file with it copies of the charges on which removals were to be based.[48] Soon the Commission, on an informal basis, began to investigate agency removals for lack of compliance with procedural rules.[49] This investigative function was eventually formalized by the creation of a Division of Investigation and Review,[50] and later of the Board of Appeals and Review,[51] but Commission recommendations regarding removals remained advisory only, as Congress during the 1920's and 1930's persistently ignored its requests for effective appellate authority.[52] The Veterans' Preference Act in 1944 gave statutory sanction to the advisory appellate system,[53] although Commission appellate decisions were not made binding on agencies.[54] Not until 1948 did the Commission acquire authority to compel agencies to reinstate discharged employees.[55]

Despite the increasing role of the Civil Service Commission, employing agencies, as in 1833, have remained the primary repositories of adverse action authority.[56] The decision to initiate an adverse action is entirely the employing agency's. Agency, not Commission, personnel are in charge of procedures for a proposed action and are responsible for deciding initially whether an employee should be separated or disciplined. Once an agency has taken adverse action against an employee, the burden of initiating further review lies with the employee. In removals the employee is usually dropped from the agency's payroll as of the effective date of adverse action or upon receiving notification of the action, whichever occurs last.[57] Thus, an employee who appeals does so on his own time, not the government's. Furthermore, it is only through employees' exercise of their appellate rights that the Commission is brought into the decisional process.

1. *Notice of proposed adverse action.*—When an agency [58] has decided to take action against an employee, ordinarily it must provide him with written notice of the proposed action at least thirty days before it is to become effective.[59] The Commission's regulations require that this notice state the reasons for the proposed action in such detail as will enable the employee to have adequate information on which to base a response.[60] The specifications contained in the notice of proposed charges delimit the grounds on which action can ultimately be taken. Discipline based on other reasons would violate an employee's statutory right to be apprised of the basis for a proposed action.[61]

Prior to November 1, 1970, an agency was not required to make available to an employee in advance of his answer or any hearing the evidence on which it planned to rely to support its action. As a result an employee, although apprised of the charges against him, sometimes found himself unable to rebut the specific details of his employer's case.[62] This failure to require disclosure also made it possible for an agency to act precipitously, without realizing that evidence to support its action simply did not exist.[63] The Commission's 1970 amendments of regulations remedied this deficiency by requiring that material relating to a proposed adverse action be made available for review by the charged employee.[64] Evidence that the agency does not or cannot show to the employee for any reason, such as its allegedly confidential or classified nature, may not be relied upon.[65]

2. *Opportunity to Answer.*—After receiving notice of a proposed adverse action, an employee must be afforded a reasonable time to answer the charges and submit affidavits in his defense.[66] Under the Commission's regulations, what is a reasonable time "depends on the facts and circumstances of the case." [67] Most agencies permit employees at least ten days in which to respond, although the courts have been flexible in interpreting this provision.[68]

An employee may answer either personally, or in writing or, if he chooses, both personally and in writing.[69] The right to reply personally does not, how-

ever, imply that the employee has a right to a trial-type hearing at this stage of the proceeding, for in most agencies he does not. Commission regulations require agencies to afford an employee one opportunity for an evidentiary hearing, but leave them the option of providing the hearing prior to the initial decision or delaying it until the employee appeals from an unfavorable decision.[70] All but nine agencies have chosen the latter alternative, providing a hearing only on appeal. This approach is favored, among other reasons, because a majority of adverse actions are not appealed (or are appealed directly to the Civil Service Commission) and the number of formal agency hearings necessary is ostensibly reduced.[71] In most agences, therefore, an employee's right to reply simply means that he may meet informally with a representative of the agency and advance oral representations that he hopes will sway the final decision.[72] He has no right at this stage to present witnesses or to confront and cross-examine the agency's witnesses.[73] The agency official before whom he appears must be in a position either to make the final decision on whether action should be taken, or at least to recommend what decision should be made.[74] In preparing and making his reply, an employee may have the assistance of counsel, of an union representative, or of another employee or person of his choosing.[75]

During the thirty-day notice period, the employee threatened with adverse action is entitled to remain on active duty unless the agency finds that his presence may result in damage to government property or be detrimental to the interests of the agency.[76] If such danger exists, the employee may be temporarily assigned to other duties.[77] In cases involving imputation of a crime for which imprisonment may be imposed in which retention on active duty is undesirable, the agency may suspend an employee without pay after providing at least twenty-four hours notice. Since such suspension it itself an adverse action, the employee must receive written notice of the reasons, as well as be afforded an opportunity to answer this notice separately.[78] Thus, except in unusual cases, an employee is likely to remain on duty until after the agency has considered his reply and decided against him.[79]

Under the Commission's 1970 revisions of its regulations, an employee may use a reasonable amount of on-duty time to prepare his answer.[80] This provision was added because an employee remaining on active duty was often unable, without using official time, to review documents or discuss his case with individuals readily available only during working hours.[81]

3. *Notice of decision.*—After receiving an employee's answer, and assuming no pre-action hearing is provided, the employing agency must render a "notice of adverse decision" at the earliest practicable date, but not later than the time the action is to become effective.[82] Commission regulations do not specify which agency official must make the decision; nor do they provide standards to guide agencies in assigning that responsibility.[83] It is thus possible, though not usual, that the final decision may be made by the same official who originally brought charges against an employee.[84]

The agency's written notice of adverse decision must inform the employee of the factual grounds found to support the action and advise him of his appeal rights, including the time limits for filing an appeal.[85] Prior to 1970, the final notice had only to discuss those charges relied upon by the agency, even if the notice of proposed action contained additional charges. Thus an employee, although the action against him might ultimately be reversed, could have outstanding allegations concerning his conduct on his employment record. Now, the agency's notice of decision must spell out which of the initial charges have been found sustained and which have not.[85]

D. Agency Appeals Procedures

After receiving a notice of adverse decision, an employee who wishes to regain his job or to avoid disciplinary action is faced with a choice. Under present regulations, he may appeal either directly to the Civil Service Commission [86] or to the first appellate level within his agency.[87] If an employee appeals within his agency at this stage, he does not lose the right to appeal to the Commission at a later date.[88] He will forfeit his right to an agency appeal, however, if he seeks Commission review in the first instance.[89]

The uniform right of appeal within the employment agency is of more recent vintage than the right to seek Commission review. By executive order in 1962 President Kennedy ordered each department and agency to establish internal procedures for reconsideration of administrative decisions to take

adverse action against employees.[90] Previously, an employee's right to appeal internally varied from agency to agency, and existing appeal procedures were far from uniform.[91] The President's order not only required all agencies to establish appellate systems, but also required that they conform to uniform standards and procedures. Guidelines for implementation of the order were subsequently set out in the Commission's regulations.[92]

Internal agency appeals systems theoretically provide several benefits. Such systems allow career employees to obtain review within their own agencies, obviating the necessity of going immediately to the Commission for assistance. Internal review is said to permit agency management an opportunity to correct hasty or improper action by subordinates and to improve internal operations. From the Commission's viewpoint, internal appeals supposedly weed out less difficult and frivolous cases, thereby permitting it to serve a more general policy making and over-sight function. Even assuming these benefits are obtained, their cost has been greater complexity in the handling of adverse action cases, including the possibility of successive evidentiary hearings—one in the agency and another at the Commission—in may cases.[93]

1. *The appeal.*—If an employee initially choses to remain within the agency, he must file a written appeal with the appropriate agency official (who will have been identified in the notice of adverse decision) no later than 15 days after the action against him has been effected.[94] An employee's appeal must set forth clearly its basis as well as his request for an evidentiary hearing if he desires one.[95] In preparing his appeal, an employee may be assisted by counsel, by his union representative, or by any other person of his choice.[96] Commission regulations specify that the fifteen-day limit is to be strictly observed, but permit the agency to extend the time when the employee (1) shows that he was not notified about, and was unaware of, the time limit, or (2) demonstrates that he was prevented by circumstances beyond his control from appealing within the time liimt.[97] In the unusual case that an employee remains on active duty status after the adverse action, he is entitled to a reasonable amount of official time to assist him.[98]

2. *Opporunity for hearing.*—An evidentiary hearing will be granted only if an employee requests it in a timely appeal.[99] Once a request is made, however, the agency must ordinarily hold the hearing.[100] If, contrary to the general practice, a hearing was held prior to the adverse decision against the employee, the agency may dispense with a hearing on appeal.[101] According to the regulations, a hearing may also be avoided when it is "impracticable by reason of unusual location or other extraordinary circumstance." [102]

3. *Conduct of the hearing.*—The Commission in 1970 significantly altered the rules governing the conduct of adverse action hearings. Previous regulations required the agency hearing to be conducted by a committee chosen in accordance with agency regulations.[103] Although under the regulations the "committee" could consist of a single examiner, three-member panels were common in several agencies. In some the committee would consist of one person chosen by the agency, one by the employee and a third selected by the first two.[104] Hearing officers were not required to have legal training and frequently lacked experience in conducting adversary proceedings.[105]

Before 1970, the hearing officer or committee did not have ultimate responsibility for deciding employee apeals. His function was imply to hear and record the facts so that the agency official charged with deciding the appeal would have an adequate basis upon which to act.[106] Agencies were allowed the option of having the hearing officer or committee submit only findings of fact or findings accompanied by a recommendation,[107] and many agencies chose the former course.[108] Where the hearing officer submitted recommendations, they were advisory only and the reviewing official was free to arrive at a contrary decision.[109] The former regulations excluded officials with ultimate decisional responsibility from serving on hearing committees, but they did not bar praticipation by their subordinates.[110]

Agency hearing committees were subject to several criticisms.[111] With no requirement of training or experience, every member of a committee might be unfamiliar with the intricacies of civil service law and hearings, thus, were often something less than full and adequate inquiries.[112] The use of three-man committees also frequently proved cumbersome. Because hearing officers were sometimes subordinates of the deciding official, the system's objectivity was questioned. A committee member might strive to be scrupulously impartial,

but it is difficult to discount the subtle and unconscious influence of having to report to an official with authority over the conditions, and perhaps even the continuance, of his tenure.[113] Finally, the "advisory" status of committee recommendations in many agencies caused some to doubt the significance of agency hearings, particularly where adequate treatment of an employee's appeal turned on assessment of the credibility of witnesses or similar subjective factors. Where hearing officers were confined to recording facts, such factors often got excluded from the decisional process. Even in agencies that permitted them to make recommendations, their influence was problematical since the deciding official was in no way bound by them.

The Commission's 1970 amendments swept away the committee system. Agency hearings now must be conducted by a single examiner.[114] Examiners must meet standards of experience and training prescribed by the Commission, and must be selected through procedures it has approved.[115] An examiner may not occupy a position directly or indirectly under the jurisdiction of the official who proposed the adverse action or who bears ultimate responsibility for decision, unless that official is the head of the agency.[116] In the latter situation, however, an agency may, but is not required to, designate an examiner from another agency.[117]

The new regulations accord the examiner's views substantial weight. Agencies no longer have the option of limiting the examiner's report to findings of fact. The report must contain the examiner's recommendations,[118] and the deciding official, unless he is the agency head, may no longer arbitrarily reject the examiner's views. If he decides the examiner's recommendation is unacceptable, he must refer the case to a higher level of authority for decision, with a statement of his reasons for rejecting it.[119] Although these changes have not eliminated the problems of the old system, they have enhanced the employee's opportunity to receive a meaningful hearing.

Agency adverse action hearings are trial-type, though ordinarily less formal than adjudicatory proceedings under the Administrative Procedure Act.[120] Both the employee and the agency may produce, examine, and cross-examine witnesses,[121] who testify under oath or affirmation.[122] Documentary evidence may also be introduced.[123] The rules of evidence applicable in jury trials are not strictly observed, but the examiner may exclude irrelevant or unduly repetitious evidence.[124] One justification offered for informality is that "adverse action proceedings are administrative in nature," and since "[t]he cause of action generally involves an alleged offense against the employer-employee relationship, . . . justice would not be served by converting the administrative process to a judicial one."[125] This explanation, which bears some flavor of the discredited notion that federal employment is a "privilege" that may be withdrawn at will by the government,[126] would have more force if the presiding officers were professionals who were experienced in evaluating evidence. A more persuasive justification is that rigorous formality might disadvantage employees who are not represented by counsel.[127]

Congress has not empowered either employing agencies or the Civil Service Commission to subpoena witnesses or documents in adverse action cases. However, the agency must, if at all practicable, make its employees available as witnesses when requested by the examiner to do so.[128] Such a request is ordinarily initiated by the employee and should be granted when, in the examiner's opinion the testimony of the witness requested will aid the hearing. If an employee fails to request witnesses in the agency's employ in a proper and timely manner, he may not later object to the absence of these witnesses.[129] Under the old regulations, the practicability exception became a major loophole for agencies reluctant to produce witnesses. An agency's determination that production of one of its employees was impracticable was, for practical purposes, unchallengeable.[130] The Commission in 1970 sought to close this gap by authorizing examiners to determine whether the absence of a witness makes a full and fair hearing impossible. If an examiner finds that a witness' presence is essential, he may now suspend the hearing until the agency and the employee can arrange for his testimony to be produced.[131] During their appearance, witnesses who are employees of the agency continue in active-duty status and the regulations require that they be free from restraint, coercion and reprisal.[132]

The employing agency must keep a record of the hearing and supply a copy to the employee.[133] Until 1970, however, agencies had the option of preparing

either a verbatim transcript or a summary of the hearing. If only a summary was supplied, the employee could object to sections that he felt failed accurately to reflect the substance of the hearing, and his objections would become par of the record.[134] These summary reports cause numerous problems,[135] for they rarely reflected the nuances and inconsistencies in complex cases. In 1970 the Commission withdrew authority for use of summaries; all agency hearings must now be reported verbatim.[136]

The agency official to whom the hearing examiner transmits his findings and recommendations must be at a higher administrative level than the official who took the original adverse action. An exception is made where the agency head made the original decision.[137] Review of the original decision includes, but is not limited to, a review of issues of fact and of compliance with agency and Commission procedural requirements.[138] The deciding officials' decision must be in writing, must contain specific fact findings, and must notify the employee of his right to further appeal.[139]

E. Appeals to the Civil Service Commission

When Congress in 1944 gave the Civil Service Commission authority for binding review of agency adverse actions,[140] it spoke in very general terms:

> The employee shall submit the appeal in writing within a reasonable time after reecipt of notice of the adverse decision, and is entitled to appear personally or through a representative under regulations prescribed by the Commission. The Commission, after investigation and consideration of the evidence submitted, shall submit its findings and recommendations to the administrative authority and shall send copies of the findings and recommendations to the appellant or his representative. The administrative auhority shall take the corrective action that the Commission finally recommends.[141]

The Commission accordingly has been relatively free to adopt the procedures it believes will best fulfill its appellate responsibilities.

At a minimum the statute appears to require a *de novo* review of the facts.[142] The language empowering the Commission to make binding recommendations "after investigation and consideration of the evidence submitted" has been read both by it and by the courts as contemplating more than an ordinary appeal. In *McTiernan* v. *Gronouski*,[143] for example, the Second Circuit held that procedural error within the agency review system was cured when the employee received *de novo* consideration of his claim on appeal to the Commission.[144] The statute seemingly also requires that appellants ot the Commission have an opportunity for an oral hearing rather than simply a review of the record,[145] although in some cases this hearing may amount to less than a full trial-type proceeding.[146]

1. *The appellate system.*—The Commission operates a two-tiered system for deciding employee appeals. Initial appellate authority had been delegated to the Commission's regional offices, of which there are eleven. Second-level review is before the Board of Appeals and Review, located in the District of Columbia.[147] Within each region, the CSC Regional Director is formally responsible for adjudicating first-level appeals in adverse action cases. The decisional authority actually exercised by appeals examiners in the regional offices derives from the Regional Directors and is subject to their authority to change proposed decisions.[148] Similarly, the Board of Appeals and Review exercises the power of final decision on behalf of the Commission and subject to its ultimate authority,[149] although, unlike the Regional Directors, the Commissioners themselves rarely exercise their revisory power.

2. *The initial appeal.*—As previously noted, an employee may by-pass his agency's appellate system and appeal an adverse decision directly to the Commission.[150] Or he may pursue an internal agency appeal and then appeal to the Commission if the action is sustained.[151] An employee may also appeal to the Commission if, after appealing within his agency, he receives no decision within sixty days,[152] though few ever interrupt their internal appeal in this fashion.

An employee's appeal must be in writing and filed within fifteen days after the last action by his agency.[153] An employee's failure to file within the specified period precludes him from appealing to the Commission, in the absence of special circumstances.[154] Upon being satisfied that an appeal is timely, the CSC regional appeals examiner will instruct the employing agency to forward

the case file. The appeal should set forth the employee's reasons for contesting the adverse action, together with such offer of proof and pertinent documents as he is able to submit.[155] Employees are not held to rigorous standards of pleading. If an appeal is formally deficient, the regional examiner will make an effort to ascertain its basis and to clarify or supplement the record. This practice represents an important safeguard, since more than thirty percent of all appellants to the Commission are unrepresented,[156] but it often results in a record before the Commission's regional office different from the one on which the agency acted. If an employee fails to furnish additional information with reasonable promptness, however, his appeal may be dismussed. Appeals must be filed with the regional office in the region where the employee is employed.[157]

3. *Right to a hearing.*—Appealing employees have a statutory right to a "personal appearance" before the Commission, which interprets this language as requiring an evidentiary hearing and independent determination of the facts. Thus an employee may have two trial-type hearings, one in his agency and a second on appeal to the Commission.[158] Prior to 1970, this possible duplication may have had much to commend it, but since changes that year were designed to increase the reliability of agency hearings, it is simply inefficient.[159] Several factors, however, including the Commission's procedures, limit the number and scope of Commission hearings.

One factor is the attitude of employees. Only one-half of those who apepal to the Commission request a hearing at that level.[160] Although we have little empirical data to explain this result, some explanations may be surmised. Many employees may be satisfied with the hearings conducted by their agencies. They may be aware that, having had one hearing, they will not get a full retrial before a Commission appeals examiner and thus conclude that the cost, including the cost of travel to the Commission's regional office, may exceed any benefit. In other cases, an employee may forego a hearing because he believes the agency record is adequate or because of tactical considerations.

Prehearing conferences in most cases also limit the number, as well as the scope, of Commission hearings. The conference is conducted by the regional appeals examiner, and is attended by the employee or his representative and by an agency representative who has sufficient authority to modify the action taken. The conference may provide an opportunity for the parties to reach settlement, which will be binding on the parties. If, as in the great majority of cases, no settlement can be agreed upon, the examiner will attempt to narrow the issues for hearing.

Some employee representatives have voiced disapproval of the prehearing technique on the ground that there is a conflict in the appeals examiner acting first as a mediator and then as judge. The practice nonetheless closely resembles the pretrial conference authorized in the Federal Rules of both Civil and Criminal Procedure.[161] This practice has been reasonably successful in the federal courts and its adaptation to administrative adjudications, such as adverse actions, seems sensible.

Even when an employee insists on a hearing after the conference, he is not necessarily assured a full re-trial of his case. By administrative practice, the Commission has determined that in cases in which a hearing was held at the agency, its appeals examiner may properly restrict the scope of the Commission hearing.[162] The examiner, in his discretion, may decline to receive additional testimony except as to matters not covered at the agency hearing or as to subsequently discovered information. Some Commission "hearings" are thus largely confined to oral argument on the basis of the prior record.

4. *Conduct of hearings.*—Except to the extent that the examiner restricts the scope of testimony, Commission hearings are similar to, but probably more professional than, those conducted by employing agencies.[163] Both parties may produce and cross-examine witnesses.[164] Testimony is given under oath or affirmation.[165] The rules of evidence are again not strictly observed, but irrelevant or repetitious testimony may be excluded. As at the agency level, all Commission hearings have been closed to the public.[166]

The Commission's examiner, however, plays a more important role than most agency hearing officers. Although the Commission has required that agency examiners possess prescribed qualifications, they need not be full-time hearing officers. Except in larger agencies, such as the Air Force, Army, Navy, and HEW, examiners continue to be drawn from other work for part-time duty

presiding in adverse action cases. Commission appeals examiners, by contrast, are specialized hearing officers whose sole duty is to review appeals from agency decisions, although they are not qualified as hearing examiners under the Administrative Procedure Act.[167]

5. *Initial Commission Decisions.*—.After considering the entire appellate record,[168] the Commision's regional office must issue a written decision containing findings of fact and conclusions, specifying any corrective action required, and notifying both parties of their right to appeal to the Board of Appeals and Review.[169] The decision is supposed to include an "analysis" of the findings and a statement of the reasons for the conclusion reached.[170] Except upon specific authorization of the Commissioners, the regional decision may not modify the agency's disciplinary action. Practically speaking, the regional office is limited to affirming the action, or reversing it on either substantive or procedural grounds.[171]

6. *Appeals to the Board of Appeals and Review.*—After receiving the decision of the regional office, either party has fifteen days in which to appeal to the Board of Appeals and the Review.[172] This appeal too must be in writing[173] and must set forth the employee's or agency's full argument, since there is no right to oral appearance before the Board.[174] However, the Board may in its discretion, though it rarely does, permit the parties to apear and present oral arguments and representations.[175]

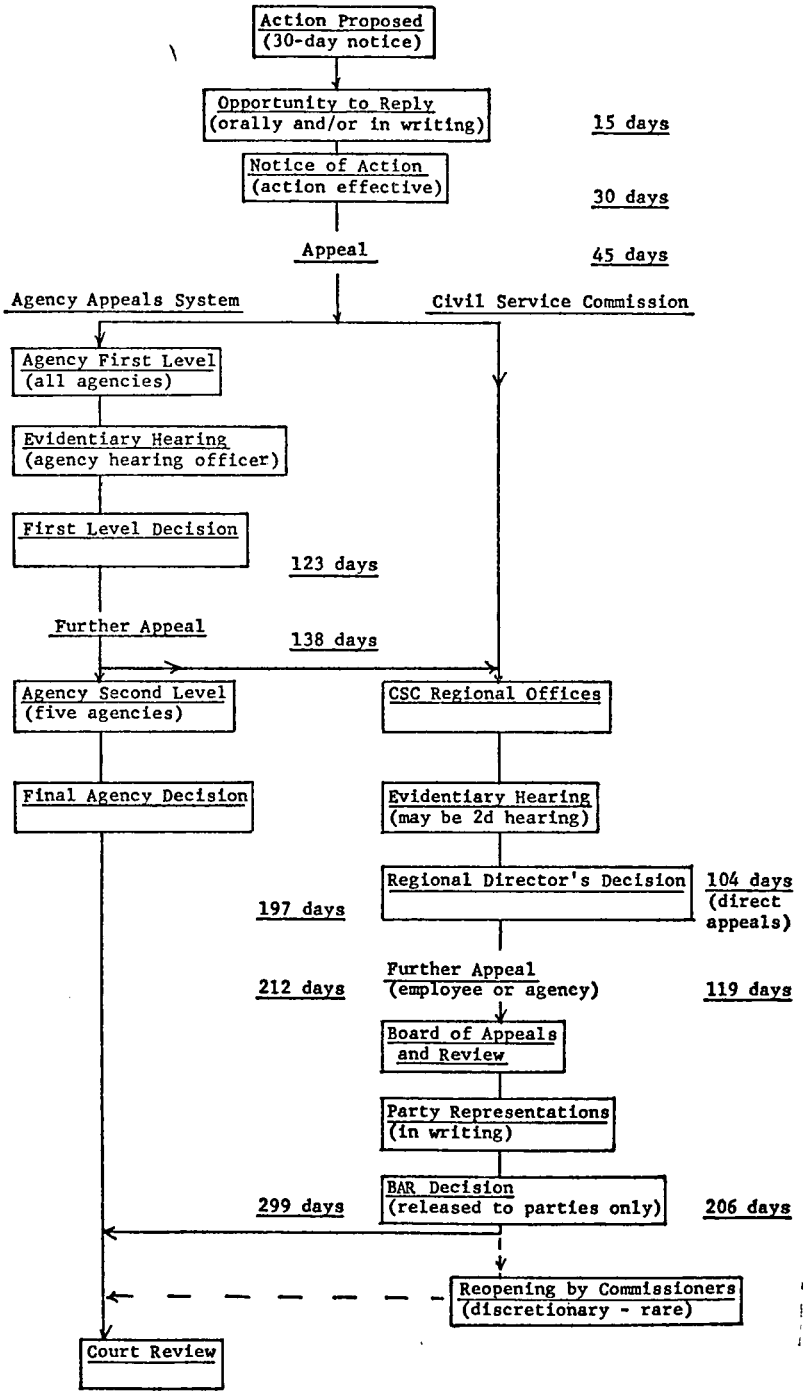
The Board of Appeals and Review consists of seven members who are assisted by a pool of appeals examiners. When an appeal is received by the Board, and after the arguments of both parties have been submitted, the case is assigned to an examiner who prepares a proposed decision. The examiner's draft is then circulated to two Board members. If both concur in a disposition, it will issue as the decision of the Board. Only if the two disagree will the case be reviewed by a third Board member.[176]

The Board reviews appeals on the basis of the entire appellate file, which includes the agency record, the record developed by the Commission's regional office, as well as any further representations by the parties, which may be factual as well as argumentative. Occasionally the Board will actively seek out additional factual material a member or an examiner believes essential to a fair decision. The Board may also call upon other bureaus in the Commission for expert advice on the resolution of technical issues, such as the proper classification of a job or the extent of physical disability. In neither case are the parties to the appeal likely to be given an opportunity to comment on the information the Board has solicited. If the Board finds the file is simply inadequate for resolution of the issues, it may remand the case to the Commission's first appellate level so that further facts may be developed.[177]

Decisions of the Board are in writng, but are not published or, until very recently, available outside the Commission to any but the appellant and employing agency. Even internal circulation of Board decisions has been sharply restricted. The Board's decisions are final and, if adverse, exhaust an employee's administrative remedies, for there is no right of appeal to the Commissioners.[178]

7. *Discretionery Reviow by the Commissioners.*—Although no appeal of right lies to the Commissioners, an employee or agency may petition the Commissioners for reopening and reconsideration of an adverse decision by the Board of Appeals and Review.[179] The regulations authorize reopening where the petition establishes that new material evidence not previously considered has become available.[180] or that the "previous decision involves an erroneous interpretation of law or regulation or a misapplication of established policy." [181] A case may also be reopened if the decision is of "a precedential nature involving a new or unreviewed policy consideration that may have effects beyond the actual case at hand, or is otherwise of such exceptional nature as to merit the personal attention of the Commissioners."[182] Reopening by the Commissioners is infrequently sought, and even more rarely granted. Its theoretical availability serves more as a protection against Commission embarrassment than as a significant additional protection of employee rights.

PRESENT ADVERSE ACTION PROCEDURE



IV. COMMENTARY ON PROPOSED RECOMMENDATIONS

A. Definitions and Standards

1. *Redefining "adverse action."*—Adverse actions currently include four types of disciplinary action: removals, reductions in rank, pay, or grade (demotions), suspensions for more than 30 days, and furloughs without pay. Since employing agencies initiate comparatively few long suspensions or furloughs, and fewer still are contested, it is appropriate to focus attention on the first two categories.[1]

Agency officials frequently lament the formality of adverse action hearings, which feature confrontation, testimony under oath, cross-examination, and now verbatim transcription of the record. Given the tenor of recent court decisions,[2] it is unlikely that the adverse action process could be supplanted by informal, off-the-record investigations. More important, however, adverse actions are proceedings, among many for which formal adjudication is required, for which such procedures usually make sense.

Reductions in rank or grade comprise the majority of adverse actions taken, but most appealed adverse actions are removals. In well over 80 percent of all appeals,[3] the agency's action is based on the employee's inability or failure to do the work—inefficiency in the colloquial sense—or on some kind of misbehavior, on- or off-duty, that is thought to impair his capacity to carry out his responsibilities. Examples of such misconduct include absence without leave, fighting on the job, destruction of government property, falsification of government records, and indictment or conviction for criminal conduct.[4] The essential point is that most adverse action cases center on either the employee's performance or his conduct.

These disputes are inevitably two-sided. Generally, the surrounding circumstances are known to both parties and can be easily proved. Disputed issues of fact almost invariably involve past events that are not likely to recur. By contrast with many other administrative proceedings, the credibility of witnesses is often at issue, and witnesses are usually amateurs. Dispute customarily centers on two issues: (1) did the employee do what the agency alleges, and, if he did. (2) does his conduct or performance warrant the action proposed. Although the second is a matter of judgment, it depends upon resolution of issues of fact.[5]

The adjudicatory model that has evolved for handling such cases is better equipped than others in common use to find the "true" facts. From the standpoint of apparent fairness, it enjoys greater support among employees than any other process save arbitration.[6] Agency management would probably prefer adjudication to arbitration because it more readily permits full implementation of the agency's decision if the facts are proved.[7] Measured by efficiency, the present procedure will come up short against other, less formal alternatives, including ex parte investigation. A process that did not require the simultaneous attendance of parties and witnesses would undoubtedly be cheaper. But any procedure that permits external review of agency actions and affords an opportunity for employee participation—as any legitimate procedure must—will take longer.

A personnel action that results in a reduction of rank or pay clearly affects an employee *adversely* in the literal sense. Its impact may be as harsh in the long run as outright removal. Such actions, however, frequently have no punitive purpose or flavor. The employing agency's reasons may be wholly unrelated to the conduct or performance of the employee affected, and instead be prompted by structural changes or budgetary constraints. A particular type of job may be reclassified throughout government for reasons having nothing to do with the employees who perform it. A notable example involves from 3000 civilian shipworkers in the Department of the Navy, which recently adopted the Coordinated Federal Wage System. The new system, as did the old, provides extra pay for hazardous work, but the new classifications are not identical. These 3000 employees will receive approximately the same pay as before, but under a schedule that results in a pro forma reduction in rank. They have all challenged this change as an "adverse action," and each is theoretically entitled to proceed individually through the Navy and Civil Service Commission formal appeals systems.[8]

One could cite other examples. Position reclassification is the most common reason for which agencies reduce an employee's rank or pay, but under present

law each action must, if the employee demands, be processed through a system designed for adjudicating issues of fact and assessing individual penalties. This comparatively expensive process should be reserved for cases that have a disciplinary purpose and raise issues of fact involving an employee's competence or conduct; at the same time, employees should have adequate opportunity for review of other decisions that essentially involve issues of efficiency or of managerial judgment.[9]

A possible solution would be redefine "adverse action" to include only those personnel actions taken for reasons relating to an employee's performance, behavior, or past record. This essentially functional approach would make more sense than attempting to confine trial-type procedures to specific categories of personnel action. Many demotions are focused and disciplinary, but others are not. However, this approach would require amendment of the Veterans Preference Act, which constructively requires an opportunity for a trial-type hearing in the four named classes of cases without reference to the issues involved.[10]

A partial, interim solution would be to permit consolidation of cases that involve the same issue, such as those of the 3000 Navy shipworkers.[11] Trial type procedures would be tolerable in such cases, even though no issues of fact were involved, if a single proceeding could resolve all identical claims. The Civil Service Commission has been understandably reluctant, however, to suggest that an agency may legally dilute an employee's hearing right by consolidating his appeal with all similar cases. Therefore, this approach, too, might require Congressional action, and it would only ameliorate the problem where an agency was taking identical actions against two or more employees.

A third possibility, which would not require legislation, would be to adopt the rule—routinely followed in other adjudicatory settings—that an evidentiary hearing need not be held when no issues of fact are raised.[12] If an employee threatened with demotion contests only the agency's classification of his job or its reading of Commission's regulations-issues that are susceptible of resolution without a "trial"—an opportunity to present *arguments* to management, perhaps oral as well as written, affords adequate protection. The Commission's regional appeals examiners are already accustomed to simplifying hearings when an employee who has had an agency hearing wants only to reexamine his own witnesses or those of the agency.[13] An affirmation of the hearing officer's authority to narrow the proceeding to the contested issues would improve efficiency without sacraficing any employee interest. It could also expedite cases that *did* involve an employee's performance or conduct by permitting summary resolution of issues on which the parties did not disagree.[14]

Whatever steps are taken to eliminate the need for trial-type procedures in cases for which they are not appropriate, agencies should not be able to circumvent an employee's right to a hearing in a proper case by invoking procedures that are nominally nondisciplinary. An employee should be able to challenge the truth of the agency's contention that its action is based solely on managerial considerations. One court has recently so held in the context of an alleged agency attempt to secure an employee's removal by transferring him to another city.[15]

2. *Defining "efficiency of the service."* The quoted phrase is the sole statutory standard by which the legitimacy of any adverse action is to be measured. The legislative history of the Postal Service Appropriations Act of 1912[16] in which the phrase first appeared is silent on its meaning, and neither the Lloyd-LaFollette Act nor the Veterans Preference Act, which adopted it, provide any insight into Congress' intent. The core of the concept obviously was inefficiency in the colloquial sense: inability to perform in the job. But routine inefficiency is among the least frequent grounds for action, relied on in fewer than nine percent of cases that are contested.[17] Misconduct, on- and off-duty, accounts for almost 46 per cent, while unspecified "other" reasons are offered in another 27 per cent.

As the reasons for an agency initiating disciplinary action move further from the central criterion of substandard performance, the risks of official interference with purely private behavior and government enforcement of conventional morality increase. With growing frequency, the federal courts have begun insisting that the government show some rational nexus between an employee's behavior and its legitimate needs as an employer to justify his removal.[18]

The generality of the statutory standard of "efficiency" creates serious problems of adequate notice. Not only do court decisions provide little guide as to the types of behavior government agencies may *legitimately* forbid; it is often difficult to discern what kinds of behavior agencies *intend* to treat as a basis for disciplinary action. Many agencies have devised "tables of penalties," which not only attempt to identify disqualifying behavior but specify the range of punishments particular offenses may carry.[19] These provide better guidance for employees than the statute itself, but invariably include a catch-all category, such as "immoral, indecent, or disgraceful conduct," that permits abuse.

The Civil Service Commission has done no better. In its regulations,[20] the Commission has attempted to identify several reasons that will disqualify an applicant or probationer, or justify removal of a tenured employee:

(*a*) Dismissal from [other] employment for delinquency or misconduct;

(*b*) Criminal, *infamous*, dishonest, *immoral*, or *notoriously disgraceful conduct*;

(*c*) International false statement or deception of fraud in examination or appontment;

(*d*) Refusal to furnish testimony as required by § 5.3 of this chapter;

(*e*) Habitual use of intoxicating beverages to excess;

(*f*) Reasonable doubt as to the loyalty of the person involved to the Government of the United States; or

(*g*) *Any legal or other disqualification which makes the individual unfit for the service.* (Emphasis added.)

This regulation is deficient both as a guide to agency management and as a warning to employees of the sorts of behavior that will get them in trouble. This is not to suggest necessarily that a court should declare the statutory standard invalid without further administrative elaboration.[21] Even as "fleshed out" by the Commission, however, the statute remains an invitation to arbitrary action by government agencies.

These problems of overbreadth and adequate notice are not easy to solve. It may be impossible to define in advance all the types of behavior that can so damage an agency's reputation or disrupt its program that removal is warranted. Yet, most large agencies as well as the Commission in the course of deciding appeals have developed a large, still essentially secret body of law on the meaning of "efficiency." Each year, for example, the Commission's Board of Appeals and Review applies this standard in more than 600 cases,[22] but its decisions have not been available to the public or to other agencies and employees. By drawing upon this body of precedents, the Commisison should be able to amplify the statutory standard with much greater precision.

B. Procedures for Agency Hearing and Decision

1. *Advice to employees and opportunity to respond.*—An agency's letter of proposed adverse action must provide sufficient details about its charges to enable the employee to respond and prepare his defense. Although these letters have frequently been a source of procedural defects, agency practice has been improving. However, employing agencies need to do a better job of advising employees about the consequences of proposed action and about the procedural opportunities available to them. Ordinarily, the agency's letter recites in highly formal language what the employee's rights are and how long he has to exercise them. An employee of moderate sophistication should not have difficulty understanding what is to follow. Yet many employees offer no resistance whatever, and others later contend that they never understood what was happening.[23]

In criminal cases, where every defendant has legal representation, the language of indictment and plea may not inhibit communication. In a process that involves numbers of relatively unsophisticated employees, more than a third of whom have no representation,[24] the government has an obligation to communicate by means that every one can understand.

Agencies should designate one employee who would be responsible for seeking out employees threatened with adverse action to explain what can happen and what they can do about it. This emissary, or "adviser," should not undertake to represent any employee, but should be prepared to advise an employee to consult with his union, if any, or with private attorney. Such a professional "adviser" would undoubtedly be viewed with suspicion by some employees,

simply because he worked for the agency. He would not, however, bear the stamp of the agency office that initiated the action, and communication of the agency's message would not be confined to an ominous letter that simply invites the employee to seek advice if he needs it.[25]

Under current regulations an employee must be given an opportunity to respond to the agency's charges, in person as well as in writing, before the action becomes effective.[26] If a trial-type hearing were made available *before* any action could become effective, this right of reply would of course assume less importance. While courts have treated the right as fundamental and upset agency disciplinary actions in which it was neglected or impaired,[27] a full pre-action hearing at which an employee could defend himself by offering evidence as well as argument would undoubtedly provide an adequate substitute.

Even so, the right of reply should not be discarded if it can be accorded without significantly delaying the process. One assumes that an employee's reply very rarely results in withdrawal of the charges against him.[28] Although in the past agencies often initiated actions without having all of the facts, and forced the employee to correct errors of hasty investigation, managers now rarely begin actions about which *they* have remaining doubts. Some agencies even formally instruct supervisors not to send a letter of charges until they have assembled an "iron clad" case.[29] However, the right of reply affords *some* possibility that an employee can change the agency's mind, and a real chance that he can at least persuade his supervisors to reduce the penalty proposed.[30] These possibilities alone may justify retaining a step in the process that imposes few demands on the participants and need not delay a hearing.[31] More importantly, the opportunity to reply permits an employee to assess the strength of the agency's case in advance, and may induce him to acquiesce in the action proposed without proceeding further.

2. *Timing of hearing.*—Most agencies do not make a hearing available to an employee until after the proposed adverse action has become effective.[32] Some nine agencies—including the Department of HEW, HUD, and Justice, as well as the Civil Service Commission itself [33]—provide the hearing in advance, but their caseloads comprise only a small percentage of all contested adverse actions. The Department of the Navy shifted from a pre-action to a post-action hearing procedure in 1967, and the Veterans Administration followed suit in 1971. Both agencies have large caseloads.[34] Among the justifications offered for these changes and for the prevailing practice is the claim that providing a hearing in advance prolongs the process. However, neither Navy nor the VA has yet provided statistics comparing their experience before and after shifting to a post-action hearing.

Our own investigations have yielded somewhat ambiguous evidence. The data demonstrate that cases in which hearings are held do require longer to decide.[35] The problems, apparently, are coordinating schedules, assigning hearing officers, and preparing transcripts; the hearings themselves rarely last more than a day whether held before, or after, the action becomes effective. The data also show that, in 1970, agencies that provided hearings in advance of taking action processed cases faster (on average) than agencies that made a hearing available only afterwards.[36] However, the first group also held hearings relatively less frequently,[37] and their superior speed in disposition may be attributable to that fact alone. One cannot, therefore, conclude that a pre-action hearing system actually disposes of cases faster. At the same time, the data clearly do *not* show that holding the hearing afterwards helps shorten the process.[38]

Two other arguments are made in favor of post-action hearings. First, it is claimed that requiring a hearing before action can become effective would significantly inhibit government managers from taking effective disciplinary action because they would have to face and work with a threatened employee every day until the hearing was held. Furthermore, other employees would feel insecure in their work, or become skeptical of management discipline, if employees threatened with removal remained on the job until a hearing.[39] This argument, it should be noted, assumes that ordinarily it will take a good deal longer than 30 days to hold and act upon any hearing. Under present regulations, an employee must be given at least 30 days' notice of a proposed adverse action; thus, unless the agency acts also to suspend him pending removal, supervisors and fellow workers must function for at least a month with the threatened employee in their midst.[40]

The second argument in favor of the present practice, seldom articulated but widely shared, is that postponing the hearing discourages employees from challenging their removal, and thus reduces the potential caseload. As discussed above, our data raise doubt whether this hope is realized. Moreover, this justification may partially be discounted, even if factually supported. The government should not structure procedures to discourage those they are designed to protect from invoking them. A similar argument was made in favor of postponing the hearing given welfare recipients on termination of benefits, and squarely rejected by the Supreme Court in *Goldberg* v. *Kelly*.[41]

This is not to suggest that employees who have received a letter of charges do not represent a problem for employing agencies. When the agency's charges relate to serious misconduct on the job or criminal activity threatening persons or property, an employee's continued presence on duty may indeed be disruptive. Furthermore, agencies have an interest in avoiding frivolous cases that are contested simply to postpone the effective date of disciplinary action.

The Supreme Court has never held that due process *requires* the government to afford a hearing before it can remove a tenured federal employee. A District Court in California recently held that on the facts before it a pre-action hearing was not constitutionally requisite,[42] which less than two months ago a three-judge District Court in Chicago ruled that the government must provide tenured employees a hearing in advance of removal.[43] Space does not permit discussion of all the relevant legal authorities, but a brief summary of the central cases should make clear that the constitutional issue is by no means free from doubt.

In *Goldberg* v. *Kelly, supra,* the Supreme Court held that due process requires that welfare recipients be given a hearing *before* benefits can be cut off. Because the Court emphasized the financial plight of persons on welfare, some commentators and subsequent cases have read the decision as limited to its immediate context. In *Ricucci* v. *United States*,[44] however, two judges on the Court of Claims concluded—in a case involving removal of a federal employee—that *Goldberg* stood for the broader principle that government may not impair important private interests without *first* providing notice and opportunity for a hearing.[45]

During its last term, the Supreme Court had occasion to amplify its holding in *Goldberg* v. *Kelly*. The vehicle was *Fuentes* v. *Shevin*,[46] a case challenging the constitutionality of pre-judgment replevin statutes in Florida and Pennsylvania, which permitted a creditor to repossess goods from a defaulting buyer without prior hearing. The Court struck down these laws, in the process affirming a broad reading of *Goldberg* v. *Kelly* and specifically rejecting the suggestion that that decision, or the principle for which it stood, was limited to deprivations of "necessities."[47] The Court stated that postponing a hearing until after government acts can be justified only in "extraordinary" circumstances. One passage from the Court's opinion is particularly relevant here:

> A prior hearing always imposes some costs in time, effort, and expense, and it is often more efficient to dispense with the opportunity for such a hearing. But these rather ordinary costs cannot outweigh the constitutional right.[48]

A third case warranting discussion is *Carboneau* v. *Foxgrover*.[49] Carboneau was the fire chief at Miramar Naval Air Station in California, against whom the base commanding officer initiated removal proceedings because he had stored plastic explosives near the main firehouse, in violation of Navy regulations. He had also purposely reduced the crash rescue capability of the fire department by failing to assign a crew to one of the station's two trucks and by sending the second truck to another area. Carboneau sued to enjoin his removal, on the ground that the Navy had not afforded him a pre-termination evidentiary hearing.

The district court rejected his contention, declaring that *Goldberg* v. *Kelly* was limited to deprivations of necessities. The court concluded that the Navy's interest in removing Carboneau from duty promptly, in light of the seriousness of the charges against his reliability and the sensitivity of his job, outweighed his interest in being heard first. The court also emphasized that Carboneau had been given a opportunity prior to removal to reply to the charges before another officer.[50]

As a statement of constitutional law, the *Carboneau* decision is questionable on several counts. First, the court nowhere mentions the Supreme Court's ruling

in *Fuentes* v. *Shevin*, which explicitly rejects the notion that the *Goldberg* principle is confined to cases of "brutal need." Second, the court treats the employee's right to respond to charges as an important protection against groundless action, although there is no evidence that agencies generally, or the Navy, frequently terminates proceedings at this stage.[51] Third, the court ignores the possibility of achieving a closer balance between the interests of the interests of the employee and those of the agency. The Navys' undeniable, legitimate concern that Carboneau not be in a position to jeopardize the lives of pilots and others was allowed entirely to nullify any interest of his.[52]

The final case on point is *Kennedy* v. *Sanchez*,[53] decided on October 24, 1972. Kennedy, a field representative of the Office of Economic Opportunity, was removed from his job for making derogatory public statements about his agency and supervisor. (The court's opinion is notably lacking in detail about the content of these statements or the audience to which they were made.) He challenged the agency's action on the ground, among others, that failure to afford him a pre-action evidentiary hearing violated due process. The three-judge court, citing *Goldberg*, *Fuentes*, and *Ricucci*, agreed. "The clear implication [of these cases] is that absent such a specialized interest, a prior hearing must be afforded before government employees may be discharged."[54] The court concluded that Kennedy's lack of opportunity before being removed to be heard by an impartial agency official, to present witnesses, or to confront adverse witnesses contravened "minimal procedural requirements" for a valid procedure.[55]

The issue of the timing of the hearing is undeniably controversial. On balance, however, the case against providing a hearing in advance— which is manifestly fairer to the employee—does not withstand scrutiny. The asserted efficiency of the present practice has not yet been supported by evidence; agencies that postpone the hearing in 1970 disposed of cases *less* rapidly than those that afford a hearing in advance. This was partly because they held relatively fewer hearings, which tends to undermine the contention that fewer cases need be heard when the hearing is postponed. If other, more recent evidence revealed that fewer hearings were required under the post-action procedure, one would be concerned that such a system discouraged employees from contesting their removal even in meritorious cases.

The timing of the hearing unquestionably affects which of the parties will be interested in expediting disposition. Under the prevailing practice, agencies have little incentive to decide cases because employees bear most of the costs of delay.[56] If the hearing were required before removal, employees potentially would benefit from scheduling difficulties and procrastination. The real answer to this dilemma is to speed up the scheduling and completion of hearings, which should be faciliated by the use of trained Civil Service Commission hearing officers who tolerate no unnecessary delays.

Efforts to speed up the process of decision should concentrate on the arrangements for, rather than on the conduct of, hearings. Some time could be saved by allowing employees no more than ten days in which to reply to agency charges, and requiring agencies to act upon an employee's reply promptly, *e.g.*, within five days. Hearing officers should be authorized to designate the date for hearing, and to be grudging in granting postponements. Rigid time limits should be prescribed for completion of the hearing officer's recommended decision and for the agency's action upon it. Accelerating disposition will not be easy, but can be accomplished.

One cannot ignore the argument that it would be difficult for government managers to live with a requirement that an employee must always be allowed to remain on the job until after a hearing. The very nature of the charges may sometimes justify an agency in removing an employee from the premises promptly, because of the danger he may pose to other employees, government property, or a placid work environment.[57] The claim is also made that morale and discipline will suffer if government supervisors feel they must go through a "trial" to prove facts about an employee's behavior they are convinced are true before the employee can be removed from the premises. Whether or not legitimate, this attitude is real and should be considered.

The recommendation proposed is intended to accommodate both employee and agency interests. It would require an opportunity for a hearing prior to termination of an employee's pay, thus relieving him of the principal pressure to abandon his defense and find other employment. At the same time, it would

permit an agency considerable leeway in reassigning the employee or placing him on administrative leave pending any hearing and the agency's final decision, thereby protecting office morale.[58]

3. *Hearings open to the public.*—Agency and Commission hearings are not currently open to the public or to the press. Both agencies and the Commission historically have justified closed hearings in terms of protecting employee privacy and facilitating calm, informal exploration of the issues.[59] More recently the Commission, in refusing an employee's request to open his hearing to the public, also cited the possibility of disruption.[60]

Several interests must be weighed in deciding whether adverse action hearings should be open. The public has an interest in monitoring the administration of justice at all levels of government, though it is weaker in this setting than in the criminal context. Employing agencies and the Commission have an interest in the orderly and efficient conduct of hearings that would entitle them to prevent disturbance, exclude disturbers, and minimize the costs of accommodating spectators. Except in rare cases involving national security, however, they have no legitimate interest in preserving the secrecy of their hearing processes or the facts they produce. An employee has potentially conflicting interests, on the one hand, in preserving his privacy and, on the other, in open processes that inhibit arbitrariness.

In the author's judgment, an employee's privacy interest outweighs the public's interest in witnessing his case.[61] He should continue to have the right to exclude all non-participants. His interest in an open hearing, should he request it, can be reconciled with the legitimate administrative needs of the agency or Commission. No agency need advertise its proceedings, or provide accommodations for numbers of spectators greater than likely to attend the average hearing.[62] Furthermore, an agency should be free to control disruptive behavior by excluding the offender(s) or closing the hearing. The overwhelming majority of adverse action hearings will not generate sufficient public interest to require seating arrangements, much less crowd control. Among the few controversial cases that might, moreover, the employee more often than not will opt for privacy.

The recommendation that in all but extraordinary cases the hearing should be public if the employee requests it is consistent with and indeed may be required by, the recent decision of the United States Court of Appeals for the D.C. Circuit in *Fitzgerald* v. *Hampton*.[63] Fitzgerald, though formally remove from his position with the Air Force through a reduction-in-force, was nonetheless given a hearing by the Commission to contest his removal,[64] which he claimed was in retaliation for his testimony before Congress about cost overruns in the Air Force C5A program. The Commission, however, refused Fitzgerald's request that the hearing be open to the public and to the press. The court of appeals unanimously held that due process entitled Fitzgerald to an open hearing, rejecting the Commission's arguments that such a requirement would hamper the "search for truth," deter witnesses who could not be compelled to testify, and make it difficult for the hearing officer to preserve decorum.[65] Literally read, the court's opinion would leave agencies no option but to open their hearings even if the Conference adopted no recommendation.

4. *Hearing officers appointed by the Civil Service Commission.*—At the present time, each employing agency is responsible for providing its own hearing officers, although some smaller agencies borrow one from another agency.[66] A hearing officer must meet basic Commission training requirements and for independence from the official proposing the action.[67] For larger agencies with substantial caseloads—the VA, Treasury, HEW, and the military departments—these requirements pose no problem. Army has recently established its own pool of full-time examiners who preside in all of the department's adverse action and other personnel appeals throughout the world.[68] Smaller agencies, however, must often use examiners who, though they may have been exposed to Commission training, have virtually no hearing experience.

Several reasons warrant placing all examiners under the supervision of the Commission. This plan provide experienced examiners to agencies whose annual caseloads do not fully occupy even one examiner, and spare them the disruption of having to take their only employee who has Commission training off regular duty. It would strengthen the competence and experience that examiners in larger agencies may develop for themselves. Most importantly,

it would introduce an outside, independent vice at a much earlier stage in the hearing process, increasing employee confidence and minimizing the likelihood that an agency will become locked into a position that cannot withstand external scrutiny.

Some agencies may complain that this proposal would make it more difficult for them to correct their own errors, and would substitute procedural expertise for sympathetic understanding of their unique needs.[69] But it is doubtful whether sympathy for an agency's mission is important in an official who is responsible for compiling a complete factual record of an employee's behavior. So long as examiners take a tolerant view of the relevance of evidence, nothing an agency wants considered is likely to be excluded. Furthermore, if the examiner's recommended decision is then submitted to the agency, the agency will have an opportunity to justify its action in terms of its mission. An agency that believes that standards of employee behavior may legitimately differ among agencies will have an opportunity to make its case. Moreover, under the present system, an employee can avoid his agency's appeal process altogether by appealing directly to the Commission, where his hearing will be before a Commission appeals examiner who may have no understanding of the agency's special disciplinary needs.

A second objection to the proposal for Civil Service Commission hearing officers is more troublesome. The Veterans Preference Act is construed as according all preference-eligible employees a "right" to an evidentiary hearing *at the Commission.*[70] This right is already curtailed by the practice of the Commission's regional appeals examiners of limiting repetition of the agency hearing, and by the Commission's own regulation that prevents an employee who appeals to a second level within his agency from thereafter appealing to the Commission. But the question remains: Would a hearing before an examiner appointed and employed by the Commission, who would submit findings and a recommended decision to the employing agency, plus the availability of ultimate review by the Commission, satisfy the Veterans Preference Act?[71] If not, legislation would be needed to implement this recommendation.

The proposed recommendation leaves the matter of hearing officer qualifications to the Civil Service Commission. It is assumed that the Commission will prescribe qualifications of training and experience that would ensure that these presiding officers will be competent to conduct personnel hearings of an adjudicatory type. The recommendation omits any requirement that hearing officers be attorneys or have a specified minimum level of experience. Several agencies employ very competent hearing officers who are not lawyers. Furthermore, the omission of specific qualifications is consistent with the recommendation's primary objective, which is to assure hearing officer independence from employing agencies.

5. *Government burden of proof.*—The Commission's regulations do not specify who shall have the burden of coming forward with evidence and the burden of persuasion. Most participants in the process view it as the agency's responsibility to prove its case, even though ordinarily the hearing is not held until after the action has become effective.[72] Yet there are recurrent complaints that some agencies and some Commission regional examiners fail to adhere to this principle.[73] Common understanding may effectively assign responsibility for producing evidence in most cases, but the matter should not be left in doubt.

The Commission's regulations should specify: (1) Agencies have the burden of coming forward with evidence in all cases and, accordingly, shall proceed first at the hearing. (2) Agencies shall have the burden of persuading the fact finder, by a preponderance of the evidence, that an employee is guilty of the offenses charged. (3) A hearing officer may terminate an action against an employee after hearing the agency's evidence, if he concludes that the agency has failed to meet its burden of persuasion on all charges that would support disciplinary action.

6. *Prehearing conference and narrowing of disputed issues.*—The purposes of this recommendation are adequately summarized under paragraph A.1, supra.[74]

7. *Assembling a complete record.*—Most Commission appeals examiners assume responsibility for probing all of the facts underlying an agency's case, not simply those that the agency or employee developed at the agency hearing. Agency hearing officers, by contrast, are generally less inquisitive and more willing to allow the parties to dictate the scope of inquiry.

The hearing officer in adverse action proceedings should be free to question or cross-examine, to suggest avenues of exploration not pursued by the parties, and to request additional documentation—particularly if the employee is not represented.[75] The hearing officer should be responsible for compiling a complete evidentiary record which should not be subject to supplementation either before the deciding agency official or on appeal to the Commission.

In practice, however, the factual complexion of a case may change dramatically as it proceeds from the agency's first level, to the Commission's regional office, and finally to the Board of Appeals and Review.[76] Because of the Veterans Preference Act guarantee of a hearing before the Commission, compounded by the Commission's failure to define the scope of its review, both the regional examiners and the BAR permit fresh representations by the parties and occasionally seek new facts themselves.[77] Thus, the case the Board finally reverses sometimes is quite different from the one the agency upheld.

The willingness of regional appeals examiners and of the BAR to accept new evidence is justified as protecting employees, who may have failed to present the best case before the agency. Even so, the practice can only be defended as a means of compensating for the inadequacies of the agency hearing. If the hearing officer responsible for the initial hearing were experienced and independent, he should be able to elicit all of the testimony and documents needed for fair decision and meaningful review. Moreover, although the present practice may aid employees, it also affords employing agencies an opportunity to "correct" their own earlier omissions. All parties should prefer a procedure under which, except for evidence that would be admissible in court after trial, the factual record is closed with the completion of the hearing.[78]

Whether the hearing officer should accept proposed findings of fact or written argument after the hearing is concluded is problematical. Presumably he will wait until the transcript has been prepared before completing his recommended decision. It might be helpful to allow the agency and the employee to submit arguments to the hearing officer after they had read the transcript but this would delay disposition. Since most hearings consume less than a day, allowing five days following distribution of the transcript might not significantly postpone the decision. However, the same objective could be achieved more simply by providing the parties with copies of the examiner's proposed decision together with the hearing transcript and allowing both sides to submit written arguments to the deciding agency official.[79]

8. *Hearing officer's decision.*—The hearing examiner should submit his recommended decision to the employing agency official responsible for deciding the case. The purpose for this is to allow the employing agency new opportunity to review disciplinary actions taken by lower authority. The official's decision should be final for the agency, which should be able to make whatever personnel action he approves fully effective at this point. If the deciding official's decision is to dismiss the action, whether or not the examiner so recommended, the case should terminate. If the deciding official accepts the hearing officer's decision against the employee, his decision should be appealable directly to the Commission. If he does not accept the hearing officer's decision exculpating the employee or proposing a lesser penalty, he should prepare a decision in writing which includes a statement of his reasons. Under present regulations, he would be required to refer the case to higher agency authority.[80]

This referral requirement was designed to enhance the independence of the hearing officer and the importance of the agency hearing.[81] The requirement contributes to delay, however, and would afford no significant advantage if hearings were conducted by Commission examiners. It is only when the deciding official would not adopt the examiner's favorable recommendation that an employee might gain from referral to higher authority. Requiring the deciding official to state his reasons, as part of the record subject to review, would reduce the risk of initial arbitrariness. In addition, the Commission would be more likely to reverse an agency's action in favor of a decision recommended by its own examiner rather than by an employee of the agency. The present rule builds in an additional procedural step in cases where further review by the agency seems unlikely to change the result, and that are likely to be appealed to the Commission.

9. *Subpoena power for hearing officers.*—No agency or Commission hearing officer has authority to subpoena witnesses in adverse action cases. There have been complaints about the reluctance of agencies to make employees available to testify on behalf of an appellant. Such incidents should become less frequent under the Commission's regulation authorizing hearing officers to postpone a hearing until the agency makes available an employee whose testimony is considered essential.[82]

The refusal of witnesses who no longer are, or never were, in the government's employ to become "involved" is potentially a more serious obstacle to assembling a complete record. The problem may be partly one of money. A ruling of the Comptroller General permits employing agencies to pay the expenses of non-government witnesses in adverse action hearings, but they cannot reimburse for lost wages.[83] Nor can they compel the attendance of any private citizen who refuses to cooperate, even if his testimony might vindicate the threatened employee. It is difficult, however, to determine how frequently either problem arises,[84] though private attorneys who practice in this area have called attention to it before. To the extent off-the-job behavior may be a legitimate basis for adverse action non-government witnesses will remain important.

Because of the lack of hard evidence that the inability of hearing officers to subpoena witnesses has been a significant problem, the Committee has followed the suggestion of the Council that no recommendation to authorize the issuance of subpoenas be proposed at this time. A second factor in the Committee's thinking on this issue was the recognition that authorization for subpoenas would unquestionably require legislation. Finally, the question of subpoena power in adverse action cases may properly be considered in any future general inquiry into the use of mandatory process in administrative proceedings.

The failure to propose any recommendation with respect to the use of subpoenas should in no way weaken the Civil Service Commission's current regulations, which in substance obligate employing agencies to make their employees available as witnesses.[85] At the same time, it is understood that the initial responsibility for requesting the attendance of witnesses in the agency's employ rests with the employee himself.[86]

C. Procedures for Appeals from Agency Decisions

1. *Agency appeals systems.*—From the employing agency's final decision to accept or reject the hearing officer's recommendation, an employee could appeal directly to the Civil Service Commission. Agency appeals systems, as they now operate, would still have an opportunity—at whatever level it chose—to review actions taken by local installations after receiving the hearing officer's recommended decision. In designating the official(s) to render the final agency decision an agency would of course have to balance the desire to maintain uniformity in discipline and the desire to disperse responsibility for decision. Under the system proposed, employing agencies could reexamine every contested adverse action initiated by local authority, because an employee could no longer appeal directly to the Commission and circumvent his agency's internal review system.[87] The primary difference is that an employee would continue to receive pay during the agency's consideration of his case. In short, it is probably more accurate to say that the recommended system would recharacterize, rather than eliminate, agency "appeals" systems.

The proposed recommendation would entail two additional changes. No agency would be permitted to maintain a second appeals level for adverse action cases, as five now do.[88] These second levels serve little purpose. They adjudicated only 61 cases in 1970. In addition, since an employee can, and most do, now ignore his agency's second level and proceed directly to the Commission, they cannot be justified as affording employing agencies a second opportunity to review their decisions. Furthermore, under the recommendation no employee would forfeit an opportunity to seek Commission review as do employees who now appeal to their agency's second level.[89]

2. *Single appeal to the Commission.*—A central premise of the proposed recommendation is that the system for adjudicating adverse actions should give employing agencies one opportunity to correct their errors and guarantee

employees at least one opportunity for external administrative review. Accordingly, a single level of post-action review in the Commission is proposed, which would consider cases on the record assembled at the agency. A second appeals level within the Commission would add substantially to the time required for final decision without providing employees additional protection against arbitrary agency action.[90]

Arguments can be made that the Commission's appellate authority should be lodged in its eleven regional offices, which are accessible to agencies and employees, and which collectively could more easily absorb an increased caseload. Except for such short-run convenience, however, there would be few advantages in decentralizing appellate responsibility. Dispersion of decisional authority would permit inconsistent decisions among the regions, a problem that exists now partially because both regional and BAR decisions are not readily available. Little evidence exists that the regional offices possess a unique appreciation of local agency needs that support differing qualifications for federal employment. Moreover, it is doubtful whether the system should facilitate expression of local prejudices. Most regional appeals examiners are qualified, conscientious, and fair, but these are not qualities dependent on location.[91]

Furthermore, if appeals are confined to the record, with no further introduction of evidence permitted, the convenience argument loses much of its force. Centralizing the Commission's appellate function would make oral argument more costly, but in the long run would yield uniformity, independence, and efficiency. A dispersed appeals system would almost certainly lead eventually to creation of some central authority to correct what are perceived as serious errors and reconcile inconsistent results, *i.e.*, a second appellate level.

Accordingly, all employee appeals should be directly from agencies to the central appellate authority in the Commission. This would necessitate enlarging the present Board of Appeals and Review, or any successor, and employing additional staff, but these costs would be more than offset by savings achieved through the elimination of an entire appellate level.[92]

3. *Appeal record.*—The record on appeal should consist of the record assembled by the Commission-appointed hearing officer during the agency hearing; the hearing officer's recommended decision; the agency's decision; and any written arguments the parties desire to submit. Only if an employee could show he was justifiably unaware of evidence, or prevented from introducing it, at the time of the agency hearing could the Commission accept any evidence, and then only subject to the agency's opportunity to respond. Except in responding to such evidence presented by an employee, the agency should not be allowed to introduce additional facts to strengthen its case.[93]

4. *Power to modify agency decisions.*—Although agency appellate levels frequently reduce the punishment meted out to employees by local installations, the Commission's appellate offices for practical purposes never formally modify agency penalties.[94] The Commissioners themselves retain authority to reduce agency penalties, but they delegate it only in response to specific request by the Board of Appeals and Review. The BAR rarely seeks such permission to reduce the penalty an agency has imposed.[95] Theoretically, therefore, the Commission's regional offices and the BAR must either affirm an agency's action, or reverse it for procedural error or for lack of support for the penalty imposed. They cannot accept the agency's fact findings but disagree with its disposition, or impose a lesser penalty when only some of the agency's charges are upheld. This constraint on Commission disposition is justified by the argument that the Commission should not second guess agency disciplinary judgments.[96] The practice exacts costs in terms of both fairness and efficiency.

The recurrent theme of employee appeals to the Commission is that the agency's action far exceeds the offense, which the employee frequently admits. A likely result is that the Commission's appellate offices affirm actions that they privately believe are too harsh. In addition, it is widely acknowledge that regional appeals examiners reverse cases on procedural grounds that would otherwise be viewed as harmless when they find an agency's action excessive.[97] Employees thus suffer excessive penalties because of the Commission's reluctance to revise agency judgments, while at the same time procedural reversals

often exaggerate the importance of comparatively insignificant and rarely prejudicial departures from form.[98]

The Commissioners should delegate their power to modify agency decisions to the central appeals authority. A few agencies may object to the Commission's second-guessing their judgments.[99] Most would acquiesce in occasional revision of their penalties in return for fewer procedural reversals. Operating through a single level of appeal, the Commission should be able to achieve uniformity in exercising the power to reduce agency penalties, and seize the opportunity to rationalize penalties throughout the federal service. Furthermore, with authority to consider penalties openly, rather than through the subterfuge of procedural error, the Commission's appellate authority could distinguish between procedural effects that potentially affect fairness and those that do not.

5. *Decisional process.*—When a case now reaches the Board of Appeals and Review it is assigned to one of several appeals examiners for preparation of a proposed decision. After a decision has been drafted, the case file is circulated to a member of the Board for his concurrence, revision, or correction. Once he has approved a decision, the case is submitted to a second member of the Board. If he concurs, the decision will issue under the signature of the Board's chairman. If the second member disagrees with the disposition proposed, the case is submitted to a third whose vote determines the outcome. Dissents have not been reported to the agency or the employee.[100]

One would feel more comfortable if cases were examined by at least one Board member *before* a decision was drafted. Many appellate judges and agency heads follow a similar practice, however, directing a law clerk to prepare a proposed opinion before they have studied a case. So long as Board members take responsibility for decisions, their method of reaching them must be their own.

The chairman's practice of signing all decisions and the failure to announce the views of individual members are likewise troubling.[101] It is probably indispensible for the Board to operate, *de facto*, in panels of three, as do the federal Courts of Appeals, but the chairman's signature misleadingly implies that the decision is the work of the board *en banc*. There is no good reason why Board members should not be permitted formally to register their disagreement with cases about which they feel strongly. Announced dissents would breathe some life into the process and perhaps aid judicial review.[102]

Finally, so far as possible, cases should be assigned among Board members by lot or rotation, not on the basis of their backlogs. Long-time observers of the BAR believe the members differ sharply in their attitudes toward cases, which is hardly surprising, and that the outcome of an appeal can depend upon which members decide it. While the influence of philosophic differences cannot be eliminated from the decisional process, doubts that panel composition is solely a matter of chance should be laid to rest.

6. *Authority of Commissioners to reopen.*—The Civil Service Commissioners are responsible for formulating federal personnel policy. An employee or agency that believes a decision of the Commission's appellate authority departs from, or threatens, established policy should continue to be able to petition the Commissioners to reopen the case.[103] This avenue of review is rarely pursued, and should remain an extraordinary remedy. Yet it affords the Commissioners an opportunity in important cases to clarify or redirect disciplinary policy. In considering petitions to reopen, the Commissioners should not receive advice from any Commission official who previously was involved in the decision of the case, or provided advice on it to the employing agency.[104] Nor should they be required to announce reasons for refusing to reopen a case.

7. *Release of Commission decisions.*—Like decisions of the Commission's regional offices, those of the BAR are distributed only to the parties involved and, infrequently, among other Commission offices.[105] Although it is said that *stare decision* does not govern disposition of adverse action appeals, many regional appeals examiners and the BAR maintain files of their own decisions and attempt to reach consistent results in like cases. During recent years one Board member has been compiling an index of BAR decisions to facilitate internal research.[106] Some agencies whose own caseloads generate recurrent

problems and produce pressure for consistent treatment have developed their own case files. However, employing agencies do not know, except by word of mouth or judicial decision, about cases begun by other agencies. Commission regional offices are familiar with their own precedents and with BAR decisions in cases they originally adjudicated but not with cases from other regions. Private lawyers representing employees lack even this limited access to the administrative precedents. Union representatives are often able to draw on personal experience, but may never learn about cases that did not involve union members.[107]

In short, although the adverse action process is in fact precedent-oriented, it has produced no published or available case law. it is as though the NLRB published no decisions and union and employer representatives had to rely on the labor cases decided by the federal courts. The situation is probably worse, for relatively fewer adverse action cases reach court, and until recently judges were rarely willing to consider any but procedural issues.[108] Furthermore, the Commission has not attempted to amplify the substantive law of employee discipline through regulations defining "efficiency." [109]

The Commission and employing agencies have routinely justified refusal to disclose decisions as protecting employee privacy, as well as federal funds. There are two possible answers to the privacy claim. On a theoretical level, one could argue that the public's interest in the operations of government outweighs the employee's interest in privacy, as in the case of court proceedings. Without reaching that issue, however, it is possible to accommodate employee privacy and the public's right to know. Deletion of names, dates, and perhaps locations (although not the names of agencies or descriptions of installations) from agency and Commission decisions would prevent any but coincidental identification of the employees involved, without nullifying the value of the decisions as guides to employee performance and behavior. There would appear to be no reason why the BAR index of decisions should not be available on the same terms.[110]

Sanitizing decisions for release would entail modest expense. An intelligent clerk could delete identifying passages from the average five-page BAR decision in 15 minutes. If he processed 20 cases a day, he could keep pace with the production of the Board members themselves. The Commission need not bear the cost of distributing decisions beyond the parties and among its own offices. Decisions could be supplied to other agencies, employee unions, private lawyers, and libraries on a paid subscription basis, and made available for inspection at the Commission without charge.

There could be some additional expense. Release of appellate decisions would probably cause both the agencies and the Commission to increase efforts to inform federal employees about significant cases, and about the increasingly desirable contours of the "efficiency" standard.

Another reason it is rumored, that decisions are not released is that many could not withstand public scrutiny. This charge is exaggerated, but not purely hyperbole. Few commission decisions seemed wrong, but opinions often failed adequately to justify, or even explain, the result reached. *Ipse dixit* is the dominating characteristic of some decisions, which detail the offense(s) the employee was found to have committed but rarely discuss why the action upheld would "promote the efficiency of the service."[111] The "thrust" of such decisions—if that is the appropriate term—is simply that the employing agency could reasonably have concluded that its action would satisfy the statute.

Recommendations that simply urge an agency to do a better job are not likely to have much impact. Therefore, it would be pointless to recommend that the Commission and employing agencies write better decisions. But decisions are very likely to improve if they are required to be made public, and thus open to criticism.

D. Ex Parte Communications

1. *Commission advice to agencies.*—It is not uncommon for a Commission regional director or even appeals examiner to be consulted by an agency about the steps it should follow in adjudicating a particular case, or for the official consulted to give such advice.[112] Under the proposed system for adjudicating adverse action appeals, the Commission's appellate authority should neither respond to nor initiate communications with employing agencies about particular cases. It would be manifestly improper for any appellate official to advise an agency about the prosecution of a case and later participate in deciding the employee's appeal.[113]

The Commission itself would remain responsible for establishing and revising adverse action procedures, and for providing agencies with information about the operation of the system in general. Such information could be highly detailed and precise, *e.g.*, including examples of letters of proposed charges. Even in particular controversies, it would be short-sighted to forbid all communication between the agency and the commission. Consultation with Commission officials before any letter of proposed charges has been issued is more likely to persuade the agency that it has no basis for initiating action than to provoke action that the agency would not have taken on its own. Once a letter of charges has issued, however, *no* Commission official should provide aid to the agency, whether or not he might later be involved in deciding a possible appeal. If the Commission is to function successfully as an adjudicatory agency, there should not be even the appearance of its involvement in agency prosecution of individual cases.

It should be noted that under the system proposed, agencies should less often require advice about handling particular cases, because hearings should be conducted by hearing officers appointed and trained by the Commission.

2. *Ex parte and command influence.*—It is credibly alleged that some Commission regional directors exercise considerable control over the disposition of cases by their appeals examiners.[114] As the regional directors assume responsibility for decisions, they should be expected to look before they sign. But often the reasons that prompt their exercise of decisional authority reportedly have little to do with the merits of cases, or respond to communications outside the record. When the regional director intervenes, it is usually to affirm the agency's action.

To the extent such influence prevails. it threatens the fairness of the process in two ways. The inputs that cause a director to revise the appeals examiner's decision, although relevant, may not be known to the employee and thus he may have no opportunity to rebut them. There is the further danger that cases will be decided on grounds that bear no relation to the merits, a danger that is heightened in a system that requires no public explanation of decisions.

Commission regional directors could not influence the disposition of appeals under the recommended system, of course, since appeals would come directly to the Commission's central appeals authority. Off-the-record communications could still prejudice the process, however, if no rule against *ex parte* contracts were adopted. The opportunities for illegitimate influence would be considerably reduced if no further *factual* representations, *ex parte* or otherwise, were permitted after the record was closed.[115] In addition, the Commission's appellate authority should observe a rule against *ex parte* contact that requires disclosure of, and an opportunity to respond to representations on behalf of either party in a case before it.

Finally, the same rule should apply to information or assistance solicited by the appellate authority on its own motion. The appellate authority should only receive evaluative assistance from experts—*e.g.*, disability experts or job classification specialists—on the record, subject to the right of both parties to respond. Hearing officers who preside at agency hearings should, of course be subject to similar constraints.

E. Role of the Civil Service Commission

The Civil Service Commission not only adjudicates individual cases and exercises primary responsibility for establishing the procedures that governing all agencies in removal and discipline cases, it is also responsible for formulating and implementing government personnel policy. The superficial inconsistency of these roles has provoked charges from several quarters that the Commission should remove itself altogether from deciding adverse action appeals.[116] The thrust of the argument is two-fold: (1) As management's personnel advisor, the Commission is incapable of viewing employee appeals objectively or of fairly assessing managerial claims. (2) Whether or not actual bias can be shown, the Commission is viewed by employees as an arm of management, and this alone undermines confidence in the system.

I am not persuaded that responsibility for final adjudication of adverse action cases should be removed from the Commission. While some Commission decisions seem wrong, their defects are less often a product of a managerial bias rather than carelessness, lack of candor, or misjudgment. The failures are principally failures of quality, not predeliction. There are cases that support the critics,[117] but not enough of them alone to justify creation of a new agency. Furthermore, the Commission's adjudicatory functions can be better insulated from managerial pressures, and other steps taken to enhance impartiality. The specific proposals have already been discussed.[118]

It is not uncommon for government agencies to combine responsibility for formulating policy with authority to adjudicate individual cases that test its application. The Food and Drug Administration, the Federal Trade Commission, the Securities & Exchange Commission—indeed most major regulatory agencies—are examples. In these instances, experience and expertise are thought to outweigh the risks of systematic bias, which can be inhibited by appropriate separation of functions[119] and, in the final analysis, cured through judicial review. On this theory, one can justify assigning responsibility for deciding adverse action appeals to the agency most knowledgeable about government personnel policy.[120]

In addition, there is an important difference between the role of other agencies and that of the Commission in adverse action appeals. The FTC, for example, both initiates cases and later decides them. But except when one of its own employees is involved, the Civil Service Commission is not the moving party in any adverse action. It may have a stake in the efficient implementation of government personnel policies, but it has not previously taken a position respecting the employee involved.

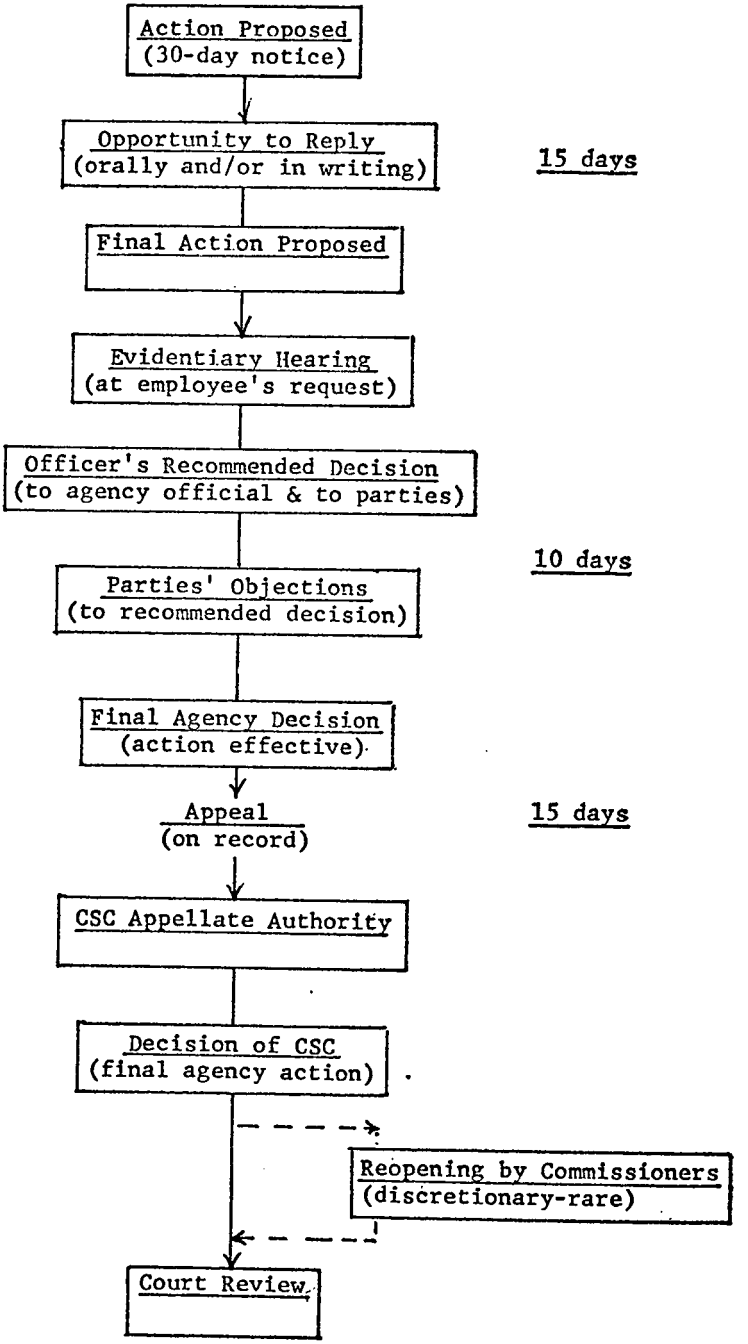
A final argument against shifting responsibility for disposition of adverse action appeals from the Commission to some other agency is that such action would require Congressional approval.[121]

CONCLUSION

A final word may be in order to forestall one objection to the procedural scheme embodied in the proposed recommendations. If one were devising procedures for personnel disputes for the first time, unencumbered by precedent or statute, one might produce a less formal, less complicated system than that proposed. The present system, however, is already highly judicialized. Furthermore, many of its features—such as the requirement of an evidentiary hearing at some stage, are clearly required by the Constitution.[122]

While several of the proposed recommendations would contribute to formality, they are designed primarily to enhance the fairness of procedures that are already undeniably adversary. Many other of the recommendations are intended to expedite disposition and eliminate duplication. For example, the recommendations would eliminate an entire level of appeallate review, and limit employees to a single evidentiary hearing. In short, the proposed reforms would simplify an already complex process and ensure greater fairness for employees.

PROPOSED ADVERSE ACTION PROCEDURE



V. COUNSEL IN ADVERSE ACTION CASES

A. Use of Representation by Employees

The Committee makes no recommendation at this time on the important and controversial issue of whether counsel should be provided for employees who cannot afford to pay for representation. A threshold reason for avoiding a recommendation is that the underlying issue is broader than the adverse action context and raises questions concerning the need for counsel for indigents in an wide range of administrative adjudicatory proceedings. Secondly, data concerning the availability of counsel to federal employees is scanty. Finally, available evidence about adverse actions fails to establish any correlation between representation and eventual success on appeal.[1]

1. *Right to counsel.*—It should be emphasized that the issue here is not whether employees have the "right" to be represented in adverse action proceedings. Under present Civil Service Commission regulations, an employee against whom adverse action is proposed may be represented in replying to the agency's charges, in preparing for and appearing at any evidentiary hearing, and in processing any further appeal. The representative can be practically anyone the employee chooses: a friend, a fellow employee,[2] a union or other organizational spokesman,[3] or a private attorney. If the representative is a fellow worker he, like the employee charged, is entitled to time during working hours to prepare and participate, and is protected against constaint or coercion by the agency.[4] Apart from this very limited form of government subsidy, however, no provision is made for assisting employees to find or pay for representation.

2. *Frequency of representation.*—Based on data from fiscal year 1970, roughly one-third of all appellants proceeded without representations.[5] Approximately one-third rely on union representatives, and roughly one-fourth employ private attorneys.[6] The remainder are represented by other groups or individuals, e.g., veterans organizations, Legal Aid, OEO lawyers, fellow employees, etc. Agency and Commission officials believe the percentage of represented employees is increasing, but there is no later data to document this impression.

We do not know how many employees subject to adverse action—not simply those who appeal—have representation. Available data disclose a striking correlation between representation and employee decisions to appeal further, either to the Commission or to an agency second level.[7] That correlation alone would suggest that far fewer non-appellants than appellants are represented. A few employees who decide not to appeal may have consulted an attorney, and others may have sought and been denied union assistance, but it is difficult to believe there are many in either category. However, because we lack information about the universe of employees subject to adverse action—such as age, grade, or pay scale—it is impossible to determine why more employees do not have representation. Inability to pay may be part of the explanation, but we have no idea how large a part.

3. *Distribution of representation.*—Representation appears to be proportionately distributed among appellants measured by almost every criterion. The only significant exception to this generalization is that appellants contesting removal are much more likely to be represented than those appealing some lesser action.[8] One finds no notable disparities in frequency of representation based on grade or pay.[9] Wage Grade and Postal Field Service employees rely more on union spokesmen than GS scheduled employees, more of whom employ private attorneys, but the percentage of unrepresented employees does not vary significantly among these groups.[10] Among employees with from 3 to 30 years of service, frequency of representation in agency appeals remains almost constant at roughtly 65 per cent.[11] Employees in the lowest grades are represented slightly less frequently, but employees in the highest grades—who presumably can best afford representation—rely on it least.[12] The disparities are small, however, and probably insignificant. Several factors are probably operating here, in addition to ability to pay. Employees undoubtedly weigh what they perceive to be their chances of ultimately defeating the action against them, their opportunities for other employment, and the importance of the jobs they are losing, as well as their need or desire for professional advice and assistance.

4. *Effects of representation.*—Based solely on employees who appeal, our data suggest that having representation does not make much difference in the

outcome. In fiscal 1970, employees with no representation of any kind fared as well in agency appeals systems as those with union or attorney spokesmen,[13] and actually prevailed more often before the Commission.[14] One must be very cautious, however, in attributing significance to the figures on this point. We know practically nothing about the cases unrepresented employees won, or why they did not have representation. Conceivably, many realized they did not need help (although the low success rate of employee appeals generally casts doubt on this hypothesis). Unions may devote more efforts to harder cases that are won less frequently. Or many successful employees may have had assistance in preparing a written appeal although they did not appear with counsel, and accordingly were recorded as "self represented."

It is particularly difficult to explain why unrepresented employees not only won on procedural grounds more often than on the merits, but won on procedures far oftener than employees who had attorney or union representation.[15] One cannot believe these successful appellants recognized at the outset that the agency had committed a procedural error that would eventually require reversal and therefore decided to dispense with representation. As these procedural reversals were more common among Commission decisions, there is a more likely explanation. Because the Commission's regional offices cannot reduce agency penalties, it is reported that they frequently find procedural errors to upset agency actions they regard as to harsh. Most appellants claim that the agency's punishment was excessive and many, including a high percentage of those who "represent" themselves, make no other argument. Thus, the surprising frequency of procedural reversals in favor of employees without representation may simply reflect examiner solicitude for appeals for clemency, and not indicate that employees are able adequately to represent themselves.[16] This does not of course explain why unrepresented employees fare no worse before the agencies.

Apart from the uncertain relationship between representation and success on appeal, our data reveal other, less equivocal correlations. Employees who are represented are twice as likely to request an evidentiary hearing as those who are not.[17] They are more likely to press their appeals beyond the initial level of decision, either to the Commission or to a second level within their agencies.[18] And the appearance of a representative adds significantly to the time required for decision.[19] There is no suggestion here that representatives purposefully delay the process. Since an employee is ordinarily out of a job during the appeals process, he gains little by delay. There are two more likely explanation. Adding another participant to the process makes coordination of schedules more difficult. In addition, employing agencies and the Commission examiners may proceed more cautiously in appeals by represented employees, perhaps because they raise more issues or are more persuasively argued, or perhaps because representation means that a case is more likely to be appealed.

B. Constitutional Considerations

Space does not permit extended discussion of the "right to counsel" issues involved in the adverse action process. Accordingly, only the basic outline of analysis will be suggested, but it supports the basic conclusion that the failure to provide counsel for indigent employees does not violate due process. This is not to suggest that some scheme for supplying representatives for employees who cannot afford them should not, for other reasons, be considered.

Since current regulations permit an employee to have representation at all significant stages of the process, it may seem a matter only of academic interest whether due process would independently require this opportunity for counsel. However, the suggestion that failing to provide counsel for indigent employees may violate equal protection depends on the availability of representation to employees who can afford it.[20] A persuasive argument could be made that the Commission could not now constitutionally prohibit employees from appearing with legal counsel. Although the rules of evidence are relaxed in adverse action proceedings, it requires skill to marshal and present facts, and the ability to analyze agency regulations and distinguish earlier decisions may be important in contesting the sanction proposed by the agency. Moreover, an employee's opportunity to present witnesses and to confront and cross-examine those of the agency may be substantially diluted without legal assistance.[21] For these and other reasons, the right to be represented by counsel—as distin-

guished from the right to have counsel appointed—may be considered as important to a fair hearing in this as in other administrative contests.[22]

The question arises then, if counsel is essential to a fair hearing, why must not the government provide counsel for employees who cannot afford to pay for one.[23] There are several answers, none entirely satisfactory but which together warrant postponing any recommendation that counsel be appointed.

First, the overwhelming majority of cases suggest that the failure to provide counsel in this and similar contexts is not unconstitutional. No court has held or even suggested that an employee in an adverse action proceeding who cannot afford an attorney must be provided one. In a closely related context, the Sixth Circuit recently held that the Air Force was not obligated to provide counsel for black civilian employees who challeneged alleged discriminatory employment practices under the department's Equal Employment Opportunity procedures.[24] In *Goldberg* v. *Kelly*, the Supreme Court, quoting *Powell* v. *Alabama*,[25] held that a welfare recipient should be allowed to appear with counsel at any pre-termination hearing, but refused to require that representation must be provided.[26] Finally, last term the Supreme Court refused to decide whether due process requires appointment of counsel for indigents charged with parole violation.[27]

Standing against the Supreme Court's conspicuous silence are the arguments of commentators that appointment of counsel in adjudicatory proceedings threatening deprivaion of vital individual interests should be a matter of constitutional command,[28] and a provocative decision of the Federal Trade Commission. In *In re American Chinchilla Corp.*,[29] the Commission ruled that when a respondent in an adjudicatory proceeding made an adequate showing of indigence, he was entitled to have counsel appointedl. The respondent was charged individually with making false and misleading representations to prospective purchasers of his company's breeding stock. Significantly, the Commission based its decision neither on its own rules of practice, which provide parties to hearings "all . . . rights essential to a fair hearing," [30] nor on the Administrative Procedure Act, which grants "any person compelled to appear in person before any agency or representative thereof the right to be accompanied by counsel." [31] Rather, the ground of decision was constitutional due process:

> We have no doubt that . . . where an adequate showing of financial inability is made out, a respondent is entitled to counsel. We can think of nothing less conductive to fairness and due process in administrative proceedings than to pit the power of the state, armed with all the panoply of the legal machinery (funds, investigatory resources, staff of skilled attorneys, etc.) against a single individual and then deny that individual the right to counsel when he denies the allegations and specifically asserts that he cannot afford counsel.[32]

If the assumptions of this decsion were accepted by a majority of the Supreme Court, it would be difficult to resist the conclusion that due process requires appointment of counsel for indigent employees threatened with removal. The sanction is serious, and the reasons for removal frequently carry a stigma that will persist beyond the loss of employment. At this writing, however, the precedents do not require provision of counsel.

Moreover, the proposed recommendations should provide significant additional protection for the unrepresented employee. The proposal that every agency appoint an officer who shall seek out employees threatened with adverse action to provide information about the nature of the process, including the possible availability of representation outside the agency, should reduce complaints by employees that they did not understand what was happening. The recommendation that all hearings be conducted by examiners appointed by the Civil Service Commission will interject an outside, inquisitive voice into the process at the time when it can help.

Finally, any scheme for providing counsel for indigent employees must assume not only that representation is likely to contribute to success, but that employees forego representation because they cannot pay for it. The available evidence does not support either assumption, although as noted we lack information about employees who do not appeal. By definition, government employees are receiving pay, at rates that are comparable to those paid in private industry and, for the overwhelming majority, are well above the criteria of indigence in criminal cases. The recommendation that employees continue to

receive pay until after any hearing will sustain their ability to afford counsel during the stage of the process at which representation is likely to be most helpful. Undoubtedly, employment of an attorney entails expense that employees are reluctant to bear, and may for that reason avoid, but we have no evidence that significant numbers fail to appeal or appeal without representation because they cannot pay.

FOOTNOTES—PART I

[1] See generally, Kaufman, "The Growth of the Federal Personnel System," in S.W. Sayre (ed.), *The Federal Government Service* 7 (1965).

[2] The civil service is divided into two major classes, the competitive service and the excepted service. Entrance into the competitive service, sometimes referred to as the classified service, is controlled by the competitive service examining process. 5 U.S.C. § § 3301–64 (supp. IV, 1965–1968). Excepted positions are not subject to the examining process, but are covered by other provisions of the civil service laws and regulations. See 5 CFR part 213, subpart C (1971). Within both the competitive and the excepted services, certain categories of employment have a particular effect on employee tenure. These include the categories of probationary or trial period employment. 5 CFR part 315, subpart H (1971) ; 5 CFR Sections 2108, 3309, 3502(a)(2), 7512, 7701 (supp. IV, 1965–1968). Of less importance, but still pertinent to the tenure distinction, are the subcategories of temporary employment, term employment, employment outside of the executive branch, and employment for which Senate consent is required. 5 CFR § 752. 103(a) (1971).

As of 1968 the breakdown of Federal employees by category was as follows:

Competitive service	2,500,000
Career	1,907,000
Career-conditional	439,000
Temporary and indefinite	154,000
Excepted serivce	210,000
Permanent	127,000
Other	83,000

U.S. Department of Commerce, *Statistical Abstract of the United States* 395, Table No. 568 (1968).

[3] Civil Service Act of 1883, ch. 27, 22 Stat. 403.

[4] The present statutory authority for the civil service system is found primarily in 5 U.S.C. parts II, III (1970). For a history of the expanding functions of the Civil Service Commission, see generally, P. Van Riper, *History of the United States Civil Service* (1958).

[5] Van Riper, for one, is critical of the increasing bureaucratization of the civil service: [I]ncreasing red tape, greater procedural controls, more restrictive dismissal procedures, and more review and appeal boards—all in the name of justice, security, and fair play for civil service employees, are wreaking havoc with flexibility, administrative discretion, decentralization and ultimately, the individual again.

Van Riper, supra note 4, at 529. Cf. W. L. Riordon (ed.), *Plunkitt of Tammany Hall* 11–16 (1963).

The late Thurman Arnold, on the other hand, took the view that the Civil Service Commission fails adequately to protect Federal employees:

"Actually * * * the civil service affords practically no protection in the tenure of Government service. The head of a department, if he is conscientious, can always get rid of an employee by the process of reorganization that abolishes his job. If he is not conscientious, he can file a list of charges against an employee, listen to the employee's defense in an absent-minded way, and then fire him. The employee can appeal to the courts if he wants to spend his money uselessly * * *"

T. Arnold, *Fair Fights and Foul* 151 (1965).

[6] See generally, Craver, "Bargaining in the Federal Sector," 19 Lab. L.J. 569 (1968) ; J. Smith, "Executive Orders 10988 and 11491" and "Craft Recognition in the Federal Service," 48 Mil. L. Rev. 1 (1970) ; Donolan, "Recognition and Collective Bargaining Agreements of Federal Unions"—1963–1969, 21 Lab. L.J. 597 (1970) ; Wray, "Crisis in Labor Relations in the Federal Service:" An Analysis of Labor Management Relations in Federal Service Under Executive Order 11491, 37 Brooklyn L. Rev. 79 (1970). Also see Wellington & Winter, "The Limits of Collective Bargaining in Public Employment," 78 Yale L.J. 1107 (1969).

[7] See, e.g., Recent Decision, "Dismissal of Homosexuals from Government Employment:" The Developing Role of Due Process in Administrative Adjudications, 58 Geo. L.J. 632 (1970) ; Note, Federal Employment of Homosexuals ; Narrowing the Efficiency Standard, 19 Cath. L. Rev. 267 (1969) ; Note, Government-Created Employment Disabilities of the Homosexual, 82 Harv. L. Rev. 1738 (1969). See also Mirel, "The Limits of Governmental Inquiry Into the Private Lives of Government Employees," 46 B.U.L. Rev. 1 (1966).

[8] See generally, R. Vaughan, *The Spoiled System* (1972) ; Chaturvedi, "Legal Protection Available to Federal Employees Against Wrongful Dismissal," 63 N.W.U. L. Rev. 287 (1970) ; "Adverse Action Symposium:" The Development and Exercise of Appellate Powers in Adverse Action Appeals, 19 Am. U. L. Rev. 323 (1970) ; Berzak, "Right's Accorded Federal Employees Against Whom Adverse Personnel Actions are Taken," 47 Notre Dame Lawyer 853 (1972).

[9] 5 U.S.C. Section 7511(a) (1970). 5 CFR §§ 752.101, 752.201(b), 752.301(b) (1971).

[10] A recommendation implicit in this statement is that the Civil Service Commission and employing agencies must substantially improve their methods of recording adverse

actions and appeals. At the present time no government agency keeps a complete count of all adverse actions taken against Federal employees.

[11] The Civil Service Commission retains a computerized record of all personnel actions—including adverse actions—affecting Federal employees whose social security numbers end in "5." The assumption is that social security numbers are randomly distributed through the Federal workforce, thus making the experience of this 10 percent representative of the experience of all Federal employees.

[12] These figures are my own extrapolation from the Civil Service Commission's 10 percent sample for each of the 3 years. Except for the total for fiscal year 1970, the figures correspond closely to those in the annual accounting of personnel appeals compiled by the Commission's Office of Appeals Program Management. See U.S. Civil Service Commission, "Appeals Program Selected Data: Fiscal Years 1969, 1970, and 1971." The Commission's figure for total adverse actions taken in fiscal 1970 exceeds 19,000, with demotions accounting for most of the difference.

Historically, the Post Office has accounted for more adverse actions initiated and actions contested than any other department or agency. Although here again computation is difficult, it would probably be appropriate to discount my government-wide totals by roughly one-third to approximate the caseload throughout the rest of the government. This share is not high when one considers that the Post Office (now the United States Postal Service) employs no more than one-fifth of all Federal civilian employees.

[13] The traditional attitude of the Federal courts towards employee discharge cases is discussed in Chaturvedi, "Legal Protection Available to Federal Employees Against Wrongful Dismissal," 63 N.W. L. Rev. 287, 307–28 (1968).

[14] See Westwood, "The Right of an Employee of the United States Against Wrongful Discharge," 7 Geo. Wash. L. Rev. 212 (1938), who concludes:

In any case, as matters now stand, the individual employee is helpless. The [Lloyd-LaFollette] Act of 1912 gives him scant protection, even on its face * * * And the courts have stood fast against enforcing it.

Id. at 231. Some years earlier Mayers similarly wrote:

"The popular misconception as to the effect of this statute [Lloyd-LaFollette] sometimes is so extreme that it is thought that the employee has the right to invoke a judicial review of the action of the administrative officer in removing him. There is absolutely no warrent for this belief. Should the administrative officer choose to make a wholly unfounded charge against an employee and remove him on the basis of such charge, even if the employee's reply to such charge, filed before removal, were ever so conclusive, there is no way whatever in which the action of the officer may be submitted to a judicial review. * * *"

L. Mayers, *The Federal Service* 498 n. 1 (1922). Cf. Merton, "Judicial Review of the Dismissals of Executive Employees," 23 Geo. Wash. L. Rev. 69 (1954).

[15] *Bailey* v. *Richardson,* 182 F. 2d 46, 57 (D.C. Cir. 1950), aff'd per curiam by an equally divided court, 341 U.S. 918 (1951). For a critical discussion of the decision, see Gardner, *Bailey* v. *Richardson* and the Constitution of the United States, 33 B. U. L. Rev. 176 (1953).

[16] The notion that the executive has unlimited discretion to hire and fire its employees dates back at least to Ex parte Hennen, 38 U.S. (13 Pet.) 230 (1839). Other decisions taking this tack include, e.g., *Eberlein* v. *United States,* 257 U.S. 582 (1921); *Burnap* v. *United States,* 252 U.S. 512 (1920); *Shurtleff* v. *United States,* 189 U.S. 311 (1903). In *Deak* v. *Pace,* 185 F. 2d 997 (D.C. Cir. 1950), Judge Prettyman in dissent wrote:

"But the fact of the matter is that a Government employee has never in our history had any right to a job except such rights as Congress or the Executive gave him. * * *" 185 F. 2d at 1001. See generally Saferstein, Nonreviewability: A Functional Analysis of "Committed to Agency Discretion," 82 Harv. L. Rev. 367 (1968).

[17] E.g., *Crenshaw* v. *United States,* 134 U.S. 99 (1890); *Bailey* v. *Richardson,* 182 F. 2d 46 (D.C. Cir. 1950), aff'd per curium by an equally divided court, 341 U.S. 918 (1951). The right-privilege distinction assertedly was first enunciated by Justice Holmes in *McAuliff* v. *Mayor of New Bedford,* 155 Mass. 216, 29 N.E. 517 (1892). McAuliffe was dismissed from a position with the New Bedford police department pursuant to a regulation prohibiting certain political activities. In refusing to disturb the dismissal, the Supreme Judicial Court, through Holmes, stated that McAuliffe may have had a "constitutional right to talk politics, but * * * no constitutional right to be a policeman." 155 Mass. at 220. See Van Alstyne, "The Demise of the Right-Privilege Distinction in Constitutional Law," 81 Harv. L. Rev. 1439–45 (1968). Some commentators, however, have disputed that McAuliffe really validates the right-privilege distinction. Dotson, "The Emerging Doctrine of Privilege in Public Employment," 15 Pub. Adm. Rev. 77 (1955).

[18] 182 F. 2d 46 (D.C. Cir. 1950), aff'd per curium by an equally divided court, 341 U.S. 918 (1951).

[19] 182 F. 2d at 57. The full text of the court's statement on this point, written by Judge Prettyman, is as follows:

"In terms the due process clause does not apply to the holding of a Government office.

"* * * Never in our history has a Government administrative employee been entitled to a hearing of the quasi-judicial type upon his dismissal from Government service * * * . The controversy concerning the removal power began when the First Congress considered the establishment of the first executive department. Since then the subject has involved many colorful events and personalities over the years, including such as Presidents Jefferson, Jackson, Lincoln, Cleveland, Hayes, Theodore Roosevelt and Woodrow Wilson. The effort to establish a degree of stability in Government employ, tempestuous though that effort has been at times, has been made in the Congress and before the Presidents and their advisers, as a legislative and executive problem."

Later in the opinion Prettyman observed:

"In the absence of statute or ancient custom to the contrary, executive offices are held at the will of the appointing authority, not for life or for fixed terms. If removal be at will, of what purpose would process be? To hold office at the will of a superior and to be removable therefrom only by constitutional due process of law are opposite

and inherently conflicting ideas. Due process of law is not applicable unless one is being deprived of something to which he has a right."
182 F. 2d at 58. *See also* Kaplan, "The Law of Civil Service" 230 (1958).

[20] *See* Note, Review of Removal of Federal Civil Service Employees, 52 Colum. L. Rev. 787, 792–97 (1952).

[21] *E.g., Golding* v. *United States,* 78 Ct. Cl. 682, *cert. denied,* 292 U.S. 643 (1934). *See also, Levy* v. *Woods,* 171 F. 2d 145 (D.C. Cir. 1948).

[22] *E.g., Levine* v. *Farley,* 107 F. 2d 186 (D.C. Cir. 1939), *cert. denied,* 308 U.S. 622 (1940); *Fulligan* v. *United States,* 107 Ct. Cl. 222, *cert. denied,* 330 U.S. 848 (1947).

[23] *See* Chaturvedi, *supra* note 26.

[24] *Id.,* at 318.

[25] In *Garrott* v. *United States,* 340 F. 2d 615 (Ct. Cl. 1965), the Court of Claims suggested, in the clearest statement rejecting *Bailey,* that "the split decision of 1950 in *Bailey* v. *Richardson* * * * is no longer authoritative on this point." 340 F. 2d at 618–19.

[26] *Privilege:* Mr. Justice Holmes' blunt "privilege" observation delivered in the *McAuliffe* case, note 30, *supra,* was flatly rejected by the Supreme Court in *Pickering* v. *Board of Education,* 391 U.S. 563 (1968). Writing for the court, Justice Marshall stated:

"To the extent that the [opinion below] may be read to suggest that teachers may constitutionally be compelled to relinquish the first amendment rights they would otherwise enjoy as citizens to comment on matters of public interest in connection with the operation of the public schools in which they work, it proceeds on a premise that has been unequivocally rejected in numerous decisions of this court."
391 U.S. at 568, citing *Wieman* v. *Updegraff,* 344 U.S. 183 (1952); *Shelton* v. *Tucker,* 364 U.S. 479 (1960); and *Keyishian* v. *Board of Regents,* 385 U.S. 589 (1967). *See also Sherbert* v. *Verner,* 374 U.S. 398 (1963); *Goldberg* v. *Kelly,* 397 U.S. 254 (1970); *Dixon* v. *Alabama State Board of Education,* 294 F. 2d 150 (5th Cir. 1961). The decline of the privilege doctrine is treated in Van Alystyne, "The Demise of the Right-Privilege Distinction in Constitutional Law," *supra,* note 30. See also Van Alstyne, "The Constitutional Rights of Public Employees: A Comment on Inappropriate Uses of an Old Analogy," 16 U.C.L.A. L. Rev. 751–54 (1969); Linde, "Justice Douglas on Freedom in the Welfare State: Constitutional Rights in the Public Sector," 39 Wash. L. Rev. 4, 31–46 (1964); O'Neil, "Public Employment, Antiwar Protest and Preinduction Review," 17 U.C.L.A. L. Rev. 1028, 1040–55 (1970).

Discretion: Gadsden v. *United States,* 78 F. Supp. 126, 111 Ct. Cl. 487 (1948), *cert. denied,* 342 U.S. 856 (1951). *See also Balany* v. *Electrical Workers Local 1031,* 374 F. 2d 723 (7th Cir. 1967); *Gonzalez* v. *Freeman,* 334 F. 2d 570 (D.C. Cir. 1964). *Cf. Fay* v. *Douds,* 172 F. 2d 720 (2d Cir. 1949). Law review comment on discretion in the employment may be found in Chaturvedi, "Legal Protection Available to Federal Employees Against Wrongful Dismissal," 63 N.W. L. Rev. 287, 307–28 (1968); Note, "Dismissal of Federal Employees—The Emerging Judicial Role," 66 Col. L. Rev. 719, 737–40 (1966).

[27] *E.g., Scott* v. *Macy,* 349 F. 2d 182 (D.C. Cir. 1965); *Mechan* v. *Macy,* 392 F. 2d 822 (D.C. Cir. 1968), *modified on petition for reconsideration,* 425 F. 2d 469, *panel opinion reinstated by court sitting en banc,* 425 F. 2d 472 (1969); *Norton* v. *Macy,* 417 F. 2d 1161 (D.C. Cir. 1969). *Cf. Greene* v. *McElroy,* 360 U.S. 474 (1959); *Cafeteria & Restaurant Workers Local 473* v. *McElroy,* 367 U.S. 886, *rehearing denied,* 368 U.S. (1961).

[28] 417 F. 2d 1161 (D.C. Cir. 1969).

[29] 417 F. 2d at 1164.

[30] Compare the authorities cited in notes 31 and 32, *supra,* with *e.g., Vigil* v. *Post Office Department,* 406 F. 2d 921 (10th Cir. 1969); *Halsey* v. *Nitze,* 390 F. 2d 142 (4th Cir.), *cert. denied,* 392 U.S. 939 (1968); *Taylor* v. *Civil Service Commission,* 374 F. 2d 466 (9th Cir. 1967); *Brown* v. *Zuckert,* 349 F. 2d 461 (7th Cir. 1965), *cert. denied,* 382 U.S. 998 (1966); *Jenkins* v. *Macy,* 357 F. 2d 62 (8th Cir. 1966); *McTiernan* v. *Gronouski,* 337 F. 2d 31 (2d Cir. 1964); *Pelicone* v. *Hodges,* 320 F. 2d 754 (D.C. Cir. 1963); *Gadsden* v. *United States,* 78 F. Supp. 126 (Ct. Cl. 1948, *cert. denied,* 342 U.S. 856 (1951).

[31] These procedures, alone, would not satisfy the requirements of due process. See *Kennedy* v. *Sanchez,* No. 72 C 771, decided Oct. 24, 1972 (N.D. Ill.)

[32] See, e.g., Berzak, "Adverse Actions by Federal Agencies and Administrative Appeals," 19 Am. U. L. Rev. 387, 394 (1970); Berzak, "Review and Analysis of Professor Egon Guttman's Article" on "The Development and Exercise of Appellate Powers in Adverse Action Appeals," 19 Am. U. L. Rev. 367, 379 (1970).

[33] In fiscal year 1970, employees contesting removal within their agencies were successful less than 20 percent of the time. Approximately 24 percent were successful before the Civil Service Commission's regional offices. In appeals from reductions in grade or pay, employees prevailed more frequently, roughly 24 percent of the time at the agency level and in 47 percent of appeals to the Commission. In appeals from reductions in rank, their rates of success were 16 percent and 9 percent, respectively.

[34] See R. Vaughn, "The Spoiled System II–1 through II–152" (1972).

[35] See tables I–1 through I–4, pages 70a through 70j.

[36] See note 33, supra.

[37] During calendar 1968, 1969, and through March 6, 1970, the district courts, courts of appeals, and the Court of Claims decided 113 cases involving challenges to adverse personnel actions. In 84.1 percent, or 95, of these cases, the administrative action was upheld. Information supplied by the General Counsel, U.S. Civil Service Commission.

[38] See part III, infra, at —. Nine agencies, including the Departments of HEW, HUD, and Justice, and the Civil Service Commission itself provide a hearing before removal, but these nine account for no more than 10 percent of the total caseload.

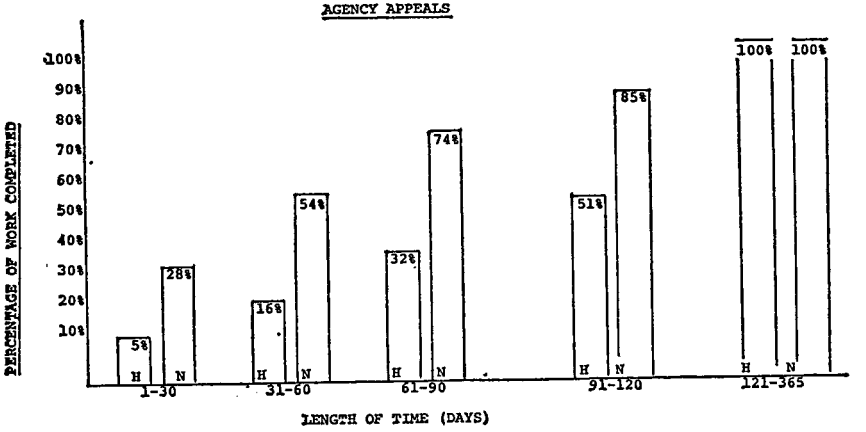
[39] *Cf. Cafeteria & Restaurant Workers Union* v. *McElroy,* 367 U.S. 886 (1961):

"[C]onsideration of what procedures due process may require under any given set of circumstances must begin with a determination of the precise nature of the Government function involved as well as of the private interest that has been affected by governmental action."

TABLE IV-1

TIME IN PROGRESS - EFFECT OF REQUESTS FOR HEARING

AGENCY APPEALS



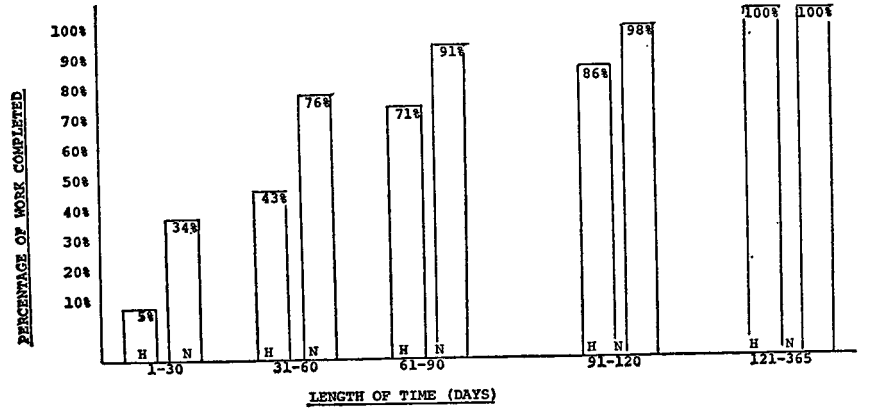
H = Hearing Requested

N = No Hearing Requested

TABLE IV-2

TIME IN PROGRESS - EFFECT OF REQUESTS FOR HEARING

APPEALS TO CSC REGIONAL OFFICES



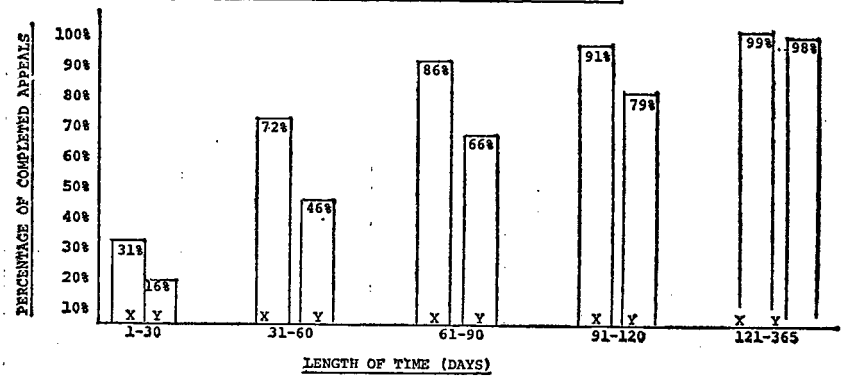
H = Hearing Requested

N = No Hearing Requested

TABLE IV-3

TIME IN PROCESS - EFFECT OF PRE-ACTION HEARING

AGENCY APPEALS AND APPEALS TO CSC REGIONAL OFFICES



X = Actions in Agencies That Grant Hearings Prior to Taking Action

Y = All Other Actions Reported

TABLE V-1

REPRESENTATION--DISTRIBUTION BY GRADE
AGENCY APPEALS

		GS CLASSIFICATION					WAGE GRADE				
		1-4	5-8	9-12	13-15	TOTAL	1-4	5-8	9-11	12-16	TOTAL
NONE	N	30	29	36	11	106	41	20	20	6	87
	P	38.9%	33.3%	25.4%	40.7%	31.8%	46.6%	20.2%	28.1%	46.1%	32.1%
ATTORNEY	N	20	19	57	10	106	17	22	14	3	56
	P	26.0%	21.8%	40.1%	37.0%	31.8%	19.3%	22.2%	19.7%	23.1%	20.7%
UNION	N	26	34	43	5	108	27	51	28	3	109
	P	33.8%	39.1%	30.3%	18.5%	32.5%	30.6%	51.5%	39.4%	23.1%	40.2%
OTHER	N	1	5	6	1	13	3	6	9	1	19
	P	1.3%	5.8%	4.2%	3.8%	3.9%	3.5%	6.1%	12.8%	7.7%	7.0%
TOTAL	N	77	87	142	27	333	88	99	71	13	271
	P	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

N = NUMBER OF ACTIONS

P = % OF APPELLANTS WITH DESIGNATED REPRESENTATION

TABLE V-2

REPRESENTATION--DISTRIBUTION BY GRADE
APPEALS TO CSC REGIONAL OFFICES

		GS CLASSIFICATION					WAGE GRADE				
		1-4	5-8	9-12	13-15	TOTAL	1-4	5-8	9-11	12-16	TOTAL
NONE	N	22	37	59	21	139	35	26	15	14	90
	P	37%	38%	34%	55%	38%	51%	31%	21%	64%	36%
ATTORNEY	N	15	15	61	13	104	9	19	12	3	43
	P	25%	15%	36%	34%	28%	13%	22%	17%	14%	18%
UNION	N	16	41	48	4	109	14	32	34	1	81
	P	28%	42%	28%	11%	30%	21%	38%	47%	4%	33%
OTHER	N	6	5	4	--	15	10	8	11	4	33
	P	10%	5%	2%		4%	15%	9%	15%	18%	13%
TOTAL	N	59	98	172	38	367	68	85	72	22	247
	P	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

N = NUMBER OF ACTIONS

P = % OF APPELLANTS WITH DESIGNATED REPRESENTATION

TABLE V-3

REPRESENTATION--DISTRIBUTION BY LENGTH OF SERVICE
AGENCY APPEALS

LENGTH OF SERVICE (YEARS)

		1-3	4-5	6-10	11-20	21-30	30+	TOTAL
NONE	N	9	15	33	73	61	2	193
	P	36%	29%	29%	33%	34%	23%	32%
ATTORNEY	N	5	13	34	59	46	3	160
	P	20%	26%	30%	27%	26%	33%	27%
UNION	N	8	18	42	85	61	3	217
	P	32%	35%	36%	38%	34%	33%	36%
OTHER	N	3	5	6	6	12	1	33
	P	12%	10%	5%	2%	6%	11%	5%
TOTAL	N	25	51	115	223	180	9	603
	P	100%	100%	100%	100%	100%	100%	100%

N = NUMBER OF ACTIONS

P = PERCENTAGE OF APPELLANTS WITH DESIGNATED REPRESENTATION

TABLE V-4

REPRESENTATION--DISTRIBUTION BY LENGTH OF SERVICE
APPEALS TO CSC REGIONAL OFFICES

LENGTH OF SERVICE (YEARS)

		1-3	4-5	6-10	11-20	21-30	30+	TOTAL
NONE	N	35	32	68	111	82	10	338
	P	38%	43%	41%	45%	38%	50%	42%
ATTORNEY	N	17	19	32	69	67	4	208
	P	19%	26%	19%	29%	32%	20%	26%
UNION	N	36	23	66	64	64	6	259
	P	39%	31%	40%	26%	30%	30%	32%
OTHER	N	4	--	--	--	--	--	4
	P	4%						--
TOTAL	N	92	74	166	244	213	20	809
	P	100%	100%	100%	100%	100%	100%	100%

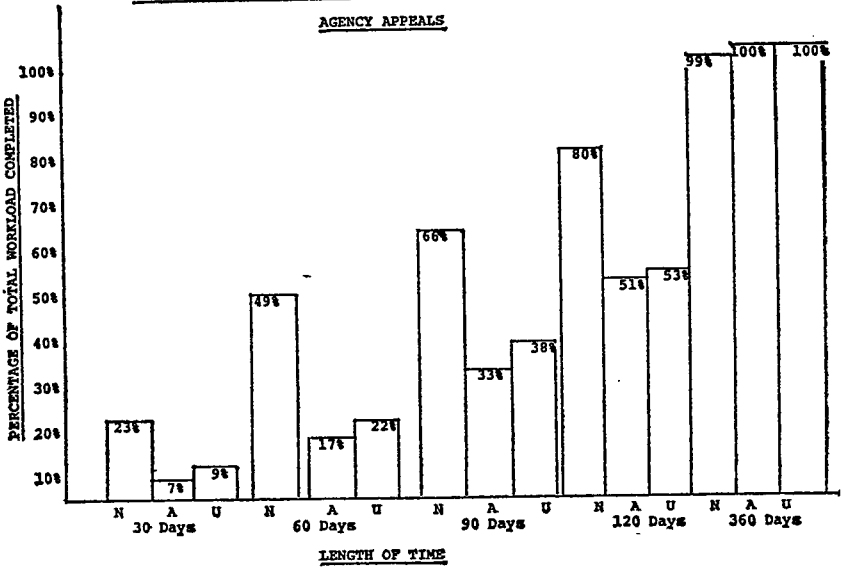
N = NUMBER OF ACTIONS

P = PERCENTAGE OF APPELLANTS WITH DESIGNATED REPRESENTATION

TABLE V-5

EFFECT OF REPRESENTATION ON TIME REQUIRED FOR DECISION

AGENCY APPEALS



N = NO REPRESENTATION

A = ATTORNEY

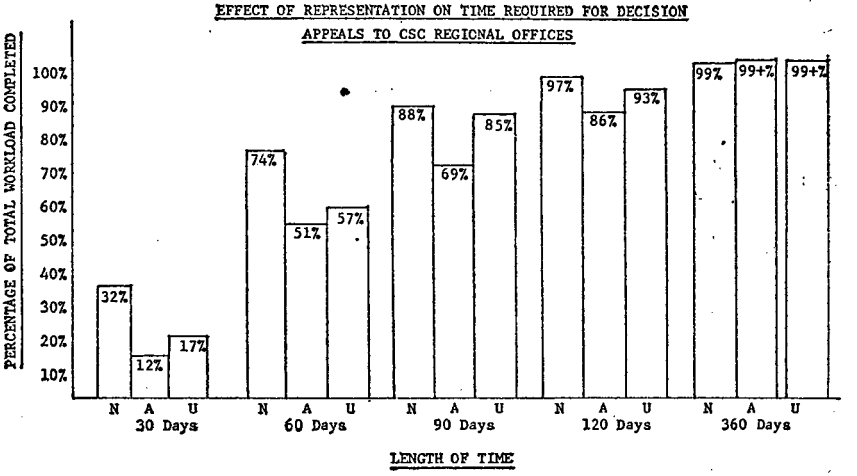
U = UNION

TOTAL CASES: 605

TABLE V-6

EFFECT OF REPRESENTATION ON TIME REQUIRED FOR DECISION

APPEALS TO CSC REGIONAL OFFICES



N = NO REPRESENTATION

A = ATTORNEY

U = UNION

TOTAL CASES: 898

TABLE V-7 EFFECT OF REPRESENTATION ON DECISION TO TAKE FURTHER APPEAL

AGENCY APPEALS

		AGENCY[1]	CSC[2]	NONE TAKEN	TOTAL
NONE	N	16	61	114	191
	P	8.4%	31.9%	59.7%	100.0%
ATTORNEY	N	14	97	51	162
	P	8.6%	59.9%	31.5%	100.0%
UNION	N	31	103	80	214
	P	14.5%	48.1%	37.4%	100.0%
OTHER	N		14	17	31
	P		45.2%	54.8%	100.0%
TOTAL	N	61	275	262	598
	P	10.2%	46.0%	43.8%	100.0%

1/ Second Level of Agency Appeals

2/ CSC Regions

N = NUMBER OF FURTHER APPEALS

P = PERCENTAGE OF APPEALS WITH DESIGNATING REPRESENTATION

FOOTNOTES—PART II

[1] The 605 case reports from employing agencies do not include any cases adjudicated by the then-Post Office internal appeals system. However, the 899 reports from the Commission's regional offices include some 270 appeals by post office employees.

[2] See note——, supra part I.

[3] See *Roth* v. *Board of Regents,* 408 U.S. (1972), in which the Supreme Court held that greater procedural safeguards against termination would be required for a public school teacher who had an "expectancy" of reemployment than for one who did not.

[4] These conclusions are based upon interviews with union representatives and a reading of many union comments on proposed changes in the adverse action process. See, in particular, the letter submitted to the Civil Service Commission by the Government Employees Council, AFL–CIO, April 4, 1972. More recently, a spokesman for the National Association of Government Employees expressed the view that "arbitration is not the answer" because "unions and employees should not bear the financial burden * * *" Letter Roger P. Kaplan, General Counsel, to Richard K. Berg, Executive Secretary of the Administrative Conference of the United States, Nov. 16, 1972.

[5] Opinion of the General Counsel, U.S. Civil Service Commission, (1970).

[6] See note——, infra part III, and note——, infra part IV, and accompanying text.

[7] See, e.g., Johnson and Stoll, "Judicial Review of Federal Employee Dismissals and Other Adverse Actions," 57 Cornell L. Rev. 178 (1972).

[8] See notes——, supra part I, and accompanying text.

FOOTNOTES—PART III

[1] Act of August 24, 1912, ch. 389, Section 6, 37 Stat. 555, codified, as amended, 5 U.S.C. Section 7501 (1970). The "act" was actually only a rider to the fiscal year 1913 Post Office Appropriation. Further citations to the Lloyd-LaFollette Act are to the present codification.

[2] Act of June 27, 1944, ch. 287, 58 Stat. 387. The Veterans' Preference Act is presently codified in numerous sections of title 5 of the U.S. Code. Section 14 of the Act, the section dealing with dismissals, is presently in 5 U.S.C. Sections 2108, 7511, 7512, and 7701 (1970). Further citations to the Act are to the present codification.

[3] 3 CFR 861 (Supp. 1966–1970), 5 U.S.C. Section 7301 (1970).

[4] 5 U.S.C. Section 7501(a) (1970).

[5] 5 U.S.C. Section 7501(b) (1970).

[6] 5 U.S.C. Section 7512 (1970).

[7] 5 U.S.C. Section 7701 (1970).

[8] 5 U.S.C. Section 2108, 7511 (Supp. V) (1970).

[9] The adverse action material in the order is found in section 22 3 CFR Section 861 (Supp. 1966–70). Roughly 92 percent of the Federal work force are protected by law against summary removal or discipline and certain agencies accord the same protections to their other employees as well.

[10] See Stahl, "Security of Tenure—Career or Sinecure," 292, The Annals 45, 50 (1954).

[11] Exec. order No. 10988, 3 CFR Section 521 (Supp. 1959–63).

[12] See note——supra, part I.

[13] Act of January 16, 1883, ch. 27, 22 Stat. 403, codified, as amended, 5 U.S.C. Sections 1101 et seq. (1970).

[14] The provision was in section 2(2)(5) of the Act, 22 Stat. 404, codified, 5 U.S.C. Section 7321 (1970).

[15] Some limited expansion of rules against arbitrary removal did take place between 1883 and 1897. One key development was an 1896 civil service rule, promulgated by President Cleveland, prohibiting dismissal or demotion of employees because of their religious beliefs.

[16] Executive order of July 27, 1897. See 15 U.S. Civil Service Commission Annual Report [hereinafter USCSC Annual Report].

[17] 29 USCSC Annual Report—— (1912). See *United States ex rel Taylor* v. *Taft,* 24 App. D.C. 95 (1904), writ of error dismissed, 203 U.S. 461 (1906).

[18] Roosevelt served as Commissioner from 1889 to 1895. Guttman, "The Development and Exercise of Appellate Powers in Adverse Action Appeals," 19 Am. U. L. Rev. 323, 324 n.4.

[19] Executive order of May 28, 1902.

[20] Executive order of Dec. 4, 1911.

[21] See Guttman, supra note 18, at 324.

[22] 5 U.S.C. Section 7501(a) (1970).

[23] 5 U.S.C. Section 7501(b) (1970).

[24] Chapter 389, Section 6, 37 Stat. 555 (1912). Similar, but slightly altered, language now appears in 5 U.S.C. Section 7501(b) (1970).

[25] See Guttman, supra note 18, at 331.

[26] See *Spanhake* v. *United States,* 55 Ct. Cl. 70 (1920).

[27] See note—— supra, part I.

[28] Westwood, "The Right of an Employee of the United States Against Arbitrary Discharge," 7 Geo. Wash. L. Rev. 212, 217 (1938).

[29] The unimportance of early civil service curbs on removal at both the Federal and State levels is suggested by examination of G.W. Plunkitt's important 1905 anti-civil service essay, "The Curse of Civil Service Reform." The essay focuses entirely on the problem of the merit system as a bar to political appointments and does not even mention regulation of removals. Plunkitt, "The Curse of Civil Service Reform," in Riordon (ed.), "Plunkitt of Tammany Hall" 11–16 (1963).

[30] This concern was expressed in the Civil Service Commission's first annual report: "The power of removal and its exercise for just reasons are essential both to the discipline and the efficiency of the public service." 1 USCSC Annual Report 26 (1884).

[31] 24 App. D.C. 95 (1904), writ of error dismissed, 203 U.S. 641 (1906).

[32] 24 App. D.C. at 98. In addition, the unwillingness of reformers to support curbs on removals may have been a reaction to the early English view that public office was a hereditament to which a property right attached. See, e.g., *Trimble* v. *People,* 19 Colo. 187, 34 Pac. 981 (1893); *Edge* v. *Holcomb,* 135 Ga. 765, 70 S.E. 644 (1911).

[33] E.g., "The Roaring Twenties" (Warner Brothers, 1939); "I Am a Fugitive From a Chain Gang" (Warner Brothers, 1932).

[34] This was the principal thrust of sections 2 through 10 of the Act. These sections are now codified in 5 U.S.C. Sections 3305(b), 3306(a)(2), 3308–13, 3317–18, 3319(b), 3320, 3351, 3363, and 3504 (1970).

[35] 5 U.S.C. Sections 7512(a)(b), 7701 (1970).

[36] 5 U.S.C. Section 7512 (1970).

[37] As amended, 5 U.S.C. Section 7701 (1970).

[38] Act of June 22, 1948, ch. 604, 62 Stat. 575, codified, 5 U.S.C. Section 7701 (1970).

[39] 5 U.S.C. Section 7511 (1970).

[40] The pertinent regulations are contained in 5 CFR part 752 (Adverse Actions by Agencies); part 771 (Employee Grievances and Administrative Appeals); part 772 (Appeals to the Civil Service Commission). Procedural protections extend to any career or career-conditional employee who is not serving a probationary trial period, any preference eligible employee who has completed 1 year of continuous employment in a position outside the competitive service and certain other employees. 5 CFR 752.201(a) (1972).

[41] Throughout this part, "agency" refers to the agency or department in which the employee involved is employed and "Commission" refers to the U.S. Civil Service Commission.

[42] 5 U.S.C. Section 554(a)(2) (1970).

[43] See, e.g., the very helpful discussion of the evolution of the Civil Service Commission's appellate activities in Guttman, "The Development and Exercise of Appellate Powers in Adverse Action Appeals," 19 Am. U. L. Rev. 23, 329–40 (1970). See also Berzak, "Rights Accorded Federal Employees Against Whom Adverse Personal Actions are Taken," 47 Notre Dame Lawyer 852 (1972).

[44] U.S. Civil Service Commission, Federal Personnel Manual Letter No. 771–3 (September 25, 1970). The changes described in this letter included alterations in 5 CFR part 752 (adverse actions by agencies) effective November 1, 1970, and in 5 CFR part 771 (Employee Grievances and Administrative Appeals), effective April 1, 1971.

[45] See 59 Nation's Business 70 (June 1971).

[46] Chapter 27, Section 2, 22 Stat. 403 (1883).

[47] See, e.g., 3 U.S. Civil Service Commission Annual Report 56 (1886); 9 U.S. Civil Service Commission Annual Report 77 (1892) (hereinafter cited as Annual Report).

[48] See. 15 Annual Report 20 (1898). The Commission at this point, however, continued to disclaim review authority. The filing request was imposed "not so that the Commission may review the findings of the department upon the charges and answers, for it is not believed that such action by the Commission would be either authorized or advisable, but this copy of the record of the action taken is desired merely to enable the Commission more readily to ascertain whether a person before his removal, is furnished with the reasons for his removal and given an opportunity to make answers in accordance with the terms of [R]ule [8]", ibid.

[49] Guttman, supra note 5, at 331.

[50] The Division was created in 1920. Id.

[51] Id.. at 332–33.

[52] For an example of Civil Service Commission requests for statutory review authority, see 48 Annual Report 41 (1931); 50 USCSC Annual Report 11 (1933); 51 Annual Report 9 (1934).

[53] Chapter 287, Section 14, 58 Stat. 391 (1944).

[54] Section 14 of the Act provided only that "after investigation and consideration of the evidence submitted, the Civil Service Commission shall submit its findings and recommendations to the proper administrative officer and shall send copies of same to the appellant or to his designated representative * * *" Id at 391. [Emphasis added.]

[55] Act of June 22, 1948, ch. 604, 62 Stat. 575, recodified 5 U.S.C. Section 7701 (1970).

[56] The number of adverse actions eventually appealed to the Commission is small in proportion to the total number of such actions taken. In fiscal year 1970, for example, only 1,452 adverse actions reached the Commission, while over 12,000 were taken by all Federal agencies, including the Postal Service.

[57] See note 79, infra.

[58] [Note on who in agency can take action.]

[59] 5 CFR. 752.202(a) (1971). This regulation implements the requirements of 5 U.S.C. Section 7501(b)(1) (1970), which requires preference eligibles to receive 30 days notice of a proposed adverse action. An agency may dispense with the 30-day notice requirement "[w]hen there is reasonable cause to believe an employee is guilty of a crime for which a sentence of imprisonment can be imposed." In this situation, the notice given need only be reasonable under the circumstances. 5 CFR 752.202(c)(2) (1972). The requirement is also inapplicable in cases of furlough without pay due to unforeseen circumstances (sudden breakdowns in equipment, acts of God, or emergencies requiring immediate curtailment of activities). 5 CFR 752.202(c)(1) (1972). With these exceptions, the 30-day period may not be ignored. See 5 U.S.C. Section 7512(b) (1970). Cf. *Manning* v. *Stevens*, 208 F.2d 827 (D.C. Cir. 1953); *Roth* v. *Brownell*, 215 F.2d 500 (D.C. Cir.), cert. denied, 348 U.S. 863 (1954).

The cases suggest some confusion concerning the computation of the 30-day period. See, e.g., *Stringer* v. *United States*, 90 F. Supp. 375 (Ct. Cl. 1950): *O'Brien* v. *United States*, 124 Ct. Cl. 655 (1953); *Engelhardt* v. *United States*, 125 Ct. Cl. 603 (1953). Cf. *Sudduth* v. *Macy*, No. 3418–62 (D.D.C. July 2, 1962), aff'd, 341 F.2d 413 (D.C. Cir. 1964).

[60] 5 CFR 753.202(a)(1) (1972). This provision apparently requires reference to such aspects of the employee's conduct as time, place, and character, e.g., inefficiency or whatever. A notice of a proposed removal relying simply on the general ground that the dismissal would promote the efficiency of the service will not suffice. *Norden* v. *Royall*, 90 F. Supp. 834 (D.D.C. 1949). See also *Deak* v. *Pace*, 185 F.2d 997 (D.C. Cir. 1950) (reasons for discharge not stated sufficiently to permit statement in defense); *Manning* v. *Stevens*, 208 F.2d 827 (D.C. Cir. 1953) (same). Claims of insufficiency of notice were also raised in *Deviny* v. *Campbell*, 194 F.2d 876 (D.C. Cir.), cert denied 344 U.S. 826 (1952), and *Baughman* v. *Green*, 229 F.2d 33 (D.C. 1956), but were rejected by the court on factual grounds.

[61] E.g., *Urbina* v. *United States*, 180 Ct. Cl. 194 (1967); *Shadrick* v. *United States*, 151 Ct. Cl. 408 (1960); *Blackmar* v. *United States*, 120 F. Supp. 408 (Ct. Cl. 1954).

[62] Nammack & Dalton, "Notes on the Appropriateness of the Current Adverse Action and Appeals System." 19 Am. U. L. Rev. 374, 377 (1970).

[63] Id. The possibility of precipitous action, in a nonremoval context, is suggested by *Scott* v. *United States*, 160 Ct. Cl. 152 (1963). An employee was charged with having engaged in sexual misconduct on the basis of an uncorroborated confession obtained under duress. When the employee filed an answer repudiating the confession, the agency expanded the case against him to include unsuitability "because he had voluntarily made derogatory statements in the confession about himself and other persons which had no basis in fact."

[64] 5 CFR 752.202(a)(2) (1972). This provision also requires that the employee be advised of the availability for inspection of evidence against him.

[65] 5 CFR 752.202(a)(3) (1972). In point of fact, this portion of the new provision does not have a substantive impact on adverse action procedures since "classified" or "confidential" material could not be relied on to support adverse action under the prior regulations. See 5 CFR, 752.304(c) (1968); Nammack & Dalton, supra note 26, at 377.

[66] 5 CFR 752.202(b) (1971).

[67] Id.

[68] E.g., *Dew* v. *Quesada*, No. 275–69 (D. D.C. 1959); *Tierney* v. *United States*, 168 Ct. Cl. 77 (1964).

[69] 5 CFR 752.202(b) (1971). See e.g., *Washington* v. *United States*, 147 F. Supp. 284 (Ct. Cl.), petition dismissed, 355 U.S. 801 (1957).

[70] 5 CFR 771.208(a) (1972). On the question of the constitutionality of this procedure, see note 73, infra.

[71] The mechanics of this phenomenon have been observed in other areas as well. Prior to *Goldberg* v. *Kelly*, 397 U.S. 254 (1970), welfare recipients could request a hearing if their benefits were terminated. As few did, welfare officials were saved considerable effort which they would otherwise have had to expend on hearings. Briar, "Welfare from Below: Recipients' Views of the Public Welfare System," 54 Calif. L. Rev. 370, 379–80 (1966); Comment, "Texas Welfare Appeals: The Hidden Right," 46 Texas L. Rev. 223 (1967).

[72] 5 CFR 752.202(b) (1971).

[73] The absence of these safeguards was considered fatal to the system's validity in *Kennedy* v. *Sanchez* No. 72 c 771 (N.D. Ill., Oct. 24, 1972). The Commission regulations specify that the right to appear "does not include the right to a trial or formal hearing with examination of witnesses." 5 CFR 752.202(b) (1972). It will be remembered that the Lloyd-LaFollette Act, while not requiring trial-type hearings, did authorize agency officials in their discretion to hold such hearings. The applicable decisions in this area have confirmed that employees have no statutory or regulatory right to a hearing. See *Studemeyer* v. *Macy*, 321 F. 2d 386 (D.C. Cir.), cert denied, 375 U.S. 934 (1963); *Hart* v. *United States*, 284 F. 2d 682 (Ct. Cl. 1960).

For discussion of some of the problems surrounding the constitutionality of postponing the opportunity for an evidentiary hearing, see "Comment, The Constitutional Minimum for the Termination of Welfare Benefits: The Need for and Requirements of a Prior Hearing" 68 Mich. L. Rev. 112, 119–28 (1969). See also Reich, The New Property, 73 Yale L. J. 733 (1964).

[74] 5 CFR 752.202(b). See, e.g., *O'Brien* v. *United States*, 284 F. 2d 692 (Ct. Cl. (1960) (employee not guaranteed an interview with any particular official; it is enough that he sees a superior who may recommend or take final action); *Brownell* v. *United States*, 164 Ct. Cl. 406 (1964) (employee does not have right to appear before agency head); *Paterson* v. *United States*, 319 F. 2d 882 (Ct. Cl. 1963) (right to oral presentation not satisfied by interview with agency investigators).

[75] 5 CFR 771.105(a)(1) (1972).

[76] 5 CFR 752.202(d) (1972).

[77] As an alternative to transfer an employee may, with his consent, be placed in a leave status, but he may not be forced to take leave during this period. *Taylor* v. *United States*, 131 Ct. Cl. 387 (1955); *Kenny* v. *United States*, 145 F. Supp. 898 (Ct. Cl.) cert. denied, 352 U.S. 893 (1956); *Armand* v. *United States*, 136 Ct. Cl. 339 (1956).

[78] 5 CFR 752.202(e) (3) (1972).

[79] While most employees are removed from active duty status on the date on which adverse action is taken, see text accompanying note 21, supra. Some agencies, including the Post Office, the Civil Service Commission itself, and until recently the Veterans Administration, retain employees in active duty status during some or all of the appeal period. The Post Office permits employees to remain on duty during first level (regional) appellate review (unlike most agencies the Post Office has two internal appellate levels). Kennedy, Adverse Actions in the Agencies; Words and Deeds; Postal Adverse Action Procedures, 19 Am. U. L. Rev. 398, 404 (1970).

[80] 5 CFR 752.202(b) (1972).

[81] Nammack & Dalton, supra note 26, at 378.

[82] 5 CFR 752.202(f) (1972). Decisions within the 30-day notice period are not forbidden once an employee has filed his answer. *Palmer* v. *United States*, 121 Ct. Cl. 415 (1952).

[83] See *DeBusk* v. *United States*, 132 Ct. Cl. 790 (1955), cert denied, 350 U.S. 988 (1956).

[84] 5 CFR 752.202(f) (1971). The agency's decision to take action must, of course, rely on reasons stated in the original notice. *Urbina* v. *United States*, 180 Ct. Cl. 194 (1967). But it need not, and rarely does, explain why removal is for "such cause as will promote the efficiency of the service." *Begendorf* v. *United States*, 340 F. 2d 362 (Ct. Cl. 1965); *Meyers* v. *United States*, 169 Ct. Cl. 1 (1965); *DeBusk* v. *United States*, 132 Ct. Cl. 790 (1955), cert. denied, 350 U.S. 988 (1956); *Blackmon* v. *Lee*, 205 F. 2d 13 (D.C. Cir. 1953).

[85] 5 CFR 752.202(f) (1972). See Nammack & Dalton, supra note 26, at 378.

[86] 5 CFR 752.203 (1972). See text accompanying notes 108–152, infra.

[87] 5 CFR 771.205 (1972). An agency is required to provide one internal appellate level. With the approval of the Commission, however, it may have more than one appellate level. 5 CFR 771.203 (1972). The three military departments and the Departments of Interior and HEW maintain two-tiered systems.

[88] 5 CFR 752.205(c) (1972). In one older case, the District Court for the District of Columbia held that a veteran's right to appeal was denied without justification when he was informed by a Commission regional director that he could not appeal to the Commission if he decided first to pursue an appeal within his agency. *Berloff* v. *Higley*, No. –56 (D. D.C. June 13, 1956).

[89] 5 CFR 752.205(b) (1972). Appeals within the agency and to the Commission may not be processed concurrently. 5 CFR 752.205(a) (1972).

[90] Executive Order No. 10987, 3 CFR 519 (Supp. 1959–1963). The order excepted several agencies from its requirements, including the Central Intelligence Agency, the National Security Agency, the Federal Bureau of Investigation, the Atomic Energy Commission, and the Tennessee Valley Authority. 5 CFR 771.103(b) (1972).

[91] For the background of Executive Order 10987, see Grossman, Adverse Actions and Appeals Therefrom: A New System for Federal Civil Servants, 14 Labor L. J. 265 (1963).

[92] 5 CFR pt. 771 (1972). This part was extensively rewritten during the 1970 revision of the Commissions regulations. See note 6, supra.

[94] But see text at note 128, infra, noting that the Commission may curtail the scope of its hearing where a prior hearing has been held by the agency. Guttman, supra note 5, at 352–354.
[95] 5 CFR 752.204(a) (1972).
[96] 5 CFR 771.207 (1972). See note 66, infra.
[97] 5 CFR 771.105(a)(1), 771.206 (1972).
[98] 5 CFR 752.204(b) (1972).
[99] 5 CFR 771.206 (1972). Until 1970, the regulations permitted an employee remaining on active duty to use official time to present, but not to prepare, an appeal. See Nammack & Dalton, supra note 26, at 378.
[100] 5 CFR 771.207 (1972). Professor Guttman criticizes this practice of placing the burden of requesting a hearing on the employee. Guttman, supra note 5, at 354–55.
[101] See the Judge Skelton's concurrence in *Ricucci* v. *United States*, 425 F. 2d 1252 (Ct. Cl. 1970), which suggests that due process requires a hearing in adverse action cases.
[102] 5 CFR 771.208(b)(2). (1972). The language of this section is deceptive. It specifies that the agency may deny a hearing "when the employee failed to request a hearing offered before the original decision." It is therefore possible for an employee to wind up with no right to an appellate hearing even though he had no predecision hearing.
[103] 5 CFR 771.208(b)(1) (1972).
[104] 5 CFR 771.214 (1969).
[105] Nammack & Dalton, supra note 26, at 379.
[106] Id.
[107] 5 CFR 771.218(a) (1969).
[108] Id.
[109] Letter from Anthony Mondello, General Counsel, Civil Service Commission, to Prof. Roger Cramton, University of Michigan Law School (Mar. 6, 1970).
[110] Cf. *Camero* v. *United States*, 345 F. 2d 798 (Ct. Cl. 1965).
[111] 5 CFR 771.214(a) (1969). The regulations did, however, require that the method of selection "will insure that members are fair, impartial and objective." The regulations further excluded from participation in appellate hearings persons responsible for the original decision.
[112] See generally, Nammack & Dalton, supra note 26, at 379–381.
[113] The Civil Service Commission distributed a pamphlet entitled Conducting Hearings on Employee Appeals (1968). This guide contained useful hints on hearing mechanics and procedures, but was no substitute for formal training or experience.
[114] For a useful discussion of the problem of subjective perception of facts, see J. Frank, Courts on Trial 146–164 (1949).
[115] 5 CFR 771.209(a) (1972).
[116] 5 CFR 771.209(a), (e) (1972).
[117] 5 CFR 771.209(b) (1972). The deciding official in an agency appeal must be at a higher administrative level than the official originally ordering adverse action, unless, of course, that official was the agency head. 5 CFR 711.218 (1972).
[118] 5 CFR 771.209(d) (1972).
[119] 5 CFR 771.213(a) (1972).
[120] 5 CFR 771.219(b)(3) (1972).
[121] See 5 U.S.C. Sections 554–57 (1970).
[122] 5 CFR 771.210(f), 771.211 (1972). See, e.g., *Brown* v. *Zuckert*, 349 F.2d 461 (7th Cir. 1965); *McTiernan* v. *Gronouski*, 337 F.2d 31 (2d Cir. 1964); *Cohen* v. *Ryder*, 258 F. Supp. 693 (E.D. Pa. 1966).
[123] 5 CFR 771.210(e) (1972).
[124] 5 CFR 771.210(b) (1972).
[125] 5 CFR 771.210(c) (1972). The objection to this approach is not that adverse action decisions will be grounded on incompetent evidence. At least in jurisdictions adhering to the substantial evidence scope of review, action based solely on evidence without probative value is unlikely to withstand judicial scrutiny. *Jacobowitz* v. *United States*, 424 F.2d 555 (Ct. Cl. 1970). See also *Morelli* v. *United States*, 177 Ct. Cl. 848, 853–54 (1966); *Montana Power Co.* v. *Federal Power Comm.*, 185 F.2d 491, 497–98 (D.C. Cir. 1950), cert. denied, 340 U.S. 947 (1950). The risk is that such evidence may color in the mind of an inexperienced fact-finder an otherwise marginal case.
[126] Berzak, Adverse Actions By Federal Agencies and Administrative Appeals, 19 Am. U. L. Rev. 387, 394–95 (1970). Chairman Berzak's discussion, it should be noted, focuses on the admissibility of evidence in hearings within the Commission. The same justification would, however, apply to hearings in the agencies, where deciding official and hearing officers are still less accustomed to adjudicatory processes.
[127] See note ———— Part I, supra.
[128] But see Comment, Trumpets in the Corridors of Bureaucracy: A Coming Right to Appointed Counsel in Administrative Adjudicative Proceedings, 18 U.C.L.A. L. Rev. 758 (1971).
[129] 5 CFR 771.211(b) (1972). See *Williams* v. *Zuckert*, 372 U.S. 765 (1963). This does not solve the problem of securing testimony from a witness who is no longer or never was in the agency's employ.
[130] See, e.g., *Begendorf* v. *United States*, 340 F.2d 362 (Ct. Cl. 1965), relying on Williams v. Zuckert, 371 U.S. 531, vacated and remanded on rehearing, 372 U.S. 765 (1963).
[131] Nammack & Dalton, supra note 26, at 379–80.
[132] 5 CFR 771.211(c) (1972). This may not help the employee in a removal case, since he is likely to be off the payroll, and delay will be to his disadvantage. See text accompanying note 21, supra.
[133] 5 CFR 771.211(d)–(e) (1972).
[134] 5 CFR 771.212 (1972).
[135] 5 CFR 771.217(a) (1969).
[136] Nammack and Dalton, supra note 26, at 380.
[137] 5 CFR 771.212(a) (1972).
[138] 5 CFR 771.218(a) (1972). The authorized official shall also be at an organizational level no lower than the head of a field organization or the head of a primary subdivision of the headquarters organization. Id.

[138] 5 CFR 771.218(b) (1972).
[139] 5 CFR 771.220 (1972).
[140] See text accompanying notes 8–17, supra.
[141] 5 U.S.C. 7701 (1970). See also Executive Order No. 11491, Section 22; 3 CFR 91 (Supp. 1966–1970), 5 U.S.C. Section 7301 (1970).
[142] This is not surprising since most employees who appeal to the Commission have not been through the agency appeals processes, and accordingly have had no evidentiary hearing.
[143] 337 F.2d 31 (2d Cir. 1964).
[144] Id. at 35. See also *Green* v. *Baughman*, 243 F.2d 610 (D.C. Cir.), cert. denied, 355 U.S. 819 (1957).
[145] Cf. *Williams* v. *Zuckert*, 371 U.S. 531, vacated and remanded on rehearing, 372 U.S. 765 (1963).
[146] See text accompanying note 133, infra.
[147] USCSC Minutes of Proceedings, March 30, 1954; June 20, 1960; August 26, 1960.
[148] Guttman, supra note 5, at 339.
[149] USCSC Minutes of Proceedings, August 26, 1960.
[150] See text accompanying notes 53–56, supra. Approximately 15 percent of all appellants do so, their cases comprising more than 55 percent of the Commission's first-level caseload.
[151] 5 CFR 752.205(c) (1972). Prior to November, 1970, the regulations contained an exception to this rule applicable where an agency has two appellate levels and an employee pursued an appeal through both levels. In such a case, the employee forfeited his right to appeal to the Commission. The 1970 revisions dropped this provision, but did not change the practice. The Commission will reject as out of time any appeal filed more than 15 days following the first level agency decision, thereby effectively forcing an employee to choose between an appeal to the second level of his agency and appealing to the Commission.
[152] Id.
[153] 5 CFR 752.203, 752.204(a) (1972). The 15-day limit does not apply where the agency has failed to act within 60 days.
[154] See *Haas* v. *Overholser*, 223 F.2d 314 (D.C. Cir. 1955); *Simpson* v. *Groark*, Civ. No. (N.D. Ill. May 26, 1965). The Commission or the agency may extend the time when an appellant shows that he was not notified of the 15-day limit and was not otherwise aware of it, or that he was prevented by circumstances beyond his control from appealing within the time limit. 5 CFR 752.204(b) (1972). See *Henry* v. *United States*, 153 F. Supp. 285 (Ct. Cl. 1957).
[155] 5 CFR 752.203 (1972).
[156] Berzak, supra note 93, at 393 n. 24.
[157] Id. at 393 n.25. Employees working in the Washington metropolitan area and in certain areas outside the continental United States appeal to the Commission's Appeals Examining Office in the District of Columbia. Id.
[158] This occurs in perhaps a fifth of all Commission cases.
[159] See Guttman, supra note 5, at 351–56. Guttman views the possibility of two hearings as unnecessarily burdensome. Since he believes there is less risk of prejudice at the Commission, he suggests that agency appeals systems be dropped or substantially revised.
[160] Berzak, supra note 93, at 394 n. 27. Actually, appellants do not "request" a hearing. The first level appellate office informs them of their right to a hearing and, if they do not desire one, they so inform the office in writing. 5 CFR 772.305(b) (1972).
[161] Fed. R. Civ. Pro. 16; Fed. R. Crim. Pro. 17.1.
[162] Berzak, supra note 93, at 394; Guttman, supra note 5, at 355.
[163] For decisions that proceedings before the Commission need not be cast in the mold of a court trial, see *Atkinson* v. *United States*, 144 Ct. Cl. 585 (1959); *Hunter* v. *Gronouski*, 234 F. Supp. 1010 (S.D. Fla. 1964); Prater v. United States, 172 Ct. Cl. 608 (1965); *Kaers* v. *United States*, 175 Ct. Cl. 111 (1966). Cf. *Williams* v. *Zuckert*, 372 U.S. 765 (1963).
[164] 5 CFR 772.305(c)(4) (1972).
[165] Id.
[166] 5 CFR 772.305(c)(3) (1972).
[167] A discussion of the status, background and training of the Commission's examiners is found in Guttman, supra note 5, at 340–51. Guttman raises some questions concerning their independence and objectivity. For a contrary view, see Berzak, Review, 19 Am. U. L. Rev. 367, 368–69 (1970).
[168] When a first level appellate office receives an appeal it takes steps to compile a complete appellate file, which usually includes copies of the notice of proposed adverse action; the employee's reply, if any; the agency's final notice of decision; any affidavits or other evidence submitted to the agency by and in behalf of the employee; and the agency appeals file if an appeal was processed through the agency's internal system. Both parties have an opportunity to review the complete appellate file when it is fully assembled. Berzak, supra note 93, at 393. Cf. *Cohen* v. *United States*, 369 F. 2d. 976 (Ct. Cl. 1966), cert. denied, 387 U.S. 917 (1962).
[169] 5 CFR 772.306(a) (1972).
[170] Id.
[171] This limitation on Commission disposition is thought to result in a disproportionate number of procedural reversals, some probably spurious.
[172] 5 CFR 772.307(a) (1972).
[173] Id.
[174] 5 CFR 772.307(b) (1972). *Steelve* v. *United States*, 150 Ct. Cl. 47 (1960).
[175] 5 CFR 772.307(b) (1972).
[176] See Report by Professor James A. Washington, Jr., to Chairman William Berzak, Board of Appeals and Review, September 11, 1968.
[177] Berzak, supra note 93, at 396.
[178] 5 CFR 772.307(c) (1972).
[179] 5 CFR 772.308 (1972). Decisions involving this authority include *Gardner* v. *Barron*, 240 F. Supp. 87 (E.D. Pa. 1965); *Keeling* v. *United States*, 172 Ct. Cl. 246 (1965); *Suddith* v. *Macy*, No. 3418–62 (D.D.C. July 2, 1963), *aff'd*, 341 F.2d 413 (D.C. Cir. 1964;

Shadrick v. *United States*, 151 Ct. Cl. 408 (1960); *De Pusana* v. *United States*, 164 F. Supp. 672 (D.C.C. 1958); *Roberts* v. *United States*, 128 F. Supp. 706, 131 Ct. Cl. 108 (1955); *Lynsky* v. *United States*, 126 F. Supp. 453, 130 Ct. Cl. 149 (1954).

[180] 5 CFR 772.308(a)(1) (1972).

[181] 5 CFR 772.308(a)(2) (1972).

[182] 5 CFR 772.308(a)(3) (1972).

FOOTNOTES—PART IV

[1] During fiscal years 1968, 1969, and 1970, removals and demotions (reductions in rank, grade or pay) comprised more than 95 percent of all adverse actions initiated, and a slightly higher percentage of actions appealed. U.S. Civil Service Commission, "Statistical Report of Appeals Activities: Fiscal years 1968, 1969, and 1970," table I (1970).

[2] E.g., *Goldberg* v. *Kelly*, 397 U.S. 254 (1970); *Kennedy* v. *Sanchez*, No. 72 C 771 (N.D. Ill. 1972).

[3] This estimate is based on the assumption that actions described as having been taken for other reasons fall principally within the misconduct category. Many agency officials have reported that they have difficulty deciding how to label actions based on repeated absence without leave, for example, and therefore class them under the heading other reasons.

[4] The Commission's 1970 data do not identify the precise reasons for action and therefore do not permit a numerical breakdown.

[5] See generally, Boyer, "A Re-Evaluation of Administrative Trial-Type Hearings for Resolving Complex Scientific and Economic Issues" (staff report to the Chairman of the Administrative Conference of the United States, Dec. 1, 1971); Cramton, "A Comment on Trial-Type Hearings in Nuclear Power Plant Siting," 58 Va. L. Rev. 585 (1972).

[6] The National Association of Government Employees commenting on the committee's recommendations, recently cast doubt on union support for arbitration. See note——supra pt. I.

[7] Adjudication may also be faster than arbitration, notwithstanding the lengthy delays built into the present procedures.

[8] The Department of the Navy reached tentative agreement with representatives of these employees pursuant to which it held consolidated hearings at different installations. Recently, the Chicago regional office of the Civil Service Commission received demands for individual hearings from several of the employees, suggesting that this agreement may be breaking down.

[9] Consistently with this principle, "reductions in force," which characteristically are prompted by budgetary constraints, are not governed by the formal procedures for taking adverse actions. See generally, 5 CFR pt. 351 (1972).

[10] See Nammack & Dalton, "Notes on Appropriateness of the Current Adverse Action and Appeals System," 19 Am. U. L. Rev. 374, 383 (1970).

[11] Specific authorization for consolidation should be provided, so that agencies could avoid the difficulty currently confronting the Department of the Navy. See note——supra.

[12] See, e.g., *United States* v. *Storer Broadcasting Corp.*, 351 U.S. 192 (1956); *Upjohn* v. *Finch*, 422 F. 2d 944 (6th Cir. 1970); *Pfizer* v. *Richardson*, 434 F. 2d 536 (2d Cir. 1970).

[13] See Berzak, "Adverse Actions by Federal Agencies and Administrative Appeals," 19 Am. U. L. Rev. 387, 394 (1970).

[14] Such authority would not conflict with the Veterans Preference Act provision that entitles employees to a hearing before the Commission. Even if that provision is properly interpreted as guaranteeing an evidentiary hearing, an agency may dispense with trial-type procedures when no factual issues are in dispute, notwithstanding statutory language that purports to require a hearing in all cases. See authorities cited note —— supra.

[15] Motto v. General Services Administration, 335 F. Supp. 694 (E. D. La. 1971); *cf. Fitzgerald* v. *Hampton*, No. 71–1771, Sept. 15, 1972 (D.C. Cir.).

[16] Postal Services Appropriations Act of 1012 § 6, 37 Stat. 539, 555.

[17] Inefficiency was the announced reason for action in only 8.7 percent of adverse actions appeals adjudicated during fiscal year 1970.

[18] See, e.g., *Norton* v. *Macy*, 417 F. 2d 1161 (D.C. Cir. 1969); *Scott* v. *Macy*, 349 F. 2d 183, 185 (D.C. Cir. 1965).

[19] See, e.g., Appendix A: Tables Pertaining to Penalties for Various Offenders, of Civilian Personnel Regulation 700, Department of the Army, Apr. 27, 1972.

[20] 5 CFR 731.201 (1972).

[21] In *Kennedy* v. *Sanchez*, No. 72 C 771 (N.D. Ill. 1972), however, a three-judge district court ruled that the statutory standard of efficiency was insufficiently specific under the First Amendment to support the removal of an employee for derogatory public statements about his agency and supervisor. To date, this is the only case that has declared the statutory standard invalid in any context.

[22] In fiscal years 1968, 1969 and 1970, the Board of Appeals and Review decided 680, 539, and 648 appeals, respectively.

[23] Fewer than one out of four non-Postal employees subject to adverse action contest their cases. My interview with one agency personnel officer evoked the admission that employees frequently seem intimidated and are reluctant to ask advice from agency officials who are connected with the personnel office.

[24] See notes ——— pt. V, infra and accompanying text.

[25] A Civil Service Commission pamphlet, "Conducting Hearings on Employee Appeals," Personnel Methods Series No. 16 (January 1968), reiterates the requirements of the Commission's regulations that an employee must be informed of all of the reasons for the action against him. Id. at 3–4. The problem is the employee who fails to understand the agency's notice of action or to appreciate the potential consequences. The purpose of this recommendation is to make sure that every employee comprehends what the formal notice means. Some agencies claim to be providing such advice already, but many are not.

[26] See 5 CFR 752.202(b) (1971).

[27] See, e.g., *Washington* v. *United States*, 147 F. Supp 284 (Ct. Cl.), cert. dismissed, 355 U.S. 801 (1957).

[28] An employee has a better chance of persuading the agency to reduce the penalty proposed. See letter of Roger P. Kaplan, general counsel, National Association of Government Employees, to Richard K. Berg, Executive Secretary of the Administrative Conference of the United States, Nov. 16, 1972.

[29] This, according to officials with whom I spoke, is the unwritten rule in the Department of the Army.
[30] See note —— supra, and accompanying text.
[31] There is no obvious objection to a requirement that an employee must answer the agency's charges within 10 days of receiving its notice, and that the agency must act upon the employee's response no more than 5 days later. This would shorten the process by some 2 weeks in the average case
[32] See notes ——— pt. III supra, and accompanying text. In 1969 the Commission originally proposed that agencies be required to afford an opportunity for a hearing prior to removal, but retreated in the face of agency opposition.
[33] Agencies that provide a hearing in advance of the effective date of adverse action account for less than 10 percent of the Government-wide caseload. In addition to the four agencies mentioned, currently provide a preaction hearing.
[34] The Department of the Navy adjudicated 138, 184, and 215 internal appeals during fiscal years 1968, 1969, and 1970, respectively. During the same period, the Veterans Administration decided 18, 15, and 57 appeals.
[35] See tables IV–1 and IV–2.
[36] See table IV–3.
[37] In fiscal year 1970, the four agencies with the largest caseloads that routinely provided a hearing in advance held hearings in only 32.4 percent of appeals. Other agencies, almost all of which postponed the hearing, held hearings in 70.4 percent of appeals. At the time, it should be noted, the Veterans Administration was one of the agencies that provided a preaction hearing.
[38] It is possible, of course, that more recent experience of the Department of the Navy or the Veterans Administration would document such a correlation.
[39] In response to requests for comments on the Committee's recommendations, both the Department of the Air Force and the Office of the Secretary of Defense favored the postaction hearing procedure. The Department of Justice and the Department of the Army, with some qualification, approved the committee's recommendation.
[40] Only if the hearing comes well after the employee's removal does this postaction procedure protect the agency's interest in morale.
[41] 397 U.S. 254 (1970).
[42] *Carboneau* v. *Foxgrover,* Civ. No. 72–318–T (S.D. Cal., Aug. 31, 1972).
[43] *Kennedy* v. *Sanchez,* No. 72 C 771 (N.D. Ill., Oct. 24, 1972).
[44] 425 F. 2d 1252 (Ct. Cl. 1970).
[45] 425 F. 2d at ——.
[46] 98 Sup. Ct. 1983 (1972).
[47] 98 Sup. Ct. at ——.
[48] 98 Sup. Ct. at 1999 n. 22.
[49] Civ. No. 72–318–T (S.D. Cal., Aug. 31, 1972).
[50] Slip opinion at 23–24.
[51] The primary reason for retaining this right of reply is to keep alive the possibility of compromise and to afford the employee an opportunity to test the agency's seriousness.
[52] One reason that agencies may have been reluctant to experiment with extended paid leave as an alternative to removal prior to a hearing is the ruling of the Comptroller General that agencies may not place employees in a nonduty status and continue to pay them for more than 5 days. 38 Comp. Gen. 203.
[53] No. 72 C. 771 (N.D. Ill., Oct. 24, 1972.)
[54] Slip opinion at 4–5.
[55] Id. at 7. See also *Kunzig* v. *Murray,* 462 F. 2d 781 (D.C. Cir. 1972), in which the appellate court held that the district court had jurisdiction to enjoin an employee's discharge pending her appeal to the Civil Service Commission.
[56] Some agencies take longer than 100 days to adjudicate employee appeals, a few considerably longer.
[57] Cases in which an employee is charged with conduct for which he is already under criminal indictment are clear examples, and present considerable difficulty. The employee may want the administrative proceeding postponed so that his defense of the criminal charges will not be prejudiced. For similar reasons, the agency may be disinclined to move expeditiously so long as the employee can be removed from the rolls. For such cases a special rule might be appropriate, requiring the employee to proceed promptly to hearing or forfeit his right to continue to receive pay.
[58] To implement this regulation it would be necessary to amend the ruling of the Comptroller General referred to in note —— supra.
[59] See R. Vaughn, "The Spoiled System II–82 and II–83 (1972)."
[60] See *Fitzgerald* v. *Hampton,* supra note ——, at 23–24.
[61] A primary justification for requiring public proceedings is to protect individuals against oppressive administrative action. If the employee in an adverse action hearing wishes to sacrifice this protection in order to protect his privacy, he should be permitted to do so.
[62] It will be the rare adverse action proceeding in which more than one or two members of the public will want to attend the hearing.
[63] No. 71–1771 (D.C. Cir., Sept. 15, 1972).
[64] Compare *Motto* v. *General Services Administration,* 335 F. Supp. 694 (E.D. La. 1971), discussed at text accompanying note —— supra.
[65] *Fitzgerald* v. *Hampton,* slip opinion at 23–24. The Civil Service Commission has requested the Solicitor General to file a petition for certiorari in the Supreme Court in the case.
[66] An agency may designate an outside examiner simply to avoid disrupting work of its own employees, or it may be genuinely concerned about finding an examiner who will bring an open mind to a proceeding.
[67] 5 CFR 771.209(a) (1972).
[68] In military fashion, the Army's hearing officer pool is designated by the acronym, "USACARA." These examiners are also responsible for hearing employee grievances and EEO complaints. See generally, Appendix C: Department of the Army Grievance and Appeals System, Department of the Army Personnel Relations and Services Regulations, June 2, 1972. The Air Force, too. has its own corps of full-time hearing officers.
[69] The Departments of Army and Air Force have already expressed their opposition to the committee s recommendations. A companion objection is that the use of Civil Service Commission hearing officers would break up the consolidated functions of the two departments' own examiners.

[70] See, e.g., Nammack & Dalton, supra note ——, at 383.
[71] In terms of affording the employee protections equivalent if not superior to those desired by the congressional authors of the act, the proposed recommendation cannot be faulted. Even the Department of Justice, however, is unwilling to declare that the proposal would meet its formal requirements. See letter from Assistant Attorney General Roger C. Cramton to Richard K. Berg, Executive Secretary of the Administrative Conference of the United States, Nov. 14, 1972.
[72] The Civil Service Commission's pamphlet, "Conducting Hearings on Employees Appeals," note —— supra, specifies that the agency shall have the burden of proof. The Commission's regulations, however, are silent on the issue.
[73] See e.g., letter from Roger P. Kaplan, General Counsel, National Association of Government Employees, to Richard K. Berg, Executive Secretary of the Administrative Conference of the United States, Nov. 16, 1972.
[74] The Commission's instructional pamphlet, supra note ——, includes specific instructions to this effect, but agency hearing officers are irregular in following them.
[75] Many Commission regional appeals examiners and some agency hearing officers already do precisely this.
[76] Both parties may be to blame for failing to make their best case initially. See, e.g., Guttman, "The Development and Exercise of Appellate Powers in Adverse Action Appeals," 19 Am. U. L. Rev. 323, 362 (1970).
[77] See id., *R. Vaughn*, supra note ——, at II–124.
[78] Compare Fed. R. Civ. P. ——.
[79] This alternative has been endorsed by the Department of Justice. See letter of Assistant Attorney General Roger C. Cramton, supra note 71.
[80] 5 CFR 771.219(b)(3) (1972).
[81] See *Nammack & Dalton*, supra note ——, at 380–81.
[82] Id. at 379–80. See 5 CFR 771.211(c) (1972).
[83] There is little hard evidence that this occurs frequently, but complaints about the lack of subpoena authority are common. See letter of Roger P. Kaplan, supra note ——; R. Vaughn, supra note ——, at II–148.
[84] —— Comp. Gen. —— (196).
[85] See *Nammack & Dalton*, supra note ——, at 379–80.
[86] See, e.g., *Begendorf* v. *United States*, 340 F. 2d 362 (Ct. Cl. 1965).
[87] See text accompanying notes ——— Part III, supra.
[88] The five are the Departments of the Army, Navy, and Air Force, HEW, and the Interior. In 1969 the Civil Service Commission proposed, but failed to press for, the elimination of second appeals levels within employing agencies.
[89] See text accompanying notes —— pt. III, supra.
[90] In fiscal year 1970 the average time for disposition of appeals by the Board of Appeals and Review was 87 days, compared with 59 days at the Commission's regional offices. The same year, the Board upheld the regional decision in 92 percent of appeals by employees, but in only 63 percent of appeals by employing agencies.
[91] Indeed, their location within the Commission bureaucracy exposes them to considerable pressure frequently unrelated to the merits of cases. See, e.g., Guttman, supra note ——, at 338–39.
[92] Ostensively, the proposed recommendations would eliminate two appeals levels, all agency appeals systems and one level of Commission review. By moving the hearing forward, however, the recommendations would force agencies to review cases before the action became effective, thus in effect postponing action until after an employee's initial appeal.
[93] There is no reason to allow employing agencies to submit additional affirmative evidence. An agency is in a position to control not only the timing but the scope of the hearing by its decision to initiate action and to present or withhold particular evidence. If additional evidence is required to substantiate the agency's action, that action, by hypothesis, was improper.
[94] In fiscal 1970 agencies modified the initiating authority's penalty in roughly 8 percent of removal cases, and in nearly 4 percent of demotion cases. Although on rare occasions the Commission's regional offices remand cases for further evidence or consideration, they practically never reduce an agency's penalty. See Guttman, supra note ——, at 361–62.
[95] Id.
[96] See, e.g., Berzak, "Review and Analysis of Professor Egon Guttman's Article on "The Development and Exercise of Appellate Powers in Adverse Action Appeals,'" 19 Am. U. L. Rev. 367, 372 (1970).
[97] This assessment is based primarily upon interviews conducted off the record.
[98] During fiscal years 1968, 1969, and 1970, the Commission's regional offices reversed agencies in approximately 25 percent of employee appeals. In each of those 3 years, more than twice as many reversals were for procedural errors as on the merits.
[99] Only one agency among those that I consulted—the Department of the Army—objected strenuously to empowering the Commision's appellate authority to reduce agency penalties.
[100] Se generally, report of Professor James A. Washington, Jr., to Chairman William P. Berzak, Board of Appeals and Review, Sept. 11, 1968, at 6–17 (hereinafter Washington Report).
[101] See *Guttman*, supra note ——, at 364.
[102] See *R. Vaughn*, supra note ——, at II–147.
[103] See text accompanying notes —— pt. III, supra.
[104] See *Guttman*, supra note ——, at 364–65.
[105] Within the past year significant Board of Appeals and Review decisions have been circulated among selected offices within the Commission. *Cf. R. Vaughn*, supra note ——, at II–152.
[106] See Washington Report at 15–17.
[107] During discussions with employing agencies I encountered no opposition toward, and considerable enthusiasm for, the recommendation that Commission decisions be made public. One or two agencies had reservations about a similar requirement for agency decisions, but none thought the proposal impractical.
[108] See text accompanying notes ——— pt. I, supra.
[109] See notes ——— supra and accompanying text.
[110] *Cf. Guttman*, supra note ——, at 362.

[111] Compare *White* v. *Bloomberg*, 345 F. Supp. 133 (D. Md. 1972), in which the court takes the Commission (the Board of Appeals and Review) to task for failing to explain the bases of its decision.
[112] See *Guttman*, supra note ——, at 338–45.
[113] Id. at 343–44.
[114] Id. at 338–39. Off-the-record interviews also confirmed these allegations.
[115] See text accompany notes —— supra.
[116] See, eg., *R. Vaughn*, supra note ——, at II–144, VI–1 through VI–50.
[117] Vaughn cites several through the course of his indictment of the Commission. Id. at II–1 through II–143.
[118] See text accompanying notes ——— supra.
[119] See 5 U.S.C. 554(d). See generally, K. Davis, Administrative Law Text §§ 13.01–.08 (1971).
[120] Prescribing qualifications for federal employment and the disposition of adverse actions are not unrelated activities, and their close interrelationship supports the desirability of assigning responsibility for both to the same, quasi-expert agency.
[121] See pt. III, supra.
[122] See *Kennedy* v. *Sanchez*, No. 72 C 771 (N.D. Ill. 1972); see also text accompanying notes ——— pt. V, infra.

FOOTNOTES—PART V

[1] In fiscal year 1970 employing agencies affirmed 80.3 percent of cases in which the employee was without representation; in cases in which employees were represented by attorneys, the affirmance rate was 78.9 percent; and in cases in which employees had union representation, the rate was 77.4 percent. These differences are not significant. The Commission's regional offices affirmed agency actions at the following rates: for employees without representation, 65.5 percent; for employees with attorneys, 77.9 percent; and for employees with union representation, 73.9 percent. Corresponding figures for the Commission's Board of Appeals and Review are not available, because by no means all of its decisions are included in the data base and because case reports do not distinguish between Board affirmances in employee and in agency appeals.
[2] There are no data on the frequency with which employees are represented by other employees from the same agency. One view holds that few employees would risk the resentment of their agency in order to represent a colleague threatened with removal. This explanation was offered by three APA hearing examiners (now administrative trial judges) in the Interstate Commerce Commission who recently undertook to act as counsel for several Commission employees subject to adverse action.
[3] In years past veterans organizations provided representation for many employees, but they are involved in few cases currently.
[4] 5 CFR 752.202(c), 771.105, 771.2206 (1971).
[5] At employing agencies 32 percent of all appealing employees were without representation, while 38 percent of all appellants at the Commission's regional offices had no representative.
[6] At employing agencies 36 percent had union representation, while 27 percent employed attorneys. At the Commission's regional offices, 33 percent relied on union representation and 23 percent had attorneys.
[7] At employing agencies 60 percent of employees without representation took no further appeal, while 68 percent of those represented by attorneys and 63 percent of those with union representation appealed at least once more.
[8] At employing agencies only 25 percent of employees contesting their removal were without representation, while 49 percent contesting their demotion and 47 percent contesting reassignment had no representative. Among appellants to the Commission's regional offices the figures were 32 percent, 50 percent, and 50 percent, respectively.
[9] See tables V–1 and V–2.
[10] At employing agencies, the percentages of employees appearing with union representation were: GS, 32.5 percent; Wage Grade, 40.2 percent. The percentages of employees without representation were: GS, 31.8 percent; Wage Grade, 32.1 percent. (No data is available concerning appeals by Postal Service employees within that agency's appeals system.) At the Commission's regional offices, the percentages of employees with union representation were: GS, 30 percent; Wage Grade, 33 percent; and PFS, 36 percent. The percentages of employees without representation were: GS, 38 percent; Wage Grade, 36 percent; and PFS, 39 percent.
[11] See tables V–3 and V–4.
[12] See tables V–1 and V–2, supra.
[13] See note 1, supra.
[14] See note 1, supra.
[15] At employing agencies 12.4 percent of employees without representation won procedural reversals, compared with 3.7 percent of employees with attorneys and 7.8 percent of employees with union representation. At the Commission's regional offices, a whopping 24.8 percent of appellants without representation won on procedural grounds, compared with 8.7 percent and 12 percent, respectively, of employees with attorney and union representatives.
[16] One might speculate whether appeals officials are not also likely to consider more sympathetically the case of an employee who does not make a big production of his appeal and, as the data reveal, is likely to request an evidentiary hearing.
[17] Employees without representation requested hearings only 24 percent of the time. For employees with attorneys the figure was 73 percent, and for employees with union representation 66 percent.
[18] See note 7, supra. Of the 68 percent of appellants represented by attorneys who took further appeals, 12 percent appealed to a second level within their agencies, and 88 percent sought review by the Commission. Of appellants with union representation who appealed further, 24 percent remained within the agency and 76 percent appealed to the Commission.
[19] The sharp correlation between representation and the length of time required for decision is depicted in tables V–5 and V–6, appended to these footnotes.
[20] The suggestion was made by the late Justice Black in *Goldberg* v. *Kelly*, in his dissent from the majority's holding that welfare recipients are entitled to a pretermination hearing at which they may appear with counsel. 397 U.S. 254, —— (1970).

[21] There is no intention here to suggest that legal training is the sine qua non of effective representation. Many union representatives, most of whom are not attorneys, are equally if not more effective than private counsel in adverse action hearings.

[22] In *Motto* v. *General Services Administration*, 322 F. Supp. 1218 (E.D. La. 1971), the court acknowledged the difficulty of seeking administrative review of adverse action without the assistance of counsel and held that laches did not bar review where the employee had diligently, though unsuccessfully, sought review on his own. *Cf. Webb.* v. *Finch*, 431 F. 2d 1179 (6th Cir. 1970) (proceeding contesting termination of Social Security benefits; court remained for further administrative hearing where recipient was prejudiced by lack of counsel).

[23] See note, 68 Mich. L. Rev. 112, 137–38 (1969).

[24] *Ogletree* v. *McNamara*, 449 F. 2d 93 (6th Cir. 1971).

[25] 287 U.S. 45, 48–69 (1932):

"The right to be heard would be, in many cases, of little avail if it did not comprehend the right to be heard by counsel. Even the intelligent and educated layman has small and sometimes no skill in the science of law ***. He lacks skill and knowledge adequately to prepare his defense even though he [may] have a perfect one."

[26] 397 U.S. 254, —— (1970).

[27] *Morrisey* v. *Brewer*, 98 Sup. Ct. —— (1972).

[28] See generally note, "Trumpets in the Corridors of Bureaucracy: A Coming Right to Appointed Counsel in Administrative Adjudicative Proceedings," 18 U.S.L.A. L. Rev. 758 (1971).

[29] 26 Ad. L. 2d 284 (1969).

[30] 16 CFR 2.41(c) (1969).

[31] 5 U.S.C. 555(b).

[32] 26 Ad.L.2d at 288. Rather than remand for appointment of counsel and further hearings, the Commission found the proceedings fundamentally unfair and dismissed the complaint.

ADVERSE ACTION APPEALS IN WHICH COMMISSION DECIDED IN FAVOR OF EMPLOYEE
PART 752[1]

Name	Agency	Date
Frost, Roger O	FAA	July 9, 1971
England, David A., Gaines, Jackie F., Wright, James D., Hill, Thomas G., LeBlans, Charles.	do	June 30, 1971
Estep, James T	do	July 9, 1971
Orokos, John W	do	July 6, 1971
Wills, Kenneth E	Bureau of Customs	July 8, 1971
Rena, Hubert W	IRS	June 30, 1971
Marra, Anthony	Department Consumer and Marketing Service	July 13, 1971
Schuldt, Claude J., Carver, Maurive R., Edwards, Garland S.	FAA	July 8, 1971 July 7, 1971 July 21, 1971
Goff, Walter L., et al	do	July 19, 1971
Howard, Wesley L	do	July 8, 1971
Johnson, Richard H	do	July 7, 1971
Meyers, Robert E	do	July 9, 1971
Gonsalves, John Jr., et al	Department of Navy	July 21, 1971
Wheatley, Charles B	Postal Service	July 9, 1971
Alesia, Ralph F	do	June 30, 1971
Wiegman, John W	do	July 6, 1971
Jackson, Merrill T	Bureau of Engraving and Printing	July 23, 1971
Kanefsky, Daniel	Department of Navy	June 28, 1971
Bell, Sina	Bureau of Indian Affairs	July 27, 1971
Beasley, Francella C	Postal Service	Aug. 2, 1971
Olivier, Andrea E	do	Aug. 20, 1971
Colbert, John F	do	Aug. 3, 1971
Humphreys, Dorothy L	do	Aug. 19, 1971
Dennis, Herman	do	Aug. 18, 1971
Harris, John S	do	Aug. 4, 1971
Moriarty, Brian J	Veterans Administration	Do.
Tempest, David L	Department of Transportation	Aug. 16, 1971
Davis, William	Postal Service	Do.
Hodges, Ira	do	Do.
Elliott, Martin J., Sr	FAA	Aug. 19, 1971
Litwinowich, Joseph, Gagnon, Ronald H., Lambert, Raymond P.	Department of Navy	Sept. 17, 1971
Richardson, Johnnie L	do	Do.
Pierce, George H	Postal Service	Sept. 14, 1971
Brown, Leonard, Jr	do	Sept. 13, 1971
Doussett, Calvin	do	Sept. 1, 1971
Saverino, Sarah	Social Security Administration	Sept. 9, 1971
Bell, William R	Postal Service	Do.
Gandy, Ruby M	do	Sept. 17, 1971
Williams, Mary C	do	Aug. 30, 1971
Tibbs, Robert W., Jr	do	Sept. 10, 1971
Wheeler, Walter A	Department of Navy	Sept. 17, 1971
Pazdon, John J	do	Do.
Strochan, Lewis	Postal Service	Sept. 23, 1971
Mestrovich, J. Jan	GSA	Sept. 13, 1971
Rooney, John J., Jr	Department of Transportation	Sept. 22, 1971
Debockler, Charles F	Postal Service	Sept. 24, 1971
Davis, Rose L	do	Oct. 15, 1971

See footnote at end of table.

ADVERSE ACTION APPEALS IN WHICH COMMISSION DECIDED IN FAVOR OF EMPLOYEE—Continued
PART 752[1]

Name	Agency	Date
Gariepy, Donald F	Department of Navy	Sept. 21, 1971
Ward, James L. R	Department of Army	Sept. 29, 1971
Altman, Barry	Postal Service	Sept. 22, 1971
Bell, Edward	do	Sept. 20, 1971
Ware, Herman L. (also Toner)	Department of Navy	Oct. 15, 1971
Johnson, Walter E	do	Oct. 7, 1971
Toner, Charles H. (also Ware)	do	Oct. 15, 1971
Allen, Kim L	Department of Transportation	Oct. 4, 1971
Fisher, Norman R	FAA	Sept. 20, 1971
Peterson, James O	Air Force	Oct. 4, 1971
Staub, Elenore M	Selective Service	Nov. 8, 1971
Johnson, Keedah K	BIA	Oct. 22, 1971
Dawson, Hariette M	IRS	Oct. 20, 1971
Greene, Isaiah	Postal Service	Oct. 27, 1971
Pendley, Edmund R	Department of Navy	Oct. 29, 1971
Geringer, Meyer	do	Nov. 11, 1971
Meyers, Helen H	Small Business Admin	Nov. 10, 1971
Parker, Kenneth D	Postal Service	Dec. 6, 1971
Miller, Roslyn	do	Nov. 29, 1971
Mortell, John A	do	Nov. 17, 1971
Thompson, Yancy S	EEOC	Dec. 3, 1971
Dix, William Jr	Air Force	Nov. 22, 1971
Franco, Joseph L	Department of Army	Nov. 16, 1971
Starbuck, Robert L	do	Jan. 5, 1972
White, Ivy	Postal Service	Jan. 7, 1972
Marrero, Bruce A	do	Dec. 21, 1971
Barrett, Frank W	do	Jan. 3, 1972
Newberry, Stephen	do	Dec. 29, 1971
Barton, Leo K	do	Jan. 7, 1972
Minor, Daniel L	do	Dec. 20, 1971
Logan, Kenneth	do	Dec. 15, 1971
Stewary, Mary Ann	do	Jan. 12, 1972
Blair, Roy I	FAA	Jan. 31, 1972
Miller, Allen P	Postal Service	Jan. 27, 1972
Rodgers, LaVerne A	do	Jan. 19, 1972
Branch, Bradford, Sr	Department of Navy	Jan. 21, 1972
Hitt, Harold C	do	Jan. 18, 1972
Carrington, Alfred	Postal Service	Jan. 21, 1972
Simmons, Joseph M	U.S. Marine	Feb. 4, 1972
Tidwell, Billie	U.S. Army	Feb. 1, 1972
Garcia, Patrick C. Jr	Dept. Navy	Jan. 20, 1972
Williams, Frank Jr	Postal Service	Feb. 28, 1972
Contero, Raul	do	Mar. 1, 1972
Deshields, George A	do	Mar. 2, 1972
Martel, Dora E	Department of Army	Mar. 3, 1972
Melcher, Richard A	do	Feb. 10, 1972
Carmichael, Benjamin E	Department of Interior	Feb. 8, 1972
Vasek, Leon C	U.S. Air Force	Feb. 25, 1972
Sansing, James C	Department of Navy	Feb. 18, 1972
Mannarino, Necco J	GSA	Mar. 31, 1972
Tyner, Amy L	Postal Service	Mar. 17, 1972
Ferrara, Barbara R	do	Mar. 24, 1972
Compton, Jimmie D	do	Mar. 17, 1972
Couch, John D	do	Mar. 21, 1972
Hunt, William D	do	Mar. 24, 1972
Pitts, Carstell	do	Mar. 31, 1972
La Fond, Martin L	BIA	Mar. 23, 1972
Bays, Edwin R	Department of Army	Mar. 13, 1972
Gibson, Leonard	U.S. Air Force	Mar. 9, 1972
Williams, Sammie C	do	Do.
Ragin, Albert	do	Do.
Christensen, William D	Postal Service	Mar. 16, 1972
Ruthford, Leonard E	do	Mar. 30, 1972
Powell, Phillip	do	Mar. 13, 1972
Sands, Daniel G	FAA	Mar. 20, 1972
Boykins, William J	Department of Navy	Mar. 28, 1972
Slayton, Leo	Tennessee Valley Authority	Apr. 25, 1972
Williams, Richard A	Postal Service	Apr. 5, 1972
Jackson, Martha F	do	Apr. 28, 1972
Boyd, Catherine	do	Apr. 3, 1972
Scott, Arthur L	co	Do.
Dalton, Robert J	Department of Navy	Apr. 27, 1972
Horborn, Henry J	do	Do.
Curtiss, Donald P	do	Do.
Jue, Henry	do	Apr. 7, 1972
Roberts, Allan	Postal Service	Apr. 10, 1972
Hobbs, Clarence T	U.S. Mint	Do.
Nelson, Sarah L	Department of Navy	Apr. 14, 1972
Steer, Harold E	Department of Defense	Apr. 24, 1972

[1] Appeals won by employees from removal, suspension, furloughs without pay, and reductions in rank or pay

REDUCTION-IN-FORCE APPEALS IN WHICH COMMISSION DECIDED IN FAVOR OF EMPLOYEE

Name	Agency	Date
Warschauer, Douglas M., et al	NASA	July 13, 1971
Sampson, John		
Ridgeley, Dana		
Malamed, Louis		
Kirsch, Jordan		
Kellett, Claude M.		
Childress, James D.		
Holland, Harold	do	July 8, 1971
Magers, Laurence M.	do	July 16, 1971
Allen, Edward G.	Air Force	Aug. 4, 1971
Reinhart, Joseph F.	Army	Aug. 10, 1971
Trenner, Donald E.	Defense Supply Agency	Aug. 3, 1971
Bennett, John R.	Army (Engineers)	July 29, 1971
Evans, John C.	NASA	Aug. 16, 1971
Fossa, John P.	Air Force	Aug. 26, 1971
Galassini, Robert J.	Army	Sept. 17, 1971
Tubbs, JoAnnie	DSA	Sept. 7, 1971
Rose, Levi T.	NASA	Aug. 30, 1971
Greenwood, Michael	Navy	Sept. 23, 1971
Gilliam, Sterling E.	DSA	Oct. 6, 1971
Johnson, Richard E.	NASA	Sept. 30, 1971
Hevenor, Molly F.	Commerce	Sept. 22, 1971
Pieterick, Mary B.	Navy	Sept. 30, 1971
Detmer, Mary F.	SBA	Nov. 11, 9711
Holcomb, Lilian I.	Defense Contract Administrative Services	Nov. 1, 1971
Beeny, Jack D.	NASA	Oct. 22, 1971
Little, James C.	Army	Oct. 29, 1971
McKeever, David E.	do	Nov. 5, 1971
Panitch, Charles	do	Dec. 1, 1971
Hamilton, LeRoy R.	POD	Dec. 16, 1971
Jounakos, Fred	do	Do.
Himmel, Sidney	do	Do.
Itskowitz, Jack	do	Do.
Shudy, Frank A.	do	Do.
Bernal, Richard	Army	Dec. 13, 1971
Pomerants, Milton	POD	Dec. 16, 1971
Van Willis, Roy A.	do	Do.
Marinaro, Anthony J.	do	Do.
Tiney, Donald S.	DCA	Jan. 6, 1972
Tengood, Max	Navy	Jan. 7, 1972
Kennedy, Gordon J.	NASA	Dec. 22, 1971
Roberson, Willie A.	Army	Jan. 7, 1972
Morewitz, Alvin H.	NASA	Jan. 3, 1972
Patukonis, Peter R.	DCA	Jan. 6, 1972
Tate, Sherman E.	Army	Jan. 26, 1972
Pasquerella, Donna	SSS	Feb. 22, 1972
Tuna, Simon J.	Army	Mar. 7, 1972
Gourdin, Dorothy A.	SSS	Feb. 22, 1972
Unger, Leroy A.	Interior	Feh. 17, 1972
Jayne, John P.	NASA	Feb. 22, 1972
Bedenbaugh, Fredrick L.	Navy	Mar. 2, 1972
Nielson, Ralph E.	Army	Do.
Dickinson, Stanley K.	Air Force	Mar. 3, 1972
Mize, Robert F.	NASA	Feb. 9, 1972
Weyerman, Hazel R.	Postal Service	Feb. 9, 1972
Turner, Jesse L.	NASA	Mar. 3, 1972
Fossa, John P.	Air Force	Mar. 20, 1972
Staskus, John	NASA	Apr. 3, 1972
Alexander, Roger L.	do	Mar. 8, 1972
Womack, William L.	Air Force	Mar. 13, 1972
Slavik, Ralph J.	NASA	Apr. 24, 1972
Mitchell, James U.	Navy	Apr. 21, 1972
Thom, Theodore G., Jr.	NASA	Apr. 28, 1972
Fulmer, James T.	TVA	Apr. 1, 1972
Foster, Berlin C.	Navy	May 1, 1972
Trenner, Donald E.	DSA	Apr. 24, 1972
Hale, Shirley P. (Mr.)	NASA	Apr. 13, 1972
Krave, Gerhard John	Air Force	Apr. 19, 1972
Talley, Te[illegible]	Navy	May 8, 1972
Sidick, James G.	NASA	May 15, 1972
Normile, Wayne A.	Navy	May 24, 1972
Lewis, Jackie W.	NASA	May 15, 1972
Cross, Clifford G.	Navy	May 11, 1972
Blankenship, Everett E.	do	Do.
Mondfrans, Legrande	Air Force	May 26, 1972
Echmalian, Susan O.	POD	May 5, 1972
Wilcox, Walter W.	Navy	May 18, 1972
Tompkins, Beryl W.	do	May 11, 1972
Pettingill, Joseph W.	do	Do.
Goldberg, Roger C.	do	Mar. 22, 1972
Mohr, George S.	do	May 11, 1972

REDUCTION-IN-FORCE APPEALS IN WHICH COMMISSION DECIDED IN FAVOR OF EMPLOYEE—Continued

Name	Agency	Date
Henry, Wood T	NASA	July 26, 1972
Rhode, Ralph E	Navy	June 20, 1972
Harbins, Ralph C	NASA	June 2, 1972
Coffey, Eugene E	do	June 23, 1972
Monks, Thomas C	do	June 14, 1972
Cobb, Shirley S	Navy	June 8, 1972
Kotom, Lester	POD	July 31, 1972
McCombs, William M	NASA	July 3, 1972
Welce, Lottie J	Navy	July 18, 1972
Batten, Daniel M., Jr	Army	July 13, 1972
Hudak, Albert A	do	July 6, 1972
Zachary, Burr S	VA	Aug. 24, 1972
Black, Helena	do	Aug. 29, 1972
Norquist, Dora	AEC	Aug. 23, 1972
Makrides, George C	POD	Do.
Silver, Richard	Navy	Do.
Stitts, Jack C	DSA	Aug. 18, 1972
Woodie, William J	do	Do.
Bee, Charles W	TVA	Aug. 28, 1972
Donnelly, James F	Navy	Sept. 25, 1972
Mills, Gilbert D	do	Sept. 18, 1972
Countryman, Robert F	DSA	Sept. 7, 1972
Horton, Eugene R	NASA	Oct. 3, 1972
Samms, Bernice H	Air Force	Oct. 20, 1972
Wappaus, Walter A	NASA	Oct. 17, 1972
Smith, Charlotte, R	do	Oct. 13, 1972

MEMORANDUM, U.S. CIVIL SERVICE COMMISSION,
October 13, 1972.

To: Directors of Personnel, Directors of Equal Employment Opportunity, Federal Women's Program Coordinators.

From: Bernard Rosen, Executive Director.

Subject: Annual Report—Office of Complaints, July 1, 1971 thru June 30, 1972.

The attached report covers the activities of the Office of Complaints for Fiscal Year 1972. Compared with Fiscal Year 1971, there was an increase (over 49 percent) in the number of individual cases handled during Fiscal Year 1972, as the following table indicates:

	Fiscal year	
	1971	1972
Telephone contacts	2,136	3,493
Visitors	819	1,036
Correspondents	502	641
Total	3,457	5,170

Over seventy-five percent of the inquiries and complaints received during this Fiscal Year fell into the following seven categories: grievances, pay and leave, adverse actions, promotions, duty assignments, classification, and job applicants. (Fourteen categories are reported.) Each case listed in the report represents an indivdual contact computed on a one-time-only basis.

In operating the Office of Complaints, we have continued the practice of emphasizing the responsibility of the aggrieved party to use the established channels of appeal available to him. However, a large number of the contracts listed in this report represent inquiries that were answered on-the-spot or counselling sessions confined to the Office of Complaints. Also, we have continued to expedite the referral of matters we think the departments and agencies need to explore, to follow up on these referrals, and to analyze and evaluate the replies we receive in order to assure that appropriate action has been taken to resolve the issues raised by the complainant.

Overall the cooperation we have received has been execllent. This has enabled us to meet our overall objective of providing service to the public and the Federal service in a responsive and timely manner, even with an increased workload.

Attachment.

STATISTICAL SUMMARY—COMPLAINTS RECEIVED JULY 1, 1971 TO JUNE 30, 1972, DISTRIBUTION

	Total complaint activity		Source of complaints		Sex of complainants	
			District of Columbia metro area	Other	Male	Female
	Percent		Percent	Percent	Percent	Percent
Telephone contacts[1]	3,493	(68)				
Visitors	1,036	(20)	946 (91)	90 (9)	648 (63)	388 (37)
Correspondents	641	(12)	203 (32)	438 (68)	437 (68)	204 (32)
Total	5,170	(100)	1,149 (69)	528 (31)	1,085 (65)	592 (35)

[1] Complete data on distribution of telephone contacts by location and sex not available.

COMPARATIVE DATA—INDIVIDUAL INQUIRIES AND COMPLAINTS RECEIVED

	Fiscal year 1970–1971–1972				
	1st quarter	2d quarter	3d quarter	4th quarter	Total
Telephone contacts:					
Fiscal year:					
1972	742	658	1,016	1,077	3,493
1971	616	589	443	488	2,136
1970	384	340	366	494	1,584
Visitors:					
Fiscal year:					
1972	275	213	238	310	1,036
1971	173	180	245	221	819
1970	230	213	224	203	870
Correspondents:					
Fiscal year:					
1972	159	148	146	188	641
1971	145	125	105	127	502
1970	119	123	114	[1] 132	[1] 488
Totals:					
Fiscal year:					
1972	1,176	1,019	1,400	1,575	5,170
1971	934	894	793	836	3,457
1970	733	676	704	[1] 829	[1] 2,942

[1] Data adjusted to show individual cases.

TYPE OF COMPLAINT

Category	Telephone	Visitors	Correspondents	Total
Job applicant	701	168	93	962
Pay and leave	404	61	72	537
Classification	149	39	37	225
Employee relations	35	22	5	62
Adverse action	247	165	58	470
Promotion	305	102	57	464
Duty assignment	188	52	7	247
Retirement	136	25	19	180
Reinstatement	64	30	9	103
Discrimination	96	42	64	202
Transfer	101	38	5	144
Grievance	724	170	128	1,022
Performance evaluation	23	6	5	34
Other	320	116	82	518
Totals	3,493	1,036	641	5,170

TELEPHONE CONTACTS—FISCAL YEAR 1972

Agency	Total	Nature of complaint													
		Job applicant	Pay and leave	Classification	Employee relations	Adverse action	Promotion	Duty assignment	Retirement	Reinstatement	Discrimination	Transfer	Grievance	Performance evaluation	Other
Legislative branch:															
AC	3		1				1		1				3		3
GAO	14	1	4	1		1					1				
GPO	60	2	23		1	8	2	8		1	4		11		
LC	4							1					2		1
Judicial branch: U.S. courts	2				1								1		
Executive branch:															
Executive Office:															1
OMB	2				1								2		3
Other	8		1			2									
Departments:															
State:															
State	23	2	3	2		1	2	2	1			4	5		1
AID	8	2		2							1		3		
Treasury	109	5	20	3		12	16	7	1	1	4	5	25	4	6
DOD:							1			1			2		1
OSD	5														
Army	383	28	60	27	5	29	39	21	10	6	15	16	92	4	31
Navy	297	10	29	29	5	25	53	20	7	1	8	7	81	1	21
Air Force	49	3	1	1		8	2	3	1	2	2	2	18		6
DIA	6					6									
DSA	4					2							2		
Other	40	1	6	1	1	4	3					3	18		3
Justice	78	2	17	8		6	5	6			6	1	24		3
Interior	75	8	15	3	1	6	5	1		2	2	4	20		8
Agriculture	71	4	10	3		4	9	2			8	1	23	1	6
Commerce	83	4	5	7	2	8	13	6		1	5	3	21		8
Labor	35	4	4	3		1	9				2	1	5		6
HEW	201	12	39	12	5	7	15	22	3		8	4	57	3	14
HUD	17	1	1				5	1	1		1	2	4		1
Transportation	84	6	7	7		6	12	5	3		2	2	20	2	12
Independent agencies:															
ACTION	7		2	1		1						1	1		1
CIA	1											1			
CAB	3		1					1				1			
CRC	2	1													1
CSC	25	9	2	1			1		1	1		3	4	1	2
DCG	303	12	47	11	5	26	40	18		1	5	12	108		18
EPA	65	1	6	3		3	10	9	1		1	2	20		9
EEOC	15	1	1	1		1	1	1		1	2	1	3		2

EIB	3	1					2								5
FCC	17		2	1	2		1			1		5			
FDIC	1					1									
FHLBB	4					1	1					2			
FMC	1											1			
FPC	4		1		1							2			
FTC	14	3	2		2	1					3	3			
GSA	131	6	19	3	4	9	10	31	6	1	1	2	32		7
ICC	7	1			1	1	1						2		1
NASA	21	1	2	1	1	4	3		1		2		4	1	1
NCHA	15		1			3	3	1		1		1	4		1
NCPC	1						1								
NCUA	1														1
NGA	4		1		1										2
NSF	7	1					1					1	4		
NSA	2				1								1		
OEO	7		1		1			1					4		
OPC	1		1												
RLA	12		1	1		1		2			2		5		
SEC	7				1		3						1	1	1
SSS	14	1	5		1	1	2						1	1	2
SBA	5		1	1			2								1
Smithsonian	22		2		5	1	1		1	2		7			3
Soldiers Home	2					1					1				
TC	3		1								2				
USIA	9	2	1	4							2				
USPS	50	4	89		16	3	2	2	2	1	2	7			3
VA	70	4	4	2	1	11	10	4	1	1	2	23			7
Other	976	558	48	9	1	19	15	9	97	40	9	14	36	3	118
Total	3,493	701	404	149	35	247	305	188	136	64	96	101	724	23	320

Agency	Total	Nature of complaint													Sex		Location	
		Job applicant	Pay and leave	Classification	Employee relations	Adverse action	Promotion	Duty assignment	Retirement	Reinstatement	Discrimination	Transfer	Grievance	Performance evaluation	Other	Male	Female	District of Columbia metro area	Outside District of Columbia metro area
Legislative branch:																			
AC	1						1									1		1	
GPO	24	4			1	6	3	2				2	4		2	15	9	23	1
LC	4	1									1		1		1	3	1	4	
Judicial branch: U.S. courts	1														1	1		1	
Executive branch:																			
Executive Office:																			
EOP	2					1						1				2		2	
OMB	1					1										1		1	
Other	2		1					1								1	1	2	
Departments:																			
State:																			
State	14	1	1			1	2	3				2	3		1	10	4	13	1
AID	4						1	1	1						1	2	2	3	1
Treasury	38	3	1		4	10	4	2	1			4	4		5	25	13	36	2
DOD:																			
OSD	3						1	1					1			1	2	2	1
Army	104	4	10	6	3	11	11	7	2	1	12	6	19		12	66	38	87	17
Navy	80	5	5	4		10	9	4	3	3	5	4	18		10	60	20	75	5
Air Force	30	3	4		1	4	2				3	1	8		4	22	8	21	9
DIA	3					1		1	1							1	2	3	
DSA	6					3					1		2			2	4	6	
Other	17	2				3			1		1	1	4	1	4	8	9	13	4
Justice	28	1	8	3		4	1				1		7		3	7	21	28	
Interior	40	1	2	3		7	4	3	1			4	12		3	20	20	36	4
Agriculture	20	4			1	2	2	1			2	1	5		2	8	12	18	2
Commerce	35	3	2	4	1	10	4	3			1	2		1	4	23	12	34	1
Labor	15	1	1	1			4				2		4		2	2	13	13	2
HEW	59	9	4		1	7	8	8	1		2	2	11	1	5	33	26	57	2
HUD	5					1		1				1	1	1		2	3	5	
Transportation	23	1		4		7	1					1	7		2	15	8	23	

Independent agencies:																			
ACTION	1														1	1		1	
CIA	1								1							1			1
CRC	1					1											1	1	
CSC	15	2				6	1	1		1		3		1	4	11	15		
DCG	79	7	5	8	2	16	16	6	2	1	2	1	10	3	50	29	78		1
EPA	11		1			4	1	1	1				1	2	7	4	10		1
EEOC	4							1			1		2		2	2	4		
EIB	4	1				2								1	3	1	4		
FCC	3					1	2								1	2	3		
FPC	4					1	1		1				1		2	2	4		
FTC	2					1							1			2	2		
GSA	48	2	2	3	2	7	3	4	2		1	1	15	1	5	36	12	47	1
ICC	4					1							2		1	4		4	
NASA	12	3				5						1	1	1	1	8	4	12	
NCHA	13			1	1	7	2						1		1	12	1	13	
NCPC	3					1							1		1	1	2	3	
NCUA	2					1							1				2	2	
NFAH	1												1				1	1	
NGA	1					1										1		1	
NSF	2						1						1				2	2	
RLA	1												1				1	1	
SEC	2												1		1	1	1	2	
SSS	3									1			2			3		3	
SBA	3					1		1						1		3		3	
Smithsonian	18		2		2	5	3				1		2		3	13	5	18	
Soldiers Home	4					1	2					1				3	1	4	
TC	2						2									2		2	
USIA	13		1	1	2		1				4		1		3	7	6	13	
USPS	26	4	1			10	1		1	1	1		3		4	21	5	24	2
VA	20	3	2		1	7						1	3		3	8	12	15	5
Other	174	103	8	1		6			5	23		1	5		22	123	51	147	27
Total	1,036	168	61	39	22	165	102	52	25	30	42	38	170	6	116	648	388	946	90

CORRESPONDENTS—FISCAL YEAR 1972

Agency	Total	Nature of complaint														Sex		Location	
		Job applicant	Pay and leave	Classification	Employee relations	Adverse action	Promotion	Duty assignment	Retirement	Reinstatement	Discrimination	Transfer	Grievance	Performance evaluation	Other	Male	Female	District of Columbia metro area	Outside District of Columbia metro area
Legislative branch:																			
GAO	3		1			1							1			2	1	3	
GPO	2			1											1	2		2	
Departments:																			
State:																			
State	7					1			1	1	1			1	2	1	6	6	1
AID	1								1								1		1
Treasury	7		2	1							2		1		1	4	3	4	3
DOD:																			
OSD	1												1			1		1	
Army	91	9	18	8		11	10		2	1	12		15		5	69	22	21	70
Navy	61	1	10	6	1	9	3	1	1		8	2	17		2	51	10	12	49
Air Force	41	2	3	4		5	3			4	5		13		2	27	14	5	36
DSA	3	1				1									1	2	1		3
Other	11		1				2				2		6			5	6	3	8
Justice	9	1	1	1		1		1			1		2		1	6	3	5	4
Interior	19	2		1	1	3					2		10			13	6	12	7
Agriculture	21	2	1	2	1	1	2				2		9		1	16	5	6	15
Commerce	11	1	1			2	5								2	8	3	8	3
Labor	8	1	1								3		2		1	5	3	4	4
HEW	31		6	1	1	3	10				1	1	6		2	14	17	18	13
HUD	5										1		3		1	3	2	4	1
Transportation	11		4				1	1			1		2	2		9	2	8	3

Independent agencies:																			
Action	3		1												2	1	2	2	1
CAB	1						1										1	1	
CSC	1						1									1			1
DCG	9			2			2		1			1	3			3	6	9	
EPA	5	1				1	2						1			4	1	4	1
EEOC	4			1			1							1	1	3	1	2	2
FCC	1					1										1		1	
FPC	1												1			1		1	
FTC	1												1			1		1	
GSA	14		3	1		2	2	1			1		3		1	13	1	9	5
ICC	1					1											1	1	
NASA	3					1							2			3			3
NCPC	1						1										1	1	
NLRB	1												1				1	1	
OEO	1														1	1		1	
SSS	2										1			1		1	1	1	1
Smithsonian	2										1				1	1	1	2	
USPS	48	5	7		1	8	2	2			10		7		6	35	13	22	26
VA	34	3	5	2		5	4				2	1	7		5	17	17	10	24
Other	166	64	7	6		1	5	1	13	3	8		14		43	113	53	33	133
Total	641	93	72	37	5	58	57	7	19	9	64	5	128	5	82	437	204	203	438

United States Court of Appeals for the District of Columbia

Civil Action, No. 476–61, Filed, Nov. 22, 1961, Harry M. Hull, Clerk

RICHARD J. STECK, PLAINTIFF *v.* JOHN D. CONNALLY, JR., SECRETARY OF THE NAVY, DEFENDANT

OPINION

Edward L. Merrigan, of Washington, D.C., for the plaintiff.

David C. Acheson, U.S. attorney; and Brian K. Welch, assistant U.S. attorney, both of Washington, D.C., for the defendant.

This is an action for reinstatement by a civil service employee who was dismissed on charges that he had circulated a petition to a member of Congress, among his fellow employees during working hours. The matter is before the Court on cross-motions for summary judgment.

The Civil Service Act, 5 U.S.C. § 652, subsection (d), guarantees to all civil service employees individually and collectively, the right to petition Congress, or any member of Congress, or to furnish information to either House of Congress, or to any Committee or member thereof, free from any restriction or interference on the part of their superior officers.

Subsection (c) of the same Section, explicitly provides that the presentation of any grievance or grievances to Congress or any member thereof, shall not constitute or be a cause for reduction in rank or compensation or removal of such person or group of persons from the service. This statute does not contemplate that the head of a Department may censor the contents of the petition or that he may dismiss the employee concerned therein, if he can prove that the statements contained in the petition are untrue.

To be sure an activity of this kind can adversely affect the morale of a Government department. It can be vexatious and annoying at times if the employee acts unreasonably, but the statute contains no limitation. The fact that the petition was circulated during working hours involves minutiae unless it can be shown there was a serious distruption of work and a substantial loss of time.

The Court realizes, of course, the difficulties confronting the Assistant United States Attorney in defending this action. Under the circumstances, the Court has no alternative but to grant the plaintiff's motion for summary judgment and deny the Government's motion.

ALEXANDER HOLTZOFF,
United States District Judge.

NOVEMBER 15, 1961.

United States Court of Appeals for the District of Columbia Circuit

No. 18,012

WILLIAM W. TURNER, APPELLANT *v.* ROBERT F. KENNEDY, ATTORNEY GENERAL OF THE UNITED STATES, ET AL., APPELLEES

Appeal from the United States District Court for the District of Columbia

Mr. Vincent J. Fuller, with whom *Mr. Edward Bennett Williams* was on the brief, for appellant.

Mr. Stephen B. Swartz, of the bar of the Supreme Court of Minnesota, *pro hac vice*, by special leave of court, with whom *Assistant Attorney General Dougas*, *Mr. David C. Acheson*, United States Attorney, and *Mr. Alan S. Rosenthal*, Attorney, Department of Justice, were on the brief, for appellees.

Before: WILBUR K. MILLER, FAHY AND BASTIAN, *Circuit Judges.*

JUDGMENT

This cause came on to be heard on the record on appeal from the United States District Court for the District of Columbia, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is ordered and adjudged by this court that the judgment of the District Court appealed from in this cause is hereby affirmed.

Per Curiam.

Dated: April 2, 1964

FAHY, *Circuit Judge, dissenting*: 5 U.S.C. § 652(d) provides:

> The right of persons employed in the civil service of the United States, either individually or collectively, to petition Congress, or any Member thereof, . . . shall not be denied or interfered with.[1]

Appellant was separated from his position in the classified Civil Service following proceedings in the agency [2] and in the Civil Service Commission. These included appropriate hearings which eventuated in findings and conclusions of the Commission that statements made by appellant in letters to a Senator and a Member of the House of Representatives regarding his treatment in his position, and other personnel conditions in the agency, were false, irresponsible and unjustified, demonstrating his unsuitabliity for continued employment in and imparing the efficiency of the agency.

The case comes to us on appeal from the grant by the District Court of summary judgment for appellees, with denial of appellant's cross-motion for summary judgment. It must be considered that appellant, in moving for summary judgment, conceded arguendo that the letters referred to contained false and irresponsible statements which were not justified, and that they demonstrated his unsuitability for the position he held; for the decision by the trial court was made on the administrative record which included such findings by the Commission and this record was not challenged by petitioner.

It is appellant's position that by reason of Section 652 (d) his separation from his position cannot rest upon proof of the falsity, irresponsibility and unjustifiability of his statements in petitions to Congress or a Member thereof. I appraise this position in light of the right to petition "for redress of grievances" guaranteed by the First Amendment.

I agree with the Commission that this right may be abused and is not absolute. It has been held that one who accepts employment in the Government also accepts curtailment of certain activities which he would be free to engage in were he to remain in private life, as illustrated by the Hatch Act. See *United Public Workers* v. *Mitchell*, 330 U.S. 75, 95–104 (1947). But the Hatch Act is a limitation placed by Congress upon the activities of the employees covered by it, whereas Section 652(d), to the contrary, is a guaranty by Congress to Civil Service employees of a right, the exercise of which "shall not be denied or interfered with." It would deny or interfere with the right if a consequence of its exercise were deprivation of employment. Equally clear would the right be denied or interfered with if the petition must be limited to statements which subsequent hearings and proceedings may show to have been true, responsible and justified. I recognize that in many situations the question whether particular conduct falls within the protection of a legal right depends upon findings made in hearings and proceedings subsequent to the conduct; but where the right claimed is the right to petition for redress of grievances the validity of its exercise cannot be made to depend upon a subsequent conclusion that the petition contained statements which were true, responsible and justified. Our District Court, speaking through Judge Holtzoff, stated in *Steck* v. *Connally*, 199 F. Supp. 104 (D.D.C. 1961),

> The Civil Service Act. 5 U.S.C. § 652, subsection (d), guarantees to all civil service employees individually and collectively, the right to petition Congress, or any member of Congress, or to furnish information to either House of Congress, or to any Committee or member thereof, free from any restriction or interference on the part of their superior officers.
>
> Subsection (c) of the same Section, explicitly provides that the presentation of any grievance or grievances to Congress or any member thereof, shall not constitute or be a cause for reduction in rank or compensation or removal of such persons or group of persons from the service. This statute does not contemplate that the head of a Department may censor the contents of the petition or that he may dismiss the employee concerned therein, if he can prove that the statements contained in the petition are untrue.

The same reasoning applies to statements subsequently shown to have been irresponsible and unjustified.[3]

---

[1] 62 Stat. 356 (1948).

[2] Federal Bureau of Investigation.

[3] I do not decide, however, that the contents of a petition furnishing classified information or confidential information of a nature that is in the public interest not to disclose is privileged.

In urging otherwise appellees refer to remarks of Congressman Reilly during consideration by the House of the Bill which became the Act. In its then form it did not contain Section 652(d), but there was a provision which became Section 652(c), reading:

> The presenting by any person or groups of persons [in the postal service of the United States] of any grievance or grievances to the Congress or any Member thereof shall not constitute or be cause for reduction in rank or compensation or removal of such person or groups of persons from said service.

Congressman Reilly said that employees "would have to assume the responsibility for their acts in the event of making false or misleading charges that could not be borne out by evidence on investigation." 48 Cong. Rec. 4656.

The Bill was passed by the House and went to the Senate. In reporting the Bill the Senate Committee recommended deletion of what is now Section 652(c):

> [I]t is the view of the committee that all citizens have a constitutional right as such to present their grievances to Congress or Members thereof. But governmental employees occupy a position relative to the Government different from that of ordinary citizens. Upon questions of interest to them as citizens, governmental employees have a right to petition Congress direct. A different rule should prevail with regard to their presentation of grievances connected with their relation to the Government as employees. In that respect good discipline and the efficiency of service requires that they present their grievances through the proper administrative channels.

S. Rep. 955, 62nd Cong., 2d Sess. 21 (1912).

This recommendation encountered strong opposition in the Senate. The tenor of the debate was that Government employees should have just as broad a right to petition as that possessed by ordinary citizens. Senator Ashurst stated: "I am opposed to the striking out of this provpsion from the House bill. Under the Constitution all men have the right freely to speak, peaceably to assemble, and petition the Government for a redress of grievances." He read into the record an article which in part stated: "This provision of the Constitution [the right of petition] does not make exception of citizens who happen to be in the service of the Government. It does not say that all people may petition the Government, except, for instance, railway mail clerks." 48 Cong. Rec. 10671. Senator Reed also strongly opposed the Committee recommendation. He spoke of existing limitations on a government employee's right of petition, saying, "The effect of these ruels, all taken together, has been that the employees of the Post Office Department have been fearful of their right to speak, even to the Congressman from their district, and to suggest to him needed changes. Mr. President, it will not do for Congress to permit the executive branch of this Goverment to deny it the sources of information which ought to be free and open to it, . . ." 48 Cong. Rec. 10674. Senator Williams stated: "It seems to me the freer we leave these people, the better. In fact, it is my iea that the freer we leave everybody, the better. These men have the right . . . if they wish to do so, to petition me for readers of grievances, or to petition you or anybody else, or any part of the Government, and I do not see why Congress should be 'putting its finger in the pie'." 48 Cong. Rec. 10803.

The Senate not only rejected its Committee's recommendation to strike the House language but added a new and broader section. See 48 Cong. Rec. 10804. This is now subsection (d). It applies to all Civil Service employees, not only to postal employees, and its language is more general than that used in the House Bill. This language was accepted by the House and the Bill became law. Clearly, Section 652(d) encompasses petitions with respect to personnel grievances.

When we turn to the light cast by the First Amendment the scope of the protection of Section 652(d) is also seen to be broad. See *United States* v. *Cruikshank*, 92 U.S. 542, 552 (1875); *Thomas* v. *collins*, 323 U.S. 516, 530 (1945); *White* v. *Nicholls*, 44 U.S. 266 (1845); *Bridges* v. *California*, 314 U.S. 252 (1941). Mr. Justice Story, in his Commentaries on the Constitution, Vol. II, § 1895, at 645, note b (5th ed. 1891), wrote of the right of petition:

> The statements made in petitions addressed to the proper authority, in a matter within its jurisdiction, are so far privileged that the petitioner is not liable, either civilly or criminally, for making them, though they prove to be untrue and injurious, unless he has made them maliciously.

Notwithstanding the fact that the Senate debate indicates that full First Amendment rights were to be extended to a Civil Service employee by Section 652(d), perhaps his right is conditioned to a degree by the circumstance that he is in government service. Even so, we repeat, this can hardly require the content of his petition to be limited to statements which after investigation and hearing are found by the Commission to be true, responsible and justified. To require the valid exercise of the right to depend upon such a subsequent "audit," as it were, would inhibit its exercise so substantially as to take away its scope as gathered from the language of the section, its history, and its relationship to the First Amendment.

The recent decision of the Supreme Court in *New York Times Co.* v. *Sullivan.*——U.S.——(1964) fortifies the view I take. The *Times* case is concerned with the protection accorded by the First and Fourteenth Amendments to freedom of speech and of the press. The reasoning of the court, however, seems to me to be in good part applicable to our case. There, responsibility in a libel action for criticism of the conduct of public officials with respect to matters of public interest was involved. The present case may be said to involve criticism of more limited concern, contained in a petition and not in the press. But the right of petition as well as freedom of the press is protected by the First Amendment. And not only is Section 652 (d) explicit as to the right of petition but it is intended to have as broad a coverage as the similar right guaranteed by the First Amendment. Moreover, the grievances which may be the subject of a petition under the section clearly included personnel grievances of the employee. Not only so, but the letters of appellant were petitions to the very officials specified in the statute as the intended recipients of such petitions—the "proper authority" of Mr. Justice Story's language above quoted.

I think the privilege, though not absolute, should be governed by the same standard as has been adopted by the Court in the *Times* case, namely, whether the statements were made with actual malice, that is, with knowledge that they were false or with reckless disregard of whether false or not.[4]

I realize this view gives rise to something of a pardox. Appellant has been found unsuitable for the position from which removed, yet I do not approve the removal in the proceedings before us. The explanation—indeed the justification—is that I think the means by which the removal was accomplished were not permissible under Section 652(d), read with the First Amendment. Even desirable ends are required to be achieved by lawful means. This is the sacrifice, if it may be so termed, required to maintain a rule of law, to which we are bound as the greater good. There may be instances where the error in means is insignificant in the full context of the matter and so may be overlooked; but if, as I think, appellant's removal was inconsistent with the protection accorded by Congress in Section 652(d), and by the First Amendment, the error of course cannot be said to be insignificant.

I would have the case remanded to the Commission for reconsideration under the standards I have indicated.

— —

FEBRUARY 2, 1973.

Hon. JACK BROOKS,
House of Representatives

DEAR MR. BROOKS: This is in response to your letter of January 11, 1973, which requests certain information regarding outside activity of Civil Service Commissioner Jayne Baker Spain, and comments to several questions regarding Civil Service Commission rules and procedures relating to outside activity of Government employees.

Outside activity of Government employees, including employment and financial interests, is governed by Executive Order No. 11222 of May 8, 1965 (copy enclosed). That order prescribes standards of ethical conduct for all Government officers and employees in the Executive branch including Civil Service Commission members and staff. Under section 701 of that order, the Civil Service Commission is authorized and directed to issue regulations implementing the provisions of the order and to approve and review from time to time

[4] The Examining Office found that some of the statements were made without appellant having a reasonable basis therefor. Aside from the absence of such a Commission finding, it is not clear the Examining Office found that appellant himself knew he had no reasonable basis.

other agency regulations for conformance with the order. The Civil Service Commission "umbrella" regulations which serve as guidelines for other agencies and departments appear as Part 735 of title 5, Code of Federal Regulations. Regulations which apply specifically to employees of the Civil Service Commission appear as Part 1001 of title 5, Code of Federal Regulations. Each agency and department has similar regulations applying specifically to its employees which appear in that agency's appropriate title of the Code of Federal Regulations.

You requested a report on Vice Chairman Spain's activities on behalf of Litton Industries or any other non-government employment since becoming a member of the Civil Service Commission, and how that matter will be handled. Vice Chairman Spain is not properly regarded as a regular employee of Litton Industries, nor has she engaged in any other non-government employment. She has not performed any consultant services for Litton Industries. The amount of $7500 which she has received is payment as the result of a contract with Litton dated in 1965 which does not require the rendition of services, and the payment under which contract may be made in full at anytime. If Litton continues payment on an annual basis, the last payment will be made in 1975. This matter was reported to me at the time of Vice Chairman Spain's original appointment. Vice Chairman Spain is a member of the Board of Directors for Litton Industries and attends Board meetings for that organization. This activity has not previously caused conflict with her duties as Vice Chairman and member of the Civil Service Commissison. So far as we know, the only matter in which these interests in Litton could become relevant to her Commission duties is the matter involving Mr. Gordon Rule; and Mrs. Spain has already announced that she will not participate in any matter concerning him.

Your other questions are answered in the order asked.

1. The rules governing outside activities of members of the Civil Service Commission are set forth in Part IV of Executive Order No. 11222. Section 401(a) of that order requires each full time member of a commission appointed by the President to submit to the Chairman of the Civil Service Commission a statement containing:

(1) A list of the names of all corporations, companies, firms or other business enterprises, partnerships, nonprofit organizations and educational or other institutions—(A) with which he is connected as an employee, officer, owner, director, trustee, partner, adviser, or consultant; or (B) in which he has any continuing financial interests, through a pension or retirement plan, shared income, or otherwise, as a result of any current or prior employment or business or professional association; or (C) in which he has any financial interest through the ownership of stocks, bonds, or other securities.

(2) A list of the names of his creditors, other than those to whom he may be indebted by reason of a mortgage on property which he occupies as a personal residence or to whom he may be indebted for current and ordinary household and living expenses.

(3) A list of his interests in real property or rights in lands, other than property which he occupies as a personal residence.

This statement is required to be submitted not later than 30 days after the Presidential appointee enters on duty (Section 401(b)). I review these statements and consult with those who submit them, as required, in order to eliminate interests which might create a conflict between the financial interests of the official concerned and the performance of his services for the Government. (Section 404.)

2. It is not a violation of Civil Service rules and regulations for members of the staff of the Civil Service Commission to perform advisory and consulting services for private corporations or to be members of a corporate board of directors provided that this outside activity is not incompatible with the full and proper discharge of the duties and responsibilities of their Government employment, and provided that this outside activity does not create an actual or apparent conflict of interest. (Section 203.) Guidelines which relate specifically to Civil Service Commission employees are found in section 1001, 735-203 of title 5. Code of Federal Regulations, and provide that incompatible activities include, but are not limited to:

(1) Acceptance of a fee, compensation, gift, payment of expense, or any other thing of monetary value in circumstances in which acceptance may result in, or create the appearance of, conflicts of interest; or

(2) Outside employment which tends to impair his mental or physical capacity to perform his Government duties and responsibilities in an acceptable manner.

In addition to the above specific regulations regarding outside activity, all government employees are required by Executive order and regulation to avoid any action which might result in, or create the appearance of—(1) using public office for private gain; (2) giving preferential treatment to any organization or person; (3) impeding Government efficiency or economy; (4) losing complete independence or impartiality of action; (5) making a Government decision outside official channels; or (6) affecting adversely the confidence of the public in the integrity of the Government.

(E.O. 11222, § 201(c); 5 CFR 735.201a; 5 CFR 1001.735–201). Aside from these restrictions, employees are free to engage in lawful financial transactions to the same extent as private citizens. (E.O. 11222, § 203).

3. The administrative procedures utilized by the Civil Service Commission to determine whether there is a potential conflict of interest between the official functions of the Commission and the personal economic interests of its members are those prescribed by the President in Executive Order No. 11222. These include submission by the member of a statement of financial interest and review of the statement by me as Chairman of the Civil Service Commission. In reviewing the statement for possible real or apparent conflicts of interest the guidelines as prescribed by Executive order and the regulations as discussed in question 2 are applied.

Several actions may be taken to avoid a real or apparent conflict of interest. First, the member may be required to divest himself of the interest in question.

A second action which may be taken is the establishment of a "blind trust". Under this approach a member is required to convey the financial interest in question to an independent and impartial trustee. The terms of the trust require that the trustee manage the corpus solely in accordance with his own financial judgment and that he not communicate to the settlor (member) any information with regard to the holdings or dealings of the trust. The trustee is required to report information regarding holdings and dealings of the trust directly to the Chairman of the Civil Service Commission.

A final action which may be taken is the disqualification of the member from any proceeding in which his private activities create a real or apparent conflict of interest. This action is generally reserved to those unusual instances where the conflict was so remote as to be unforeseen at the time the interest was acquired or the member entered Government service. Of course, any interest or activity which causes frequent disqualification would be incompatible with the full and proper discharge of the member's Government duties and would necessitate divestment or a trust arrangement.

I hope that this response has been helpful to you. If I can be of further assistance in this matter please feel free to contact me.

Sincerely yours,

ROBERT E. HAMPTON, *Chairman.*

OGC INDEX DIGEST OFFICE, *March 18, 1971.*

HON. STUART SYMINGTON,
U.S. Senate

DEAR SENATOR SYMINGTON. This is in reply to your communication of February 17, 1971, forwarding a letter you received from Miss Pam Moran, 912 South Street, Saint Joseph, Missouri 64503, and asking for our views and findings on the questions raised by her letter.

There is a statute which protects the right of Federal employees to petition or furnish information to Congress. This statute, 5 U.S.C.A. § 7102, reads as follows:

"The right of employees, individually or collectively, to petition Congress or a Member of Congress, or to furnish information to either House of Congress, or to a committee or Member thereof, may not be interfered with or denied."

The statute has been highly effective over the years in protecting the rights of employees which are act out therein. The right to "furnish information" includes the right to "testify". I do not recall any case in which a Federal employee has been discharged for giving such testimony.

In January, 1971, the press reported that Postmaster General Winton H. Blount had issued a directive establishing a liaison office as the sole voice of the Postal Service in communicating with Congress. Although the directive reportedly said this action did not affect the right of any employee, as a private citizen, to petition his U.S. Representative or Senators on his own behalf, it was reported that implementing instructions stated that it was mandatory that postal employees immediately cease any direct or indirect contacts with Congressional offices on matters involving the Postal Service.

This material reportedly created quite a stir. As a result, it is understood that information was included in an official publication of the Department which was designed to clarify the matter. It is our understanding that this clarifying information reiterated the rights of employees under 5 U.S.C.A. § 7102 but emphasized that employees could not speak for the Postal Service unless authorized to do so.

I think it possible that the happenings described above may have been the subject of the editorial which prompted Miss Moran's letter to you. In any event, I hope the information outlined above will be helpful in responding to her inquiry. If I can be of further assistance, please let me know.

Sincerely yours,

ANTHONY L. MONDELL,
General Counsel.

OGC INDEX DIGEST OFFICE, *June 9, 1969.*

DAVID B. GARDINER
Decatur, Ala.

DEAR MR. GARDINER: I am sorry that we have not been able to make an earlier reply to your letter of May 3, 1969, to Chairman Hampton.

The right of Federal employees to petition Congress is stated in the following terms in section 7102 of title 5, United States Code:

"The right of employees, individually or collectively, to petition Congress or a Member of Congress, or to furnish information to either House of Congress, or to a committee or Member thereof, may not be interfered with or denied."

The courts have had little occasion to interpret this provision. Similarly, appeals to the Commission have rarely involved questions concerning how the section should be interpreted and applied. Nevertheless, the legislative history of this section indicates it was the intent of Congress to open and keep open the channels of communication between executive branch employees and the Congress or a member, or members, thereof.

Thus, with respect to question 1 on page 2 of your letter, any rules of an agency in the executive branch which would prohibit your group from making the type of petition you describe would be in violation of the statute. We are not aware of any agency having a prohibitive rule of the type to which you refer.

For the reasons mentioned above, neither the Commission nor your agency could require that your group's opinions and recommendations accompanying a petition to Congress be submitted for discussion or clearance. If material relating to areas of concern to the Commission were submitted, we would be pleased to review it and give the group our comments on it but I want to make clear there is no requirement for such an advance submission. I suggest you check with your agency concerning its desires in this regard. Your question 2 is answered accordingly.

With respect to question 3, the release of information of the type to which you refer by Federal agencies is governed by 5 U.S.C. 552 and the implementing regulations of each agency. The Commission's regulations in this regard are in 5 CFR Part 294 (a copy of which is enclosed). The regulations of the National Aeronautics and Space Administration are in 14 CFR Part 1206. To obtain an answer to your question 3 you should write either to Headquarters Information Center, National Aeronautics and Space Administration, Headquarters Administration Office (Code DHA 72), Washington, D.C. 20546, or the Field Information Center, NASA George C. Marshall Space Flight Center, Huntsville, Alabama 35812.

The Commission is concerned about the alleged violations of Commission regulations and of irregularities in personnel management operations at the Center. However, it is difficult to respond to these on the basis of the limited

information given. We will refer your letter to our Atlanta Regional Office for its use in making our next survey of personnel management operations of the Center.

Also, if you will give us information of any specific violations of Commission regulations and/or of improper classification determinations, we will take appropriate action.

Sincerely yours,

ANTHONY L. MONDELL, *General Counsel.*

[From the Civil Service Journal, January–March 1971]

PUBLIC DISSENT AND THE PUBLIC EMPLOYEE

(By William H. Rehnquist, Assistant Attorney General, Department of Justice)

Twenty years ago, an employee of the Federal Government was summarily removed from his official position because be made remarks to a newspaper reporter which were cricical of his superiors. Indeed, his superiors had sternly enjoined him against making any statements at all to representatives of the news media. You are doubtless already thinking back in your minds to the time that this took place—1950—and have already mentally cataloged this incident as another case of McCarthyism run rampant. But the name of the employee I am referring to was General Douglas MacArthur, and the name of the superior who removed him was President Harry S. Truman, acting upon the advice of his Secretary of State, Dean Acheson, and his Secretary of Defense, George Marshall.

Several years earlier, President Truman had sharply curtailed Secretary of Commerce Henry Wallace's exercise of the right of "free speech" when Wallace was dismissed for publicly criticizing Administration policy with respect to Russia. I don't suppose anyone seriously quarrels with either the legal right or the propriety of President Truman having dismissed Henry Wallace or Douglas MacArthur, whatever one may think of the merits of the disputes in which they were respectively engaged. These bits if history stand for the proposition that high-ranking Executive officials have no right to free speech which permits them to publicly criticize the President with impunity.

BEST-KNOWN PROVISION

The free-speech guarantee of the First Amemdment is probably the best-known provision of our Constitution. It is entirely proper that this is so, since the right of freedom of expression is basic to the proper functioning of a free, democratic society.

Less well known, but equally important, are those restrictions on complete freedom of speech which result from the balance of competing interests in the jurisprudential scale—the need to preserve order, the need to afford a remedy to the innocent victim of libel, the need of government to govern. It is the conflict between the latter and the free-speech clause with which we deal today.

Once we get past the celebrated cases involving Secretary Wallace and General MacArthur there is a pronounced difference of understanding as to the latitude accorded public statements and public acts which are made by persons entrusted to carry on the Nation's business. The issue is now of front-page importance, probably put there because of the highly politicized nature of our society today. There is a tendency on the part of young people entering government service to feel that they should have complete and unrestrained freedom to speak out on political and policy matters, regardless of how detrimental their speech may be to government programs in general or to the proper functioning of their own assigned responsibilities within the departments.

At one time, the courts approached this issue in terms of a "right versus privilege" analogy, as epitomized by Justice Holmes' famous dictum concerning the dismissal of a policeman:

"The petitioner may have a constitutional right to talk politics, but he has no constitutional right to be a policeman." *McAuliffe* v. *City of New Bedford,* 155 Mass. 216, 220, 29N.E. 517 (1892).

NOTE.—Remarks before the Federal Bar Association on September 18, 1970, at the Shoreham Hotel, Washington, D.C.

As we all know, courts in recent years have retreated from this stern dichotomy and have expanded government employees' free-speech rights considerably. But now we are hearing equally categorical statements from the champions of employee free speech. Without much critical analysis, they insist that unless the public employee has every bit as much right to speak freely on public issues as a private citizen, the public employee becomes a "second-class citizen" who has given up some of his constitutional rights by virtue of accepting public employment.

If the vice of the Holmes analysis is that it separated entirely the government as sovereign from the government as an employer, the vice of the "second-class citizen" argument is that it entirely equates the two phases of governmental action. If Justice Holmes mistakenly failed to recognize that dismissal of a government employee because of his public statements was a form of restraint on his free speech, it is equally a mistake to fail to recognize that potential dismissal from government employment is by no means a complete negation of one's free speech.

FREE SPEECH VS. GOVERNMENT INTERESTS

The principal case from the Supreme Court of the United States on the subject, *Pickering* v. *Board of Education*, 391 U.S. 563 (1968), makes clear that the test in this area, as in related branches of constitutional law, is a balancing of the claim for freedom of speech against whatever governmental interests may be opposed to that claim. The Court, speaking through Justice Marshall, said:

"The problem in any case is to arrive at a balance between the interests of the teacher, as a citizen, in commenting upon matters of public concern and the interest of the State, as an employer, in promoting the efficiency of the public services it performs though its employees." *Id.* at 568.

Here, the interest on the other side of the sale may be generally described as the interest of the government in governing effectively. The Supreme Court in earlier cases has said that government has the right to carry on public business even at the expense of some forms of individual freedom of expression. Thus, regulations limiting picketing in front of a courthouse, in order to permit free access and exit, are constitutionally permissible. *Cameron* v. *Johnson*, 390 U.S. 611 (1968). And Congress may constitutionally restrict government employees in conducting political campaigning. *United Public Workers* v. *Mitchell*, 330 U.S. 75 (1947).

In the area of public dissent, it may be useful to consider the different types of statements that might be made by public employees. Most typical of those which make today's headlines are statements of opinions which criticize governmental policy: "We disapprove of the President's Cambodian incursion"; "We oppose the funding of the anti-ballistic missiles"; "We oppose the Justice Department's position on the school segregation cases."

Because the major part of my remarks will be addressed to this type of statement, I would like to point out now that the question of the government employee's right to speak out in public without fear of disciplinary sanctions may arise in other contexts.

For example, an employee may make public information that is in violation of applicable regulation, ranging from the sort of departmental prohibition which Otto Otepka was charged with violating when he was employed by the State Department, to the divulgence of highly secret and sensitive material to the agents of a foreign power, as was the case with Julius and Ethel Rosenberg. I think it would be rather difficult to defend this sort of action under a claim of freedom of expression.

The employee may publicize information which, although not technically classified, is false or misleading. Here we encounter the well-established doctrine of *New York Times* v. *Sullivan*, 376 U.S. 254 (1964), holding that the First Amendment prohibits the awarding of civil damages against a libel defendant in the absence of a showing that the publication was both false and malicious. While it does not necessarily follow as the night the day that the First Amendment imposes the same sort of limitation on the right of the governmental employer to dismiss employees because of such statements, the Supreme Court in *Pickering* suggests that very much the same principle will be applied where the basis urged for discharge is the falsity of the information.

But the fact of the matter is that the charge of maliciously publicizing false information about one's governmental employer will rarely exist by itself. Generally, if an employee publishes a false statement, the government may be concerned with ramifications other than mere falsity; almost inevitably, there will be connected with the complaint overtones of disloyalty, promotion of dissension, and related harm which is said to have arisen from the public statement. When this occurs, the decided cases make clear that the simple incantation of the *New York Times* v. *Sullivan* doctrine does not dispose of the typical case of public dissent by the public employee.

PICKERING CASE

I would like to turn now to the facts of the *Pickering* case, because it so well illustrates the way facts, alleged facts, and opinions can be combined in one public statement.

Marvin Pickering was a high school teacher in Will County, Ill., which is one of the outer ring of suburban counties around Chicago. The high school district in which Pickering taught had on its second attempt in 1961 obtained voter approval of a bond issue to provide for the construction of two new high schools. During 1964, a proposed increase in the tax rates for educational purposes was submitted to the voters and defeated, not once but twice.

The day following the second defeat of the proposed tax increase, a letter from Pickering appeared in the letters to the editor column of a local newspaper, in which he sharply criticized the school board for its allocation of school resources between the school's educational program and its athletic program. For writing and publishing this letter, Pickering was dismissed by the school board, and he took his case to the Illinois State courts.

In the Supreme Court of Illinois, Pickering's dismissal was affirmed with two judges dissenting. Reading the majority and dissenting opinions, one gets the impression that the case there was very much cast in terms of *New York Times* v. *Sullivan*.

The school board apparently rather largely based its claimed right to dismiss Pickering on the falsity of several of the purported factual statements which his letter contained; Pickering insisted that by analogy to the *New York Times* rule in libel cases he could be dismissed only if the statements were found to be not only false, but malicious as well. The board's dismissal charge mentioned the need to maintain discipline, morale, and harmony among co-workers and supervisors, but the lack of discussion of this issue in the Supreme Court of Illinois suggests that it was touched on but lightly by the parties.

Justice Marshall, speaking for the Supreme Court of the United States in *Pickering*, said that the writing and publishing of this teacher's letter was protected by the Federal Constitution. There was a good deal of emphasis on the truth or falsity of the statements in the Court's opinion, which appended an analysis indicating that the Court disagreed with the lower courts and with the school board as to how many of Pickering's statements could be described as false.

The opinion also gives some indication of what factors the Court thinks are important in resolving such issues as loyalty and discipline. In the first place, says the Court, Pickering's statements were "in no way directed towards any person with whom appellant would normally be in contract in the course of his daily work as a teacher. Thus no question of maintaining either discipline by immediate superiors or harmony among co-workers is presented here. Appellant's employment relationships with the Board, and, to a somewhat lesser extent, with the superintendent are not the kind of close working relationships for which it can persuasively be claimed that personal loyalty and confidence are necessary to their proper functioning." 391 U.S. at 569–70.

The Court also pointed out that in *Pickering* "the fact of employment in only tangentially and insubstantially involved in the subject matter of the public communication" (*Id.* at 574), and that therefore the Court would regard the teacher as being a member of the general public as he sought to be.

MEEHAN CASE

As might be expected, subsequent lower court decisions have tended to turn more on the loyalty and harmony facets of *Pickering* than on the truth or

falsity facet. A good example is *Meehan* v. *Macy*, which has been three time decided by the Court of Appeals for the District of Columbia Circuit.

Richard Meehan was the president of a local labor union in the Panama Canal Zone which represented the Canal guards. The governor of the Panama Canal Zone, in an effort to assuage Panamanian ire at continued American occupancy of the Canal Zone. had proposed that a previous policy limiting guard employment to United States citizens be revised in order that Panamanians would be eligible. Meehan, during a troubled time in the Canal Zone, publicly and vigorouly criticized the governor's proposed change in policy.

The original opinion of the Court of Appeals, written by Judge Leventhal, upheld one of the three stated grounds for Meehan's dismissal from employment, and contains probably as good a short description of the governmental interest which is served by dismissal as is to be found in the cases:

"There is a reverse side to the coin: With mounting provision of increased and increasingly indispensable services rendered by Government employees, the public weal demands administration that is effective and disciplined, and not beset by turmoil and anarchy."

The Court went on to say: "While a free society values robust, vigorous and essentially uninhibited public speech by citizens, when such uninhibited public speech by Government employees produces intolerable disharmony, inefficiency, dissension and even chaos, it may be subject to reasonable limitations, at least concerning matters relating to the duties, discretion and judgment entrusted to the employee involved." *Meehan* v. *Macy*, 392 F.2d 822, 832, 833 (D.C. Cir. 1968).

The government does have an interest in governing. While the words "loyalty," "harmony," and avoidance of "dissension" all express part of what this notion embodies, I don't believe that all of them together convey the entire idea. In the executive branch of the Government, policy decisions, at least in theory, come down from the top since the President of the United States is the only official of that branch who can lay claim to a popular mandate.

While it is quite proper that his policy decisions be debated and challenged in the legislative branch, and be subjected to vigorous criticism in the country as a whole, the rule within the executive branch must be quite different.

The President and the Secretary of Defense whom he appoints should be able able to push for the funding of an anti-ballistic missile without necessarily obtaining the approval of a majority of the employees of the Defense Department; the President and his Attorney General should be able to push for a crime bill in the District of Columbia even though a majority of the employed lawyers in the Justice Department, if given their "druthers," might oppose some of its provisions. If the case be otherwise, the executive branch will be controlled not by an elected President, but by a number of temporary tenants of Government jobs who have no vestige whatever of a popular mandate to operate the branch.

If the executive branch is to be reasonably efficient, it must have a certain amount of internal cohesion in its operation. In the midst of the anti-ballistic missile battle on Capitol Hill, it simply would not do for the Secretary of Defense, the Deputy Secretary of Defense, or any other high-ranking Defense official to publicly state that he has now had second thoughts about the proposal and sees that it is wrong. By the same token, in the midst of the debate over whether or not Judge Haynsworth should be confirmed to the Supreme Court of the United States, it will not do for the Attorney General or for any Assistant Attorney General to publicly state that he now sees that the presidential nomination was a mistake, and that he certainly understands why the Senate will probably reject it. If the President is not free to dismiss advisors such as this for such public statements, the executive branch might just as well shut up shop tomorrow.

As we get to situations involving government employees less close to the final decision-making authority, less responsible for carrying out those decisions, the government's interest in governing becomes lesser in the scale, and the employee's right as a citizen to speak his mind becomes greater.

BALANCING TEST

The courts have made quite clear that just as the government does not have the freedom to deal with an employee in this area as would a counterpart employer in private industry, so the public employee does not have the same

freedom from government restriction on his public statements as would the employee's counterpart in private industry. The government as employer has a legitimate and constitutionally recognized interest in limiting public criticism on the part of its employees even though that same government as sovereign has no similar constitutionally valid claim to limit dissent on the part of its citizens.

But how do we apply these very general principles to concrete cases? What factors must we use to meet the balancing test pronounced in *Pickering?* One factor is the level of the job. Thus, a President may fire a Cabinet officer or other political appointee for any reason whatever, or for no reason. No court would second guess the President on such a matter for any reason. See K. Dabis, *Administrative Law Test*, § 7.11, at 127 (1959).

In a case framed in terms of civil service law, rather than constitutional law, this right of removal has been extended to high-level career employees. In *Leonard* v. *Douglas*, 321 F. 2d 749 (D.C. Cir. 1963), the court upheld a dismissal of the First Assistant to the Assistant Attorney General, since the latter needs "someone in whom he can confide, and to whom he can turn with trust in his judgment as well as in his legal ability." *Id.* at 752.

Also, some employees as a class (for example, attorneys) have less statutory job protection than others. Persons not in the competitive service are outside the protection of 5 U.S.C. § 7501 (1964), which permits discharge only to promote the efficiency of the service.

ACADEMIC FREEDOM

The occupation involved also has significance. Teachers may well be given more freedom to speak out than others in the community because of the deep-rooted concept of academic freedom. *Keyisbian* v. *Board of Regents*, 385 U.S. 589 (1967); *Pred* v. *Board of Public Instruction*, 415 F.2d 851 (5th Cir. 1969).

Whether this notion of academic freedom is strongest when the teacher's speech is part of classroom conduct or a part of extracurricular conduct seems to me debatable. In a sense, academic freedom is a vocational concept—that is, it would seem applicable in connection with the teacher's *teaching*, and not to his extracurricular activities. And yet the notion that no sort of regimen at all may be imposed upon a teacher in the classroom would seem to play hob with the idea that any particular curriculum could be expected to be taught to the students.

The Court of Appeals for this circuit has held that while a Government teacher may be free to discuss the Vietnam War in public on his own time, when he is hired to teach English to foreign military officers in a quick-training program, his classroom discussion critical of his employer's position on the war justifies dismissal without abridging the First Amendment. *Goldwasser* v. *Brown*, 417 F. 2d 1169 (D.C. Cir. 1969).

A government employee is simply not permitted to use the taxpayers' time in pursuit of expressing personal opinions since he has been hired for other specific duties. We may have here the paradoxical situation in which the teacher's academic freedom is presumably strongest in the classroom, rather than in the teacher's private life, and yet it is in the classroom that the teacher may reasonably be expected to spend time on the curriculum prescribed by his superiors, rather than on his own observations of the world situation.

POSITION OF TRUST

Whatever may be the situation with respect to teachers, there can be no doubt that attorneys occupy a special relationship to their employer, whether it be a private client or the Government of the United States. The peculiar position of trust occupied by attorneys is evidenced by the traditional attorney-client privilege, which suggests that unauthorized public disclosure of information on any issue which has been committed to their professional trust by their clients would be a serious breach of that trust which would justify dismissal.

For example, Canon 6 of the Canons of Professional Ethics speaks of an "obligation to represent the client with undivided fidelity and not to divulge his secrets or confidences." The concept of fidelity is also apparent in Canon 37, which states flatly, "[i]t is the duty of a lawyer to preserve his client's

confidences," and further that "[a] lawyer should not continue employment when he discovers that this obligation prevents the performance of his full duty to his former or to his new client." Thus, the notion of professional loyalty extends beyond the area of lawyer-client privilege.

I think one may fairly generalize that a government employee, and certainly a government attorney, is seriously restricted in his freedom of speech with respect to any matter for which he has been assigned responsibility. It is in this area where I stressed earlier that the President's popular mandate could be negatived by members of a particular executive agency publicly dissenting to that department's policies.

Courts recognize this factor and give it weight. The Court's language in *Pickering*, for example, stresses the relationship of the communication to the type of work performed. The Court there pointed out that the teacher's communication pertained to school financing, and not to school teaching. See 391 U.S. at 574.

When we move from the "assigned-responsibility" situation into the "off-duty" or "extracurricular" situation, the claim for freedom of expression is stronger. If a person identifies himself as being associated with a particular agency or holding a specific government job when he makes public statements, his case is not as strong as where he is content to be identified simply as a member of the general public.

The courts have at times distinguished between statements made in an official capacity and those made as a member of the general public. In *Pickering*, for example, the fact that Pickering was a teacher in the school system whose administration he criticized was treated by the Court as being relatively unimportant, which permitted the Court to characterize his statement as made by a "member of the general public." 391 U.S. at 574.

In *Murray* v. *Vaughn*, 300 F.Supp. 68 (D.R.I. 1969), a Peace Corps Volunteer in Chile sent a letter to a local newspaper criticizing the United States' involvement in Vietnam, for which action he was dismissed. The court held that this statement, like the one in *Pickering*, had been made in a protected, individual capacity. Unlike the teacher in *Pickering* or the Peace-Corps Volunteer in *Murray*, there are undoubtedly situations in which the public employee is so well-known, or his position so close to the center of authority, that he is simply not able to disassociate himself from that position and become a member of the public at large.

EMPLOYEE-EMPLOYER LOYALTY

Another factor that inevitably is in the background of every dismissal action is the concept of discipline, personal loyalty, and harmony in the working relationships among employees which I illustrated earlier in connection with the *Meehan* case involving the Panama Canal Zone policeman. The Federal Government is entitled to demand at least as large a part of the same personal loyalty owed by any employee to his employer.

For example, the Court of Claims in *Harrington* v. *United States*, 161 Ct. Cl. 432 (1963), held that a civilian employee of the Air Force was justifiably dismissed for printing and circulating a pamphlet criticizing Air Force efficiency and conduct. One simply cannot work a part of the time in serving the Air Force or any other organization and then expend other efforts in tearing it down.

The impact of a public statement on one's co-workers, and the ability to continue working efficiently with them, is a related facet of the overall picture. Most government employees are not as isolated from co-workers as Marvin Pickering was from other teachers, but in many cases enjoy a close working relationship.

In the recent case of *Lefcourt* v. *Legal Aid Society*, 38 U.S.L.W. 2633 (S.D.N.Y., May 11, 1970), the dismissal of a Legal Aid attorney was upheld since his critical comments about the society's policies promoted "disharmony and inefficiency." Such comments, the court stressed, cannot be tolerated "where they result in internal friction inimical to the welfare of the organization." *Id.* at 2634. The court specifically distinguished *Pickering* by stating that this situation, unlike *Pickering, did* present the issue of the attorney's relationship with supervisors and co-workers.

Another recent case, involving a group of VISTA Volunteers who published also-called "Declaration of Conscience" opposing the Government's position on Vietnam, also distinguished *Pickering* by stressing the need for discipline and harmony. In this case, the VISTA Volunteers at an official meeting discussed, drafted, and signed an anti-war petition. Prior to signing, they were warned by superiors not to go ahead with their project. Threatened with dismissal, the Volunteers brought suit in the U.S. District Court in Colorado against VISTA officials to enjoin any dismissal and seeking a declaratory judgment that dismissal would violate their constitutional rights as well as a judgment that VISTA regulations governing expression were unconstitutionally vague.

Judge Doyle saw no merit to these assertions. The subsequent signing in disregard of their superiors, said the court, "caused a conflict between plaintiffs and their immediate superiors, and the evoking of such conflict is one of the criteria established in *Pickering* as a cause for limiting statements of public employees." *Murphy* v. *Facendia*, 307 F. Supp. 353, 355 (D. Colo. 1969).

This case gives us some limits to the decision in *Murray* v. *Vaughn*, where the Peace Corps Volunteer was held to have been improperly dismissed for writing an anti-war letter to a local newspaper. In *Facendia* there was group action, acts were initiated during working time, and these acts affected the efficiency of VISTA as well as the relationships among VISTA employees.

Judge Doyle held on these facts that the employees were not protected by free-speech guarantees:

"In short, the 'Declaration of Conscience' in this action conflicted with a definite goal of VISTA, detracted time and effort from the primary work of the Volunteers, promoted dissension between Volunteers and their superiors, and generally interfered with the regular operation of VISTA. Accordingly, VISTA supervisors would appear to have been within the constitutional limitations on free expression by public employees in attempting to suppress the 'Declaration of Conscience' and plaintiffs have not asserted a substantial claim under the First Amendment." *Murphy* v. *Facendia*, 307 F. Supp. 353, 355 (D. Colo. 1969).

Such insubordination affects the normal functioning of an office and obviously cannot be tolerated by any organization, governmental or private.

SPECIAL RELATIONSHIP

In the final analysis, all of these factors plus any others relevant to the dismissal must be taken together to see if there exists between the government and the public employee at the time of the public utterance what the *Pickering* Court described as a special relationship to justify the dismissal. The Court stated:

"It is possible to conceive of some positions in public employment in which the need for confidentiality is so great that even completely correct public statements might furnish a permissible ground for dismissal. Likewise, positions in public employment in which the relationship between superior and subordinate is of such a personal and intimate nature that certain forms of public criticism of the superior by the subordinate would seriously undermine the effectiveness of the working relationship between them can also be imagined." 391 U.S. at 570 n. 3.

This special relationship can occur in a number of situations. In *Meehan* v. *Macy*, 425 F. 2d 469, 470–1 (D.C. Cir. 1968), the court referred to the above portion of *Pickering* to say that between the policeman and the governor of the Panama Canal Zone, that special relationship existed during political disturbance in the Zone. Judge Leventhal referred to the generally tense situation because of the rioting and the "diplomatic overtones" of the disturbances as factors creating the relationship. Thus, the intemperate public remarks and derisive poem about the governor by a policeman charged with promoting security and peace in the Zone could be restricted. Otherwise, in the words of *Pickering*, "public criticism of the superior by the subordinate would seriously undermine the effectiveness of the working relationship between them. . . ."

In another case Judge McGowan found the special relationship created by the presence of foreign military officers in a classroom. This justified the dismissal of an English teacher making critical comments concerning the United States' policy in Vietnam. *Goldwasser* v. *Brown*, 417 F. 2d 1169 (D.C. Cir. 1969).

Although not as certain of application as the extremes put forth by Justice Holmes or the proponents of absolute free speech, the present balancing approach of the courts offers, it seems to me, a reasonable approach in protecting the reasonable rights of public employees to free expression and the equally necessary ideal of the government's right to govern. In light of the importance of the interests involved, the added burden of tallying up the foregoing factors in each case becomes a worthwhile exercise.

[From the Civil Service Journal, January–March 1970]

THE FEDERAL EMPLOYEE'S RIGHT TO SPEAK VERSUS THE NEED FOR RESTRAINT

(By Anthony L. Mondello, General Counsel, U.S. Civil Service Commission)

Any analysis of judicial decisions during the decade just passed would be deficient if it failed to note an increased swing of the pendulum toward recognition of the rights of people. Even more significant, in reviewing the sixties, is the continuation and expansion of judicial recognition that government employees are people, or, put another way, that a person does not lose his constitutional rights by becoming a government employee.

At the same time, a student of history would probably characterize the sixties as the decade of dissent. He would be struck by the increase of types of dissent and the number of dissenters. Campus disorders over disagreement with university policies, draft-card burnings and other incidents showing displeasure with the Selective Service System, and anti-Vietnam war protests of various kinds are some of the examples.

Toward the close of the decade it became apparent that the question of whether, and to what extent, the constitutional right of the government employees to speak entitled him to dissent would have to be answered in the seventies. This article is written not to provide the answers, but in the hope that the reader will be enabled to see more clearly what the questions are.

FIRST AMENDMENT

In pertinent part of the First Amendment reads as follows:

"Congress shall make no law * * * abridging the freedom of speech * * *."

The courts have ruled that this and other provisions of the Bill of Rights were made applicable to State action by the due process clause of the Fourteenth Amendment. Thus, its reach extends to persons subject to action by State and the Federal Governments.

Over the years there have been a number of judicial decisions interpreting and applying the freedom of speech provision of the First Amendment to different situations. However, the definitive court decisions in the freedom of speech area is of recent origin.

NEW YORK TIMES *v.* SULLIVAN

The case is that of *New York Times* v. *Sullivan*, decided March 9, 1964. In this case, local Alabama law enforcement officials sued the New York Times and certain civil rights organizations for damages in libel because the newspaper printed an advertisement, paid for by the civil rights organizations, which excoriated the officials for their part in dealing with local civil rights demonstrations. It cannot be disputed that the advertisement contained several inaccuracies and was unduly defamatory in certain respects. The plaintiff won a judgment of $500,000, which was upheld by the Alabama Supreme Court. The United States Supreme Court reversed, relying solely on First Amendment grounds. Its ruling stands for the proposition that a person will not suffer legal liability for critical speech or writing unless what he says or writes is maliciously false or is stated with reckless disregard for the truth.

The court placed heavy reliance on history, and reviewed the pronouncements of several of the framers of the Constitution. In so doing, the court asserted that it had found a "key" to the meaning of the First Amendment—that the First Amendment had a "central meaning"—that it had a core of pro-

tection of speech without which democracy cannot function. According to the court, the right of public discussion of the stewardship of government by public officials was, in the framers' view, the fundamental principle of the American form of government.

What is most important in this case is that the court found each citizen had not merely the right, but the duty, to criticize. It justified this finding of duty on the basis that the "maintenance of the opportunity for free political discussion, to the end that Government may be responsive to the will of the people, and that change may be obtained by lawful means, an opportunity essential to the security of the Republic, is a fundamental principle of our constitutional system."

The court also said that "debate on public issues should be uninhibited, robust, and wide open, and that it may include vehement, caustic, and sometimes unpleasantly sharp attacks on Government and public officials."

TURNER *v.* KENNEDY

The *Times* decision did not concern a citizen who was a public employee. The question of the right of a public employee to criticize government officials, absent actual malice, arose within a month after the *Times* decision.

The case of *Turner* v. *Kennedy* involved an FBI agent who had been dismissed after having written letters to a Senator and a Congressman alleging certain irregularities in the Oklahoma City office of the FBI. He was dismissed, and filed suit in the United States District Court for the District of Columbia. Plaintiff asserted he was exercising his statutory right to petition Congress, a right stated in section 7102 of title 5 of the United States Code. Turner lost in the District Court and the Court of Appeals affirmed that decision without opinion.

Only Judge Fahy spoke to the issues raised by the case. He examined the legislative history of the statute and concluded that it was intended to encompass petitions arising from work grievances. This legislative background, and the relationship of the provision to the First Amendment right to petition, indicated to Judge Fahy that the exercise of the right to petition could not depend on a "subsequent audit" showing that the statements were true, responsible, and justified. He urged that the statute be interpreted to incorporate a standard similar to that established by the Supreme Court in the *Times* decision.

SWAALEY *v.* UNITED STATES

No further cases of related significance were decided until the decision of the Court of Claims in *Swaaley* v. *United States* in May 1967. Swaaley, an employee of the Brooklyn Navy Yard, wrote a letter to the Secretary of the Navy complaining about promotional practices at the Yard and naming three supervisors as "mostly responsible for these unethical promotional policies." "Then," as the court said, "needless to say, the roof fell in on the plaintiff." He was discharged for making "unfounded" statements in his letter. His superiors termed his statements unfounded merely because Swaaley had not provided sufficient information to convince them that all his statements were true.

The court, on the basis of *New York Times* v. *Sullivan*, found for plaintiff and said that the doctrine of that case applies to Federal employees' petitions. The court concluded by saying that, "We hold that a petition by a Federal employee to one above him in the executive hierarchy is covered by the First Amendment and, if it includes defamation of any Federal official, protection is lost only under the circumstances in which a newspaper article would lose such protection if it defamed such official."

PICKERING *v.* BOARD OF EDUCATION

The *Pickering* case involved a non-Federal schoolteacher who was discharged because of publication of a letter he wrote to the editor of his local paper. The letter criticized the way in which the Board of Education was allocating the school's financial resources. Pickering taught classes in one school of a multi-school educational system. He did not work directly with the school board he criticized, nor did he have a close or confidential relationship to any of its members.

On June 3, 1968, the Supreme Court ruled that the letter writing was not a proper cause for discharged because the teacher was exercising his right to

speak on issues of public importance. At the same time the court specifically pointed out that—

"It is possible to conceive of some positions in public employment in which the need for confidentiality is so great that even completely correct public statements might furnish permissible ground for dismissal. Likewise, positions in public employment in which the relationship between superior and subordinate is of such personal and intimate nature that certain forms of public criticism of the superior by the subordinate would seriously undermine the effectiveness of the working relationship between them can also be imagined. We intimate no views as to how we would resolve any specific instances of such situations, but merely note that significantly different considerations would be involved in such cases."

The basic teaching of the case may be summed up in these words of the court:

"The theory that public employment which may be denied altogether may be subjected to any conditions, regardless of how unreasonable, has been uniformly rejected. At the same time, it cannot be gainsaid that the State has interests as an employer in regulating the speech of its employees that differ significantly from those it possesses in connection with regulation of the speech of the citizenry in general. The problem in any case is to arrive at a balance between the interests of the teacher, as a citizen, in commenting upon matters of public concern and the interest of the State, as an employer, in promoting the efficiency of the public services it performs through its employees."

Meehan v. *Macy*. Meehan was a member of the Canal Zone Police Force and president of the local policeman's union. Shortly after the rioting which broke out in the Canal Zone in 1964 had been quelled, Meehan was invited to a meeting at which the Governor's plan to admit Panamanian Nationals to the police force was discussed. The day after the meeting, Meehan criticized the plan to representatives of the news media and a week or so later he prepared and circulated an anonymous letter urging recipients to write their Congressmen and voice their opposition to the plan. Attached to the letter was a poem which contained a burning attack on the Governor and his policies.

Meehan was discharged on three grounds. The Court of Appeals for the District of Columbia Circuit ruled that two of the grounds were invalid. The one remaining charge is of particular interest to this discussion because it alleged conduct unbecoming a police officer in publishing the letter and poem containing derogatory and libelous statements about his superior, made in a sarcastic and contemptuous manner. Thus, the *New York Times* and *Pickering* decisions are immediately brought into focus.

The *Meehan* case was argued before a three-judge panel of the Court of Appeals for the District of Columbia Circuit and reargued before the full court. A final decision has not yet been made because the court ultimately remanded the case to the Civil Service Commission to decide whether or not the one remaining charge was sufficient to justify removal. However, the opinions of the court, particularly in relation to the one charge left standing, do shed some light on how the *New York Times* and *Pickering* decisions apply to Federal employees.

For example, the court said:

"We do not agree with appellant that an employee may, without fear of discipline, say anything and anywhere whatever a private person may say without fear of a libel action, on the doctrine of *New York Times*. The added interests of the sovereign are factors to be considered in adjusting and balancing constitutional concerns."

The court went on to say:

"There is a reasonable difference between the kind of discipline and limitations on speech the government may impose on its employees and the kind it may impose on the public at large. To ensure a basic efficiency in public service a limitation may be imposed as a condition of government employment that is broader than the standard that defines the wrongdoing that subjects a private citizen to penalty or damage action."

The court referred to the common-law doctrine that an employee has a duty to be loyal to his employer. This is, perhaps, the most significant item in the many pages of the opinions. The court, in effect, is saying to public employees "we recognize that you have rights; but don't forget that you also have responsibilities."

". . . the First Amendment gives a citizen the right and, perhaps, even imposes on him the duty to criticize Government policy and Government officials absent actual malice. A citizen does not lose that right by becoming a Federal employee. However, as an employee he has certain obligations toward his employer which make his relationship with the Government different from the relationship he had before he became an employee."

Goldwasser v. *Brown.* Plaintiff was a civilian instructor for the Air Force who taught basic English to foreign military officers who were in this country for training. He was removed on the allegations that he had discussed controversial subjects such as religion, politics, and race during class hours despite prior warnings to avoid such subjects.

The Court of Appeals for the District of Columbia Circuit on September 17, 1969, ruled that the restriction imposed on the teacher's conduct within the classroom was not an unconstitutional encroachment on his right of free speech. The court distinguished this case from the *Pickering* case observing:

"In *Pickering* the Supreme Court * * * recognized that public employment may properly encompass limitations upon speech that would not survive constitutional scrutiny if directed against a private citizen, although there is certainly no easy leap from this to the proposition that a public employee necessarily assumes monastic vows of silence when he looks to the taxpayer for his salary. The Government's interest as an employer is in heightening the level of the public services it renders by assuring the efficiency of its employees in the performance of this tasks; and efficiency comprehends the maintenance of discipline, and prevalence of harmony among co-workers, and the elimination of conduct which may reasonably be thought to have 'impeded' the proper performance by a teacher of 'his daily duties in the classroom.' Conversely, the free speech interest of the teacher is to have his say on any and everything about which he has feelings, provided there is no significant likelihood of impairment of his efficiency."

Relating the *Pickering* test to the case before it, the Court of Appeals stated that the facts in *Goldwasser* required a different result:

"We would * * * be blinking reality if we did not recognize that a class of foreign military officers at an Air Force installation on invitational orders presents special problems affecting the national interest in harmonious international relations. We are certainly not equipped to second-guess the agency judgment that the instructional goals of the Air Force program would be jeopardized by the teacher's volunteering his views on subjects of potential explosiveness in a multi-cultural group."

It is interesting to note that both the *Meehan* and *Goldwasser* cases refer to "efficiency of the service" as a factor to be considered in assessing limitations on employees' freedom of speech. In the *Meehan* case, the court talks about "a basic efficiency in public service," a concept obviously broader than Meehan's efficient performance of his duties as a policeman. In the *Goldwasser* case, the court refers both to conduct of the teacher in the classroom, which obviously relates to the efficient performance of one's duties as a teacher, and jeopardizing the instructional goals of the Air Force program, which again is a broader concept.

The relevance of the discussion stems, of course, from the fact that the basic removal statutes speak in terms of removals "for such cause as will promote the efficiency of the service." There has been a recent tendency on the part of some courts to treat the clause as though it referred merely to the efficient performance of an employee's duties. This has never been the Civil Service Commission's interpretation, since over the years the Commission has been influenced by the legislative history of the Civil Service Act of 1883, which resulted in large part from congressional concern about the low esteem in which the public at large held the entire Federal civil service. It is significant, therefore, that the court in these two cases, and Judge Nichols of the Court of Claims concurring in *Schlegel* v. *United States* (October 17, 1969), recognize that the clause does have broad implications.

Judge Nichols says that actions that will bring an "agency into hatred, ridicule, and contempt, to the grave detriment of its ability to perform its mission" do have an impact on the efficiency of the service. "An agency," said Judge Nichols, "is not necessarily wrong if it deems that good public relations favor efficiency and that bad ones detract from it. I believe that myself. Nor is it absurd to fear that a public which loses respect for the employees of an agency will lose respect for the agency itself. It follows that the agency has (or, up to now, had) a right to require its employees to refrain from off-duty behavior of kinds the public will regard (however obtusely) as scandalous and disgraceful."

SUMMING UP

To sum up, the First Amendment gives a citizen the right and, perhaps, even imposes on him a duty to criticize Government policy and Government officials absent actual malice. A citizen does not lose that right by becoming a Federal employee. However, as an employee he has certain obligations toward his employer which make his relationship with the Government different from the relationship he had before he became an employee. This means that to attain an object of Government, the maintenance of an efficient public service, the Government may restrict the exercise by its employees of their right to criticize.

Consistent with the principles derived from court decisions concerning employee cases, these conclusions may be drawn:

A Federal employee may not be penalized for:

A public statement that he has cleared through an established clearance process.

A statement made in the course of filing an appeal or a grievance that he does not publicize outside the agency.

Criticisms made within prescribed channels; or attempts to achieve improvements in employment or working conditions or changes in personnel or management policy through lawful participation in activities of employee organizations.

A Federal employee may be disciplined;

If his criticism of Government policy or a Government official is false and is made with actual malice, that is, with knowledge of its falsity or with reckless disregard for its truth or falsity.

If his criticism, whether true or false, involves disclosure of information which he knows is confidential.

If his criticism involves false statements about matters so closely related to the day-to-day operations of his agency that the harmful effect on the public would be difficult to counter because of the presumption that the employee would have special access to the real facts.

If the criticism is of a superior by a subordinate when the relationship between them is of such a close nature that the criticism seriously undermines it.

If the criticism is made outside the channels prescribed by, or is in violation of, a statute, Executive order, or regulation.

If the criticism adversely affects job performance, discipline, work relationships, or his agency's mission. This includes public statements in opposition to a Government policy which the employee's duties require him to implement or enforce.

These conclusions by no means solve all the problems. For example, should consideration be given in defining restrictions or criticism, to the employee's duties or his level of responsibility? Should the imposition of a sanction rest on whether a critical employee is recognized by the public as having an official capacity which presumptively validates his knowledge of what he speaks about?

Must actual harm to the criticized program or policy be proved, or is it enough that the purpose of the critic or the tendency of his criticism is damaging?

Should an employee be penalized for failure to adhere to grievance procedures if to do so would require him to take his complaint to the same agency or individual which is the target of the complaint?

Most immediately, questions have been raised over the extent of Federal employee participation in organized dissent over United States policy concerning Vietnam. May an agency head deny use of Government facilities to Fed-

eral employees who request them for holding a lecture by a critic of United States policy? Is it tolerable for Federal agencies to permit employees to use Government bulletin boards to post notices about events like Moratorium Day, notices which lampoon the President and characterize him as misinformed and misled in his Vietnam policy? Should an employee be penalized for participation in an orderly demonstration that becomes violent by the urgings of a few?

These questions can only be resolved by a sensible accommodation of the First Amendment rights of employees with the rights of the Government as an employer. It should be remembered that lawfully operating governments, State and Federal, derive their powers from the same constitutions which contain our charters of personal liberties. The framers of the Federal constitution made these original, sensible accommodations. The task of continuing accommodation calls for the utmost in maturity, good judgment, tolerance, and restraint.

This may seem like a middle ground between the views of extremists on both sides, but to us it is high and defensible ground. We position ourselves here not out of any regard for the value of compromise or the safety of the middle of the road. We are here because of the belief that only by the rational accommodation of these two sets of important, competing constitutional interests can this Nation continue to flourish with a Government that fairly and effectively represents all the people.

APPENDIX

Investigation Of Charges Concerning Unsatisfactory Management Practices In The C-5 Aircraft Program At Lockheed-Georgia Company B-162578

Department of Defense

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

(2355)

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

B-162578

Dear Mr. Chairman:

This is in response to your letter of October 12, 1971, concerning the testimony of Mr. Henry M. Durham before the Subcommittee on Priorities and Economy in Government, Joint Economic Committee. You requested that we investigate the charges and verify the evidence he presented to the Subcommittee.

Although we found that certain of the conditions Mr. Durham described had been present in the early period of Lockheed's performance under the C-5 aircraft contract, we could not determine how extensive those conditions had been or how they compared in severity with similar problems encountered by other manufacturers in producing new aircraft. We also found that Lockheed's management had been aware of the problems and had initiated corrective actions before Mr. Durham's charges were published.

We interviewed officials and reviewed documents at Lockheed-Georgia Company, Marietta, Georgia, and at Chattanooga, Tennessee. We also interviewed Air Force representatives and reviewed documents at the Air Force Plant Representative Office, Marietta, Georgia; the System Program Office, Wright-Patterson Air Force Base, Ohio; and Air Force Headquarters, Washington, D.C.

Our Atlanta Regional Office prepared a staff study on the results of the investigation. As requested, a copy of this staff study was furnished to your office on March 24, 1972. We explained that we did not have an opportunity to review the study in the normal manner within the General Accounting Office and that additional fieldwork was required. During hearings on March 27, 1972, we suggested that attention be given to:

1. Lockheed's awareness of the problems cited by Mr. Durham.

2. Lockheed's experience on the C-5 aircraft, compared with its past experience and with that of other contractors.

3. The awareness of, and the actions taken by, the Air Force.

We also obtained Lockheed and Air Force comments on the Atlanta staff study in letters dated May 26 and July 13, 1972, respectively.

Mr. Durham's charges, our evaluation, and agency and contractor comments are briefly summarized in this letter and are discussed in the appendix. Due to the volume of the comments received from the agency and contractor, the entire comments are not included in this report. Our review of Mr. Durham's charge concerning aerospace ground equipment is underway, and our finding will be reported to you upon completion of our review.

LOCKHEED-GEORGIA COMPANY, MARIETTA, GEORGIA

Mr. Durham charged that there was mismanagement of assembly operations in producing the C-5 aircraft at the Marietta plant. He charged, in part, that (1) assembly records were inaccurate, (2) parts had been removed without authorization, had been scrapped by mistake, and had been unnecessarily procured, (3) inventory controls over titanium fasteners were inadequate, (4) aircraft were moved along the production line in order to collect payments related to the accomplishment of milestones, although the aircraft were incomplete, and (5) the subterfuge to conceal such problems began with the rollout of aircraft 0001. Mr. Durham stated that, as a result, production costs had been increased significantly.

We found that during the period covered by Mr. Durham's charges:

--Aircraft assembly records did not accurately reflect the physical condition of the aircraft.

--Parts had been removed from aircraft without authorization.

--Parts had been erroneously scrapped.

--There were problems relating to controls over disbursement, handling, and usage of titanium fasteners.

We could not, however, determine the extent of these conditions or their impact on the cost or schedule of the C-5 aircraft program.

With respect to the other charges:

--We did not find evidence to indicate that parts had been unnecessarily procured. This is based on a detailed review of a random sample of purchased parts.

--We did not find evidence to indicate that Lockheed maintained the production schedule in order to collect payments related to the accomplishment of milestones. We did note, however, that the Air Force withheld about $3.7 million from milestone payments on the five test aircraft because of shortages and variances from specifications when the aircraft were delivered to the flight-test organization.

--We did not find evidence to indicate that there was subterfuge involved in the rollout ceremony of aircraft 0001.

We visited several aerospace firms to determine whether problems similar to those experienced by Lockheed could normally be expected in producing a new aircraft. We were advised that conditions such as out-of-sequence work and missing parts exist on every new aircraft program. However, it was also pointed out that management emphasis is directed toward insuring that such conditions do not develop into major problems. We were unable to obtain specific detailed information that could be used for comparison.

Lockheed provided data which compared certain factors in its production experience on the C-141 aircraft with those of the C-5 aircraft. We believe the data to be inconclusive because, from the available information, we could not evaluate the production experience on the two programs.

We also found that Lockheed's management was aware of these problems and was directing corrective action, as evidenced by (1) discussions at special meetings held to review the progress of the C-5 aircraft program and (2) numerous Lockheed internal audit reports which were widely disseminated to Lockheed officials.

We found that the Air Force was also aware of some of the conditions cited by Mr. Durham. For the most part, however, the Air Force did not direct the contractor to take specific corrective action because the Air Force, in administering the contract, followed a philosophy of "disengagement." This philosophy required minimal participation by the Air Force in the day-to-day management of the program as prescribed by the total package procurement concept under which the C-5 aircraft was originally purchased.

LOCKHEED-GEORGIA COMPANY
CHATTANOOGA, TENNESSEE

Mr. Durham charged, in part, that (1) there were inadequate controls over tools, raw materials, and miscellaneous small parts, (2) there was unnecessary procurement of material and high-strength nuts and bolts, and (3) there was mishandling of materials. He stated that these conditions and practices had increased the cost of operating the Chattanooga plant.

At Chattanooga, we found that:

--High-strength nuts and bolts had been purchased for plant maintenance when, for some purposes, lower grade materials would have sufficed.

--Substantial quantities of material and miscellaneous small parts had accumulated as a result of canceled orders and transfer of items from another plant.

--Some items which were available at less cost from the Marietta storeroom had been purchased locally.

With respect to the other charges:

--The practice of not providing detailed inventory controls over certain tools was consistent with the practices of others in the industry.

--Raw materials and miscellaneous small parts were purchased and controlled on an individual job order basis in lieu of detailed inventory controls.

Lockheed commented that Chattanooga had a limited procurement function and was authorized to purchase only usage and maintenance materials, along with some items for production. All standard tools, except for such expendable items as cutters, drill bits, and reamers were charged out to employees and employees were required at the time of termination to pay for tools not returned. Lockheed stated that materials for fabricating aircraft parts were basically supplied from Marietta and that materials for aerospace ground equipment were controlled on the basis of individual job requirements.

The Air Force commented that in July 1971, the Air Force Plant Representative visited Lockheed's Chattanooga plant to review operations and to determine whether there was substance to the newspaper reports of Mr. Durham's allegations. By letter dated August 2, 1971, the Air Force advised Lockheed of certain deficiencies in inventory control, discrepancy reports, and housekeeping matters found by Air Force personnel who visited the plant.

B-162578

We trust that the information discussed above and in the appendix to this letter is responsive to your needs. We shall be pleased to discuss this information with you or members of your staff if you so desire.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

The Honorable William Proxmire
Chairman, Subcommittee on Priorities and
Economy in Government
Joint Economic Committee
Congress of the United States

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ABBREVIATIONS

AGE	aerospace ground equipment
DR	discrepancy report
MSP	miscellaneous small parts
SPO	System Project Office
VSP	valuable small parts

APPENDIX I

INTRODUCTION AND SCOPE OF REVIEW

Attached to Mr. Durham's prepared statement to the Subcommittee were 23 exhibits containing examples and explanations of his charges. Some of these charges were referred to in more than one exhibit and some were interrelated with other charges. We have summarized Mr. Durham's principal charges, followed by our evaluation, and, when appropriate, contractor and agency comments.

On October 12, 1971, you requested that we investigate the charges and verify the evidence presented to the Subcommittee. Our Atlanta Regional Office staff met with Mr. Durham on several occasions to discuss his charges in greater detail and to obtain additional documentation.

We conducted our review at Lockheed's plants in Marietta, Georgia, and in Chattanooga, Tennessee. We found that, because the charges concerned conditions in 1969 and in early 1970 at Marietta and in late 1970 and in early 1971 at Chattanooga, we could not verify them by observation. However, at Marietta, the staff did obtain copies of most of Mr. Durham's memorandums, Lockheed's internal audit reports, replies from management officials to the internal auditors, and other records, such as minutes of special meetings by management to review the C-5 aircraft program.

The staff interviewed management and engineering personnel at Marietta, including Mr. Durham's immediate supervisors. These Lockheed employees explained plant operations and controls associated with assembly, quality control, inventory, production control, and other procedures, and provided copies of Lockheed's manufacturing procedures.

We observed and photographed physical conditions at the Chattanooga plant and interviewed the plant manager and other personnel, including several former employees. We obtained copies of Mr. Durham's correspondence and other Lockheed records. We also examined the purchase order files and the system for determining whether material was available in Marietta and obtained copies of pertinent procedures.

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The staff interviewed officials of the Air Force and the Defense Contract Audit Agency and obtained available records to determine the extent to which they had investigated Mr. Durham's charges or had been aware of the problems cited.

In most instances, we could not determine the cost impact of the problems because of the passage of time and the lack of records, and because, some problems were due to workers who violated Lockheed's policies and did not record such violations.

At your request, we furnished you a copy of the staff study prepared by our Atlanta Regional Office on March 24, 1972, although we had not had an opportunity to review it in the normal manner within the General Accounting Office. In addition, the staff study indicated that certain charges, primarily related to procurement of parts, management of part kits, and design of aerospace ground equipment, were still being reviewed and would be reported later.

During the hearings on March 27, 1972, the Comptroller General suggested that attention be given to:

1. The contractor's awareness of the problems cited by Mr. Durham and the timeliness and effectiveness of the actions taken, including the communication of such actions to Mr. Durham and others in the contractor's organization.

2. The comparison of Lockheed's experience on the C-5 aircraft with its past experience and with that of other major aircraft companies in producing new aircraft systems.

3. The awareness of, and the actions taken by, the Air Force in respect to these matters.

He also suggested that Lockheed and Air Force comments be obtained on the staff study to insure a full and impartial disclosure of the facts.

We obtained copies of the documentation supporting Lockheed's comments and interviewed appropriate Lockheed personnel who prepared the Lockheed response. In many instances, Lockheed, in preparing its response, encountered problems similar to those we encountered in evaluating the charges--lack of documentation and passage of time. When it encountered these problems, Lockheed obtained signed statements from their employees who had been involved in the problem areas or who had been associated with Mr. Durham.

Lockheed also analyzed the production records on selected aircraft and commented on the results. Because of the sheer volume of these records and the special skills required in analyzing aircraft assembly records, we did not verify these data.

We noted that the primary documents Mr. Durham used in compiling his data on missing parts were known as call sheets. Lockheed stated that these call sheets were not official documents and therefore were not retained when the production records on individual aircraft were retired to storage.

We examined Lockheed's controls over requirement determinations, procurement, inventory, and assembly operations to determine if parts which had been lost or damaged would cause immediate reprocurement to obtain replacement parts. We also examined a random sample of 30 parts in each of three inventory accounts to determine if Lockheed's controls were effective.

We visited several aerospace firms to determine whether problems similar to those experienced by Lockheed could normally be expected in producing a new aircraft. However, we were unable to obtain detailed information that could be used for comparison.

We did obtain information on the total production manhours expended at Chattanooga and found that, at the peak, Chattanooga had accounted for only 3 percent of total program effort by the Lockheed-Georgia Company.

APPENDIX I

We reviewed correspondence to determine the extent to which the records reflected the Air Force awareness of the problems and interviewed Air Force officials and reviewed correspondence related to delinquency notices to determine the action taken by the Air Force.

CHARGES PERTAINING TO

MARIETTA, GEORGIA

UNNECESSARY PROCUREMENT OF PARTS

Mr. Durham charged that unecessary procurement occurred because a worker would damage a part and, to obtain a replacement, would prepare and submit a discrepancy report (DR). To obtain the replacement part quickly, however, a lost part authorization (LPA) would also be prepared and submitted. Parts would therefore be delivered and replaced through the system using the LPA and, when the DR went through the system, it would replace the same part again. By these means, thousands of parts were double ordered and double procured at great cost.

We found, on the basis of a detailed review of a random sample of purchased parts from three separate inventory accounts, that parts in these accounts had not been unnecessarily procured as a result of production personnel submitting two separate documents, a DR and an LPA, as duplicate authority to replace damaged parts.

We selected three types of materials, as classified by Lockheed, from the eight types which are shown on the C-5 aircraft bill of material. We considered that the types of materials selected, which generally had a unit cost of less than $300, were related to Mr. Durham's charge and were most susceptible to being lost and damaged.

On a random basis, we selected 30 part numbers for examination from each of the three types of material classifications. The total number of part numbers in these three classifications were about 5,800. We then examined all issues to production from January 1969 through June 1972 which were for the replacement of parts that had been lost or damaged. We did not find any instances where two separate authorizations had been used to obtain a replacement part for the same need.

We also noted that submitting an LPA and a DR on the same part to obtain a replacement violates Lockheed's policy and is so stated on the LPA form.

Lockheed comments

Lockheed stated that additional procurement of parts does not automatically occur even though, for some reason, there are multiple issues of parts to the requesting organizations or even though some parts are temporarily misplaced, because Lockheed management has established a comprehensive system of checks and balances and approval requirements over the ordering of any additional parts. If, on the basis of the best information available at the time, some additional parts are ordered, other checks and balances are provided to detect parts overages and to reduce the quantities of parts ordered.

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INACCURATE ASSEMBLY RECORDS

Mr. Durham charged that numerous parts shown to be installed according to aircraft assembly records actually had not been installed and that, in other cases, parts shown by these records as requiring installation already had been installed.

We found that, during the period covered by Mr. Durham's charges, aircraft assembly records in many instances did not accurately reflect the condition of the aircraft received at the flightline from assembly.

The records indicated that early in 1969 Lockheed officials began holding a series of meetings to review the C-5 aircraft program. They considered the corrective action needed to resolve the problems of inaccurate assembly records and out-of-sequence work. For example, as a result of a special meeting on October 25, 1969, the board chairman, Lockheed Aircraft Corporation, directed that a data control center be established at the flightline to coordinate and reconcile aircraft assembly records in order to establish accurate parts requirements.

On December 31, 1969, Lockheed's auditors issued an interim report which indicated that an unusually large number of parts had been missing from aircraft delivered to the flightline and that procedures had not required reconciling assembly records or verifying that work had been performed. Lockheed officials replied that (1) because the assembly line had not been stabilized, it would not be practical to implement corrective action until aircraft 0014 reached the flightline, (2) additional personnel would be assigned to take corrective action, and (3) records would be audited more frequently.

A subsequent audit of aircraft 0013 was undertaken at Lockheed management's request to determine the extent of and cause of the missing parts problem. The report stated that:

--Parts were missing from the airplane but had been recorded as installed. An inspector had verified that some had been installed.

APPENDIX I

--Parts were missing from some feeder plant assemblies and subcontractor assemblies but had not been reported as missing on assembly records.

--Parts reported as missing had been installed.

The audit report stated also that the quality, schedule, and cost of the C-5 aircraft assembly operations had been affected significantly by inadequate administrative controls over assembly work.

At a special meeting on February 21, 1970, the Director of Manufacturing Control reported the quantity of flightline parts requirements to management officials.

The data showed the following.

Flightline Parts Requirements

Aircraft number	Inconsistencies (note a)	Damaged or unsuitable parts	Known shortages and parts to be installed	Total
9	4,000	1,500	4,943	10,443
10	3,750	1,300	4,692	9,742
11	3,300	1,750	3,915	8,965
12	3,000	1,300	2,882	7,182
13	1,750	1,000	2,414	5,164
14	1,300	500	2,843	4,643
15	650	450	875	1,975
16	600	400	875	1,875
Total	18,350	8,200	23,439	49,989

[a]Inconsistencies represent differences between the assembly records and the physical condition of the aircraft when they were reconciled at the flightline.

A Lockheed internal audit report of aircraft 0019 indicated that the conditions found previously still existed to some extent but that progress had been made since the last audit. The report also indicated that there was a downward trend in the variances between the physical status of the aircraft and the status of the production/inspection records.

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The Lockheed internal audit staff planned a followup examination on aircraft 0025. However, because its examination on aircraft 0019 indicated that corrective actions were having the desired effect, this followup audit was postponed. Lockheed internal auditors subsequently selected aircraft 0045 for examination and, in a report dated May 25, 1971, stated that the corrective actions had been fully effective.

Lockheed comments

Lockheed stated that, although there were some problems at the start of the program, Lockheed management had known of the problems and had initiated corrective action before and during the period covered by Mr. Durham's allegations. Lockheed also stated that its procedures were designed to provide good parts control and that, when errors were made, it generally resulted from misinterpretations of record data or from deviations from established procedures by individuals.

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SUBTERFUGE IN ROLLOUT OF AIRCRAFT 0001

Mr. Durham charged that the subterfuge began with the rollout of aircraft 0001 with slave landing gears, false landing edges, and a dummy visor (nose of aircraft).

We did not find evidence of subterfuge in the rollout ceremony conducted on March 2, 1968.

The Air Force issued a press release on February 21, 1968, that the C-5 aircraft rollout would be conducted on March 2, 1968. The release also indicated that the C-5 aircraft was scheduled to fly for the first time in June 1968. This would indicate that the aircraft was not considered fully operational at the time of rollout.

We noted that Lockheed, by letter dated February 26, 1968, had notified the Air Force of some 16 item shortages on aircraft 0001, including the main landing gear side braces and slot doors, as well as the wing leading edges and visor. The Administrative Contracting Officer subsequently withheld $412,000 to cover completion of these open items of work and installation of required parts. This amount was in addition to $1,683,420 withheld by the Air Force for refurbishing the aircraft before final delivery.

Lockheed comments

Lockheed denied that there was any subterfuge at the time of rollout. Lockheed stated that aircraft 0001 was a flight-test aircraft and was delivered to the flightline engineering flight-test organization on February 24, 1968, 1 week before the rollout ceremony. At that time and at the time of rollout, the structural configuration of the aircraft was basically complete, with only a minor number of parts not installed on the aircraft and only a few systems not completely functional. Lockheed also stated that the Air Force was formally notified on February 26, 1968, of all significant shortages, along with anticipated dates for installing flyable replacements.

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Air Force comments

According to the Air Force, there was no subterfuge with respect to utilizing nonfunctional components on aircraft 0001 at rollout. The Air Force stated that it was aware of the aircraft's condition and of Lockheed's plan to install flyable replacements after rollout. It concluded that using nonflyable components was not in itself a serious problem because it was never intended for the purposes of the rollout ceremony that the aircraft be airworthy.

APPENDIX I

FAILURE TO CONTROL VALUABLE SMALL PARTS

Mr. Durham charged that Lockheed was facing a $30 million cost overrun resulting from failure to control valuable small parts (VSP).

We found that Lockheed experienced problems related to controls over disbursing, handling, and using VSP. VSP consists of titanium fasteners (generally threaded bolts or screws) ranging in size from less than 1/2 inch to several inches long. The average cost of an individual fastener is about 44 cents each, although the cost ranges from about 16 cents to more than $30 each.

We could not find, nor did Mr. Durham furnish us, a report showing that, as of May 1, 1970, Lockheed had faced a cost overrun of about $30 million due to overprocurement of VSP resulting from inadequate controls. Lockheed agreed that forecasts of VSP cost overruns as high as $30 million had been made and that a Lockheed industrial engineer had mentioned this figure to Mr. Durham. On the basis of the latest available VSP cost projection, the overrun will be about $7 million as of January 1972.

A report dated September 12, 1969, prepared by Lockheed's internal auditors reported that adequate controls over disbursing, handling, and using VSP in assembly had not been provided. As a result, large excess quantities of VSP were possessed by assembly personnel, mishandling of VSP was widespread, and usage appeared to be too high. These conditions were explained, in part, by the large number of new assembly workers and the similarity of VSP to miscellaneous small parts (MSP), which historically had been loosely controlled because of low value.

The audit report also recognized that management had been aware of the problems of controlling VSP in the assembly area and that it had initiated action more than 1 year before to provide better controls. The report recommended that the implementation of some controls should be accelerated and that additional controls should be developed.

Subsequently, additional controls over requirements and physical handling of VSP were implemented in the assembly

area. These new controls included trays to provide assembly workers with an improved method of storing and maintaining segregation of VSP issued to them, stocking of VSP in a crib (stockroom) with an attendant responsible for issuing VSP to assembly workers, and having the attendant sort and return to stock those VSPs which had been mixed together.

A physical inventory of VSP in the cribs was taken and, thereafter, all receipts and issuances were recorded. This information was fed weekly into a computer, and the output provided both requirements and inventory data.

Lockheed adopted other measures, including periodic inspections of workers' tool boxes and working areas, a display board emphasizing the high cost of VSP, and a 14-minute film shown to production workers to improve VSP handling practices.

At the special request of the Assistant Director of Manufacturing Control, Lockheed's internal auditors again reviewed the controls over VSP. In their report dated December 31, 1970, they stated that generally adequate physical controls over stocking and using VSP had been provided at the Marietta plant and that these controls had been effective. With regard to records of stock on hand in the VSP cribs, however, the auditors reported that fully adequate controls had not been provided and that the balances reflected by the records were not reasonably accurate. As a result of this audit, additional controls were imposed to improve the records' accuracy.

In a followup review performed in the spring of 1971, the internal auditors reported that the controls over VSP which had previously been established were still largely effective. They reported also that the overall usage of VSP appeared to be at a reasonable level.

In addition, Lockheed had awarded a purchase order to a subcontractor to clean and sort VSP which had been mixed with scrap and other materials in the assembly area. From July 1968 through January 1972, Lockheed paid about $906,000 for these services and recovered about 43,667 pounds of VSP; 1,334 pounds of miscellaneous parts; and 6,047 pounds of scrap. Although Lockheed did not record the value of the

material returned, it estimated that more than $6 million of VSP had been sorted and returned by the subcontractor.

Lockheed comments

Lockheed stated that it began early in the C-5 aircraft program to exercise controls over VSP and to improve these controls as conditions indicated that improvements were needed.

In the case of high-usage small parts such as VSP, Lockheed stated that certain costs over basic requirements were unavoidable, i.e., costs associated with engineering design changes, usage in excess of basic requirements, and some surplus material. Lockheed also stated that it had experienced problems in establishing physical controls over VSP but that these problems had been largely resolved before significant losses occurred.

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APPENDIX I

UNWARRANTED DELAY IN REPLACING DAMAGED PARTS

Mr. Durham charged that, although parts had been damaged during earlier production stages, proper replacement action had not been taken and that this caused numerous parts to be replaced at the flightline.

We found that numerous discrepancy reports on defective or damaged parts had been prepared at the flightline and that some of these discrepancies were attributable to an earlier production stage, other Lockheed organizations, vendors, or Government-furnished property. We could not determine, however, the reasons these defective parts had not been detected at an earlier stage in the production program.

Records made available to us showed that there had been 2,481 discrepancy reports (DRs) written at the flightline on aircraft 0009, 0010, 0011, 0012, and 0013. Of these 2,481 DRs, 879 were determined to be the responsibility of the division which releases the aircraft to the flightline and 473 were due to vendors, Government-furnished property, and other Lockheed departments. The remaining 1,129 were charged to the flightline.

Lockheed comments

Lockheed stated that both the Lockheed and the Air Force quality assurance programs were such that, although a damaged part might occasionally be overlooked during manufacturing, this damaged part certainly should be disclosed before delivery.

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HIGHER COSTS AT SUBASSEMBLY PLANTS

Mr. Durham charged that units assembled at subassembly plants could have been assembled more cheaply at Marietta.

We found that it was more economical to assemble units at a subassembly plant than at the main plant at Marietta.

A 1967 General Accounting Office review of the operations of subassembly plants associated primarily with C-130 and C-141 aircraft components showed that, after learning was substantially complete, subassembly plant costs were less than costs at the main plant because cheaper labor costs had more than offset additional transportation and other costs.

Lockheed established six subassembly plants in depressed labor areas to supplement assembly operations at the main plant. Most of these plants supported the C-5 aircraft program. The plants were located at Clarksburg, West Virginia; Charleston, South Carolina; Logan, Ohio; Shelbyville, Tennessee; Uniontown, Pennsylvania; and Martinsburg, West Virginia. The Shelbyville, Logan, Uniontown, and Martinsburg plants have been closed.

Lockheed comments

Lockheed did not comment on this charge.

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PARTS ERRONEOUSLY SCRAPPED

Mr. Durham charged that purchased parts which could have been reworked had been scrapped because of erroneous disposition instructions.

Although we found evidence that some parts had been scrapped because of erroneous disposition instructions, we could not determine the number or the value of these scrapped items.

On April 14, 1970, Lockheed planning officials reported to management that an investigation had shown that expensive salvageable parts and assemblies had been discarded erroneously for various reasons. The officials recommended corrective action which would clarify dispositon instructions by requiring appropriate personnel to attach proper, color-coded tags to parts that had been removed to indicate their disposition.

A Lockheed interoffice memorandum dated April 29, 1970, stated that quantities of purchased and subcontractor parts for C-5 aircraft had been found improperly tagged in scrap gondolas which supposedly contained only scrap materials which could not be reworked. The memorandum also advised that the Lockheed production control department would establish a screening crib to insure proper tagging and the flightline activities had been requested to send scrap gondolas to the crib for review.

Lockheed comments

Lockheed indicated that some reworkable purchased parts were scrapped because relatively inexperienced employees failed to comply with published procedures. Lockheed said that it was not possible once they were scrapped to determine the exact number of reworkable purchased parts which were scrapped.

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PROBLEMS WITH KIT INSTALLATION

Mr. Durham charged that, because of poor planning, parts were assembled into kits and shipped to the field at great expense but were not needed or the kits were incomplete and could not be fully utilized. He also charged that control over kits and parts in the field was ineffective.

Palmdale, California

We found that about 90 modification kits had been returned to Marietta from Palmdale. We were advised that the kits were returned because the aircraft were not available long enough for the kits to be installed.

An interdepartmental communication dated April 28, 1970, from the C-5 aircraft Wing Modification Program Manager at Palmdale to Mr. Durham, stated that a considerable number of kits which had been shipped to Palmdale for aircraft 0001, 0002, and 0009 were not part of the work originally planned and, therefore, were not installed. This communication also stated that the kits were being returned for restocking and distribution for future updating on these aircraft.

Lockheed comments

Lockheed stated that a relatively small number of kits had been returned chiefly because the aircraft had not been available for the length of time as had been originally scheduled and because there had been some later engineering changes.

Eglin Air Force Base, Florida

Records made available to us indicate that personnel installing the kits at Eglin Air Force Base encountered only minor problems with the kits. Aircraft 0005 was a climatic test aircraft tested in the Climatic Test Laboratory at Eglin Air Force Base, Florida, and scheduled to go to Panama for tropical testing in November 1969. Lockheed and Air Force officials decided that, instead of returning the aircraft to Marietta for installing the modification kits before departure for Panama, the aircraft would remain at Eglin Air Force Base and the kits would be installed there. Lockheed was to assist Air Force personnel in the modification program.

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In a November 3, 1969, memorandum to his immediate supervisor, Mr. Durham stated that the manager of the Lockheed flight-test control department, who visited Eglin Air Force Base on October 31, 1969, found that absolutely no control was being exerted over kits when or after they were received, that parts lists were incomplete, and that parts were scattered.

A week later, a subordinate of Mr. Durham's reported that the kit installation was complete. He suggested that, in the future, tighter controls be exercised over similar modification work, more specifically, that:

1. When kits are shipped, the receiver should be advised of the kit item numbers being shipped and the shipper number.

2. When kits are received, they should be checked for completeness.

3. When new parts are installed, all items removed from the aircraft should be tagged.

There was no mention of problems being encountered by the personnel who were installing the kits.

Another employee submitted a report on November 11, 1969, to his supervisor concerning a visit to Eglin Air Force Base when the kits were being installed. On arrival he was made aware of deficiencies in some kits because miscellaneous small parts, tools, chemicals, paints, sealers, and similar items had been omitted from the kits.

In discussing this matter with the Director of Manufacturing Control, we were advised that, initially, planning papers were incomplete because field installation was not contemplated. Therefore, kits did not include miscellaneous small parts, fasteners, and other items which were available at the main plant but not at field installations. He said that these problems had been corrected.

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Lockheed comments

Lockheed stated that Mr. Durham chose to exaggerate the extent and impact of some minor problems which occurred in incorporating a number of updating kits on aircraft 0005 at Eglin Air Force Base after the climatic test program was completed.

APPENDIX I

UNAUTHORIZED REMOVAL OF PARTS

Mr. Durham charged that there were thousands of parts removed from aircraft without proper authorization.

We found that, during assembly, some parts were removed from aircraft without proper authorization. We could not determine the extent of these removals because such actions would not have been recorded, because they violated Lockheed's production control procedures. We noted, however, that internal audit reports and interoffice memorandums showed that tests of selected items had indicated the following information.

Date of report	Aircraft serial numbers	Number of missing parts investigated	Number of parts improperly removed
Oct. 13, 1969	0009 and 0010	160	13
Feb. 16, 1970	0013	124	12
May 28, 1970	0019	63	31

Another Lockheed interoffice memorandum of April 1, 1970, stated that an audit to determine if parts had been improperly removed from main landing gear assemblies for aircraft 0033 through 0036 showed that 26 parts had been removed. Although certain removals were authorized because of parts shortages or to facilitate completion of aircraft further along in the assembly process, unauthorized removals were contrary to Lockheed's production control procedures.

Lockheed comments

Lockheed stated that, when the first C-5 aircraft moved to the flight line area in March 1969, it became apparent to Lockheed management that some unauthorized parts removals were being made by employees. Accordingly, in April and August 1969, memorandums were issued regarding the need to follow governing procedures. Regarding the April 1, 1970, memorandum, Lockheed stated that there was no indication of whether authorizing paperwork was filed.

APPENDIX I

INCOMPLETE UNITS FROM SUBASSEMBLY PLANTS

Mr. Durham charged that incomplete units had been shipped from subassembly plants to Marietta because of poor planning and workmanship.

We found that some units shipped from subassembly plants were received at Marietta with parts missing or other discrepancies. We could not, however, determine the extent of these deficiencies.

Lockheed comments

Lockheed informed us that some problems occurred initially because many design changes required parts to be scheduled for replacement after assemblies were received at Marietta. Because of parts shortages, decisions were also made at times to ship some assemblies to Marietta with the parts not installed. Lockheed stated that the status of the parts and assemblies were fully documented in the appropriate paperwork. In addition, early in the program, management took various actions to promptly detect and correct startup problems with assemblies manufactured at subassembly plants.

APPENDIX I

OVERDESIGN OF AEROSPACE GROUND EQUIPMENT

Mr. Durham charged that aerospace ground equipment (AGE) for the C-5 aircraft was overdesigned and overpriced.

We have initiated a review of AGE procured for the C-5 aircraft and are examining the design criteria and characteristics and the cost incurred by the Air Force in procuring this equipment. We are also comparing AGE Lockheed provided for the C-5 aircraft with similar equipment provided for other aircraft systems.

Lockheed comments

Lockheed stated that a review of the applicable records and discussions with personnel disclosed that Lockheed management had identified 2,847 different items of AGE necessary to support the C-5 aircraft. Furthermore, 1,250 (44 percent) of those items were already available in the Air Force inventory; 155 (6 percent) were standard commercial items procured in the open market; 1,174 (41 percent) were obtained from subcontractors; and 268 items (9 percent) were manufactured by Lockheed. In accordance with competitive bid procedures, the subcontractors were to design and supply the AGE necessary to support the equipment they contracted to manufacture.

Further, Lockheed stated that items which it had manufactured, together with those items subcontractors had supplied, had been produced in accordance with (1) Department of Defense material, design, and process specifications governing support equipment specified in the C-5 aircraft contract and (2) engineering design which the Air Force had previously reviewed, appraised, and approved, as required by the C-5 aircraft contract.

APPENDIX I

CHARGES PERTAINING TO

CHATTANOOGA, TENNESSEE

UNNECESSARY PROCUREMENT OF MATERIAL

Mr. Durham charged that Chattanooga purchased material from vendors when the material was available from the storeroom at Marietta.

Some items purchased from vendors were available at less cost from the Marietta stores. Our analysis of 20 examples furnished by Mr. Durham showed that the vendors had charged $1,516, which was more than three times the cost that would have been incurred had the items been obtained from the storeroom at Marietta. We examined other items purchased locally and found that some of these items could also have been obtained at lower costs through Marietta. Our analysis of these purchases, however, did not include costs which might have been incurred at the Marietta plant for cutting, preparing, packaging, and transporting the items to Chattanooga.

We also found that minimum order charges were incurred on some items that were available in the Marietta storeroom. During a 3-month period in 1971, 217, or 44 percent, of 489 orders for material were procured at the vendor's minimum order charge of $5 ($4 prior to April 3, 1971), which could have been avoided or minimized by combining the orders. We noted instances in which the same materials having the same dimensions had been ordered separately on the same day, sometimes on consecutively numbered forms.

Lockheed comments

Lockheed stated that over the years the activity at Chattanooga had consisted of approximately 70 percent fabrication of aircraft parts and 30 percent manufacture of AGE. Marietta usually furnished the materials required for producing aircraft parts; materials for AGE were furnished by Marietta when they were available or were purchased by Marietta or Chattanooga procurement organizations. The majority of Chattanooga's procurements were made under blanket purchase orders issued by the Marietta procurement

organization for materials used in manufacturing AGE.

Lockheed also advised us that Marietta's and Chattanooga's procedures for determining and providing material for producing AGE required that the material needed be screened against the inventory at Marietta and the surplus inventory at Chattanooga. These procedures should have precluded unnecessary procurement by Chattanooga. Lockheed recognized that Marietta and Chattanooga personnel could have made clerical errors in this screening function; Lockheed believes that materials procured by Chattanooga that were available in Marietta were those types of errors and were isolated cases.

As for the minimum order charge, Lockheed stated that it ordered parts separately to facilitate matching material and related paperwork. Although a dollar value cannot be placed on this practice, Lockheed believed it saved money by facilitating the material receiving process and by affording better control over the material and the related paperwork.

APPENDIX I

LACK OF CONTROLS OVER TOOLS

Mr. Durham charged that there was no checkout control system or any effective controls over standard tools. As an example, he stated he had found rusty drills in an old water-soaked cabinet discarded in the backyard.

Lockheed did not control individual standard tools--such as drill bits, reamers, and cutters--but provided them to employees as they were needed. We found that the procedures used by Lockheed to handle small tools at Chattanooga were consistent with the practices at two other aerospace firms. In addition, it is generally impractical to provide a detailed inventory control system for items that are small and inexpensive.

Some standard tools, such as kit-type tools, power tools, and certain hand tools, were controlled. In addition, Lockheed required all employees upon termination of employment to pay for all lost tools charged to them. The cost to provide and maintain such controls over small tools, we were told, would be greater than the cost of the lost tools.

Lockheed provided us with a signed statement from the supervisor of tool cribs about drill bits found rusting in the plant yard. He stated that he had found only a shoe box partly full of such drills. Two former employees told us they had observed substantially more such drill bits and cutters. These statements could not be reconciled or verified because these tools were considered expendable and therefore accountable records were not maintained.

Lockheed comments

Lockheed stated that standard tools, such as kit-type tools, power tools, and certain hand tools, were stocked in cribs. These standard tools were charged out to employees and were accounted for by control records. Furthermore, procedures required that all employees, upon termination of employment, pay for all lost tools charged to them. Management decided in 1966 not to control certain other standard tools such as drill bits, reamers, cutters, etc. This decision was evaluated, but not changed, in 1970.

APPENDIX I

UNNECESSARY DISRUPTION OF WORKLOAD

Mr. Durham charged that proper planning could have prevented a layoff and a subsequent rehire--a practice which added to the costs of the Chattanooga operations.

We could not determine whether the layoff and the subsequent rehiring of employees could have been avoided. About 70 employees were laid off on March 12, 1971, and 24 were subsequently rehired on April 16, 1971, to perform work transferred from the Marietta plant. The manager of the Manufacturing Services Department advised us that the employees were laid off due to a lack of work. The plant manager stated that, before the layoff, he did not know that work would be transferred from the Marietta plant.

The discharged employees did not receive severance pay; therefore, any additional expense would have been related to the administrative work involved in laying off and rehiring the employees.

Lockheed comments

Lockheed stated that the administrative effort involved in the layoff and rehire was performed by the employees within the responsible organization and no overtime was worked.

APPENDIX I

LACK OF INVENTORY CONTROLS OVER RAW MATERIALS

Mr. Durham charged that there were no inventory controls over such materials as sheet metal, aluminum, and bar steel at Chattanooga.

Chattanooga did not maintain detailed inventory controls over such materials as sheet metal, aluminum, and bar steel because these materials were purchased for normal production on the basis of engineering requirements and were charged directly to a shop order when received. The plant did not maintain a ready supply of all materials needed for production because of the small quantities of the various types of aerospace ground equipment manufactured at Chattanooga. However, some raw material had been accumulated as a result of such factors as canceled orders and materials left over from completed orders.

The procedures for procuring materials used in manufacturing AGE provided for the release of individual job orders that listed the material requirement for that particular job. The material requirements were to be screened against Marietta inventories and Chattanooga surplus inventories. If materials were not available, Chattanooga procured them. This system was established at Chattanooga so that materials were ordered for each job order and were charged to the job when received rather than being placed in inventory and being charged to the job when used.

We did note that, in a September 1970 memorandum to employees, the Chattanooga manager stated that the accountability and handling of material were out of control. He stated also that plans were underway to install control systems. In addition, he described certain procedures to control and account for material released to the shops. The Plant Manager approved an interoffice memorandum written by Mr. Durham in April 1971 stating that (1) all raw stock and material have been located on specific racks inside and outside the plant and (2) the material locations have been indexed and catalogued.

APPENDIX I

Lockheed comments

Lockheed stated that it was Chattanooga's policy to order material requirements by job for manufacturing AGE, rather than to maintain a controlled parts and material inventory for manufacturing aircraft, as is done in Marietta.

In regard to the September 1970 memorandum which stated that the accountability and handling of material was out of control, Lockheed pointed out that this communication was written by Mr. Durham for the Plant Manager's signature.

APPENDIX I

LACK OF INVENTORY CONTROLS OVER MISCELLANEOUS SMALL PARTS

Mr. Durham charged that the MSP inventory at Chattanooga had not been controlled and was excessive.

Chattanooga did not maintain inventory controls over MSP because it was purchased to fill the requirements of specific production orders. MSP consists of bolts, nuts, screws, washers, and similar items costing from less than 1 cent each to a few dollars each. Lockheed advised us that, due to the nature of MSP (i.e. high usage, low cost, and small size) and the fact that MSP usage normally exceeded requirements, it was standard practice to procure more parts than required. In addition, it is generally impractical to provide a detailed inventory control system for items that are small and inexpensive.

An Air Force Plant Representative report of August 2, 1971, indicated that only 813 of the 4,894 MSP were needed for the current assembly orders. The report stated that, when orders were canceled, these parts were neither removed nor sent back to Marietta, but were held in stock for possible future orders.

Lockheed comments

Lockheed stated that it was not economically feasible to maintain MSP inventory levels on the basis of usage because of the many different requirements of the orders for small quantities of AGE. Lockheed believes that the final cost under the system of handling MSP at Chattanooga was no greater, and possibly was smaller, than it would have been to spend additional funds to control the low-cost parts as closely as Mr. Durham recommended.

Regarding the Air Force Plant Representative's report, Lockheed stated that the Plant Manager recognized in April 1970 the possibility of excess MSP. It also stated that the Plant Manager proposed, at that time, that MSP be screened and excess items usable at Marietta be transferred. However, Lockheed indicated this proposed screening was not accomplished until several months after Mr. Durham's employment.

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APPENDIX I

UNNECESSARY PROCUREMENT OF
HIGH-STRENGTH NUTS AND BOLTS

Mr. Durham charged that Chattanooga had purchased high-strength nuts and bolts for plant maintenance purposes when lower grade items could have been purchased at lower costs. He explained that the salesman who sold the nuts and bolts would supply whatever he thought was needed and, when this salesman changed companies, he continued selling the items to Chattanooga.

Lockheed purchased high-strength nuts and bolts for ordinary plant maintenance purposes when, for some purposes, lower grade material would have been satisfactory. These purchases were made from a salesman who, for a period of time, represented several competing firms. The salesman was fired in July 1970 by one of the firms when this practice became known. Chattanooga began purchasing nuts and bolts from another vendor in 1971.

The employee in charge of maintenance and general plant service told us that, although he did not have a price list, he knew that the higher strength items were more expensive and that he was responsible for ordering whatever was necessary. He stated also that, in addition to use for general maintenance repairs, some high-strength items were used in a heat treating process and lasted much longer than ordinary lower strength bolts. Some high-strength screws also were used to repair machinery.

Lockheed comments

Lockheed stated that the employee in charge of maintenance operations at Chattanooga explained that the salesman would check the bins, straighten up the bolts and nuts, and separate them if they were mixed, and then the salesman and the employee would determine what was needed. Lockheed also stated that the employee approved each order.

Lockheed stated that it purchased the high-tensile and plated bolts for maintenance purposes because they were safer and they lasted longer.

APPENDIX I

Lockheed also stated that its investigation disclosed that this salesman, while working for one company, had established two other companies and was representing all three during 1970. He left the first company in July 1970. The investigation also disclosed that prices charged by the two companies which the salesman established were, for the most part, equal to or less than the prices charged by the company he originally represented.

MISHANDLING MATERIAL

> Mr. Durham charged that old scrapped material, new material, old rusty pipes, maintenance equipment, rubber goods, dirt, wood, trash, and other debris were all heaped together. Expensive castings and forgings were piled in old, rusty, water-filled barrels or were buried in the muck.

Although there was apparently a large accumulation of equipment and material in the plant yard at Chattanooga during 1970, at the time we visited the plant in December 1971 we found the plant yard was in reasonably good condition with most material properly stored.

We were advised by Lockheed officials that a large amount of material and equipment had been accumulated in the yard at Chattanooga. Lockheed further advised that this was a temporary condition caused by (1) the cancellation of Air Force orders and (2) the movement of tooling and material from Lockheed Industrial Products to the Chattanooga plant in addition to the normal accumulation of scrap from the production process. This accumulation was sorted, catalogued, and much of it sold.

Lockheed's records of scrap sales indicate that about 603,000 pounds of material, equipment, and other items were sold as scrap for about $37,000 from June 1, 1970, through July 4, 1971. Other items valued at about $77,000 were donated to the Tennessee Department of Health, Education, and Welfare.

Lockheed's records also indicated that these sales included the 42-1/2 tons of scrap cited by Mr. Durham. However, according to Lockheed officials, there were no records available to describe the material sold. As stated in the staff study, these officials told us that it included unidentifiable raw materials, tools, and production scrap. We subsequently determined that a large fixture and a monorail were included. Although the original cost of these items could not be determined, the sale was made at competitively established rates.

APPENDIX I

The Manufacturing Services Department manager explained that some titanium had been scrapped because it was excess due to engineering changes and because its metallic contents could not be determined.

Lockheed comments

Lockheed stated that there were some inexpensive AGE castings for which no requirements existed stored outside in the drums in which they had been received from Marietta. The castings were rusty, as are many castings when received.

Lockheed stated that in early 1970 plans were underway to make certain plant rearrangements and to improve housekeeping. In a communication to the Plant Manager dated April 14, 1970, the Manager of Manufacturing Services established dates for completing the cleanup of various sections of the facility and stated that the material stored on the exterior grounds would be rearranged and put in order. On August 12, 1970, just prior to Mr. Durham's employment at Chattanooga, the Plant Manager's activity report stated that "The back-yard has been improved considerably and more time will be spent here as time allows."

APPENDIX I

GENERAL CHARGES

PROBLEMS PERMITTED TO EXIST BY THE AIR FORCE

Mr. Durham charged that Air Force personnel were negligent in that they allowed unsatisfactory conditions to prevail.

Air Force representatives were aware of, and reported to higher headquarters, some of the problems cited by Mr. Durham. However, the Lockheed contract was awarded under a total package procurement concept which, according to the Air Force officials, restricted the Air Force's participation in managing the program and in decisionmaking. The Air Force, therefore, did not believe it could require Lockheed to take specific corrective actions.

The Air Force Plant Representative Office at Marietta prepared a production progress report for October 1968 which discussed specific problems with the late delivery of items needed for assembly operations. The report also disclosed that there was a shortage of titanium fasteners due to lead-time requirements and greater usage than anticipated. The report also cited that Lockheed encountered quality control problems.

In a July 24, 1969, report to the Secretary of the Air Force, the Assistant Secretary of the Air Force (Installation and Logistics) stated that one of the major manufacturing problems on the C-5 aircraft program was titanium fasteners. The report also stated that titanium fasteners, which were introduced to reduce weight, had caused a manufacturing problem because they required close tolerances of component parts and greater skills in assembly operations.

In addition, the Air Force Plant Representative Office and the Defense Contract Audit Agency's office at Lockheed were on the distribution list to receive copies of Lockheed's internal audit reports. Some of these reports related to the specific areas cited by Mr. Durham.

The documents cited indicate that the Air Force was aware of some of the problems encountered by Lockheed. However, in most cases, the Air Force did not provide us with

documentation indicating its awareness of the problems and the effects these problems had on the program.

Air Force comments

The Air Force stated that the C-5 Aircraft System Program Office (SPO) knew many of the problems cited before Mr. Durham's disclosure. In November 1968, the Air Force Plant Representative Office issued a notice to SPO which reported potential delinquencies on aircraft 0004 through 0012. This document cited shortages of fabricated parts, feeder plant assemblies, and subcontracted parts, and late deliveries of wing leading edge panels, air pressure doors, and visor doors.

The Air Force also stated that the Air Force Plant Representative visited Lockheed's Chattanooga plant in July 1971 to review operations and to determine whether there was substance to the newspaper reports of Mr. Durham's allegations. The Air Force provided the results of its review to the President, Lockheed-Georgia Company, in a letter dated August 2, 1971.

The Air Force stated further that there was no question but that there were missing parts and parts shortages; that out-of-sequence work did occur; that there were cases of poor housekeeping and wasteful practices by employees of Lockheed, both at the Lockheed-Georgia Company and at Chattanooga. However, it was difficult to assess the degree to which these situations existed and their real effect on the program. The Air Force went on to say that, although the total-package procurement concept in use at that time limited visibility of the total contractor operation, it was aware of the problems, as evidenced by the large amount of out-of-sequence work, overtime, and behind schedule conditions.

According to the Air Force, specific actions were taken to require a detailed review of out-of-sequence work and of the status of work performed and these actions, along with action undertaken separately by the company, were effective. In addition, out-of-sequence work, which had been a major cause of parts control problems, has been under control since before June 1971, when a special management

review of the program showed that the number of open-work items on aircraft moving from final assembly to the flightline had been reduced to between 10 and 40 per aircraft, compared with 500 and 600 open items on the initial production aircraft 1 year earlier.

APPENDIX I

SCHEDULE MAINTAINED TO COLLECT PAYMENTS RELATED TO MILESTONES

Mr. Durham charged that Lockheed was moving major assemblies and aircraft on a prescribed schedule, regardless of the state of completion, in order to collect payments as related to milestones.

We did not find evidence that Lockheed moved aircraft and major assemblies on a prescribed schedule in order to collect payments for achieving certain milestones. We did note, however, that the Air Force withheld about $3.7 million from milestone payments for the five aircraft delivered to the flight-test organization because of shortages of parts and variances from specifications.

The original contract contained a provision for billing milestones which related to tooling and flight-test aircraft. The payment for tooling was tied to the milestone of aircraft 0001 reaching assembly position number three. When this event was achieved in December 1967, Lockheed submitted a bill to the Air Force for the contract price for tooling, less the amount previously received in the form of progress payments for tooling.

With respect to flight-test aircraft, the milestone payment was based on delivery of aircraft to the flight-test department and pertained only to the first five aircraft. The payment was specified at 98 percent of the billing price because these aircraft would not be delivered to the Air Force until after the flight-test program was completed at the contractor's plant. The 2 percent was to be withheld until each aircraft was refurbished and delivered to the Air Force. In accordance with the terms of the contract, the Air Force also withheld from the contractor additional funds because of shortages and variances. The amounts received and withheld and the dates of the invoices for the five aircraft are shown in the following tabulation.

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	Aircraft serial Number					
	0001	0002	0003	0004	0005	Total
Invoice date	2-27-68	7-30-68	10-21-68	12-21-68	3 17-69	
Unit billing price	$84,171,000	$70,471,000	$63,888,000	$60,991,000	$59,115,432	$338,636,432
Less funds withheld for refurbishment	1,683,420	1,409,420	1,277,760	1,219,820	1,182,309	6,772,729
	82,487,580	69,061,580	62,610,240	59,771,180	57,933,123	331,863,703
Less funds withheld for shortages	412,438	690,616	313,051	1,195,424	1,158,662	3,770,191
	82,075,142	68,370,964	62,297,189	58,575,756	56,774,461	328,093,512
Less progress payments previously paid	67,137,466	55,927,449	50,959,100	47,914,968	48,258,292	270,197,275
Milestone payment received	$14,937,676	$12,443,515	$11,338,089	$10,660,788	$ 8,516,169	$ 57,896,237

Lockheed comments

According to Lockheed, the payment for initial tooling was requested when aircraft 0001 reached assembly position three. At this point, the aircraft would have been processed through all major jigs and fixtures and, therefore, the bulk of original tooling would be complete.

With respect to the payments for delivering the aircraft to the flight-test organization, Lockheed stated that:

1. The contract specifically provided for delivering aircraft with shortages.

2. The contract provided for withholding 2 percent for the test aircraft under discussion.

3. The 2 percent was automatically withheld and, under the terms of the contract, would have not been paid until each airplane completed the test program. In addition, the Administrative Contracting Office withheld an amount from each billing to cover shortages and variances.

Air Force comments

The Air Force said that the original contract provisions for milestone payments which related to tooling and flight-test aircraft were developed for sound reasons. The contract performance period was very long (7 to 8 years' mimimum, depending on options), and the first 3 years were for

efforts which would not require formal deliveries, and thus repayment of the progress payments made for costs incurred were not allowed. In such cases it is normal to establish billing milestones for those long periods when certain costly, early efforts can be measured as to completion.

Liquidated damages

The original contract provided for liquidated damages of $12,000 a day, up to $11 million, for late delivery of the first 16 aircraft, exclusive of test aircraft. On January 30, 1969, the Air Force notified Lockheed of a delinquency in delivering aircraft. The notice stated that, because of the Government's urgent need for the aircraft, it was not invoking its rights under the contract's "default" clause. In addition, it stated that all rights which the Government had, or which would inure to the Government, because of Lockheed's delinquency were expressly reserved by the Government.

All aircraft to which the liquidated damages applied were accepted with specific reference to the liquidated damages and the reservation of the Government's right to later make claim for such damages. The Air Force did not collect the liquidated damages as the aircraft were delivered.

Lockheed comments

Lockheed stated that the liquidated damages clause of the contract applied only to deliveries of aircraft and not to movements from one assembly position to another. There was only one movement that mattered as far as this clause was concerned--"delivery," defined as delivery of "...aircraft which are acceptable to the Government." In short, Lockheed could not, unilaterally, make a delivery merely to avoid liquidated damages.

Lockheed also stated that it had submitted a claim of excusable delay in connection with this clause, along with extensive documentary evidence to support that claim. This was one of the matters that had been disputed and settled by the restructured contract.

Air Force comments

The Air Force stated that the total $11 million was included in the negotiations which led to the $200 million fixed loss for Lockheed. The Air Force never gave up its claim to liquidated damages until the restructured contract was signed with new terms. The Air Force position throughout the 18 months of negotiations that followed was that the full $11 million was due. The original schedule was not amended until the contract was restructured and the contractor was officially carried as delinquent throughout this period.

APPENDIX I

INEFFECTUAL AUDITING BY LOCKHEED'S INTERNAL AUDITORS

Mr. Durham charged that Lockheed's internal auditors were ineffective because management had been provided advance notice of pending audits.

Lockheed's internal auditors were aware of many of the problems at Marietta cited by Mr. Durham. These problems were reported to management, together with recommendations for corrective action. The reports were given wide distribution at Marietta and were sent to corporate officials in Los Angeles, California. Followup audits were made to evaluate corrective actions. In our opinion, the internal audit reports were an effective management tool.

We discussed the question of advance notice of pending audits with the Director of Internal Audits. He stated that, although Lockheed's policy manual does not contain a specific prohibition against advance notice, Internal Audit certainly does not follow or permit such a practice. He also agreed that there was always a possibility that an auditor might provide advance notice, but he did not believe this was common.

Lockheed comments

Lockheed stated that a corporate management policy statement permits the internal auditing function full, free, and unrestricted access to all company operations and records to the extent that Federal security regulations allow. Advance notice of when audits are to be conducted are not provided to management except in those instances in which management recognizes or suspects a problem and requests an immediate audit.

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

B-162578

JUN 25 1973

The Honorable William Proxmire
Chairman, Subcommittee on Priorities
and Economy in Government
Joint Economic Committee
Congress of the United States

Dear Mr. Chairman:

Our report (B-162578) of November 22, 1972, presented the results of our investigation into Mr. Durham's charges and indicated that we would report later on those charges relating to aerospace ground equipment (AGE). He charged that costs of C-5 AGE had been increased significantly because (1) parts and components used to manufacture AGE were supplied by aerospace companies specializing in aircraft parts rather than by commercial sources, (2) aircraft nuts and bolts of close tolerances and other specifications were being used, (3) silver-plated nuts were used on one piece of equipment to hold the wheels on, and (4) commercial parts were used on AGE of other aircraft programs but not on AGE of the C-5 program.

We interviewed Air Force management and engineering personnel at the C-5 System Project Office and at the San Antonio Air Materiel Area which is responsible for depot maintenance of the C-5 aircraft. These personnel explained the procedures followed in acquiring and managing C-5 AGE.

We reviewed correspondence and examined records to determine Air Force and Lockheed responsibilities in acquiring the equipment. Lockheed was responsible for identifying AGE to be used on the C-5 and the sources that could supply such equipment, and the C-5 System Project Office was responsible for approving or rejecting Lockheed's recommendations and for determining the availability of substitute AGE.

To determine if conditions cited by Mr. Durham did occur, we selected a sample of 30 items of C-5 AGE from a Lockheed-prepared list of 263 items it designed and manufactured.

We examined the specifications and drawings used to manufacture C-5 AGE to determine (1) the type of materials used, (2) whether commercial parts and components were used, and (3) the tolerances required. We also examined Lockheed's detailed records to identify the source for the parts and components.

We discussed the design and use of AGE with Air Force personnel who use it for maintenance, and we observed the use of some AGE.

We compared commercial parts and components for C-5 AGE with functionally comparable AGE for three other aircraft programs to determine if their usages varied significantly. Air Force personnel identified the comparable AGE. We also identified the type of bolts specified for comparable AGE on the other programs to determine if usage on the C-5 was significantly different.

Our findings follow.

PARTS AND COMPONENTS

The majority of firms supplying parts and components for the AGE we examined were not aerospace companies specializing in aircraft parts.

In examining Lockheed's records, we identified 37 suppliers of parts and components used to manufacture the 30 selected items. We did not identify the business specialty of 11 of the 37 suppliers; however, they supplied electrical cable, bolts, tools, lumber, and rubber and foam padding. Of the remaining 26 suppliers, only one specialized in aircraft parts.

AIRCRAFT NUTS AND BOLTS

All of the bolts and a majority of the nuts specified for use on 15 of the 30 items of AGE were intended for aircraft use. The total cost of the 15 items was about $1,285,000, and the cost of the aircraft nuts and bolts was $1,200. When compared with nonaircraft nuts and bolts, they generally had closer tolerances and cost more.

Lockheed personnel stated that these nuts and bolts were used because they were on hand as a result of ordering them in economic quantities. We were unable to verify this statement because of the lack of records. According to Air Force personnel, such items are used because AGE is designed by aeronautical engineers who are more familiar with aircraft hardware and tend to use it rather than to search for possible commercial items that could be used.

We compared the types of bolts specified for AGE in the C-5 program with the types of bolts specified for functionally comparable AGE in the other three aircraft programs. Of 29 bolts specified for use under the other programs, 28 were aircraft bolts.

Although Lockheed's use of aircraft hardware on C-5 AGE did not differ significantly from that of other airframe contractors, we believe that it should be used only when essential to operations. In other cases, commercial hardware should be used to insure the most economical cost to the Government.

SILVER-PLATED NUTS

We did not find evidence to substantiate the charge that silver-plated nuts were used to hold wheels on.

The detailed drawings showed that the 30 items did not require silver-plated nuts. Air Force personnel responsible for standardization stated that they did not know of any instances in which silver-plated nuts were either specified or used. They stated also that such nuts are used in equipment subject to extreme heat conditions, such as aircraft engines.

COMMERCIAL PARTS

Seventy-four percent of the major components used to manufacture the 30 items of C-5 AGE were commercial parts. The use of commercial parts on AGE acquired under three other programs was essentially the same as under the C-5 program.

B-162578

The results of our comparison follow.

	Major components used on 30 items of AGE in C-5 program		Components used on AGE in other programs	
	Number	Percent	Number	Percent
Commercial parts	71	74.0	54	73.0
Specified aircraft parts	20	20.8	16	21.6
Unidentified	5	5.2	4	5.4
Total	96	100.0	74	100.0

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We discussed these matters with Air Force and Lockheed officials, but we did not request their formal comments.

We trust that this information responds to your needs. We do not plan to distribute this report further unless you agree or publicly announce its contents.

If we can further assist you in this matter, please let us know.

Sincerely yours,

Comptroller General
of the United States

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

B-162578

DEC 11 1972

Dear Mr. Chairman:

During hearings held by your Subcommittee on March 27, 1972, progress payments made to the Lockheed Aircraft Corporation on the C-5 aircraft contract were discussed. You were particularly interested in our (1) comments on a February 20, 1970, report of the Defense Contract Audit Agency which stated that overpayments of about $400 million had occurred as of January 20, 1970, and (2) comments in our Atlanta regional office staff study that the Air Force made an additional $705 million available for progress payments to Lockheed between January 1970 and May 31, 1971.

We advised you that we planned to examine the progress payment practices in effect before the contract was restructured in May 1971. In conducting our examination, we interviewed officials of Lockheed, the Air Force, the Defense Contract Audit Agency, and the Office of the Secretary of Defense, and examined available correspondence and reports pertaining to progress payments made to Lockheed on this contract.

Our findings and observations are presented below.

THE PURPOSE OF PROGRESS PAYMENTS

Sometimes a Government contract requires a long period of performance or substantial expenditures before the contractor makes delivery and receives full payment. Using private capital in such cases may not be economical or feasible because the financial requirement may exceed the contractor's capability or impair its ability to perform.

Thus, the Government has followed the practice of reimbursing the contractor for part of the costs incurred on work in process but not yet delivered. For a cost-reimbursement contract, payment of allowable costs is made as the work progresses. This letter is concerned with how progress payments are made under fixed-price contracts.

B-162578

COMPUTATION OF PROGRESS PAYMENTS
ON FIXED-PRICE CONTRACTS

The standard progress payment clause provides for payment of a stipulated percentage of the contractor's incurred costs. For the C-5 aircraft contract, the cumulative progress payments could not exceed 90 percent (subsequently increased to 100 percent) of the ceiling price established in the contract.

When an item is delivered and invoiced, the progress payments received by the contractor during its production are deducted from the total amount due. This is known as liquidating the progress payments. The C-5 aircraft contract provided that the amount of unliquidated progress payments not exceed 90 percent of the costs incurred on undelivered items or 90 percent (subsequently increased to 100 percent) of the contract price of the undelivered items.

The regulations provided that the costs for undelivered items be determined by deducting the costs attributable to items delivered, invoiced, and accepted from the total costs incurred. The regulations also provided that the costs of delivered items be computed as follows:

"In order of preference, these costs are to be computed on the basis of one of the following:

(a) The actual unit cost of items delivered, giving proper consideration of the deferment of the starting load costs;

(b) projected unit costs (based on experienced costs, plus estimated costs to complete the contract), where the contractor maintains cost data which will clearly establish the reliability of such estimates; and

(c) the total contract price of items delivered."

B-162578

LOCKHEED'S COMPUTATION OF PROGRESS PAYMENTS

Lockheed followed method (c) in computing the cost of delivered items. Therefore, in arriving at the cost of undelivered items, Lockheed deducted from the total costs incurred an estimated cost based on the contract billing price of delivered items rather than on actual or projected costs. Use of method (c) meant that cost overruns for delivered items were not deducted from the total cost in computing the maximum permissible progress payments.

An illustration of the effect of using contract billing prices when a contractor is experiencing a cost overrun is presented below.

	Method	
	(a)	(c)
Total costs incurred	$200	$200
Less cost of delivered items:		
Actual costs	70	
Estimated cost based on contract billing price	___	50
Total costs eligible for progress payments	$130	$150
Maximum permissible progress payments at 90 percent	$117	$135

Using method (c), a contractor having overruns receives more in progress payments than it would receive using method (a). This situation was shown in the Defense Contract Audit Agency's February 1970 report, which stated that Lockheed had been overpaid about $400 million.

The regulations of the Department of Defense permitted this procedure. (See p. 2.) The Air Force's written comments to the General Accounting Office on this matter pointed out that:

--Both parties recognized that an upward adjustment in the contract ceiling was essential because of several factors, including inflation, repricing because of the number of aircraft being procured under "Run B," and repricing because of overceiling costs on "Run A."

--This method of computing progress payments had been in effect from the start of the contract. Because the contractor had filed an appeal with the Armed Services Board of Contract Appeals indicating an intent to litigate contractual differences, the Air Force considered that progress payments should be continued using this method. The Air Force believed that to do otherwise might incur a breach-of-contract action.

--The Air Force felt that, were progress payments suspended or past payments significantly recouped, C-5 aircraft production would come to a halt and the ultimate cost of completing the program would greatly increase.

After the Defense Contract Audit Agency's report was issued, the Air Force acted to provide additional funds for progress payments. Between February 1970 and May 1971, when the contract was restructured, the Air Force increased the ceiling price of the contract by about $557 million, as shown below.

Increase in ceiling price	Amount of increase (millions)
To recognize:	
Abnormal fluctuation of the economy	$143
Provisional items and change orders for which firm prices had not been established	114
Interim repricing adjustments for Run B	300
Total	$557

The Air Force also changed the limit on the percentage of the contract price that would be available for progress payments. Originally, progress payments were limited to 90 percent of Lockheed's allowable incurred costs, up to a maximum of 90 percent of the contract ceiling price. In April 1970 the Air Force changed this maximum to 95 percent of the ceiling price, which provided an additional $73 million for progress payments. The contract was again changed in September 1970 to allow progress payments up to 100 percent of the ceiling price and thus made available an additional $75 million. Therefore, by changing the limit from 90 percent to 100 percent, an additional $148 million was made available for progress payments to Lockheed. This $148 million and the $557 million increase in the ceiling price comprise the $705 million discussed in the staff study.

The contract was converted to a cost-reimbursement contract in May 1971, and the contractor stopped receiving progress payments and started receiving reimbursement on the basis of costs incurred. Negotiations to convert the contract considered all payments previously made to Lockheed.

The method Lockheed used was allowable under the contract and was permitted under the regulations then in effect; however, as previously illustrated, this method permitted the contractor to receive progress payments for costs incurred on delivered items in excess of the unit prices for such items. By June 1968, 6 months after Lockheed started using this method, Lockheed and the Air Force were projecting an overrun on the contract.

It is our opinion that the method used for computing the progress payments was inappropriate under the circumstances. Progress payments are to help contractors finance the cost of undelivered items, and we believe that when an item is delivered and accepted the actual costs to produce the item should be deducted from total costs incurred when computing the maximum permissible progress payments.

As a result of the Defense Contract Audit Agency report and of subsequent Office of the Secretary of Defense studies,

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it was recommended in November 1971 that using method (c) to compute costs of delivered items be discontinued. Defense Procurement Circular 94, dated November 22, 1971, announced plans to revise the progress payment request form, and a new form omitting method (c) became effective on April 1, 1972.

We trust that the information presented above is responsive to your needs. We shall be pleased to discuss this information with you or members of your staff.

Sincerely yours,

Comptroller General
of the United States

The Honorable William Proxmire, Chairman
Subcommittee on Priorities and
Economy in Government
Joint Economic Committee
Congress of the United States

Assessment Of Army Should-Cost Studies B-159896

Department of the Army

UNITED STATES
GENERAL ACCOUNTING OFFICE

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

PROCUREMENT AND SYSTEMS
ACQUISITION DIVISION

B-159896

Dear Mr. Secretary:

This is our report on our assessment of the Army's should-cost studies. The significant contents of the report are summarized in the digest.

Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C 67).

Copies of this report are being sent to interested congressional committees; the Director, Office of Management and Budget; and the Secretary of the Army.

Sincerely yours,

R.W. Gutmann

Director

The Honorable
The Secretary of Defense

Contents

ABBREVIATIONS

AMC	Army Materiel Command
DOD	Department of Defense
GAO	General Accounting Office

GENERAL ACCOUNTING OFFICE
REPORT TO THE SECRETARY OF DEFENSE

ASSESSMENT OF ARMY
SHOULD-COST STUDIES
Department of the Army B-159896

D I G E S T

WHY THE REVIEW WAS MADE

The use of should-cost studies is one of several actions taken to improve Department of Defense (DOD) procurement practices. A should-cost study is a method of cost analysis made by a team of Government specialists in engineering, pricing, procurement, auditing, and management. The should-cost approach differs from the traditional approach in that it involves a more in-depth analysis of the contractor's proposal and a more extensive review of the contractor's operations to identify potential cost reductions.

These studies have been discussed in hearings before the House Committee on Government Operations and the Subcommittee on Priorities and Economy in Government, Joint Economic Committee. In hearings before the Subcommittee in December 1969, the General Accounting Office (GAO) stated that it would make follow-up reviews of DOD should-cost studies.

This report concerns the first nine studies used by the Army Materiel Command in contract negotiations. GAO's primary objectives were to examine the manner in which the should-cost studies were conducted and to identify areas in which improvements could be made to increase the studies' usefulness and the benefits derived from them. In making its assessment, GAO did not attempt to evaluate the overall conduct of contract negotiations.

FINDINGS AND CONCLUSIONS

GAO believes the should-cost teams gave insufficient attention to identifying ways to improve the contractors' efficiency and economy of operations. Therefore, some of the benefits which GAO believes should have been obtained from these studies were not obtained.

The teams made in-depth analyses of the contractors' proposals and arrived at cost estimates which were much lower than those of the contractors. In each case the Government negotiated price reductions greater than those realized on prior procurements of the same or similar equipment from the nine contractors. Although the impact of the should-cost studies on price negotiations cannot be determined for a number of reasons (see pp. 8 and 9), GAO believes the studies strengthened the Army's bargaining position.

For the most part, the should-cost teams tested and evaluated the data and the rationales used by the contractors in developing their price proposals. Although such work is important, GAO believes the benefits from the should-cost studies can be increased substantially by placing greater emphasis on analyzing the contractors' manufacturing processes and practices to identify specific actions needed to improve efficiency and economy.

For example, one team recommended a

gross reduction in the contractor's overhead costs but did not identify the specific improvements which the contractor could make to achieve the desired reductions.

The contractors often disagreed with the study findings during negotiations, and this contributed to extensive delays in negotiations. GAO believes that improving communication between the contractors and the teams during the studies can increase benefits from the studies. This would encourage greater contractor participation and better understanding of the findings and the specific actions needed to improve efficiency and to reduce costs. Further, it would provide the Government with a better opportunity to get its recommendations accepted. (See p. 20.)

GAO found little evidence that the teams had considered changing Government policies, procedures, or practices to reduce the costs of contractor operations. The Navy study of the TF-30 engine and GAO's reviews have identified areas in which such changes could reduce costs substantially. (See p. 21.)

In addition to agreeing to the contract price reductions negotiated, six of the nine contractors agreed to apply their best efforts toward attaining a number of improvement goals in areas which the should-cost teams felt had potential for improvement. (See p. 14.) For the most part, however, the studies did not identify specific actions which the contractors should take to improve the efficiency or economy of their operations.

In some cases, when contractors agreed to work toward improving their operations, the local Government representatives were not provided with copies of the should-cost reports or specific instructions on the areas to be monitored until several months after final negotiations. GAO believes these representatives should be fully aware of the teams' findings to effectively monitor the contractors' actions to improve operations. The Army has taken action to improve this matter. (See p. 22.)

Local representatives experienced difficulty in monitoring contractors' progress toward improvement goals for certain indirect expenses. These goals were expressed as percentages and, as such, were subject to change as the base costs changed, irrespective of actual improvements. GAO believes that, to monitor contractors' progress, the goals should be expressed in terms which can be readily traced during contract performance. (See p. 24.)

RECOMMENDATIONS OR SUGGESTIONS

To increase the benefits from future should-cost studies, the Secretary of the Army should insure that should-cost teams:

--Place increased emphasis on analyzing the contractors' operations, to identify specific actions needed to improve efficiency and to reduce costs. (See p. 19.)

--Make a greater effort to encourage the contractors' increased cooperation through earlier discussions of the teams' findings. (See p. 20.)

--Give sufficient attention to identifying opportunities for savings through modifications in Government policies, procedures, and practices. (See p. 21.)

--Define improvement goals, whenever possible, in terms which will permit meaningful evaluations of contractors' progress toward the goals. (See p. 24.)

CHAPTER 1

INTRODUCTION

Department of Defense (DOD) procurement has captured the attention and criticism of the Congress and the public because of the increasing cost of defense hardware. Many contracts are awarded on a negotiated, noncompetitive basis without the benefit of competition to insure that the prices are fair and reasonable. Therefore, the Government must analyze the contractors' proposal prices to arrive at fair and reasonable price objectives for negotiations.

TRADITIONAL APPROACH VERSUS SHOULD-COST APPROACH

In a negotiated, noncompetitive situation, the traditional practice in arriving at a contract price is to obtain audit and technical evaluations of the contractor's cost history and estimating rationale relating to the current proposal. The results of these evaluations are used to develop a Government negotiating objective. Negotiations are then held to arrive at agreement on the contract price. However, by using the contractor's prior cost history and estimating rationale as a basis for negotiations, the Government implicitly accepts the contractor's mode of operation, regardless of how efficient or inefficient it might be. Often the resultant price represents what hardware "will cost" instead of what it should cost to be produced, and the inefficiencies in the historical base may be perpetuated.

The Army defines "should cost" as a method of cost analysis made by the fully coordinated efforts of a team of Government specialists in engineering, pricing, auditing, procurement, and management. The analyses are used to identify uneconomical or inefficient practices in the contractor's operations and to formulate the Government's negotiation positions on the basis of the should-cost teams' estimates of what the contracts should cost to perform, assuming reasonably achievable economies and efficiencies. In addition to making the studies, the teams participate in negotiating the contract prices.

The should-cost approach differs from the traditional approach to cost analysis principally in (1) the depth of the analyses and (2) the extent to which the Government challenges inefficiencies in contractors' operations. The principal objectives of should-cost analyses are (1) to facilitate the negotiation of realistic contract prices and (2) to bring about both short-range and long-range improvements in the efficiency and economy of contractors' operations.

SHOULD-COST STUDIES IN THE ARMY

In late 1967 DOD, concerned about the sharp cost increases for the TF-30 jet engine, directed that the Navy form a team to make an in-depth evaluation of the contractor's operations and to identify areas for cost reductions. This evaluation became known as a should-cost study. The significant results of the study demonstrated its usefulness both for lowering costs on the current contract and for identifying the potential for long-range improvements in the contractor's operations.

In a July 1969 memorandum to the Secretaries of the Army, Navy, and Air Force, the Deputy Secretary of Defense expressed his concern over problems associated with weapon system acquisitions. He suggested the use of should-cost studies as one of several actions for improving current practices. In late 1969 the Army began to develop plans for conducing should-cost reviews. Having responsibility for procurement of most of the Army's hardware, the Army Materiel Command (AMC) was assigned primary responsibility for implementing the should-cost approach.

The first Army study, conducted in March 1970, convinced the Army of the value of the should-cost approach. Since that time AMC has made a number of studies, and it plans to continue to make them.

CONGRESSIONAL INTEREST

The use of should-cost techniques by the General Accounting Office (GAO) and DOD has been discussed in several hearings before the Subcommittee on Priorities and Economy in Government, Joint Economic Committee. In hearings before this Subcommittee in December 1969, we stated that we would make follow-up reviews of the DOD should-cost studies.

In its report dated December 10, 1970, on policy changes in weapon system procurement, the House Committee on Government Operations made certain recommendations to DOD. One recommendation was that DOD develop a special competence in making should-cost studies. During later hearings before the Subcommittee on April 29, 1971, the Chairman of the Subcommittee on Priorities and Economy in Government expressed concern regarding the application of the should-cost approach within DOD and recommended that GAO make follow-up reviews of the DOD should-cost studies.

SCOPE OF OUR ASSESSMENT

This assessment covers the first nine should-cost studies used by the Army in contract negotiations. We examined the reports prepared on the nine studies and AMC regulations and directives, and we discussed the studies with AMC personnel. In addition, we selected three studies for detailed examination.

For the three studies we reviewed the study reports, analyzed the scope and methodology of the studies, reviewed price negotiation memorandums and the negotiation minutes, reviewed contractor and agency files, and interviewed contractor and agency officials who were involved in the studies and in ensuing negotiations.

Our purpose was not to review and evaluate the overall conduct and success of the price negotiation process. Although the should-cost studies play an important part in negotiations, other factors, such as those listed below, can affect the success achieved during negotiations.

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1. The contractor's desire for the work.

2. Urgency of the Government's need for the item.

3. Potential for follow-on contracts.

4. Type of contract to be negotiated and related risk to the contractor.

5. Willingness and capability of the contractor to take the steps necessary to reduce costs.

6. Competitive influences.

7. Extent of hard data versus judgments to support cost estimates.

8. Relative ability of the negotiating parties.

CHAPTER 2

SHOULD-COST RESULTS

IMPACT ON NEGOTIATIONS

The impact of the should-cost studies on contract negotiations can be summarized as follows:

--The Government and the contractor price objectives differed widely at the start of negotiations.

--Negotiations lasted much longer than usual, and a significant portion of the differences in the initial cost positions was settled on a lump-sum basis.

--The price reductions achieved were greater than had been experienced in past negotiations with the same contractors. However, the extent to which the should cost studies contributed to this cannot be measured.

Although no two studies were the same in areas covered, depth of review, findings, or recommendations, on the whole we believe the studies strengthened the Army's bargaining position in contract negotiations.

Potential price reductions identified

The nine Army should-cost studies evaluated contractors' proposals totaling $299.2 million and, according to the Army, identified potential reductions of $97.8 million. (See table below.)

Potential Price Reductions Identified

Study	Contractors' proposals	Should-cost estimates	Difference
	(millions)		
A	$ 95.8	$ 58.2	$37.6
B	44.9	33.6	11.3
C	24.9	17.0	7.9
D	24.1	19.4	4.7
E	20.1	13.2	6.9
F	29.7	21.5	8.2
G	13.5	9.1	4.4
H	7.5	5.2	2.3
I	38.7	24.2	14.5
Total	$299.2	$201.4	$97.8

The potential price reductions represent the differences between the contractors' proposed prices and the estimates developed by the teams. The teams' estimates were the quantified results of eliminating from the proposed prices the effects of inaccurate, noncurrent, or incomplete factual data and of applying different judgments to contractors' data; when the teams identified a need for improved efficiency or economy, they estimated the probable effect of improvement on costs.

Negotiated price reductions

The price reductions realized by the Army in negotiations, based on information from the nine studies, totaled $46.7 million as shown below.

Study	Potential price reductions	Reductions achieved	Percent of reductions from contractor's proposal
	(millions)		
A	$37.6	$13.7	14.3
B	11.3	5.7	12.7
C	7.9	4.4	17.7
D	4.7	1.9	7.9
E	6.9	3.4	16.9
F	8.2	5.7	19.2
G	4.4	4.0	29.6
H	2.3	.9	12.0
I	14.5	7.0	18.1
Total	$97.8	$46.7	15.6

The Army's analysis of the reductions showed that in each case the price reduction was greater than that realized on prior procurements of essentially the same hardware from the same contractor. Our analysis of three selected studies confirmed this. For example, on three previous procurements of one of the items, the Army had negotiated an average price reduction of 7.1 percent, whereas a reduction of 12.7 percent was realized on the contract evaluated by the team. Although the Army negotiated contract price reductions greater than those on prior procurements, actual savings will not be known until work is completed and final costs on the contracts have been determined, since seven of the nine contracts were fixed-price-incentive contracts.

The Army did not realize a greater portion of the potential savings for a variety of reasons. In one case the negotiator was unable to convince the contractor of the validity of the team's estimate of direct labor hours because the Army's sample was insufficient to support the reduction.

In another case the chief negotiator cited the following reasons for not realizing a greater portion of the team's potential price reductions.

1. Some of the team's findings were based on opinion and experience. One contractor opposed the team's opinion on how the contractor's move to a new plant would affect its operation.

2. Some of the team's findings could not be implemented overnight, even though they were firm and properly supported.

3. Contract negotiations are a two-way street involving compromise by both parties.

We could not determine the full extent of the cost reductions for each cost element because the parties concluded negotiations on a lump-sum basis. In one instance, after 44 negotiation sessions, an impasse was reached when the parties could not resolve a $6 million difference in their respective positions; the parties concluded negotiations on a lump-sum basis with an additional reduction in costs of $3 million.

BENEFITS BEYOND NEGOTIATIONS

In addition to negotiating more realistic contract prices, the teams' objective was to bring about short- and long-range improvements in the efficiency and economy of contractor operations. To this end the Army negotiated management improvement programs with six of the nine contractors. The programs included in the contracts concerned accomplishing such tasks as preparing estimating manuals or improving material control. Also, in some cases specific values were established for such areas as labor efficiency, labor hours, and indirect expenses.

Only one of the three studies reviewed in depth had specific labor efficiency, labor hour, and indirect expense rate goals. The Army estimated that, if this contractor achieved the established goals, the Government would save about $4 million and the contractor would save about $2 million during the life of the contract.

In this case the improvement program contained no penalties or rewards related to the goals; it provided only that the contractor make its best effort. The contractor was to report the results of the program quarterly; however, the program required no specific quantified actions that could be measured in evaluating progress toward the established goals.

Although development problems and fund restrictions made it necessary to negotiate a stretchout in production and a revision of the goals under this contract, the contractor made some progress toward most of the goals. The contractor's latest progress report indicates a favorable outlook for attaining the goals of increased labor efficiency and reduced indirect expense rates. The Army stated that as of August 1972 the contractor anticipated that final costs would not exceed the contract target costs.

In one case the team proposed several significant improvements, such as achieving a minimum of (1) 90-percent compliance with work standards, (2) 80-percent labor effectiveness, and (3) 80-percent machine efficiency. The Army did not discuss an improvement program with the contractor until final agreement was reached on a firm fixed price of

$6.9 million for production of the principal hardware and on an incentive target price of $2.6 million for development, test, data, and test sets.

The contractor refused to accept a management improvement program incorporating the above goals because (1) the program was not a part of the request for proposal, (2) the contractor was not fully aware of the program until price negotiations were concluded, (3) the contractor believed the program would limit management flexibility, and (4) the program had no provision for recovering costs of implementation.

The contractor agreed to some procedural improvements suggested by the team; it agreed to prepare accounting, estimating, and pricing manuals in accordance with the Armed Services Procurement Regulation. Although these improvements are not likely to lower costs of current contracts, they can improve the preparation and review of price proposals for subsequent contracts.

The Army did not negotiate a management improvement program with specific goals on the third contract; however, the contractor signed memorandums of agreement concerning changes in labor-estimating practices, make-or-buy pricing policies, material control and cost accounting procedures, and allocation of tooling and engineering maintenance costs. All the memorandums of agreement related to longstanding problems which had not been resolved in past negotiations.

CHAPTER 3

COSTS OF SHOULD-COST STUDIES

We inquired into the costs of making the three studies we selected for in-depth review. The direct costs incurred by the teams ranged from $55,500 for a 15-man Government team to $230,228 for a 19-man Government team assisted by consultants. Our estimates of the costs of the three studies follow.

	Study		
	A	B	C
Salaries:			
Team members	$ 91,863	$41,300	$ 98,743
Support assistance (professional and clerical)	19,155	-	37,275
Overtime	15,778	-	10,390
Travel, per diem, and miscellaneous	35,162	14,200	51,464
Subtotal	161,958	55,500	197,872
Consultant fees	32,064[a]	(b)	32,356
Total cost	$194,022	$55,500	$230,228
Period of in-plant review (weeks)	6	5	8

[a]Includes a $16,535 fee for preparing documents that assessed the lessons learned and a should-cost guide.

[b]Not applicable.

The cost of each study includes the time and expenses of personnel to

--plan the detailed study,

--perform the in-plant review,

--analyze data and prepare the negotiation objective,

--write the study report, and

--participate in contract negotiations.

We recognize that the costs shown above do not include all expenses associated with this type of study. Additional clerical and printing expenses are involved, although the exact amounts of these expenses are not readily available. Also, the contractors are expected to incur additional costs in supporting the teams while in the plants.

An additional unquantifiable cost to the Government for a should-cost study is the time lost from, and effect on, the routine work of team members when they are absent from their normal duties for extended periods.

We found that the Army had used consultants for its earlier studies but had made limited use of consultants for its later studies. The Army has established a cadre of specialists, in lieu of consultants, at the Army Research Center to assist its teams.

We found that $16,535 of the consultant fees of $32,064 paid by the Army for the initial should-cost study covered writing the first draft of the Army's should-cost guide and analyzing the lessons learned from the study. The remainder of the consultant fees covered the time spent assisting the team.

CHAPTER 4

OPPORTUNITIES FOR IMPROVEMENT

GREATER EMPHASIS ON IDENTIFYING WAYS TO IMPROVE CONTRACTOR EFFICIENCY AND ECONOMY

The three studies we reviewed had few suggestions for specific changes in the contractors' operations to improve efficiency or economy. The teams made in-depth evaluations of the contractors' proposed prices by using primarily the same techniques used in traditional preaward analyses by audit and technical personnel. We estimated that one team arrived at about 75 percent of the potential reductions by using traditional cost analysis techniques. The traditional approach places primary emphasis on reviewing contractors' records and rationales, to evaluate the contractors' cost estimates.

The most marked departure from normal cost analysis techniques was in the teams' evaluations of the contractors' proposed labor hours. One team prepared its estimate on the basis of the contractor's labor standards, although the contractor had estimated its labor hours by projecting its prior experience. Another team compared the contractor's labor standards and labor efficiency with industry norms and took a limited sample of actual operations. Almost half of the contractor's direct labor costs were questioned by the should-cost team.

The teams used, to a limited extent, accepted industrial management techniques, such as ratio delay and work sampling, for evaluating the efficiency and economy of a contractor's operations but did not use these techniques to quantify should-cost positions. When the teams made samples of actual operations, the samples were limited and not sufficient to support general reductions of costs in the sampled areas. The teams relied principally on in-depth analyses of the contractors' records and on the teams' judgments.

One team did not make a sample of actual operations because of time constraints and the contractor's involvement in labor union negotiations.

We believe that the best means to challenge the efficiency of a contractor's operations is to identify the specific practices which need improvement. Our own experience indicates that the greatest potential cost reductions were identified, quantified, and agreed to by the contractors as a result of evaluations of manufacturing operations in such areas as plant layout, production control, preventive maintenance, equipment modernization, and quality assurance. For example, observations of one plant's problems in production control resulted in an improvement program which, for an investment of $580,000, would bring about an estimated annual reduction in production costs of $3.1 million. The contractor would achieve these savings by a reduction of 139 indirect labor positions and a reduction of about 10 percent in the direct labor force.

Recommendation

We recommend that the Secretary of the Army insure that future should-cost teams place increased emphasis on analyzing the contractors' operations, to identify specific actions needed to improve efficiency and to reduce costs.

EARLIER DISCUSSION OF FINDINGS

Our analyses of the negotiations for the three studies showed that the teams chose not to discuss specific findings with the contractors prior to negotiations for fear of jeopardizing their negotiation positions. One team questioned the contractor's standard labor hours after comparing a sample of those standards with industry norms and making limited observations of actual operations. During negotiations the contractor contended, and the negotiator agreed, that the contractor had used an accepted method of establishing standards and that the team's sampling techniques might be in error.

We believe that open and frank discussions throughout the studies will help to develop strong bargaining positions and will reduce the time required to reach agreement on contract prices.

It is unrealistic to expect the contractors to agree completely with the teams' findings. However, we believe that contractor receptivity can be improved in future studies by discussing the teams' findings and the rationales for them with the contractors prior to the start of price negotiations. This would enable the teams to isolate areas of agreement and disagreement earlier; to undertake additional work, when necessary, to deal with dissenting views of the contractors; and to refine their positions when justified by information provided by the contractors. Such discussions would also allow greater contractor participation in determining actions needed to improve their efficiency and would lead to quicker agreements on contract prices during negotiations.

Recommendation

We recommend that the Secretary of the Army instruct future should-cost teams to make greater efforts to encourage the contractors' increased cooperation through earlier discussions of the teams' findings.

IMPROVING GOVERNMENT POLICIES AND PROCEDURES

It appears that the teams gave little attention to improving Government policies and procedures which affect the cost of contractor operations.

The Navy study of the TF-30 engine, as well as our own reviews, found that improving Government procurement policies and practices imposed upon the contractors could substantially reduce costs. Following are examples of improvements we found in Government procurement policies and practices that substantially reduced costs.

1. Eliminating Government overseas packaging requirements for spare parts scheduled for use in the continental United States.

2. Reducing the number of tests required by the Government according to the quality of the products being tested and the reliability reported by the field.

3. Consolidating Government procurements to allow contractors the maximum benefits from economic orders.

Recommendation

We recommend that the Secretary of the Army insure that should-cost teams give sufficient attention to identifying opportunities for savings through modifications in Government policies, procedures, and practices.

IMPROVED COORDINATION WITH LOCAL GOVERNMENT REPRESENTATIVES

Realization of the should-cost potential requires continued attention to the contractors' progress toward improvements suggested by the teams. When improvement goals were included in the contracts, the contractors agreed to submit quarterly progress reports to the procuring agencies. Our review of the three studies indicated that, although local Government audit and technical representatives were present to monitor the contractors' day-to-day operations, they were not fully aware of the study findings at two plants and had not been provided with specific instructions on the areas to be monitored at all three plants until several months after final negotiations.

The procuring agencies, with limited participation by responsible local Government representatives, formed and directed the teams. The teams analyzed the data collected during the in-plant reviews and formulated the final negotiation positions. As a consequence, responsible local representatives were not aware of the teams' findings or the bases for suggested improvements until after award of the contracts, when the procuring agencies gave them copies of the study reports or extracts from them.

We found that, for two of the three contracts, the local representatives had not been provided with copies of the reports until several months after final negotiations. For example, negotiations on one contract were completed on May 13, 1971, but the cognizant administrative officer did not receive a copy of the report until January 3, 1972.

In the one instance in which goals were established as specific values, procuring agency personnel initially monitored operations by visiting the contractor's plant, reviewing the contractor's reports, and preparing trend analyses for indications of achieving or not achieving a goal. About 10 months after the contract award, the procuring agency requested the resident administrative and audit offices to review and analyze the contractor's reports and to submit the analyses to the procuring agency.

The resident engineer submitted the first analysis of the goals for labor hours and efficiency 6 months later, but it contained only limited information. As a result, the procuring agency issued specific directions for the resident engineer to observe (1) scrap and rework, (2) fabrication and assembly operations, and (3) test and inspection activities. These specific instructions were not issued until about 16 months after the contract was awarded.

We believe that responsible local representatives should be fully informed of the teams' findings, the recommended improvements, and any agreements made with the contractors to implement improvements. This information is necessary to effectively monitor the day-to-day progress toward the management improvement goals. We also believe information in the should-cost reports could be used by local representatives in reviewing proposals for other procurements or contract changes.

As soon as possible after final negotiations, the responsible audit and administrative officials should be provided with copies of the should-cost reports and with specific instructions concerning the areas to be monitored.

Agency actions

AMC signed memorandums of agreement with the Defense Contract Audit Agency in March 1971 and with the Defense Supply Agency, Contract Administration Services, in February 1972 to clarify the roles of these agencies in future should-cost studies. Under these agreements the local audit and administrative representatives will participate more fully in the studies. The responsible administrative contracting officers will also serve on the should-cost teams in an advisory capacity. The agreements recognize that administrative personnel who participate in the studies will be thoroughly familiar with areas needing improvement and therefore can more effectively monitor the contractors' actions.

BETTER DEFINITION OF IMPROVEMENT GOALS

The resident audit office at one location has had problems in measuring the contractor's progress toward the goals established for certain categories of indirect expenses, because of the impact on the rates of cost accounting changes or fluctuations in the base costs. The goals were expressed as percentage reductions or percentage levels to be attained at either the end of a particular year or by the end of the contract. Representatives of the procuring agency have held meetings with the resident audit staff and the contractor to arrive at a method of monitoring changes in indirect expenses. The resident auditor has suggested that the goals be expressed in absolute dollars. Although this matter had not been resolved at the end of our review, the contractor had agreed to study the relationship of fixed and variable expenses in an attempt to define goals in absolute dollars.

Recommendation

We recommend that the Secretary of the Army insure that should-cost teams define improvement goals, whenever possible, in terms which will permit meaningful evaluations of contractors' progress toward the goals.

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U. S. GENERAL ACCOUNTING OFFICE

STAFF STUDY

GENERAL PURPOSE AMPHIBIOUS ASSAULT SHIP (LHA) AND THE DD-963 ANTISUBMARINE WARFARE DESTROYER SHIPBUILDING PROGRAMS

DEPARTMENT OF THE NAVY

MARCH 1973

GENERAL PURPOSE AMPHIBIOUS ASSAULT SHIP (LHA)

AND

THE DD-963 ANTISUBMARINE WARFARE DESTROYER

SHIPBUILDING PROGRAMS

The General Accounting Office (GAO) has examined aspects of the Navy's General Purpose Amphibious Assault Ship (LHA), and the DD-963 destroyer shipbuilding programs. This work was undertaken as part of GAO's continuing review of Department of Defense major acquisition programs. It also includes information developed to answer specific questions raised in congressional requests while our review was underway.

These two shipbuilding programs are under contract with Ingalls Shipbuilding Division of Litton Systems, Inc., for construction at their new shipyard in Pascagoula, Mississippi. Much of the controversy which has been associated with these programs started at the time of the award of the contract for 30 DD-963 class destroyers. More recent controversy centers on the LHA program's cost and schedule problems which have become evident. There is concern that these problems will impact on the destroyer program.

The purpose of our review was to examine into the status of these programs. We also examined into the special circumstances of starting up a new shipyard and into the difficulties experienced in organizing and staffing for management and production. In our review we made no attempt to determine the need for these programs or to become involved in current negotiations being carried on between the Navy and the contractor on the LHA contract.

SUMMARY

1. Our findings confirm the fact that there were numerous miscalculations at the outset on the part of both the contractor and the Navy in respect to start-up problems, labor availability and on the assumption that the design function could be carried on by a newly established design organization in California, two thousand miles from the construction site. However, there appears to be a growing optimism in respect to the completion of both shipbuilding programs--(1) if there is a settlement of current financial issues, and (2) if the various improvements begun since last July proceed satisfactorily.

2. Weaknesses in the contractor's organization and management area have undoubtedly contributed to the problems of cost growth and slippage. There have been three Presidents, five Vice Presidents of Finance, five Vice Presidents of Operations, six LHA program managers, two DD-963 program managers, and four directors of Quality Control since 1969.

The present management team which assumed direction on July 21, 1972, of the merged East (old) and West (new) shipyards is a seasoned team the majority of whom were formerly responsible for the East Yard. If this team can be held together and strengthened as needed, it will solve one of the serious problems which have faced the new yard from the outset.

3. Unique contracting concepts used on these programs contributed to problems being encountered. Under these concepts the Navy, for the first time, delegated almost complete responsibility to the contractor for decisions in program execution. Design responsibility

was placed entirely on the contractor. At the same time the concepts required that the Navy disengage from close monitorship and control of design and other contractor activities.

In this case, charges and countercharges have been filed related to actions or inactions by both parties. The final appraisal of how these concepts affected the programs will not be known until the current negotiations are concluded and all contractor claims resolved.

4. The stage of development of suitable systems for production planning and control has been a major contributor to delays, out-of-sequence work, failure to meet costs and time targets, etc. The East Yard system has now been extended to the West Yard and it is our opinion that it is beginning to function on current programs. However, the current application is on the first LHA and the first two destroyers, which are being built under less than full modular (nearly conventional) construction methods. The remaining LHAs and destroyers will use modular construction techniques. The system appears capable of functioning in the future but until it has actually operated under the modular construction technique, its success cannot be assured. In summary, the outlook is promising, but as yet not fully proven.

5. Labor factors have been among the most distressing of all the problems faced. Departures from the West Yard have on occasion exceeded new hires, and the rate of turnover has been far higher than in other shipyards.

Absenteeism has been a major problem. The ability to attract and retain critical skills such as welders has been a problem. Beginning with the merger of the two yards last July, these problems began to come under control. One labor force is now used instead of two competitive labor forces. Further, it was the contractor's decision not to seek new work for the East Yard, but to favor the accomplishment of the West Yard workload. The management now projects that the downtrend in labor will be reached by the end of March and that thereafter the work force will be stabilized.

Productivity in the West Yard was compared by the new management with the productivity it had achieved on construction of ships in the East Yard. Upon merger they appraised the West Yard to be 42 percent as productive as the East Yard. In January 1973, the management estimated the West Yard was up to 77 percent of the East Yard target. A goal of equal productivity (100 percent) between the two yards by July 1973 has been set.

These favorable developments, accompanied by more vigorous personnel management programs and improved training programs offer promise, but of course, must be monitored closely until they have succeeded.

6. The LHA construction program is now reported to be about two years late for the first ship and 2-3/4 years late on the last ship. The initial unit cost on the 9-ship program was projected at $154 million. By June 30, 1972, the Navy's estimate for a 5-ship program had reached $194 million, and of September 30, 1972, the estimate was $233 million.

The LHA contract price is under negotiation between the parties involved and the estimates of cost may be revised again. (See p. 7 for additional information

The major causes of past schedule slippage and cost growth cannot be precisely determined. They include the overoptimism about starting up the new yard, the cancellation of four ships, a strike, a hurricane, the escalation problem, changes in the design during the first phase of performance, major delays in merchant ship construction, and instability of contractor top management and production force.

There has been no change in cost or schedules in the DD-963 program since June 1970, when the contract was awarded. However, we believe, looking ahead, that some indeterminate cost growth and schedule slippage can be expected.

These can be minimized if the managerial and other reforms discussed above take effect. The outlook for meeting cost and schedule targets can be best presented by summarizing the uncertainties and unfavorable factors as well as those which are working in favor of meeting the cost and schedule targets.

The uncertainties and unfavorable factors--in addition to normal escalation--are as follows:

a. There is as yet no experience with meaningful learning curve and productivity on the DD-963 program, since the first keel was not laid until November 1972.

b. Any major design changes or addition of requirements, if not avoided, could cause the cost and schedule thresholds to be exceeded.

c. Further slippage in the LHA schedule must be avoided. While it now looks possible for the two programs to proceed concurrently, further slippage in the LHA program would pose interference with workload scheduling in the various shops which would undoubtedly impact on the DD-963 program.

d. The DD-963 production schedule, which eventually reaches one ship delivery per month is very optimistic. Such a tight schedule fails to allow for unanticipated problems in the shakedown phase which could create a bottleneck.

The favorable factors are:

a. Current improvements in management, labor, and planning.

b. The opportunity for learning curve improvements that a run of 30 ships in one facility offers.

c. The fact that the DD-963 is not stretching technology.

d. The fact that the contractor has already developed, and the Navy has concurred in, a plan for concurrent production of the LHAs and the destroyers in the West Yard.

e. The merchant ships are scheduled to be completed within calendar year 1973.

In summary, although the current outlook is generally good in view of the management changes in process and the design stability which has now been reached, the construction of the ship programs is at such an early stage that a clear judgment on achievement of cost and schedule goals is not possible.

The status of LHA negotiation is discussed on the following page.

LHA NEGOTIATIONS

The Navy and the contractor have been negotiating price changes since March 31, 1972, to reset the LHA program prices, giving recognition to the cancellation of 4 ships, escalation estimate changes, delays and changes in the contract. Negotiations on these items were scheduled for completion by February 28, 1973.

The Navy and the contractor were not able to reach a negotiated settlement and a contracting officer's decision was issued on February 28, 1973. This unilateral action by the Navy established a firm target price, a delivery schedule, a progress payment system and escalation provisions. The amount of funds now required by this action to complete the program over the $970 million already approved is $169.2 million. No reserve for possible claims has been designated.

The Navy also informed the contractor that after March 1, 1973, payments would be made on the basis of physical progress rather than cost incurred. The Navy said that the contractor owes the Navy approximately $55 million for payments in excess of physical progress earned. The contract provides that the contractor must repay in full the money owed within three months and that further payments will be suspended until the repayment has been made.

On March 1, 1973, Litton Industries announced that its Ingalls Shipbuilding division and the Navy were $108 million apart in the negotiation of a final fixed price to produce five LHA ships. Litton said the difference represents the cost of work and schedule delays caused by actions of the Navy and not included in the original scope of the contract. They indicated that the Navy's unilateral price is unreasonable

and unrealistic and that they intend to seek an equitable settlement. Litton also said that failure of the unilateral decision to recognize the Navy's responsibility for costs and delays establishes the repayment to the Navy of $55 million. Litton said such a repayment is not due and will oppose the Navy.

GENERAL PURPOSE AMPHIBIOUS ASSAULT SHIP(LHA) AND THE DD-963 ANTISUBMARINE WARFARE DESTROYER SHIPBUILDING PROGRAMS

CHAPTER 1

INTRODUCTION

The General Accounting Office (GAO) has examined selected aspects of the Navy's General Purpose Amphibious Assault Ship (LHA) and DD-963 destroyer shipbuilding programs. This work was undertaken as part of GAO's continuing review of Department of Defense major acquisition programs. It also includes information developed to answer specific questions raised in congressional requests while our review was underway.

The LHA is a combatant general purpose amphibious assault ship designed to be capable of transporting and landing troops and their essential combat equipment and supplies in amphibious assault by means of helicopters, amphibious craft and vehicles. A multi-year fixed-price-incentive development and production contract for the construction of 9 ships was awarded to Litton Systems, Inc., on May 1, 1969. In December 1970, the number of LHAs to be procured was reduced to 5 ships.

DD-963 is the designation for a class of gas turbine-propelled destroyers to be used for antisubmarine warfare with shore bombardment capability and sufficient speed for escort of strike forces. A multi-year fixed-price-incentive development and production contract for the construction of 30 ships was awarded to Litton Systems, Inc., on June 23, 1970.

Prior GAO reports on the LHA program were issued in 1970, 1971 and 1972. Reports on the DD-963 program were issued in 1971 and 1972. In addition, a report B-170269, dated August 26, 1970, dealing with circumstances surrounding the award of the DD-963 destroyer contract and plans to construct all 30 ships in a new and untested shipyard was prepared in response to a request of former Senator Margaret Chase Smith.

Extensive coverage of these two programs can also be found in the published hearings on Military Posture before the Committee on Armed Services, House of Representatives, H.R. 12604, held on April 17 and 24, 1972. In December 1972, these programs were also discussed in hearings held by the Subcommittee on Priorities and Economy in Government, Joint Economic Committee.

Much controversy has developed over the awards of these contracts, particularly over the slippage of delivery and cost growth of the LHA. Contract cost estimates for the LHA are now more than ceiling price and delivery of the ships has been delayed two years or more. The contractor and the Navy disagree on who is primarily responsible for the problems. Questions are being asked as to the effect of LHA schedule and cost problems on the DD-963. Questions have been raised also as to whether the shipyard can physically handle both programs simultaneously.

Concerning the LHA, the Navy and the contractor have been negotiating price changes since March 31, 1972,to reset the LHA program prices, giving recognition to the cancellation of 4 ships, escalation estimate changes, delays and changes in the contract. Negotiations on these items were scheduled for completion by February 28, 1973.

The Navy was not able to reach a negotiated settlement with the contractor and a contracting officer's decision was issued on February 28, 1973. This unilateral action established a firm target price, a delivery schedule, a progress payment system and escalation provisions. The amount of funds now required by this action to complete the program over the $970 million already approved is $169.2 million. These funds are included in the fiscal year 1974 budget. No reserve for possible claims has been designated by the Navy.

Concerning the destroyer program, the fiscal year 1974 budget contains a request for complete funding and authorization for the 17th through the 23rd ships. Congress will likewise in that year need to decide whether or not to provide complete long lead time funding for the last seven ships (24th through 30th).

This report encompasses the cost and schedule estimates as they have evolved for the LHA and Destroyer program, the special circumstances of start-up in a new shipyard of modern design and difficulties experienced in organizing and staffing for management and for production.

During our review we enlisted the aid of consultants to assist us in assessing the technical aspects of shipyard operations. The views expressed in this report, however, are entirely those of GAO.

CHAPTER 2

THE LITTON SHIPYARD FACILITIES

The Ingalls Shipbuilding Division of Litton Industries, Inc. at Pascagoula, Mississippi, includes an old facility, the East Yard, and the new West Yard. Since July 1972, these two yards have been consolidated under one management. Labor, shops and equipment are now interchangeably used, and all is available in support of the two major Navy programs. Efforts to bring new construction into the East Yard have been suspended. It is expected to continue submarine overhaul and Naval ship overhaul, but its special shops, outfitting docks and skilled craftsmen are being applied to the destroyer and LHA programs as required.

The West Yard was built on a 600 acre peninsula at the mouth of the Pascagoula River, Pascagoula, Mississippi. Construction of the Yard began in January 1968 and first ship construction operations began in March 1970.

The shipyard was designed for series production of one-design ships and incorporates many advanced ideas. The shipyard is so designed as to encourage a logical flow of material from cutting and shaping to subassembly, to large modules and then to final ship assembly. Material, subassemblies and parts can be moved by truck to the module and heavy-lift cranes can lift assemblies up to several hundred tons. Translation cars on tracks move modules into integration and, finally, whole ships onto the launch pontoon. Automation of high volume operations has provided steel and aluminum fabrication shops with capacity more than adequate for the work under contract. The arrows on the schematic of the yard, pictured on p. 13, show the flow of work.

Although particularly designed for quantity modular construction of one-design ships, the yard is flexible, and physically should support the competitive construction of ships of any design. Exceptions to this might include outsized vessels which exceed the dimensional capacity of the existing pontoon launch system and cranes, such as aircraft carriers.

This yard contains some features which are unique in this country. The Pontoon Launch and Retrieval System is an excellent system for this yard. It offers more flexibility than a large building drydock and represents less capital expenditure. This device also permits the drydocking of ships during or after fitting out if this proves necessary.

The Land-Based Test Facility for electronic equipment is a new kind of shipyard capability. Ship sets of complex electronic and computer systems are checked out with the associated software prior to ship installation. The use of metal pallets for the installation of electronic systems in the DD-963 is a novel method of reducing some shipboard cabling, and handling of systems during installation. This system is intended to save time and money in the outfitting and check-out of ships. It is also intended to permit the installation to be made at the latest possible time, which may, in turn, reduce the hazards of damage and protect the integrity of fragile operating equipment.

LITTON INDUSTRIES
AUTOMATED SHIP PRODUCTION FACILITY
PASCAGOULA, MISSISSIPPI
ADMINISTRATION BUILDING
PARKING
PANEL SHOP
LAND BASED TEST FACILITY
SHOT BLAST BLDG
PARKING
HELIPORT
SUB-ASSEMBLY AREA
MODULAR ASSEMBLY AREA
STAGING & KITTING AREA
SHELL ASSEMBLY SHOP
FABRICATION SHOP
BUFFER STORAGE AND FUTURE EXPANSION
RAW MATERIAL STORAGE
MULTI PURPOSE WAREHOUSE
COMBINED SHOPS & WAREHOUSE
MACHINERY ASSEMBLY SHOP
BOILER ERECTION
MAINTENANCE SHOP
OUTFITTING DOCKS
FLOW KEY
INCOMING MATERIAL
PROCESSED AND PACKAGED MATERIAL
ASSEMBLIES SUB-ASSEMBLIES AND MODULES
MACHINERY AND EQUIPMENT

A principal concern of both the contractor and the Navy is the concurrent construction of the LHA and the DD-963 and the potential adverse effect that a slippage in the construction schedule of one program could have on the other program. The contractor's plans for scheduling the erection of ship modules or sections and the movement of these modules from the bays to the ship integration areas and to the launch area have been reviewed and concurred in by the Navy. The contractor has formulated various erection plans whereby the smaller and more quickly constructed destroyers may be moved around the LHA for launch. The Navy has reviewed these plans and stated that "they provide sufficient confidence in the adequacy of Ingalls facilities to perform the DD-963 Class and LHA-1 Class shipbuilding activities." It should be added, however, that the present management has elected to construct the first LHA and first two destroyers by adding pieces and subassemblies, smaller than the large ship modules as planned, to the keels in the final erection area. This means longer occupancy of these final positions prior to launch. Unless full modular construction is undertaken thereafter, congestion can be expected which will affect schedules. This critical pattern of construction should become visible in the next year.

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CHAPTER 3

YARD MANAGEMENT

There is little question but that the Ingalls Shipbuilding Division, Litton, in bidding and the Navy in accepting the proposal for the LHA ships, substantially underestimated the problems involved in (1) startup of a new facility, (2) obtaining an adequate work force, (3) the effects of designing a ship two thousand miles from the construction site by a completely new design organization (4) the effects of aerospace concepts in production upon a labor force unfamiliar with the concepts and perhaps unwilling to accept them for fear of undermining the "craft" approach long prevalent in shipbuilding.

There was no real precedent from which the potential difficulty of these series of actions could have been measured. Very rarely in peacetime has a shipyard been designed and built from the beginning, workers hired, and this force " tuned up" to competitive productivity. Dr. Svensen, the designer and manager of the Arendal Yard in Sweden advised the Navy recently that this process took him three years.

All of the above problems in the new yard are reflected in the schedule delays and cost overruns. They are also reflected in the numerous changes in the management cadre since the inception. We are advised, for example, that since the award of the LHA contract, there have been three different Presidents, five Vice Presidents for Finance, five Vice Presidents for Engineering, five Vice Presidents for Operations, six LHA Program Managers, two DD-963 Program Managers and four Directors of Quality Assurance.

During the last year Litton has undertaken very aggressive action to bring in shipbuilding expertise and to stabilize the top management. Within the next year, the Government should have clear indications as to whether this stabilization has been achieved.

From the beginning of the West Yard operation until July 1972 the management organization was entirely separate from the East Yard operations. Both yards had complete management organizations and competed for scarce manpower. The West Yard organization consisted, basically, of aerospace type managers as opposed to shipbuilding type personnel in the East Yard. Also, each yard had its own management concept, reports, and recording systems.

The two yards were merged on July 21, 1972, and the process of consolidating management organizations and eliminating duplicative functions began.

The first step taken was to attempt to strengthen the yard management by moving the key men from the old East Yard and putting them in charge of the combined yards. This brought substantial shipbuilding experience into top Yard management.

The next major effort undertaken was the development and installation of a planning process that provides work planning data and the framework with which to accumulate and compare work performance so that the status of programs would become more than educated guesses.

The planning process being installed, roughly speaking, consists of breaking up the large ship's work drawings into segments which contain the elements of a manageable work package.

These are segregated using predominantly one craft (pipefitters, welders, etc.) adding detailed notations and sketches for pieces which guide the yard supervision and craftsmen. These are then scheduled in a build-up of the pieces, subassemblies, modules and ship assembly and outfitting which are logically progressive in sequence and on which labor is assigned in the most efficient way management can devise. Estimates of manhours by craft and materials are applied to each package. Actual work is then tracked as to cost, completion, materials, labor, etc.

The new management is installing the computer-aided planning system on these ship programs which they previously used in the East Yard. It appears sophisticated, logical and derived from systems in use elsewhere. We were advised that this system should be installed by July 1973. In view of the complex work breakdown structure needed to build a ship and the hundreds of thousands of elements of information to be inserted, such a system becomes mature and accurately driving and synchronizing Yard work only by trial and adjustment.

The third critical management action being taken is to better manage the work force.

Labor problems have been among the most distressing faced by the management. Departures have on occasion exceeded new hires--and the rate of turnover has been far higher than in other shipyards. Absenteeism has been a major problem. Productivity in the West Yard at the time of merger last year was at a low rate compared to the East Yard (42 percent).

Beginning with the merger of the two yards last July, these problems began to come under control, since one labor force is now used instead of the yards competing for scarce labor. Further, a decision was made not to seek new work for the East Yard, but to favor the accomplishment of the West Yard workload. Management reports that the productivity has improved from the 42 percent level to 77 percent in the West Yard, compared to the East Yard. The projection is that the 100 percent comparative level will be achieved by next July, and improvement beyond that is anticipated.

Combining the Yards in July 1972, and Litton's decision not to seek new work in the East Yard which would impact current schedules, plus a further extension of LHA delivery schedules, reduced the pressure on labor resources. Personnel were transferred from the East to West Yard and some commercial work scheduled for the West Yard was transferred to the East Yard. This seems to be an effort by the contractor to expedite and sustain progress on the DD-963 shipbuilding program.

These favorable developments, accompanied by more vigorous personnel management programs and improved training programs offer promise, but of course, must be monitored closely until they have succeeded.

There are factors which may affect planned versus actual work force goals. They include the contractor's ability to (1) recruit and keep people, (2) achieve manpower productivity levels, and (3) maintain its plan to accept no new work in the East Yard which might pull critical skilled labor off of the Navy programs.

Currently the direct labor work force is approximately 12,000 people. The projections predict a decline in needed force throughout 1973, and then a rise to slightly over 14,000 in late 1974, and then a decline as the programs move toward completion. This work force profile is based on existing contracts plus follow-on DD-963 procurement up to 30 ships and a constant level of effort for submarine overhaul work. It does not include any new major contracts.

Maintaining the work force levels with replacements is a formidable task. The overall monthly attrition is about 4-1/2 percent to 5 percent.

Ingalls officials advised us that the following measures are being implemented in an attempt to curb the unfavorable attrition rate:

--all employees are exit-interviewed to determine reasons for termination. The feedback is provided to managers to transmit data for corrective action,

--all new employees interviewed one week and one month after employment to solve problems of adjustment to new job and company.

—all applicants are interviewed in yard by prospective supervisor to tighten screening and to show prospective employees their work place,

—less long distance recruiting and more Southern Regional recruiting,

—reference checks will be initiated for all applicants being considered for employment,

—establish a control on those who abandon their jobs without proper notice in order to assist departments in maintaining accurate head count, and

—Internal Placement Section assistance for any employee who feels that he wants to transfer from one department to another because he is qualified, would be happier, and can make more money.

In addition to its recruiting efforts, Ingalls conducts two entry-level training programs (one funded by Ingalls and one funded by the Federal Government) for direct labor force personnel. The curriculum is basically the same for both programs, however, the Government-funded program is designed to assist the disadvantaged and underprivileged minorities.

The chart on page 23 shows the extent of slippage between the original contract delivery date and the currently estimated delivery date for each ship constructed or planned for construction in Litton's new West Yard. It illustrates the delays resulting from the start-up problems encountered in getting the yard into operation in 1970 and 1971.

The chart also shows at (A) Litton's efforts to relieve West Yard congestion by moving the construction of the four American President Line (APL) merchant shipsand one Farrell Line merchant ship to the East Yard. This move was necessary due to the slippage on the Farrell ships and to accommodate the Navy ships under contract. It shows the effect of delays in completing the Farrell ships on the LHA construction and the potential impact of the LHA slippage on destroyer construction.

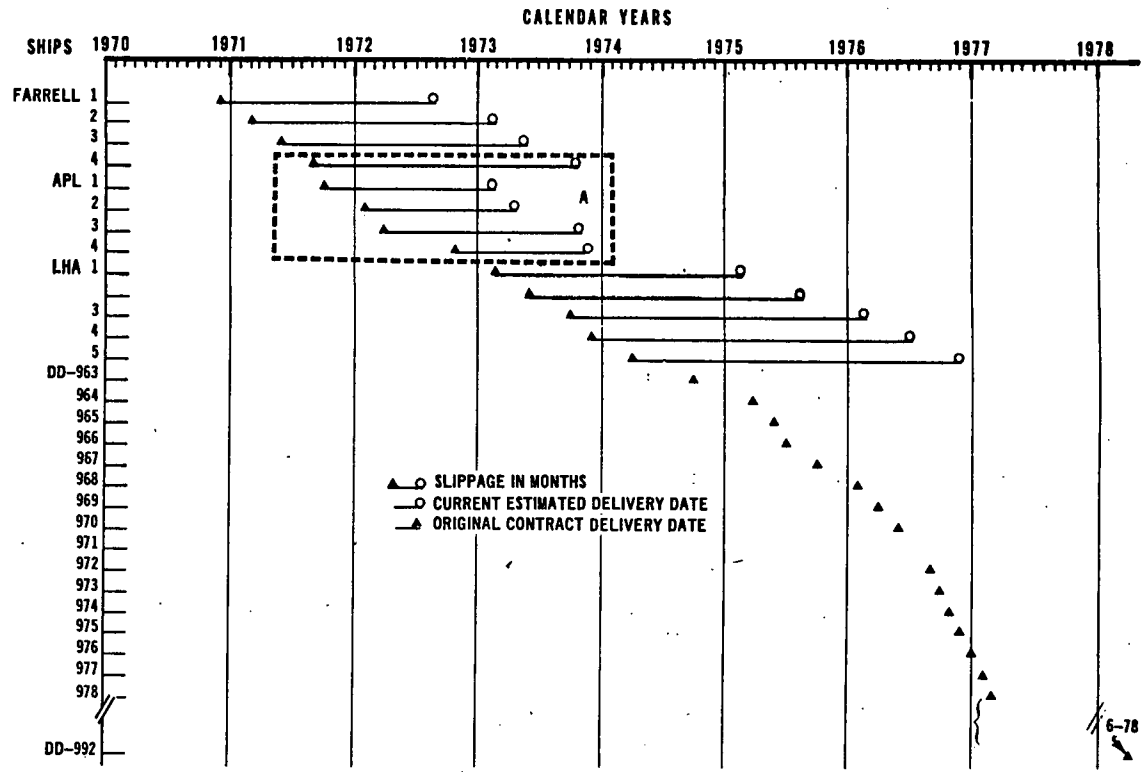
The chart also shows that by the Fall of 1973 all commercial work under contract will be completed. However, whether the delivery scheduled for these two Navy programs can be achieved is not known. The chart shows, for example, that the fifth LHA was originally scheduled for delivery seven months before delivery of the first destroyer. Under present schedules the first destroyer will be delivered about five months before the first LHA. The increased overlap in production of the LHAs and the destroyers may generate problems not previously anticipated and, while these two programs have been completely integrated for planning purposes, we believe some slippage in delivery of the destroyers must be anticipated.

The management decision to accept no new work which would impact current schedules in the East Yard should enhance chances of meeting LHA and DD-963 delivery schedules. At some point in time, however, new business must be forthcoming in order to provide sufficient lead time to preclude lowering the Yard activity beyond a reasonable economic level. Current schedules indicate that new business must be acquired by Ingalls to begin in the first quarter of 1975 to maintain production capability. If Ingalls wants to maintain its engineering capability, it will need to find business to support it in early 1974.

In summary, it should be observed that the contractor has responded to 12 major construction milestones on the first LHA set by Navy in August 1972 by completing them all on time or early. Since installed in July 1972, the present management took the initiative of moving up the DD-963 construction schedule, working around missing drawings, and keeping substantially to this schedule thus far.

These actions, plus announced changes in policy with respect to hiring and managing the labor force, are indicators that a much more forceful attempt is underway to demonstrate Litton's ability to build these ships. Whether this increased effort will emerge as a sustained trend, only time will show. Certainly in one year, the stability of this management and sustained accomplishment will be visible. Based on these actions, and their recent production audits, the Navy appears to be more optimistic regarding the completion of both shipbuilding programs.

COMPARISON ORIGINAL CONTRACT DELIVERY DATE VS CURRENT ESTIMATED DELIVERY DATE



CHAPTER 4

SOME IMPLICATIONS OF THE CONTRACTING CONCEPTS

It would be a serious oversight not to recognize the unique nature of the procurement for these two ship programs. For the first time, the Navy has delegated almost complete responsibility to the contractor for decisions in the program execution. Design responsibility has been placed entirely on the contractor. This includes conceptual work, parametric studies, preliminary drawings, etc. System responsibility likewise is given Litton. Consequently, less GFE is supplied. Integration of all ship systems, including design of the command and control system and associated computer support, is this contractor's responsibility.

Litton also has the responsibility for the integrated logistic support system, including maintenance and supply support. They identify skills and numbers of crew to man the ships as well as training programs and manuals supporting maintenance and operations. The chart on page 25 shows a comparison of the responsibilities delegated to the contractor for the LHA and DD-963 ships compared to usual Navy practice.

LHA AND DD-963 PROGRAM

RESPONSIBILITY FOR ELEMENTS OF A SHIP ACQUISITION PROGRAM

Elements	Standard Navy Method	LHA and DD-963 Method
Conceptual Studies	Navy plus study contracts	Competing Shipbuilders
Preliminary Drawings and Specifications	Navy	Shipbuilder
Contract Drawings (Used for construction bidding)	Navy plus contract architects	Shipbuilder
Detail Drawings (Used for construction)	Shipbuilder	Shipbuilder
Change Management	Sup Ships and Headquarters	Supship and Headquarters
Sub-system Supplied	GFE-major combat systems	More Contractor furnised Equipment
Construction	Shipbuilder	Shipbuilder
Functional performance shakedown	Shipbuilder	Shipbuilder
Weapons & systems Combat Demonstration	Navy	Navy/Shipbuilder

Requiring the contractor to establish unit costs for production and delivery schedules on complex products at an early time, and to guarantee performance, before design and test has been accomplished, poses a serious responsibility on the contractor in this form of procurement. Actual cost schedules and performance often do not match these early contractual commitments, and the differences are the root of much of the criticism of apparent cost growth. However, serial production after the design is stabilized should have some advantages: improves component standardization where it is not otherwise obtained (ships), restrains the Government in requesting changes in design, permits the contractor to stabilize his work force and work plan with mutual benefit from the efficiencies achieved, and stimulates improvements in shipyard plant and methods. It does inhibit the participation of the Government agencies who must monitor the acquisition process to insure that, within the terms of the contract, the program is progressing in a manner consistent with the funding authorization and that the ships being produced are compatible with the fleet and its support systems.

CHAPTER 5

PROGRAM COST ESTIMATES

The LHA Program

Both the Navy and the contractor project a cost increase on the LHA contract, but the amount cannot be determined at this time. The Navy's estimate set out in the September 30, 1972, Selected Acquisition Report (SAR) is $1,164.8 million. The following table shows a comparison of this and earlier program estimates. (Navy and contractor estimates as of March 1, 1973 are discussed on page 28.)

	Estimate (in millions)		
	4/15/69	6/30/72	9/30/72
Quantity under Procurement	9 ships	5 ships	5 ships
Cost Category			
Basic Ship Costs			
Contract target price	$ 1053.4	$ 562.5	$ 562.5
Contract ceiling price increment			103.9
Cancellation costs		109.7	109.7
Changes		27.1	27.1
Escalation	73.5	85.4	176.4
Government-Furnished Equipment	179.3	134.7	134.6
Other Costs	18.0	9.5	9.5
Total Production	1,324.2	928.9	1,123 .7
Outfitting and Post Delivery	33.8	18.8	18 .8
Procurement Cost	1,358.0	947.7	1,142.5
Development Cost	22.3	22.3	22.3
Total Program Cost	$1,380.3	$ 970.0	$1,164.8
Procurement Unit Cost	150.9	189.5	228.5
Program Unit Cost	$ 153.4	$ 194.0	$ 233.0

Serious problems have been encountered in getting the LHA program underway. The contractor and the Navy disagree on who is primarily responsible for the problems and the resulting cost growth and delivery delays.

LHA Negotiations

The Navy and the contractor have been negotiating price changes since March 31, 1972, to reset the LHA program prices, giving recognition to the cancellation of 4 ships, escalation estimate changes, delays and changes in the contract. Negotiations on these items were scheduled for completion by February 28, 1973.

The Navy and the contractor were not able to reach a negotiated settlement and a contracting officer's decision was issued on February 28, 1973. This unilateral action by the Navy established a firm target price, a delivery schedule, a progress payment system and escalation provisions. The amount of funds now required by this action to complete the program over the $970 million already approved is $169.2 million. These funds are included in the FY 74 budget and are for the increase for original target to ceiling ($103.8 million) and for additional escalation ($65.4) million. The Navy's estimate of escalation now totals $150.8 million.

On March 1, 1973, Litton Industries announced that its Ingalls Shipbuilding division and the Navy were $108 million apart in the negotiation of a final fixed price to produce five LHA ships. Litton said the difference represents the cost of work and schedule delays caused by actions of the Navy and not included in the original scope of the contract. They indicated that the Navy's unilateral price is unreasonable and unrealistic and that it intends to seek an equitable settlement.

No reserve for possible claims has been designated by the Navy.

Reimbursement Under The LHA Contract

In most fixed-price construction contracts, progress payments are made on the basis of percentage of physical progress made in performance of the contract. The fixed-price incentive with successive targets LHA contract, however, provided for payments on the basis of physical progress starting 40 months after award. Payments for the first 40 months were to be reimbursements on a "cost incurred" basis to cover anticipated high start-up and preliminary design effort. Litton's price proposal on the LHA was conditioned upon including these provisions in the contract.

The cost reimbursement method of payment was to have ceased on September 1, 1972, by which time a determination was to have been made of the status of physical progress as well as an accounting of the status of payments so far made. Because of a variety of reasons, the Navy extended the date for program payment conversion to February 28, 1973. The original plans called for establishment of an "Earned Value" system early in the program which could have served to measure progress.

On September 29, 1972, Litton submitted a plan for measuring physical progress measurement which is being evaluated by the Navy. The progress measurement issuewould either be negotiated by February 28, 1973, or determined unilaterally by the Navy in case of disagreement.

The Navy and the contractor were not able to reach a negotiated settlement and as part of a contracting officer's decision issued on February 28, 1973, the Navy established the progress payment system. The Navy informed the contractor that after March 1, 1973, payments would be made on the basis of this physical progress payment system rather than cost incurred. The Navy said that the contractor owes the Navy approximately $55 million for payments in excess of physical progress earned. Under the terms of the contract, the contractor must repay in full the money owed within three months. It also provides that further payments will be suspended until the repayment has been made.

On March 1, 1973, Litton Industries announced that its Ingalls Shipbuilding division and the Navy were $108 million apart in the negotiation of a final fixed price to produce five LHA ships. In regard to the amount owed to the Government, Litton said that failure of the unilateral decision to recognize the Navy's responsibility for costs and delays, establishes the need to repay $55 million to the Navy. Litton said such a repayment is not due and will oppose the Navy's claim.

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DD-963 Program

There has been no significant change in the reported estimates of cost of this program (30 ships) since the contract was signed in June 1970. On the other hand, the first keel was laid in late November 1972 and it is much too early to say that the program will not experience cost growth. Indeed, some cost growth in this program probably can be expected for reasons discussed later in this section. The percentage completion is on schedule for the most part, but is so small that most of the Yard work remains to be done.

The DD-963 program estimates are constructed as follows:

Total Program Cost		$2.8 billion
Litton Target Price		$1.8 billion
Subcontracts	$1.1 billion	
Ship Construction	0.45 "	
Engineering	0.10 "	
Management	0.15 "	
Government-furnished equipment		$0.32 billion
Escalation		0.40 "
Changes		0.10 "
Program Support		0.18 "

Some reservations regarding the future stability of these estimates are probably in order. There are no major technical disagreements between Litton and the Navy, but very little experience has developed in construction so that the actual productivity and the shipbuilding learning curve have yet to be demonstrated. Furthermore, Congressional reservations were shown

last year when it declined to authorize the next block of seven ships (beyond the 16 authorized), providing only long lead time funding. The stress in Litton generated by this situation tends to freeze the announced cost estimates for the 30-ship program and the delivery schedule. If variances arise they are likely not to be disclosed by Litton until after authorization or sometime in the future when the full program seems committed.

The first three fiscal year increments of 3,6, and 7 ships were funded by Congress as programmed. The FY 1973 budget request for the next increment of 7 ships was cut, however, from $610 million to $247 million as provided in the Department of Defense Appropriation Act of FY 1973 dated 28 October 1972. While the $247 million permits advance procurement of CFE/GFE, construction funding has been deferred to FY 1974. The balance of the required construction funding has been requested in the FY 1974 Navy budget submission along with advance procurement funding for the last increment of 7 DD-963 destroyers. Construction funding for the last 7 ships will be requested in the FY 1975 budget. The contractor has concurred in this funding plan.

The construction of 30 one-design Naval ships in one yard is a rarity. From other experiences, continued learning and reduction of unit cost may take place throughout production. However, the advantage of serial production in this yard is yet to be demonstrated.

For the present program cost to remain stabilized, Navy will have to defer substantial changes in the weapon systems until after individual ship delivery.

Recognizing that uncontrolled changes have, in past programs, resulted in significant cost growth, in schedule slippages, and in performance degradation, the Navy has taken extraordinary steps to control such changes as follows:

(a) All recommendations for changes must be analyzed and evaluated by several board reviews and by the Project Manager. Changes can be made only as specifically approved and directed by the Project Manager after complete analysis of cost, schedule and effectiveness. Changes which have adverse impact on characteristics or which increase cost or delay production schedule must be approved by the Chief of Naval Operations.

(b) The ship to be constructed is described in the contract. Should it be desired to make major ship system changes, it only can be done after the proposed new system has been thoroughly analyzed and justified to the Chief of Naval Operations, the Secretary of the Navy, the Secretary of Defense--through the Defense Systems Acquisition Review Council process--and then only after funds are obtained through congressional review and appropriation. Thus, major system changes in the ship must be fully funded before they are implemented.

Notwithstanding these efforts, the Navy's past experience over the years gives little encouragement that these destroyers really will be built to a single configuration. If, however, controls now planned by the Navy are strictly enforced, the changes in configuration should be kept to a minimum.

CHAPTER 6

PROGRAM SCHEDULE

The LHA Program

The first reported slippage on the LHA program was reported by the contractor in December 1970. At that time, it was estimated that LHA-1 would be delivered about 10 months late. The following schedule shows estimated slippage at other points in the program.

	Contractually Established Delivery Dates 5/1/69	Estimates of Slippage At 6/30/71[a]	6/30/72[b]	11/30/72
		---in months---		
LHA-1	3/30/73	12	19½	23½
LHA-2	6/29/73	13	21½	26½
LHA-3	10/1/73	14	22½	29
LHA-4	12/31/73	14	24½	31
LHA-5	4/1/74	14	26	32½

a/Slippage shown at 6/30/71 is the same as that reflected in the memorandum of agreement dated April 23, 1971.

b/Slippage shown at 6/30/72 is the same as that reflected in the contractor's March 31, 1972 reproposal.

The reasons for the slippages shown are entangled in the charges and countercharges between contractor and Navy. More important is the prospect of schedule keeping in the future. There are no major technical issues. Changes are being held down to a very low level. The key issues remain: whether present management can do what it did in the East Yard--increase the labor force productivity to the planned level, provide the skilled craftsmen when needed, synchronize the production plan and sustain pressure on these factors for the necessary years ahead. Short of major changes in design which no one foresees, or natural catastrophies or work stoppages, Government confidence seems slowly to be growing that it will be done. Another year, with stable management, should tell.

The DD-963 Program

The original 30-ship delivery schedule is still current. Phasing the yard operations is highly complex, with ship deliveries becoming as frequent as one per month. The schedule appears to be a "success-oriented" schedule allowing little for the many kinds of in-process delays which normally occur but it is too early in this program to know whether the very tight schedule can be maintained.

There are a few factors which might cause serious delays should they arise. The shakedown and debugging of a large number of completed ships in rapid succession may become a bottleneck. The staffing of the requisite number of contractor ship test crews can be difficult to accomplish. Any requirements to add additional electronics and ordnance could introduce major changes in cost and schedules if implemented before delivery.

November 30, 1972

The Honorable John W. Warner
Secretary
Department of the Navy
Washington, D. C. 20350

Dear Mr. Secretary:

You will recall my June 22, 1972, letter expressing my concern over the Navy's problems with Ingall's Shipbuilding Division of Litton Industries. The large amount of Navy business at that shipyard, the nearly $450 million in outstanding shipbuilding claims, the delays in the LHA, all indicate serious financial difficulties. Litton's continued efforts to shift its financial problems to the Navy further support my concern that Litton might become the Navy's Lockheed. The warning signs are evident.

a. Litton sought at high levels of Government a special $40 million payment prior to the end of their fiscal year to cover a cash shortage and to improve the appearance of its annual report.

b. Litton has submitted claims totaling $73.8 million to cover cost overruns on the AR and SSN contracts. The Navy has determined that of this amount the company is entitled to only about $7 million.

c. On the LHA contract, Litton apparently has had to obtain Navy agreement to postpone the contract date for converting progress payments from 100 percent of cost incurred basis, to payment based on percentage of completion, to mitigate a cash shortage. By deferring the changeover date, the Navy has, in effect, had to loan Litton Government interest-free funds.

d. I recently learned that Litton has also been overpaid for a matter of several years on the submarine contracts, and that the overpayment may have been as much as $30 million or more during this period.

These actions indicate to me that Litton may be in desperate financial straits. Of course, as in the Lockheed and Penn Central cases, the full extent of the problem cannot be discovered from reading the company's financial reports to the stockholders. In view of the extensive problems at Litton, I would like to know:

a. Has the Navy conducted a detailed review of Litton's overall financial situation to determine that Litton can complete existing contracts without special financial assistance from the Navy?

b. Does the Navy have access to Litton's financial books and records and a regular system to learn of developments that could adversely affect the company's financial condition and consequently its ability to complete the Navy contracts?

c. How much was Litton overpaid and for what period of time was Litton overpaid progress payments on the submarine contract? Were there similar overpayments on the other Navy contracts? What action has been taken to recover the overpayments and interest?

d. What would be the cash effect on Litton if progress payments on the LHA contract were made on percentage completion as originally required by the contract instead of based on incurred costs as they are now being paid?

I would appreciate the answers to the above questions as soon as possible, and in any event by December 14, 1972.

Sincerely,

William Proxmire, Chairman
Subcommittee on Priorities
and Economy in Government

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

December 14, 1972

Honorable William Proxmire
Chairman, Subcommittee on Priorities
and Economy in Government
Joint Economic Committee
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

I have your letter of November 30th in which you reiterated your belief that Litton Industries is having serious financial difficulties and requested further information concerning Navy shipbuilding contracts with Litton.

You asked several questions about Litton's financial situation. Regarding your first two questions, which involve the Navy's assessment of Litton's financial capability to complete its Navy contracts, the Navy has reviewed Litton's financial position and routinely monitors financial developments. However, as mentioned in our letter to you of July 12, 1972, financial data is company-confidential, and it is considered inappropriate for the Navy to comment on Litton's financial condition, which is a matter that should be addressed by Litton's corporate officers.

You also asked for information concerning possible overpaid progress payments on the Navy's submarine contract with Ingalls Shipbuilding Division. In early September, 1972, a Navy review determined that the contractor was overpaid progress payments during the period June, 1968, through September 4, 1972. The cumulative overpayment at its maximum amounted to $7,590,000 but had decreased to $1,678,010.54 by September 1972. Repayment was immediately requested, and the contractor fully refunded the outstanding $1,678,010.54 in repayment made on 6 and 13 September 1972. With respect to interest charges on the overpaid funds, the company made repayment within 30 days of demand. Therefore, under the terms of the contract no interest charge was applicable. Our reviews have not revealed any other overpaid progress payments on Litton's Navy contracts.

Your letter also addressed the six-month extension of the cost-incurred method of payments to Litton on the general-purpose amphibious-assault-ship (LHA) construction contract. The extension was based on the contractor's claim for changes and excusable delay. We are now reviewing the matter to determine what amount of excusable

delay can be substantiated. If it is determined that the period of excusable delay is less than six months, the contractor will be required to repay the difference between cost incurred and actual physical progress payments, plus interest, for that time determined not excusable. Thus, deferring the changeover date of the method of payment does not provide the contractor with interest-free funds. At this time, there is no basis upon which to forecast what the cash effect on Litton might be, as this will be determined by several factors, including the amount of excusable delay allowed.

I trust that the foregoing will suffice for your purposes.

Sincerely yours,

Frank Sanders
Under Secretary of the Navy

For RELEASE

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

SECURITIES ACT OF 1933
Release No.

SECURITIES EXCHANGE ACT OF 1934
Release No.

PROPOSED GUIDELINES FOR DISCLOSURES
BY COMPANIES ENGAGED IN DEFENSE CONTRACTING

On , 1971, the Securities and Exchange Commission released the report of its staff in the matter of Disclosures By Registrants Engaged in Defense Contracting. Upon review of the report the Commission has concluded that its rules and forms promulgated under the Acts are adequate. However, it appears that in several instances the application of these requirements by defense contractors has resulted in less than satisfactory disclosures. The Commission has determined to provide guidelines for disclosures by companies having material defense business including disclosure in registration statements and reports filed with the Commission pursuant to the Securities Act of 1933 or the Securities Exchange Act of 1934.

The Commission also takes this opportunity to point out that the responsibility for prompt and adequate disclosure rests with the registrants, their professional advisors including independent accountants and not with the Commission or its staff. See the Commission's statement "Timely Disclosure of Material Corporate Developments," dated October 15, 1970 (Release 33-5092).

Where a material portion of the business of a company is represented by defense or other contracts, or sub-contracts, which are subject to renegotiation of profits or termination at the election of the government, disclosure of certain risks characteristic of such operations should be furnished. Such business

will be deemed material where it contributed to the operations of the company in either of the last two fiscal years:

a. 10 percent or more of the total sales and revenues; or

b. 10 percent or more of income before income taxes and extraordinary items computed without deduction of loss resulting from operations of any line of business; or

c. a loss which equalled or exceeded 10 percent of the amount of income specified in b. above.

The following disclosures should be furnished in connection with annual or other required financial statements included in registration statements and reports under the Securities Act of 1933 and the Securities Exchange Act of 1934 and annual reports to shareholders but excluding quarterly reports to the Commission on Form 10-Q. Such material may be included in notes to financial statements or in material accompanying such financial statements as in reports to shareholders.

1. The dollar amount of unfilled orders under such contracts together with appropriate disclosure with regard to future periods during which performance under such orders is expected to take place. Indicate whether contracts are funded and if not the significance of this circumstance.

2. Major programs, and major contracts included thereunder, should be described including indicating whether products or research and development are involved.

3. The type of contract or contracts under which the company operates, (for example fixed price, cost-plus, etc.), should be disclosed with an explanation of how each type affects profitability and future claims for allowable costs.

4. The difficulty in estimating costs to complete especially in the early stages of the contract. For example, the contract, or contracts, may call for complex weapons systems involving significant technological advances; may be performed over extended periods of time; or may be subject to numerous changes in specifications and changes in delivery schedules; or that costs may be incurred which were not anticipated at the time a bid was submitted for the contract. Additionally, the contractor may incur substantial costs before reaching agreement with the government on the price for such contract changes. (Thus, at any given time in the performance of such a contract an estimate of its profitability is subject not only to additional costs to be incurred but also to the outcome of future negotiations or possible claims relating to costs already incurred.)

5. The fact that the contracts are subject to renegotiation of profit and to termination for the convenience of the government together with the possible financial impact of renegotiation or termination upon the company.

6. The possibility that the extended periods of time may be required to settle claims, and that during such periods the possibility exists, due to the magnitude of the contract, that working capital of the company may be seriously impaired.

7. The method used to account for government contracts for financial reporting purposes should be stated, i.e., percentage of completion, or variation thereof, and a brief description of such method.

8. Material expenditures or commitments made in anticipation of securing contracts and material expenditures or commitments for which reimbursement is not specifically provided by existing contracts or agreements.

9. Known problems in meeting specifications or delivery schedule which could result in additional expense to the company.

10. At any time a material cost overrun has been incurred, the aggregate gross amounts of such overruns should be disclosed. Cost overruns are the costs incurred to date plus the estimated costs to completion which exceed the price set in the contract plus negotiated amounts allowed or allowable by the government in excess of the original price.

11. The amounts, and the status, of any claims on government contracts other than those arising from renegotiation of profits whether by the government against the company or the company against the government.

Appropriate mention of the risks of such government contract business should be included in an introductory statement in a registration statement under the Securities Act of 1933 as provided in paragraph 6 of Release No. 33-4936, "Guides For Preparation and Filing of Registration Statements." The information called for by paragraph 31, Disclosure of Recent Developments - Backlog, should be furnished.

These guidelines are not intended to supplant provisions of existing directives for specific disclosures nor to specify accounting treatment to be reflected in financial statements. In this connection attention is invited to Accounting Research Bulletin No. 43 published by the American Institute of Certified Public Accountants. Chapter 11 of the bulletin, entitled "Government contracts" sets forth certain accounting and disclosure standards with respect to defense supply contracts. See Accounting Research Bulletin No. 43 issued by the American Institute of Certified Public Accountants.

The proposed guidelines should not be applied inflexibly where other disclosure would result in a more meaningful presentation of information.

Although the staff generally intends to follow the proposed guidelines set forth above, comments on those proposed guidelines from interested persons are invited and should be directed to Alan B. Levenson, Director, Division of Corporation Finance, Securities and Exchange Commission, Washington, D. C. 20549.

For Release June 22, 1972

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

Securities Act of 1933
Release No. 5263
Securities Exchange Act of 1934
Release No. 9650

NOTICE TO REGISTRANTS ENGAGED IN DEFENSE AND OTHER LONG TERM CONTRACTS AND PROGRAMS OF THE NEED FOR PROMPT AND ACCURATE DISCLOSURE OF MATERIAL INFORMATION CONCERNING SUCH ACTIVITIES

The Securities and Exchange Commission today emphasized the need for publicly held companies to make prompt and accurate disclosure to securities holders and the investing public of material information, both favorable and unfavorable, with respect to progress and problems encountered in the course of performing under long-term contracts and programs involving significant technical or engineering problems and significant dollar amounts, including certain defense procurement contracts.

There are a number of factors arising from defense and other forms of long-term contracting on which clear and meaningful disclosure is necessary if the public is to be adequately apprised of the investment merits and risks of the securities of companies significantly involved in this type of business. Many defense contracts, for example, are extremely complex in their terms, calling for multi-faceted weapons systems involving significant technological advances; such contracts may be performed over extended periods of time and may be subject to numerous changes in specifications or in delivery schedules. In addition, significant additional costs may be incurred which were not anticipated at the time a bid was submitted for the contract. A contractor also may incur substantial costs before reaching agreement with the

Government on the price for any contract changes. Thus, at any given time in the performance of such a contract an estimate of its profitability is often subject not only to additional costs to be incurred but also to the outcome of future negotiations or possible claims relating to costs already incurred. While long-term defense contracts have presented significant examples of these factors, there can be comparable risks and disclosure problems in other long-term contracts or programs, particularly those involving advanced technology.

Government contracts are subject to renegotiation of profit and to termination for the convenience of the Government, which in some cases may have a material financial impact upon the company. Extended periods of time may be required to settle claims and during such periods the possibility exists, particularly in major contracts, that the working capital of the company may be materially affected.

Contracts also vary as to type, such as, for example, cost-plus-fixed fee, fixed price, fixed price incentive, and so on. The ability to estimate progress at any given time may vary from contract to contract depending in part on the type of contract and its terms.

Because of the above factors, costs to be incurred in the performance of such contracts and ultimate profit to be realized often cannot be known in the early stages of the contract. Accordingly, such matters are necessarily the subject of estimates which are difficult to make with any certainty. Nothwithstanding such difficulties, registrants have an obligation to make every effort to assure that progress on material contracts -- such as earnings, losses, anticipated losses or material cost overruns -- is properly reflected in the registrant's financial statements and, where necessary to a full understanding, discussed in appropriate textual disclosure.

The Commission in emphasizing its concern about adequate disclosure in these areas has taken into account the report of the staff, released today, on disclosure practices of com-

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panies engaged in defense contracting1/ and the problems encountered by certain defense contractors as illustrated by the brief case studies contained in that report.

The defense contracting investigation was instituted following the public release of an investigative staff report on the Lockheed Aircraft Corporation.2/ The severe problems encountered by Lockheed in connection with its C5A contract, viewed in the light of the investigative record in that matter, raised questions as to whether the various disclosures made by Lockheed concerning its problems had in retrospect been adequate. With respect to certain aspects of the C5A contract the staff in its Lockheed report concluded:

> "While there was a very general disclosure . . . touching upon some of these points . . . the statements made did not fully and adequately disclose all pertinent factors and it requires much reading between the lines, with knowledge of the underlying circumstances, to catch the issues and the real risks facing this Company."3/

In view of the situation disclosed in the Lockheed report the Commission was concerned as to whether the Lockheed C5A contract involved problems typical of the defense industry. The Commission directed the staff to conduct an inquiry for the primary purpose of gathering information concerning disclosure of defense contracting and determining whether the Commission's rules and forms were adequate or whether they could or should be revised to provide a basis for improved disclosures in the future by such companies.

1/ See, "In the Matter of Disclosures by Registrants Engaged in Defense Contracting," Administrative Proceeding File No. 3-2485 (June 22, 1972).

2/ See, "Report of Investigation in Re Lockheed Aircraft Corporation, HO-423 (May 25, 1970).

3/ Ibid. page 58.

The defense contracting report has concluded that the Commission's present rules and disclosure forms are generally adequate and no amendments appear necessary. The staff noted, however, that the application of the present requirements by some defense contractors could be improved. Among other things, it was noted that disclosures vary in quantity and quality from company to company and to some extent according to the nature of the document in which they are contained -- for example between the Form 10-K and Annual Report to Stockholders. In view of the fact that of these two documents, only the Annual Report to Stockholders receives wide public dissemination, the Commission urges issuers to make every effort to assure that disclosures contained therein are as complete and accurate as those contained in documents filed with the Commission. In this connection, the Commission has published for comment and is presently considering adoption of an amendment to Form 10-K which would require specification by all reporting companies of items of information supplied in Form 10-K but omitted from the Annual Report to Stockholders.4/

The Commission has considered the issuance of a release containing specific guidelines for disclosure by registrants engaged in defense contracting or other long-term, material dollar amount operations involving similar risks. The Commission recognizes, however, that the nature of such undertakings, particularly in the area of long-term contracts involving procurement of sophisticated weapons systems, involves such varied and complex considerations -- including severe definitional problems -- as to make the imposition of inflexible guidelines impracticable. Rather, the Commission regards it as incumbent on issuers to assess the special problems in each material contract or program with a view to making adequate and understandable public disclosure. Further, in considering whether to issue formal guidelines, the Commission noted that the staff's report covers a period of time when procurement was often conducted under the concept of "Total Package Procurement", the method which played such a major part in the difficulties surrounding the

4/ Securities Exchange Act of 1934, Release No. 9576 (April 20, 1972).

Lockheed C5A contract. The Department of Defense has since recognized that development of major weapons systems by its nature is dealing with the unknown, and does not contemplate continued use of the Total Package Procurement method, providing instead that contracts and subcontracts calling for the development of a weapons system, wherever appropriate, will be on a cost contracting basis rather than a fixed price method.

Corporate managers are urged to review their policies with respect to corporate disclosure on defense and other long-term contracting and ensure that adequate disclosure policies are followed with respect to reports filed with the Commission or distributed to investors. The Commission further emphasizes that the responsibility for prompt and adequate disclosure rests with registrants and their professional advisors. The Commission also wishes to reiterate the statements made in our 1970 release regarding "Timely Disclosure of Material Corporate Developments."5/

By the Commission.

Ronald F. Hunt, Secretary

5/ Securities Act of 1933, Release No. 5092 (October 15, 1970).

REPORT TO THE SUBCOMMITTEE ON PRIORITIES AND ECONOMY IN GOVERNMENT JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

Use Of Government—Owned Equipment By Certain Large Contractors On Commercial And Defense Work B-140389

Department of Defense

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

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

B-140389

Dear Mr. Chairman:

This is our report in reply to your request of April 29, 1971, that we examine into statements by representatives of the National Tool, Die and Precision Machining Association that large defense contractors using Government-owned equipment have an advantage over smaller contractors in competing for commercial and defense work.

As agreed with your office, we have not followed our usual practice of obtaining written comments from the agency and the contractors involved. We will not distribute this report further unless copies are requested and we obtain your agreement or unless you publicly announce its contents.

Sincerely yours,

Comptroller General
of the United States

The Honorable William Proxmire
Chairman, Subcommittee on Priorities
and Economy in Government
Joint Economic Committee
Congress of the United States

Contents

ABBREVIATIONS

ASPR	Armed Services Procurement Regulation
GAO	General Accounting Office
GE	General Electric Company
IPE	industrial plant equipment

COMPTROLLER GENERAL'S
REPORT TO THE SUBCOMMITTEE
ON PRIORITIES AND ECONOMY
IN GOVERNMENT
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

USE OF GOVERNMENT-OWNED EQUIPMENT
BY CERTAIN LARGE CONTRACTORS
ON COMMERCIAL AND DEFENSE WORK
Department of Defense B-140389

D I G E S T

WHY THE REVIEW WAS MADE

On April 28, 1971, representatives of the National Tool, Die and Precision Machining Association testified before the Joint Economic Committee's Subcommittee on Priorities and Economy in Government. They cited 14 examples in which contracts had been awarded to large defense contractors that used Government-owned industrial plant equipment to perform tooling and production work which the representatives said could have been done more economically by small tool contractors if truly competitive conditions had prevailed.

The representatives said that use of such equipment gave large contractors a competitive advantage because the rent they paid the Government was less than the cost of private ownership incurred by the small tool contractors. The representatives said also that large contractors had virtually a blanket authorization to use the equipment for any commercial or Government program. The Chairman of the Subcommittee requested that the General Accounting Office (GAO) investigate the matter.

Department of Defense policy and practice

The Department of Defense policy is to remove Government-owned equipment from contractors' plants when the equipment no longer is needed. The question of retention of Government-owned equipment at contractors' plants is being covered in depth in another review, and the results will be included in a forthcoming report. (See p. 5.)

When retention is allowed contractors usually are permitted to use the equipment for commercial work if they obtain advance written authorization. Generally the equipment is used rent-free on Government work, but rent is charged for commercial use by the following method.

The cost of the equipment is multiplied by percentage rates prescribed in the Armed Services Procurement Regulation (ASPR) for the age of equipment to determine the gross rent. The percentage of contractor effort on Government work (based on direct labor hours, sales, machine hours, or other equitable measures) is applied against the gross rent to arrive at the rent charged for commercial use. (See p. 4.)

Charging rent for commercial use is intended to equalize competition for commercial work. To evaluate competing bids for Government work, the bids of contractors having rent-free use of Government-owned equipment are increased by the rental value assigned to the equipment. (See p. 4.)

FINDINGS AND CONCLUSIONS

The association's 14 examples included 12 in which the contractors had performed commercial tooling work and two in which Government work had been involved. The amounts and periods of performance of some differed from the data given in the testimony. Also one award mentioned in the testimony had not been made. One similar in many respects to those cited by the association was added in its place. (See p. 6.)

Commercial work

In all 12 examples the contractors used Government-owned equipment in the performance of their commercial work. In eight of the examples, it appeared that the equipment was used without proper authorization, and, in two of the examples, the method used to compute the rent credit was disadvantageous to the Government. (See p. 6.)

GAO could not determine whether the use of Government-owned equipment gave the contractors a competitive advantage because ASPR did not require, nor did the contractors maintain, machine-use records. Such records would have identified the specific Government machines and the number of machine hours used to fabricate commercial tooling. Without these records GAO could not determine the costs of renting the equipment from the Government and thus could not compare the costs of renting with the costs of private ownership. (See p. 6.)

In seven examples contractors were awarded the tooling orders because they had the capacity to absorb the large numbers of machining hours required and had the skills needed to design and test the tools. It was not feasible to determine the extent to which the availability of large amounts of Government-owned equipment contributed to the contractors' capacity and skills.

GAO believes, however, that a contractor with large amounts of Government-owned equipment often benefits in that it can solicit defense and commercial work without the need for additional capital investment. (See p. 7.)

Government work

In the two examples involving Government work, the contractors had authorization to use Government-owned property on a rent-free basis. Such usage, however, was not the determining factor in their winning the awards. (See p. 19.)

RECOMMENDATIONS OR SUGGESTIONS

A forthcoming report to the Congress will include recommendations to the Secretary of Defense for establishing a uniform and equitable method of computing rent and for improving controls of Government-owned plant equipment in the custody of contractors. (See p. 5.)

CHAPTER 1

INTRODUCTION

During testimony on April 29, 1971, the Chairman of the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee asked the General Accounting Office to examine into statements made during testimony on the previous day by representatives of the National Tool, Die and Precision Machining Association. The association claimed that the Government allowed large defense contractors to enjoy a competitive advantage over small contractors by permitting the large contractors to use billions of dollars worth of Government-owned industrial plant equipment (IPE) on commercial and Government work.

A competitive advantage exists, according to the association, because the rent paid by contractors for the use of Government-owned IPE is far less than the cost of ownership or commercial lease. Most IPE consists of standard general-purpose machine tools--the same type purchased privately by association firms. The association also said that these large contractors have virtually a blanket authorization to use the equipment for any commercial or Government program. These conditions, the association claimed, have caused small contractors to lose a large segment of their traditional markets to large defense contractors.

The association cited 12 examples in which large contractors allegedly had used Government-owned IPE and other types of property for machining and tooling work on commercial aerospace programs, which small contractors could have performed more economically if truly competitive conditions had prevailed. Also mentioned were two examples of small contractors competing unsuccessfully for defense work against large contractors having Government-owned equipment. Excerpts from the association's testimony concerning the 14 examples appear in appendix I.

REVIEW OBJECTIVES

We conducted our review at each of the contractor locations mentioned in the testimony to determine whether the contractors

--had used Government-owned equipment on the orders,

--had enjoyed a competitive advantage because of any such use, and

--had received authorization and had paid rent for any such usage in accordance with the applicable regulations.

DEPARTMENT OF DEFENSE POLICY

The policies concerning a contractor's use of Government-owned property are set forth in ASPR section 13 and in the appropriate contract clauses in section 7. ASPR appendix B, 603.1, states that contractors must report to the Government contracting officers all items of IPE for which retention is not justified. When retention is allowed contractors are permitted generally to use the equipment for their commercial work if they obtain advance written authorization. Also special permission is required in advance if IPE is to be used commercially over 25 percent of the time it is available for use.

Generally the equipment is used rent-free on Government work, but contractors are charged rent for commercial use by the following method. The acquisition cost of the equipment is multiplied by rental rates prescribed in ASPR 7-702.12 for the age of equipment to determine the gross rent. The percentage of contractor effort on Government work (based on direct labor hours, sales, machine hours, or other equitable measures) is applied against the gross rent to arrive at the rent charged for commercial use.

Charging rent for commercial use is intended to equalize competition for commercial work. For Government work ASPR 13-501 requires that, to evaluate competing bids, the bids of contractors having rent-free use of Government equipment be increased by the rental value assigned to the equipment.

RELATED GAO REVIEWS

In November 1967 GAO reported to the Congress (B-140389) that there was a need for improvements in controls over Government-owned property in contractors' plants. Our findings indicated that:

--Equipment was being used without proper authorization.

--Contractors' records did not reflect adequately the extent and manner of use.

--Equipment with little or no use was being retained, although some was needed for defense work at other locations.

--A lack of uniformity in the methods used to compute rent was resulting, in some cases, in inequitable rental payments.

Currently we are making a follow-up review of these matters. Our preliminary findings indicate that there is a need for further improvements in all of these areas. The forthcoming report to the Congress will contain specific recommendations to the Secretary of Defense on these matters.

CHAPTER 2

USE OF GOVERNMENT PROPERTY ON COMMERCIAL WORK

The association's 12 examples of large defense contractors using Government-owned property on commercial tooling orders included:

--Five examples in which North American Rockwell Corporation had received tooling orders from other large contractors.

--Three examples in which large contractors had received tooling orders from McDonnell-Douglas Corporation.

--Four examples concerning Lockheed Aircraft Corporation; two involved work performed in-house, and two involved tooling orders awarded to other large contractors.

We found that the aircraft programs involved and the values and periods of performance differed from the data given in the association's statements. We deleted one of the McDonnell-Douglas awards from our examination because it had not been made. We substantiated, however, that the major aerospace contractors in the 11 remaining examples cited had used Government-owned equipment in the performance of their commercial work.

Government-owned equipment also was used in commercial work awarded by Lockheed to North American; this award was not cited by the association but was added to our review because it was similar in many respects to the above examples. In two examples we found that the method used to compute rent was disadvantageous to the Government, and in eight examples it appeared that Government-owned equipment was used without proper authorization.

We could not determine if the use of Government-owned equipment gave the contractors a competitive advantage because they did not maintain use records which would identify the specific Government machines or the number of machine hours used to fabricate commercial tooling.

In most cases rent was computed on the basis of direct labor hours. This method, which is permitted by ASPR 7-702.12, provides for estimating the direct-labor-hour ratio of Government work to the total direct labor hours for all the contractor work. This percentage is used to compute the rent credit to reduce the gross rent. Use records for each machine are not required to estimate direct labor hours. Without adequate use records we could not determine which items of equipment were used for the tooling awards cited, and consequently we could not make a comparison of rental costs with ownership costs.

In seven examples large contractors were selected because they had the capacity to absorb the large numbers of machining hours which were required in a short time and had the skills needed to design and test the tools. It was not feasible to determine the extent to which the availability of large amounts of Government-owned equipment contributed to the contractors' possession of the requisite capacity and skills.

The five other examples included:

--One example in which the receiving contractor had been the only acceptable bidder.

--Two examples in which the awarding contractors refused to discuss why they chose a large contractor.

--Two examples in which the work had been performed in-house.

We believe, however, that a contractor with large amounts of Government-owned equipment often benefits in that it can solicit defense and commercial work without the need for additional capital investment.

A schedule of the contractors included in the review, the values of the orders received, the rents paid, and the acquisition costs of Government-owned property in their custody as of June 30, 1971, is shown as appendix II.

AWARDS TO NORTH AMERICAN ROCKWELL CORPORATION

According to association testimony North American Rockwell Corporation received commercial tooling orders worth about $19.5 million from five large defense contractors during 1970 and 1971. As we indicate below, however, the orders took place in an earlier period and the value of the awards totaled $60.4 million. We identified an additional award of $1.9 million received by North American from Lockheed-California Company for commercial tooling and included it in our review. The amounts and time periods of the orders are as follows:

Contractor	Time period	Program	Value of award (000 omitted)
Aeronca, Inc., Aerocal Division	1969-70	Lockheed L-1011	$ 215
Goodyear Aerospace Corp., Arizona Division	1966-69	Boeing 747	6,500
Boeing Company	1965-69	Boeing 727, 737, and 747	25,565
Mc Donnell-Douglas Corporation	1964-68	DC-8 and 9	15,202
Northrop Corporation, Norair Division	1967-68	Boeing 747	12,929
Total			60,411
Lockheed-California Company	1968-70	L-1011	1,918
Total			$62,329

Generally the orders involved planning, designing, fabricating, and testing the tools. Goodyear, Northrop, and Lockheed selected North American because:

--Large amounts of machining hours were required in short periods of time.

--The orders required tool-planning and tool-designing expertise, special facilities to handle big tools, and computer processing systems.

--Administrative problems would occur if numerous small firms were used.

Aeronca officials stated that they had chosen North American because it was the only acceptable bidder. Boeing refused to discuss the selection because the contracts had been for commercial programs. McDonnell-Douglas refused to discuss awards made so long ago.

North American had authorization to use Government-owned IPE on commercial programs during the period 1965-69. During 1971 the contractor had about $19 million worth of Government-owned machinery and equipment, including about $1 million worth in the tooling department. The tooling department also had about $2.6 million worth of contractor-owned equipment.

We could not determine how much Government-owned IPE was used on the orders because North American did not keep machine-use records adequate for this purpose. From other records it appeared that the majority of the machining work was performed on Government-owned IPE and that some of the equipment was used commercially over 25 percent of the time it was available for use. Although they had permission to use the equipment for commercial work, they did not comply with the requirement in ASPR 13-405 that advance approval be obtained from the Secretary of the department concerned, or, in some cases, from the Office of Emergency Preparedness, for commercial use in excess of 25 percent until fiscal year 1970.

Rent paid from March 1966 to September 1970 for use of Government-owned IPE in all departments totaled $3.9 million. North American officials stated that rent on these orders totaled about $959,000. We could not verify this amount because equipment-utilization records showed total hours used but not the amount of use of Government-owned IPE on commercial programs. Generally North American computed its rents in accordance with the provisions of ASPR.

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MCDONNELL-DOUGLAS CORPORATION AWARDS
TO LARGE DEFENSE CONTRACTORS

Association testimony indicated that the following four contractors had received tooling orders from McDonnell-Douglas Corporation during 1970 and 1971.

Contractor	Aircraft program	Value of award (000,000 omitted)
Aeronca, Inc.	DC-10	Over $3
Convair Aerospace Division, General Dynamics Corporation	DC-10	$5
North American Rockwell Corporation (note a)	DC-8	$4
Rohr Corporation	DC-10	(b)

[a]Discussed on pp. 8 and 9.

[b]Value not stated.

The information we developed indicated that:

--Aeronca bid on a $3 million DC-10 tooling order but, according to corporation officials, was not awarded the contract.

--The award to Convair involved a contract for more than $500 million for the production of DC-10 fuselages, and it included the design and fabrication of the necessary tooling valued at $45 million. Convair started the tooling work late in 1968.

--Rohr's contract on the DC-10 was for the production of the engine pods and included the design and fabrication of the tooling needed in production. Rohr started using Government-owned IPE on the tooling in March 1969.

The association stated that Rohr had sent some of its DC-10 tooling work from its main plant at Chula Vista, California, to its leased facilities in Riverside, California. Rohr officials justified the transfer by stating that

it was their policy to manufacture tooling in-house whenever possible. We found that the Riverside plant was not leased but was owned by Rohr, as evidenced by their property tax bill.

The DC-10 orders cited by the association had not been awarded to small contractors, according to McDonnell-Douglas officials, because:

--The orders were package procurements--the supplier had to design and fabricate the tooling and manufacture the part.

--Douglas was not able to coordinate and manage a subcontracting effort using many small suppliers.

--The large DC-10 contractors were not reimbursed until they delivered the parts to McDonnell and small business would not have been able to accept this arrangement.

McDonnell-Douglas officials said, however, that small contractors had received 2,896 of the 3,750 tooling orders awarded on the DC-10 during the period from January 1969 to July 1971. The orders included production of machine tools and tool and die fixtures for portions of the aircraft fabricated at various McDonnell-Douglas plants.

Convair officials stated that through June 1971 they had used 13,000 machine hours on Government-owned IPE for producing both tooling and aircraft parts. Their records do not identify the machines used or the number of machine hours expended on the production of tooling alone. The records at Rohr also are of limited value for identifying machine utilization. A company official estimated that Rohr had used Government-owned IPE for 12,000 machine hours on DC-10 tooling and estimated that Rohr had paid $18,000 in rent for these hours.

In both situations the companies had authorization to use the Government-owned IPE on commercial work. They computed rent on the basis of machine hours. It was not possible, however, to relate the rent paid to the DC-10 tooling work. We did test their rental computations, however, and confirmed that they were developed in accordance with the ASPR provisions.

LOCKHEED AIRCRAFT CORPORATION AWARDS TO LARGE CONTRACTORS AND IN-HOUSE ORGANIZATIONS

Association testimony

The association representatives testified that Lockheed Aircraft Corporation had used Government-owned IPE on tooling work for its commercial L-1011 aircraft in Government-owned, contractor-operated facilities at Van Nuys, California, and Marietta, Georgia. According to the representatives:

--Lockheed awarded L-1011 tooling orders, which were performed with Government facilities, to the Martin-Marietta Corporation and the LTV Aerospace Corporation.

--LTV's orders, worth $3 million to $5 million, were negotiated to include a composite rate of $0.31 per hour for the use of Government-owned IPE, whereas a firm using its own would normally charge about $4 per hour.

Lockheed-California

The L-1011 is produced by Lockheed-California Company, a division of Lockheed Aircraft Corporation, at facilities in Burbank and Palmdale, California. Tooling fabrication began in June 1968 and is being performed in four buildings at Burbank, two of which are Government-owned, and in a Lockheed-owned plant at Palmdale. Lockheed-California officials advised us that Government-owned plant equipment at the Van Nuys facilities (owned by the city of Los Angeles, California) was used exclusively for a military helicopter program. Navy plant representatives confirmed Lockheed's statement.

As of August 1968 Government facilities costing about $40 million were at Lockheed-California. On April 21, 1970, the General Services Administration agreed to sell nearly all of these facilities to Lockheed for about $30 million. The price was based on an independent property appraisal performed on November 30, 1968. Passage of title is awaiting clearance by the Department of Justice.

We could not determine the extent to which Government-owned IPE was used on L-1011 tooling because machine-use records were not retained. From June 1, 1968, to April 21, 1970, Lockheed-California paid the Government about $2 million for commercial use of Government facilities. According to Lockheed officials, about $1.9 million of the rent was for the L-1011 program. This included about $285,000 for tooling.

From our limited review it appears that the rent computations--which were based on direct labor hours--were in accordance with ASPR through April 21, 1970. Since then, under an agreement with the General Services Administration, Lockheed-California has been incurring a fixed daily possession fee of about $5,000, payable over and above the selling price when title to the property is conveyed. The accrued fee was about $3.3 million at the end of January 1972. If the sale is not made, rent for this period will be recomputed using the ASPR rates.

Lockheed-California used Government facilities on the L-1011 for over a year without advance written authorization as required by the ASPR clause in its facilities contracts. Contractor and Department of Defense officials agreed that the requirement for written authorization was overlooked but pointed out that there was full knowledge of the rental payments, indicating apparent Government permission for the usage.

Lockheed-Georgia

Lockheed-Georgia Company began work on the L-1011 program in April 1968. Lockheed-Georgia designs, fabricates, and assembles the tail section in a Government-owned, contractor-operated plant at Marietta and in privately leased plants at Charleston, South Carolina; Chattanooga, Tennessee; and Meridian, Mississippi. Meridian was the only plant not having Government equipment during L-1011 production.

The work cited by the association consisted of 7,596 tooling orders for the L-1011's fuselage, which required about 232,000 direct labor hours and represented about $3 million in sales. The work, which originally was to be

performed at Lockheed-California, was transferred to Lockheed-Georgia's Marietta plant during the period October 1969 through May 1971 because Marietta's tooling departments had excess capacity and California's were overloaded. The transfer prevented a layoff at Marietta. Small tool and die firms could have completed the orders, according to Lockheed-Georgia officials, because Lockheed-California had performed most of the tool design and had enclosed, with each order, a blueprint of the tool and the part it produced.

Three tooling departments performed 95 percent of the orders. On August 31, 1971, these three departments had 239 pieces of IPE, costing about $4 million, of which 161 pieces, costing $3.4 million, were Government owned. Because Lockheed-Georgia does not maintain usage records on each piece of equipment, there is no way to determine the extent to which Government machines were used on the tooling orders of the L-1011 program. A Lockheed-Georgia official stated it was his company's policy to use its own equipment, if available, on commercial work.

From January 1968 to July 1971, Lockheed-Georgia paid about $981,000 in rent for commercial use of Government facilities at five of its plants. About $587,000, including about $39,000 for the tooling orders, was attributable to the L-1011 program. According to Department of Defense records, Government facilities costing about $145 million were at Marietta as of June 30, 1971. Lockheed-Georgia computed rent using the rental formula in ASPR. On the basis of our test, however, the rental payments appeared to be unreasonably low because the methods used to estimate Government and commercial usage--direct labor hours and square footage--were not refined sufficiently or were inequitable.

For March 1971 we recomputed the rent due for personal property by allocating direct labor hours, between Government and commercial work, at a lower organization level (burden center) than did Lockheed. We recomputed also the rent due on real property on the basis of a direct-labor-hour allocation. The contractor classified the space associated with the real property as Government, commercial, or joint use. The gross rent for the month was allocated to the Government and Lockheed by a "sharing ration" which is the ratio of Government to commercial square footage. Joint space was allocated in the same sharing ration.

On the basis of our review of the contractor's operations, however, it appeared that joint space was being used more extensively for commercial purposes than was indicated by the sharing ration. We feel that it would be more equitable to compute rent for real property on the basis of a direct-labor-hour allocation. A comparison of our rent computations and the amounts actually paid by Lockheed for commercial use in March follows:

	Personal property	Real property	Total
GAO computations	$17,099	$12,608	$29,707
Paid by Lockheed	10,681	1,892	12,573
Difference	$ 6,418	$10,716	$17,134

Lockheed-Georgia used Government-owned IPE on the L-1011 program for over half of the production period without obtaining the renewed written authorization required by ASPR 13-405. The contractor periodically informed the Government contracting officers, in a statement accompanying the rental payments, that Government facilities were being used on the L-1011. The contracting officers stated that the requirement for written authorization was overlooked.

We plan to issue a report to the Secretary of the Air Force, the service primarily involved, informing him of these and other deficiencies in the contract administration at Lockheed-Georgia.

Tooling orders on the L-1011

Lockheed-California awarded $21.7 million in tooling orders, as follows:

Source	Value of orders (millions)
Large business--4 firms	$ 7.7
Small business--56 firms	14.0
Total	$21.7

The orders for $7.7 million in tooling work were awarded to LTV Aerospace, Martin-Marietta, North American Rockwell,[1] and the Boeing Company's Wichita Division which we excluded from the review because its award was for less than a half million dollars. Lockheed selected these firms because:

--Most of the work was needed in a short period of time.

--The orders were for entire segments of the aircraft.

--The contractors generally were required to plan, design, and test the tools.

--Using many small firms would have created administrative, scheduling, and engineering problems.

--Small firms would have had to sublet part of the work.

LTV Aerospace Corporation

The L-1011 orders to LTV required about 72,000 tool fabrication hours and, according to LTV officials, represented about $1 million in sales. The orders were performed at the Michigan Army Plant--a Government-owned, contractor-operated facility--from June to October 1969.

LTV used, with authorization, about $2 million worth of the nearly $18 million in Government-owned IPE at the plant as of June 30, 1971. Company officials could not recall if they had used any of their own equipment. For the use of Government facilities, LTV paid about $31,000 in rent, most of which was for 9,200 machine hours on IPE. The effective rental rate on IPE was about $2.35 a machine hour, according to our estimate. The rental rate for each labor hour (31,000 ÷ 72,000 hours) was $0.43. Lockheed reimbursed LTV for the actual amount of rent paid.

A representative of the association testified that a composite rate of $0.31 an hour was negotiated for the use of Government-owned equipment on LTV's tooling orders,

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[1]Awards to North American are discussed on pages 8 and 9.

whereas the corresponding rate for a firm using its own equipment would be about $4 an hour. We interviewed the representative concerning the basis for the $4 rate, and he advised us that he did not have any documentation to support it. He advised us also that the rate for his company at full capacity was about $0.35 an hour, although at current capacity the rate was $0.72 an hour.

We believe that the formula used by LTV to compute the rent payment was disadvantageous to the Government. Under LTV's formula the gross rental was computed by using the ASPR rates. LTV's share of the gross rent, however, was based on the number of machine hours used on commercial work in relation to the total machine hours available each month--176 hours. In our opinion the only method which can be relied upon consistently to produce an equitable allocation of the rental charge is one in which the total actual machine hours used are the basis for prorating commercial and Government work as provided for in ASRP. In this way the Government and the contractor share in the cost of ownership of the equipment in the ratio that it is used for each purpose.

We were advised by local officials of the Defense Contract Administration Services office that LTV's rental formula complied with the "use and charges" clause of ASPR 7-702.12. The clause states that the measurement unit for determining the amount of use of the facilities by the contractor can be any unit which will result in an equitable apportionment of the rental charge as may be mutually agreed to.

The officials indicated that Defense Contract Audit Agency personnel had been involved in the decision to use this method. The officials indicated also that ASPR, in suggesting the use of actual hours rather than hours available for use, may be directed more toward contractor-owned facilities using Government equipment than toward Government-owned plants. They pointed out that in a Government-owned, contractor-operated plant the facilities were there at all times to accomplish the mission for which the plant was intended.

LTV keeps records indicating the number of machine hours of commercial use but not of Government use; therefore

we could not determine the total hours the machines were used and, as a result, could not compute what the rent should be.

Martin-Marietta Corporation

The Baltimore Division of Martin-Marietta Corporation, Middle River, Maryland, used Government equipment in performing L-1011 tooling and parts fabrication orders awarded by Lockheed during 1969 and 1970. It was not possible to determine the extent to which the equipment was used because Martin did not maintain usage records. There was an average of $8.7 million worth of Government equipment at Martin during 1969 and 1970 that was available for L-1011 work. The contractor had authorization to use the equipment, and the contractor's rent computations, based on direct labor hours, were in accordance with ASPR. A table summarizing the value of the orders, the labor hours, and rent paid follows.

	Amount	Direct labor hours expended	Rent paid for use of Government facilities	Rent per labor hour
		(000 omitted)		
Sales to:				
Lockheed-California:				
Tool fabrication, design, and liaison services	$3,930	220	$63	
Parts fabrication	693	43	14	
Total	4,623	263	77	$0.29
Lockheed-Georgia:				
Tool fabrication	674	43	12	
Parts fabrication	247	16	5	
Total	921	59	17	$0.28
Total	$5,544	322	$94	

CHAPTER 3

USE OF GOVERNMENT PROPERTY ON DEFENSE WORK

The two examples cited by the association concerning competitive advantage on defense work involved awards made to the Avionic Controls Department of General Electric Company (GE), Johnson City, New York, and Marquardt Company, Van Nuys. We found that both contractors had authorization for using, and had used, Government property on a rent-free basis. We concluded, however, that such usage was not the determining factor in their winning the awards. A synopsis of the association's testimony and our findings and conclusions follow.

AWARD TO GENERAL ELECTRIC COMPANY FOR MISSILE PARTS

Association testimony

A GE plant in New York recently underbid a small firm, Fibreform Electronics, Inc., Los Angeles, on a subcontract awarded by Hughes Aircraft Company for the Army's TOW (tube-launched, optically-tracked, wire-command link) missile system. GE bid low because it either anticipated using Government equipment at a fraction of its true rental value or wanted to "buy in" on the program. GE has leased an Air Force plant in Johnson City and is allowed unlimited commercial use of the plant and equipment.

GAO findings

Three of the major units of the missile system, designed primarily as an antitank weapon, are produced by the Hughes Aircraft Company, Culver City, California. During the latter part of 1970, Hughes received quotes from five firms--including GE's Avionic Controls Department and Fibreform, the former supplier--for 363 assemblies required for one of the units.

GE's unit price of $179, which was the lowest bid, was based on the rent-free use of Government facilities. GE received authorization for rent-free use of the facilities

for the assemblies. Fibreform's bid of $314 was the next lowest bid. These quotes did not include the costs of required forgings. GE advised Hughes that, without the rent-free use of Government facilities, its total price for the assemblies would be increased by $1,070, or by about $3 a unit. We found that the $1,070 was computed in accordance with ASPR and that it appeared to be a reasonable estimate of the value of the proposed use.

To eliminate the risk of awarding the entire assemblies requirement (subsequently reduced to 353) to GE as a new supplier, Hughes awarded 233 to GE and 120 to Fibreform during February and March 1971. A comparison of the quotes for 353 assemblies and for the actual quantities awarded follows. (These unit prices included amounts for required forgings.)

	Bidding on total requirement			Actual award		
	(Dollar amounts rounded)					
	Quantity	Unit price (note a)	Total	Quantity	Unit price (note a)	Total
GE	353	$240	$ 84,608	233	$261	$ 60,828
Fibreform	353	346	122,092	120	346	41,504
				353		$102,332

[a]Fibreform's price includes $32 for forgings to be supplied by Hughes. GE supplied its own and adjusted its price accordingly.

After deducting the shipping charges from GE's New York facilities to California, Hughes estimated that potential savings, from not awarding the entire amount to Fibreform, would be about $17,000.

A comparison of GE's negotiated labor estimates with its revised estimates, prepared prior to production, revealed that its labor costs were underestimated. GE officials stated that the underestimate was due to their failure to

adequately consider the manufacturing effort required. Based on the new labor estimates, GE's price would have been about $405, according to our calculations, and therefore would have been higher than Fibreform's bid.

GE's Avionic Controls Department had about $9.6 million worth of Government-owned land, buildings, and equipment and $11.3 million worth of its own equipment at the end of 1970. The leased Air Force plant referred to by the association accounted for about $6 million of the $9.6 million. The lease on the plant contains the standard Air Force facilities contract clauses which require the contractor to obtain permission to use equipment and to pay rent for non-Government use. The Avionic Controls Department paid a total of $30,000 in rent in 1970 for use of Government-owned equipment on commercial work, and rental computations appeared to be in accordance with ASPR. About 97 percent of the Controls Department's annual sales represented Government (rent-free) work.

Conclusions

We believe the rent-free use of Government facilities by GE was not the determining factor in its receiving the award. The estimated value of such usage, which seemed reasonable, would have increased GE's unit price by only about $3--not enough to have had any effect on the outcome of the award. We were unable to determine whether GE deliberately had underestimated its labor costs to buy in on the program.

AWARD TO THE MARQUARDT COMPANY FOR ROCKET WARHEADS

Association testimony

A small firm was underbid recently on an Army contract for rocket warheads by the Marquardt Company, a previous supplier. Marquardt, which received between $500,000 and $1,000,000 of Government equipment for use on the original buy, claimed that it now was going to use some of its own equipment, acquired as a standby line, and was going to leave most of the Government-owned equipment idle. The small firm offered to lower its bid if it could use the

idle equipment but was told by the Army that the equipment was not available.

Who funded Marquardt's standby line? How will the Government-owned equipment be used? Why is this equipment kept in a plant where it is not needed? The answers to these questions might illustrate serious allocation and surveillance problems in the management of Government-owned equipment.

GAO findings

In 1969 Marquardt initially was awarded a noncompetitive contract for the rocket warheads (designed for a lightweight antitank weapon system) because technical data was not adequate for competitive procurement. To start production and to establish an accelerated base for mobilization, the Army authorized Marquardt to purchase or construct seven items of IPE at a cost of $529,000. Only four of the items were used on the 1969 contract; Marquardt had technical problems with the other three.

The competitive contract referred to in the testimony was worth about $835,000 and was for 193,400 units awarded in two equal parts--one as a labor surplus set-aside--during March 1971. Marquardt was awarded the non-set-aside portion at $4.32 a unit. Atlas Fabricators, Inc., Long Beach, California, which was the small firm referred to in the testimony, submitted the next lowest bid at $5.04 a unit.

In accordance with ASPR 13-501, Marquardt's bid included an adjustment (upwards) of about $0.03 a unit for authorized rent-free use of three (of the seven) items of IPE costing $53,000. About 87 percent of the machine hours for the contract were to be performed by Marquardt's equipment, according to its estimate. Marquardt was constructing a separate production line with its own funds, which would perform the same operation, at a slower rate, as that of the Government-owned IPE. The use of all seven pieces of Government-owned IPE was not contemplated by Marquardt because it thought that such use would have made its bid less competitive.

We found that, had Marquardt intended to use the seven items of IPE, the adjustment factor would have increased its unit price by $0.33 a unit to $4.65--still lower than Atlas. Atlas and Marquardt also were low bidders on the set-aside portion. Atlas was offered it at an adjusted unit price of $4.36. Atlas protested the award of the set-aside claiming that all bidders should have had the opportunity to bid on the basis of using Government-owned IPE which was available to Marquardt. The Army denied the protest for the following reasons:

--ASPR 13-301 requires that competitive solicitations not include an offer by the Government to provide new facilities or to move existing facilities into contractors' plants unless adequate price competition cannot be obtained otherwise.

--The equipment in question was being used on the current contract (awarded in 1969) which was scheduled for completion in August 1971.

--The Marquardt Company is a base producer of the warhead under the Industrial Readiness Program, and therefore all Government equipment in its possession is required to support the mobilization requirements of the program.

In March 1971 Atlas declined the set-aside which then was awarded to Marquardt.

Conclusions

The availability and use of Government-owned equipment at Marquardt was not the determining factor in its being low bidder, since even if it had anticipated using all seven pieces of IPE its proposed unit price would have been lower than Atlas. The standby line referred to in the testimony was actually active equipment constructed with Marquardt's own funds, which could be used more economically than the equipment provided by the Government. The Government-owned equipment is being retained at Marquardt, however, to permit accelerated production in the event there is a mobilization requirement.

APPENDIX I

EXCERPTS FROM TESTIMONY BY REPRESENTATIVES OF THE NATIONAL TOOL, DIE AND PRECISION MACHINING ASSOCIATION BEFORE THE SUBCOMMITTEE ON PRIORITIES AND ECONOMY IN GOVERNMENT OF THE JOINT ECONOMIC COMMITTEE

APRIL 28, 1971

STATEMENT OF WILLIAM E. HARDMAN, EXECUTIVE VICE PRESIDENT, NATIONAL TOOL, DIE & PRECISION MACHINING ASSOCIATION, WASHINGTON, D.C.

Mr. HARDMAN. Thank you, Mr. Chairman. We all have very brief statements this morning. I do not think they can be summarized to make them any briefer than they are.

My name is William E. Hardman, and I am executive vice president of the National Tool, Die & Precision Machining Association, a trade organization headquartered in Washington, D.C., representing approximately 8,000 small businesses across the country. These companies are engaged in work essential to all mass production and metalworking: the production of dies, tools, molds, gages, special machines and other similar items, and the service of precision machining. Like any critical industry—and those particularly related to metalworking—we have had a deep and continuous involvement in defense-related work.

Accordingly, our association has maintained a protracted interest in procurement policies of the Federal Government: specifically, those areas in which we have felt that such policies have been disadvantageous for small businesses.

Mr. Chairman, we all listened with interest and full agreement with Admiral Rickover's comments with regard to the disparity that exists in our procurement agency's treatment of large and small contracts. We could easily expend ourselves relating the discriminatory treatment of small business, starting with the award of the contract on a truly competitive basis, all the way through renegotiations, with the sophisticated use of exemption and federally accepted accounting methods for noting overhead and GA costs on Government work, certainly giving the large contractors a tremendous advantage.

One of the big profits of the big crime, which has just now come to the surface, is the use of Government-owned equipment and that is why we are here.

MISUSE OF GOVERNMENT-OWNED EQUIPMENT IN HANDS OF CONTRACTORS

In the course of our participation over the past several years in a number of hearings before subcommittees of the House Small Business Committee, we have commented on a number of problems in the procurement area. But the problems we have found most distressing and most fundamental have been the abuses growing out of the Government's huge investment in machine tools and other production equipment which have been leased to large prime contractors for both Government and commercial usage.

APPENDIX I

I realize that your subcommittee has also taken a deep interest in this subject. The Government's huge investment in production equipment has represented a tremendous expenditure of taxpayer's dollars, while also maintaining a very high priority in the total defense budget. We believe this program began as a well-intentioned, essential program in World War II (and later in Korea) to meet objectives that could not otherwise be obtained. However, following Korea, the program went totally out of control, and has since resulted in a huge and unnecessary involvement by the Government in the private economy.

Specifically, the Government has created billions of dollars in equipment capacity in the plants of private contractors, much of which bears little or no relationship whatever to the original Government programs for which it was leased. Now—after many investigations, studies, hearings in Congress, and other proceedings—there has seemed to develop a general consensus that the Government should do something to change this situation. But all parties involved have terribly underestimated the deep entrenchment of these leasing programs in our total economy and, in particular, in the defense-related economy. We are hopeful that these hearings, and the information that is developed in them, will help to speed the day when some meaningful phaseout program gets underway.

Our interest in this subject is very simple, and we do not hesitate to call it a selfish interest. Over the past 20 years, Uncle Sam has supplied billions of dollars worth of IPE (Industrial Production Equipment) to the large defense prime contractors that constitute a major customer market for our industry. Most of this equipment has consisted of standard, general purpose machine tools—the same type of machinery which our companies have purchased themselves with their own funds, bearing the full risk of ownership. Most important, usage by a prime contractor of Government-owned IPE has not been limited solely to Government contract work. Rather, it has been used to expand into supplier markets such as ours, with the prime contractor performing both Government and commercial work. This means that small businesses with privately purchased IPE find it difficult to compete with such primes and, accordingly, have lost a large segment of their traditional markets.

The economics are basic and very simple: the system at its best gives a contractor a huge competitive advantage, because Government IPE is not costing as much as private equipment (assuming full usage) and involves no risk of under-utilization. If you do not use it, you do not pay for it.

That is at its best. But, it has not really worked that way. The system has, in fact, permitted virtually unrestricted use of IPE for any purpose a prime contractor wishes to make of it. And in many cases, including some recent ones we will discuss later, little if any thought it given to any reasonable charge for use.

What should be done about this? We should unwind the Government machinery-leasing program as best we can. Here are the priorities as we view them:

RECOMMENDATIONS

1. Abolish commercial use completely. This is the prime area of abuse and inequity.
2. Lease no further IPE except in truly essential situations.
3. Pull IPE out of Government-owned, contractor-operated and private contractor facilities unless it is truly essential and continues to be so.
4. Develop some workable means to sell or otherwise dispose of surplus IPE removed from contractor plants, with emphasis on competitive sale.

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With that general comment, let me turn to our other witnesses who will offer some recent circumstances of an abusive nature in the IPE leasing program that underscore some of the inequities that I have suggested. I might add that while there are only two company representatives here this morning, the information we will provide comes from quite a number of companies in the industry. I am compelled to say also that, while we are satisfied as to the reliability of all information we are presenting to the subcommittee, we could not, in most cases, give complete documentary proof of these situations, nor would we wish to disclose publicly the names of individuals in the various involved companies who have gathered information. Of course, all of the situations we will comment on before the subcommittee this morning could easily be investigated by the Government, and the truth of our assertions documented. Indeed, we are very hopeful that our participation in these hearings will help to bring about just such an investigation. We feel sure that, when all of the facts are on the table, there will be total agreement in Congress and in the executive branch that action to cure these unfortunate circumstances can no longer be delayed.

Mr. Chairman, I will turn now to our two representatives from the industry. First, I will introduce Mr. William Gentz, president of Gentz Industries in Detroit, Mich. Following Mr. Gentz, we will hear from Mr. Robert H. McCullough, president of Fibreform Electronics, Inc., in Los Angeles, Calif.

Completing our testimony this morning will be our association legal counsel, Mr. William C. Brashares, a member of the Washington law firm of Peabody, Rivlin, Cladouhos and Lambert. Following his remarks we will all be happy to respond to any questions the subcommittee members may have.

Thank you.

Chairman PROXMIRE. Thank you very much, Mr. Hardman.

Mr. Gentz, please proceed.

STATEMENT OF WILLIAM GENTZ, PRESIDENT, GENTZ INDUSTRIES, INC., DETROIT, MICH.

Mr. GENTZ. Mr. Chairman, my name is William Gentz and I am president of Gentz Industries, Inc., in Detroit, a small company that builds basic jet engine parts for a wide variety of different customers. Our company has traditionally done a large share of its work in defense and aerospace industries, principally as a subcontractor to some of our country's largest defense firms.

I find it very difficult to come here and testify on problems that tend to place your industry and my own major customers in an unfavorable light. However, these problems affect the interest of every private business and every taxpayer, and unless those of us who have knowledge of the problems come forth, we can hardly expect either sympathy or improvement. Accordingly, I agreed to appear at your request to advise the subcommittee of some specific cases of abuse in the IPE leasing program that have come to my attention either through my own experience or from other firms in our industry.

GOVERNMENT EQUIPMENT FOR COMMERCIAL WORK

Those of us who have competed for years for subcontracts for tooling in aircraft and aerospace programs have grown accustomed to the gigantic presence of DOD's IPE in prime contractor plants. It gives a prime an ability and an incentive to do Government work he would otherwise subcontract to us. We have also seen this IPE appear in program after program of a strictly commercial nature, totally unrelated to the reasons for giving the IPE to the primes.

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Just taking the more recent commercial aircraft programs built in the United States, some of which are still under construction, a tremendous amount of tooling and machining work that small businesses could have handled—and could have performed at lower cost under true competitive conditions—has been subcontracted from one major prime to another major prime and performed on Government IPE. Here are some of the more notable occurrences in 1970 and 1971 that we have heard about:

Aeronca subcontracted $500,000 in tooling to North American on the Boeing 747, the work to be performed substantially, if not entirely, on Government equipment.

McDonnell-Douglas gave Aeronca over $3 million in orders on the DC–10.

Goodyear sent North American $5 million in orders on the 747.

Boeing sent North American $7 million in orders on the 727, 737, and 747.

McDonnell-Douglas sent $5 million in orders to Convair on the DC–10.

McDonnell-Douglas sent $4 million in orders to North American on the DC–8.

Northrop sent $3 million in orders to the North American on the 747.

Chairman PROXMIRE. Was all that work done on Government equipment?

Mr. GENTZ. To the best of our knowledge, all or most of it.

Chairman PROXMIRE. Thank you.

Mr. GENTZ. The Lockheed L–1011 Airbus has been a subject of much of this practice. Lockheed has used Government leased IPE in Government-owned, contractor-operated ("GOCO") facilities in Van Nuys, Calif., and Marietta, Ga., for L–1011 work. In the case of Marietta, we learned that 5,000 orders were involved. I understand that the Pentagon was asked to investigate this and that they specifically confirmed this information. They refused to do anything to stop it, however. According to our information, L–1011 tooling orders also went to the DOD leased facilities of LTV in Detroit and Martin in Baltimore.

Rohr Corp., Chula Vista, Calif., sent some of the tooling on its DC–10 subcontracts to its leased facilities in Riverside, Calif.

These situations represent many millions of dollars worth of purely commercial work that would have gone to small businesses on a cost competitive basis but for the fact that Uncle Sam put duplicate capacity in the majors' plants and to a very large extent gave them a blank check as to its use. Hundreds of small businesses in my part of the country and even more in California would not have had to close their doors in 1970 if the Government had not made this IPE available for commercial work.

We think the mere fact that the Government has created this unjustified capacity is a shocking wrong. But apparently it's only the little firm that mortgages its soul to buy its own equipment that feels so strongly about the situation. Others, including most people in Government, shrug it off with some vague comment about the mobilization base and the rental formulas that are supposed to keep everything in perspective. That's the trouble, I suppose, in many of the areas your subcommittee investigates. The IPE monster grew so easily because when a procuring facility or a prime contractor saw a need for some piece of equipment, all higher authority accepted the need on faith.

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RENTAL RATES LEASED EQUIPMENT INADEQUATE

But what about this matter of rental rates on leased IPE? There is a so-called uniform formula which charges a certain percentage per month of the acquisition cost of the tool, and the percentage declines as the tool gets older. The formula is hopelessly inadequate in many ways. Basically, it just bears no relation to the cost of ownership or even a commercial lease. Nor does the decline in rates as a function of age bear any relation to actual value of the equipment.

Even if the formula made any sense, it seems to be ignored in some very significant cases. Instead, contractors and Government contract personnel negotiate rentals on an individual basis. Two examples of the results of such negotiations may shed some light. The Lockheed L–1011 work that went to LTV in Detroit to be done in a Government-owned, contractor-operated facility, was performed under a negotiated arrangement that featured a "composite" rental rate (meaning for all IPE employed) of $0.31 per hour. A true industrial rate—one that a firm paying for its own equipment would have to charge—would be on the order of $4 per hour.

This LTV work represented $3 to $5 million in orders, or roughly 350,000 hours, and it required LTV to scramble all over the country to find additional toolmakers. It even advertised in southern California where many small firms that lost out on this work were laying off their skilled people, and LTV picked them up.

An arrangement similar to the LTV situation was entered between Lockheed and Boeing, Wichita for L–1011 tooling. In this case a 76 cents-per-hour composite rate was worked out. We have no idea why they used a different rate. While 250,000 hours were initially targeted for Boeing, we understand that for some reason the parties did not go through with the arrangement.

We do not know what rate was negotiated for Martin's L–1011 work in Baltimore. It is likely that this arrangement involved the most work of all the situations we have noted.

These arrangements are only a few of many such negotiated deals involving commercial use of IPE. And the matter of ridiculously low rental rates is only one aspect of the problem. Consider what other possibilities exist for utilizing DOD's leased facilities to best advantage where Government and commercial programs are going on in the same GOCO plant. Consider how easy it would be to use IPE rent free on commercial work when the rent-free arrangement was figured only into the Government contract being performed. Even though Government personnel may periodically check the contractor's records of Government and commercial IPE use, the supervision process does not go beyond the papers themselves. There is no way, or at least DOD has not found any way, to monitor actual usage of its machine tools. The entire system is really based on nothing stronger than an assumption that contractors will accurately record and pay for actual machine use.

We believe that commercial use must be stopped completely. It has always been abused and will always be abused as long as it is permitted. Virtually every agency in Government or study group that ever considered the pros and cons of commercial use has recommended discontinuance of it. Yet today, a full 20 years after serious criticism of the practice began, we are still no closer to action or a solution. In fact, we find that the total lack of supervision and restriction found by the General Accounting Office in its 1966 report is still the case. The law says no commercial use of IPE over 25 percent of capacity, yet DOD hasn't informed many contractors of this, and from the hundreds of continuing cases of above 25 percent usage, DOD may receive only a dozen applications a year for permission to do so. Through our taxes, we are subsidizing our competition and/or our customers.

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Mr. Chairman, what hope do we possibly have to cure some of the truly complicated difficulties in our procurement system when we can't eliminate such a simple and wholly unnecessary favoritism as this? We hope this subcommittee can increase the pressure for change and improvements.

Thank you.

Chairman PROXMIRE. Thank you very much, Mr. Gentz.

Mr. McCullough, please proceed.

STATEMENT OF ROBERT H. McCULLOUGH, PRESIDENT, FIBREFORM ELECTRONICS, INC., LOS ANGELES, CALIF.

Mr. MCCULLOUGH. My name is Robert McCullough. I am president of Fibreform Electronics, Inc., in Los Angeles, Calif. I am appearing this morning at the request of this subcommittee to provide information on the effects on small business of the use of Government-leased production equipment by the major prime contractors.

My business consists of about 25 highly skilled employees, a building and roughly $250,000 worth of machine tools. We specialize in precision machining work in the areospace field. Typically, a prime contractor will send us a blueprint or a rough casting of a part, and we will proceed to machine the solid metal stock or casting to a finished part meeting tolerances as close as a few millionths of an inch. For the 25 years of our existence, we have been almost completely committed to defense or aerospace related work.

Our company, like hundreds of others in southern California, has been going through a painful transition in the past year. Our traditional area of work has declined and we are fighting for new types of work in many areas we never looked at before.

UNFAIR COMPETITION STEMMING FROM MISUSE OF IPE

It is perhaps because of the tremendous drop in our traditional work in the past several years that we have become particularly aware of the effects on our markets of the IPE provided by the Government to many of the prime contractors we sell to. We always knew this equipment existed and was involved in a great deal of the same work we were doing, but demand for Government work was greater and there was still an overflow of that work plus other commercial programs. The decline in Government work has led to the primes turning this great capacity loose on commercial and Government subcontract markets they did not seek before. And, costwise, a company buying its own equipment can't compete with this capacity.

Our own company had a rough experience with Government-leased IPE just recently. We had participated for several years in making parts for Hughes Aircraft in the TOW missile program. The program has been segmented into what we refer to as annual "buys," and in each of the first 2 years we were awarded a substantial amount of the machining work on a particular part. For the third-year buy, we were bidding on the greatest number yet of these units. To our great surprise, we discovered that a General Electric facility in New York had bid on the same work and was quoting a price substantially below ours. As a result, GE won most of the work that would otherwise have gone to us and other small firms in California.

GE operates with an overhead far higher than a small company such as ours. There are only two possible explanations for GE's sub-

stantially lower bid. One is that GE was going to use Government equipment, at a fraction of its true rental value. An additional possibility is that GE wished to "buy in" on the program, gain some experience on it, and then bid against Hughes for the prime contract on the fourth-year buy. In any case, we know that GE is the largest holder in the country of Government-owned IPE. We also know that GE recently obtained a nondefense lease of an entire Air Force plant, including equipment, in Johnson City, N.Y., which permits unlimited commercial work.

We do not know all the details, but we believe that an investigation would show that GE gained this work partly or entirely because of a cost advantage based on having Government-owned equipment. If GE is successful in using this advantage to take the entire program over, hundreds of small businesses in California, such as ours, will lose work that is vitally important to their survival.

An interesting situation also developed recently on a prime contract for rocket warheads in which a small firm in Long Beach, Calif., lost out by a wide margin to the Marquardt Co., a large prime that had held the same prime contract previously. Apparently, the Government put somewhere between $500,000 and $1 million in special equipment in Marquardt's plant in earlier years for production of this warhead. Yet in bidding this round, Marquardt reflected the cost of only a small fraction of this equipment and came up with an incredibly low figure. Marquardt claims that it's going to use some of its own equipment that it acquired with its own funds as a "standby" line, and will leave the Government equipment idle. But, when the small firm offered to lower its bid if it could get the idle Government equipment, the Army claimed it was not available.

This case, if it were investigated, might illustrate the serious allocation and surveillance problems noted earlier. Who paid for the "standby" line? What actual use of the Government equipment is to occur? Why is the Army insisting on keeping this equipment in a plant where it isn't necessary, at least for pricing purposes?

These situations are the farthest thing from a free enterprise, competitive economy we are so proud to claim in this country. The tragedy is that once the Government gives equipment to a contractor, DOD and the contractor act in every way thereafter as if he owns it and has every right to use it however he can.

LOCKHEED L-1011

The recent reaction of the Pentagon to our association's complaint about the commercial Lockheed L-1011 work in Georgia takes the cake on this score. Assistant Secretary Shillito said interference with Lockheed's subcontracting decisions would be contrary to the free enterprise system. The Government spends taxpayer money to put equipment into a plant for some purportedly essential defense purpose, permits its use at a ridiculously low price for totally non-Government work, and then can't halt the abuse because it would be interference with natural market forces.

We hope the Pentagon and our friends in the large prime plants will respond to the leadership of Congress in ending this wasteful and unfair IPE leasing situation.

Thank you.

Chairman PROXMIRE. Thank you. It is a very interesting case you cited to us in the Huges Aircraft TOW missile program. In fact, I think I will ask the GAO to investigate that. It seems like an extraordinary situation and I would like to have it called to their attention.

Mr. Brashares, please proceed.

APPENDIX I

STATEMENT OF WILLIAM C. BRASHARES, ATTORNEY, PEABODY, RIVLIN, CLADOUHOS & LAMBERT, WASHINGTON, D.C.

Mr. BRASHARES. In the wake of the Admiral's comment on Washington attorneys, I would like to make it perfectly clear I have never worked for the Government.

Chairman PROXMIRE. That is reassuring; thank you.

Mr. BRASHARES. I am pleased to respond to your request to appear this morning as counsel for the National Tool, Die & Precision Machining Association. These hearings could provide effective pressure for change in procurement policies that have long been criticized by this association as well as many other groups.

The matter of phasing out the IPE leasing program and abolishing commercial use may seem a simple matter as we have discussed it. When the discussion turns to mobilization bases, defense capability, and the like—which you will hear about from the DOD witnesses later—however, the zest for reform turns to blank stares. It's an awfully easy matter to bury in paper plans and endless statistics. That may be why so many billions of dollars worth of general purpose machine tools are in contractor plants today and also why they can be explained generally, but rarely specifically.

It may be significant, then, that whenever the hard facts and figures have been looked at, the IPE leasing, and particularly commercial use, have been criticized.

In a 1966 report the General Accounting Office noted case after case of abusive commercial use and recommended that consideration be given to eliminating it entirely.

GAO's recent report on contractor profits recommended that contractors using Government equipment should have this lower risk reflected in lower negotiated profit levels under the weighted guidelines.

The Rand Corp.'s 1969 report on Government furnished equipment—prepared for the Air Force and based on Air Force equipment—noted that leased IPE was almost entirely general purpose (thus duplicating private capacity), that it was too easy to use equipment for commercial work, that by favoring certain contractors with leased equipment, the Government was losing the benefits of increased competition, and, concluding: the Vietnam buildup of the Air Force IPE inventory "should be halted and alternatives sought before the problem becomes mountainous."

Another private study group, the Logistics Management Institute, which the Admiral mentioned this morning, rendered a report in 1967 for the Assistant Secretary of DOD (I. & L.) called "Weighted Guideline Changes and Other Proposals for Incentives for Contractor Aquisition of Facilities." Among other things, the report urged an increase in rental rates for commercial use. Rates were increased subsequently, but not as high in most cases as LMI thought would be "equal to commercial rates or what it would cost a contractor if he owned the equipment."

LMI observed in its report: "DOD's policy, as expressed many times since 1956, has been for the Government to withdraw from the facilities-furnished field. It has executed this policy vigorously." Thus the words of LMI, whose head back in 1967 was Barry J. Shillito, the man who now administers this entire program as DOD's Assistant Secretary for Installations and Logistics.

DOD PURCHASE OF MACHINE TOOLS HAS INCREASED

To illustrate the phaseout, LMI noted that 1955 to 1965 machine tool purchases by DOD averaged about $50 million per year but that purchases went up to $140 million in 1966. (That was about 5 percent of total U.S. machine tool sales in 1966, incidentally.)

In late 1969, DOD Deputy Assistant Secretary John Malloy confirmed in a House Small Business Subcommittee hearing that DOD was spending about $100 million per year for new machine tools in the previous several years. This being, in Mr. Shillito's words, a vigorous phaseout policy, we are thankful DOD did not maintain the status quo.

In reviewing these past reactions to the IPE leasing program, I don't mean to ignore the involvement of Congress, particularly this subcommittee and Mr. Corman's House Small Business Subcommittee on Government Procurement. Your subcommittee's 1967 report noted the failure of contractors to seek approval for commercial use in excess of 25 percent and cited examples of abusive commercial use.

We are also aware of the legislation recently introduced by your chairman, S. 1469, to abolish commercial use and place tight but reasonable limits on future IPE leasing. Mr. Corman's subcommittee issued a report in 1970 condemning these abuses in the IPE leasing program and recommending reform. Incidentally, Mr. Malloy testified in the House hearings that DOD itself was taking steps to "eliminate the leasing of Government equipment for other than Government work." Perhaps if all parties were communicating we would find a surprising level of agreement.

We are concerned as to whether all of this study, restudy, and criticism of the IPE situation is having any effect at the Pentagon. We have seen policy statements and orders relating to phaseout of IPE leasing come forth from the Pentagon in the past several years. We heard former Deputy Assistant Secretary, General Stanwix-Hay, openly condemn the inequities of the program and assure a prompt phaseout before another House Small Business Committee in 1969.

Just last December we learned that DOD was undertaking an intensive mobilization study before going ahead with any phaseout plans. In February, Deputy Secretary Packard issued a memorandum reiterating generally the phaseout policy, but creating exemptions from phaseout for some awfully broad and vague situations, one of which would defer action on individual cases where removal of Government-owned IPE would "work an economic hardship." Perhaps there should be some comparison of economic hardships based upon the kinds of situations you have heard about earlier today.

Mr. Chairman, if your subcommittee can somehow untangle the facts, figures, and personalities that have delayed reform in this matter for 20 years, you will have made a magnificent contribution to the taxpayers, the principle of competition and the small business community. I hope our information and views have been of some help.

Thank you.

APPENDIX II

SCHEDULE OF AWARDS, RENTS PAID, AND ACQUISITION COSTS

OF GOVERNMENT-OWNED PROPERTY IN THE CUSTODY OF CONTRACTORS

Contractors		Value of awards (000 omitted)	Program	Time period	Rent paid (000 omitted)	Government property in custody of performing contractors as of 6-30-71 (note a)		
Awarded to	Received from					Real property	Equipment	Total
						(000 omitted)		
North American Rockwell Corp., Los Angeles, Calif.	Aeronca, Inc. Torrance, Calif.	$ 215	Lockheed L-1011	1969-70	$ 5			
	Boeing Co. Seattle, Wash.	25,565	Boeing 727, 737 & 747	1965-69	456			
	Goodyear, Aerospace Corp., Litchfield Park, Ariz.	6,500	Boeing 747	1966-69	113			
	Lockheed Aircraft Corp. Burbank, Calif.	1,918[b]	L-1011	1968-70	39			
	McDonnell-Douglas Corp. Long Beach, Calif.	15,202	McDonnell-Douglas DC-8 & 9	1964-68	107			
	Northrop Corp., Hawthorne, Calif.	12,929	Boeing 747	1967-68	239			
		62,329			959[a]	$ -	$ 19,212	$ 19,212
General Dynamics Corp., San Diego, Calif.	McDonnell-Douglas Corp.	45,000[c]	DC-10	(d)	(d)	7,867	26,599	34,466
Rohr Corp. Chula Vista, Calif.	McDonnell-Douglas Corp.	(d)	(d)	DC-10	18[c]	-	5,906	5,906
Lockheed-California Co. Burbank, Calif.	(Performed tooling work in-house)	(d)	L-1011	1968-present	285	15,779	27,972	43,751[e]
Lockheed-Georgia Co. Marietta, Ga.	Lockheed-California Co.	3,000[c]	L-1011	1969-71	39[c]	103,745	41,019	144,764
LTV Aerospace Corp. Starling Hgts., Mich.	Lockheed-California Co.	1,000	L-1011	1969	31	37,665	19,691	57,356
Martin Marietta Co. Middle River, Md.	Lockheed-California Co.	3,930	L-1011	1969-70	63			
	Lockheed-Georgia Co.	674	L-1011	1969-70	12	96	7,663	7,759
General Electric Co., Johnson City, N.Y.	Hughes Aircraft Co. Culver City, Calif.	61	TOW missile	1971	(f)	5,905	3,751	9,656
Marquardt Co. Van Nuys, Calif.	U.S. Army Munitions Command, Joliet, Ill.	835	M18E2 rocket warheads	1971	(f)	11,094	6,337	17,431
Total		$116,829			$1,407	$182,151	$158,150	$340,301

[a] Obtained from Department of Defense records.

[b] Award added by GAO.

[c] Estimated by contractor.

[d] Could not be determined.

[e] As of September 1, 1970.

[f] Rent-free use allowed.

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

COMPTROLLER

28 MAY 1972

The Honorable William Proxmire, Chairman
Joint Economic Committee
Congress of the United States

Dear Mr. Chairman:

I am transmitting a copy of our "Report on the Audit of Selected Aspects of the Progress Payment System," issued by my office on November 3, 1971, (Tab A) as requested by Mr. Richard F. Kaufman of your staff.

The audit was performed during the period November 1970 through March 1971. The purpose of the audit was to review and evaluate certain aspects of the Progress Payment System administered in accordance with the Armed Services Procurement Regulation (ASPR) and DoD policy.

The audit was requested by the Director for Information Operations of my staff, and the Chairman of the Contract Finance Committee. As a result of the audit, a number of management actions were taken, and are continuing, to improve the conditions disclosed. The first major policy change directed by the Contract Finance Committee was implemented by Defense Procurement Circular No. 94, dated November 22, 1971 (Tab B). Some of the changes in this Circular included:

1. Introduction of new procedures requiring payment by the contractor for direct material and subcontract costs prior to requesting progress payments based on these charges. This change requires that direct material and subcontract costs be handled on a cash-disbursed basis rather than on an accrued cost basis as previously permitted.

2. A limitation to prevent contractors from receiving progress payments more frequently than biweekly.

3. A requirement that certain conditions be met before the alternate method of progress payment liquidations can be used. The rationale for this change is to assure that the contractor is actually earning a profit before paying him that profit.

4. Deletion of the option to use the contract price of items delivered instead of actual or derived costs when computing "costs applicable to delivered items."

The Services and DSA also have stressed in various letters and memorandums to subordinate offices the need to strengthen controls over contract financing. The discrepancies cited in the report have been called to the attention of contracting officers. Continuing followup is planned to assure that corrective action has been taken and the pertinent ASPR regulations relating to progress payments are thoroughly understood and complied with to assure the protection of the Government interest. Statements of actions taken by the Services, DCAA and DSA are included as Tabs C through G.

The Department of Defense is continuing its efforts to improve the contract financing system in order to provide the financing considered necessary in support of Defense procurement but with sufficient constraints to avoid monetary loss to the Government.

In summary, this audit, requested by DoD management, disclosed weaknesses in the administration of the Progress Payment System that have been addressed by the Contract Finance Committee and operating elements of DoD. The free and open relationship between internal audit and DoD managers permits these types of management evaluations. We believe audits of major management program and mission areas are essential and extremely valuable for continued improvement in managing all phases of Defense operations.

Sincerely,

Robert C. Moot
Assistant Secretary of Defense

Enclosures (Tabs A to G)

REPORT ON THE AUDIT OF SELECTED ASPECTS OF THE PROGRESS PAYMENT SYSTEM

Summary

The purpose of the review was to determine if the Progress Payment System was being administered in accordance with the Armed Services Procurement Regulation (ASPR) and DoD policy.

Although some Procurement Contracting Officers (PCO) and Administrative Contracting Officers (ACO) followed the ASPR provisions to authorize, pay and liquidate progress payments, most activities included in the audit did not always comply with prescribed policies. In most instances they were not completely familiar with the ASPR provisions or the underlying rationale involved. Certain progress payments were not authorized or liquidated in proper amounts when items were delivered. As a result, substantial amounts of excess progress payments and underliquidations were made. We also determined that several ASPR provisions needed modification or clarification to assure more efficient administration of the progress payment system.

Incorrect percentages inserted in the limitation section of the progress payment clause made ASPR controls against unauthorized payments ineffective. In addition, PCOs included liquidation rates that did not conform to the ASPR guidelines in the contract clause for full recovery of all progress payments made. Underliquidations of $14.2 million resulted from these conditions. (See page 7)

Several contracts contained unusual progress payment rates which had not been approved by the DoD Contract Finance Committee. Consequently, contractors received unauthorized progress payments amounting to approximately $27.8 million. (See page 8)

The Contractor Requests for Progress Payment (DD Form 1195) were not properly prepared. The contractor (1) did not show appropriate percentages to ensure against unauthorized payments, (2) incorrectly allocated costs between delivered and undelivered items, and (3) included wrong figures in his request. Since these were not corrected by the ACOs, unauthorized progress payments of about $61.4 million were made. (See pages 14, 15 & 18)

Unauthorized payments to contractors of about $38 million resulted from underliquidations of progress payments upon deliveries when the contracts were in an overrun condition. Since these contractors earned less profit than anticipated when the contracts were negotiated, the ACOs should have increased the liquidation rates to assure proper liquidation of all related progress payments. (See page 20)

ACOs did not adequately evaluate the contractor progress to assure progress payments were fairly supported by the value of work actually accomplished on the undelivered portion of the contract. As a result, substantial progress payments were made although not supported by actual progress. (See page 22)

Increasing numbers of contracts with progress payment clauses were terminated for bankruptcy, default or convenience of the Government. At the time of our review, we noted 49 of these contracts with unliquidated progress payments totaling $67 million. Although some of these terminations may have resulted from inappropriate review of the contractor capabilities prior to contract award, our audit indicated that in many instances proper supervision as required by ASPR could have permitted corrective action before termination. (See page 26)

Certain ASPR policies governing progress payments needed clarification or modification concerning Basic Ordering Agreements (BOA), use of the progress payment clause by reference, cost data on delivered items and authority of ACOs to adjust liquidation rates. (See page 30)

The audit disclosed that Progress Payment Status Reports submitted to the Office of the Secretary of Defense (OSD) had a high incidence of inaccuracies; however, management use or need for this data could not be determined. For example, approximately one-third of the Defense Supply Agency (Defense Contract Administration Services) reports received by OSD should not have been submitted since they had "zero" unliquidated progress payment balances. This overstated the total contract value of contracts by $5.5 billion, or 10 percent, on the DoD Consolidated Report as of September 30, 1970. Greater efficiency was also possible through consolidation of progress payment reporting responsibilities currently operated by the military departments and Defense Supply Agency (DSA). (See page 38)

During the audit of each activity and command, the related findings were discussed with appropriate representatives. A copy of the draft report was provided to the DoD Contract Finance Committee and appropriate Comptroller and I&L representatives in the Army, Navy, Air Force and DSA. These offices generally concurred in the findings. Corrective action has been taken and further action is planned to (1) correct the deficiencies noted in the report, (2) correct similar deficiencies relating to contracts not reviewed, and (3) preclude the possible repetition of conditions reported. OASD(I&L) stated:

> . . . an IAC Subcommittee on Defense Contract Financing has also reviewed several aspects covered in your draft report. The Contract Finance Committee is presently involved in evaluating several recommendations made by this IAC subcommittee. We would propose to include

your report recommendations and the service and DSA comments along with this current review of the IAC subcommittee recommendations.

Specific findings and recommendations to correct the conditions noted during the audit are presented in the body of the report. Appropriate command comments have been incorporated after the recommendations in each section of the report.

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Deputy Assistant Secretary of Defense

E. Physical Progress on Contracts

ACOs were not adequately evaluating the physical progress on contracts to assure that progress payments authorized were commensurate with work accomplished. As a result, contractors were granted substantial progress payments although these were not justified on the basis of progress made.

ASPR-E-521 states that progress payment clauses cannot be self-executing and require careful administration to insure against overpayments and losses. In all cases, the physical progress of the work should be evaluated periodically to assure that progress payments are fairly supported by the value of work actually accomplished on the undelivered portion of the contract to conform with contract requirements. In addition, the standard clause used in the contract outlines the guides for the ACO to follow in protecting the interest of the Government whenever progress payments are allowed. ASPR-E-510.1, paragraph (c) states:

> The Contracting Officer may reduce or suspend progress payments . . . whenever he finds upon substantial evidence that the Contractor (i) has failed to comply with any material requirement of this contract, (ii) has so failed to make progress, or is in such unsatisfactory financial condition, as to endanger performance of this contract, ...

Verifications of contractor progress by ACOs were not always made to assure that progress payments were fairly supported by the value of work actually accomplished on the undelivered portion of the contract. In several cases, the ACO approved progress payments as requested by the contractor even though he had evidence that sufficient progress was not made.

At several DCASRs, a total of 126 contracts with unliquidated progress payments equaling 51 to 100 percent of the maximum allowable were reviewed to determine if progress payments could be reasonably correlated with actual production. Of those 126 contracts, we noted 76 cases where actual work accomplished was not commensurate with the progress payment disbursed.. For example:

1. On Contract F41608-69-C-6899, progress payments equaling 82 percent of the maximum authorized were made through August 19, 1970. The Progress Payment Administration Record (DSA Form 325), used by the ACO as a basis for approving, suspending or reducing each request, indicated that the Industrial Specialist concurred with the amounts paid. However, in November 1970, when payments totaled 90 percent of the maximum authorized, the Industrial Specialist reported that no units had been assembled under the contract. Further, in January 1971, the Industrial Specialist determined that the contract was only 40 percent complete.

2. Another contractor was paid 419 progress payments totaling $82.6 million on eight different contracts, without an ACO request for a single independent technical evaluation as to progress of actual work accomplished. At the time of the review in March 1971, six of these eight contracts were in a delinquent delivery status and some progress payment requests were approved while the contracts were delinquent.

3. The progress payment limitation of $4,191,455 on Contract NCW66-00727 was reached in December 1968. At that time only 1.5 percent of the contract value was delivered, whereas the delivery schedule required 100 percent of all items by December 31, 1968. The only technical evaluation obtained by the ACO in September 1968 estimated physical progress to be 45-50 percent of completion. As of January 31, 1971, deliveries were not completed and the contract was in a delinquent status for 14 months.

The ACO primary source of technical evaluation is the designated Industrial Specialist who is assigned to each contract with a progress payment clause. It was noted that at one of the DCASRs, seven contracts were not assigned an Industrial Specialist for surveillance. On one of the contracts, the contractor was paid 80 percent of the maximum progress payments authorized with no deliveries to the date of review.

The examples discussed above illustrate the need for improvement in the ACO surveillance of contractor progress in relation to progress payments allowed.

F. Utilization of Defense Contract Audit Agency (DCAA) Services

Many of the Administrative Contracting Officers (ACOs) were not making maximum use of the services of the DCAA.

ASPR E-506 requires that the contractor accounting system and controls must be adequate for the proper administration of progress payments as determined by the DCAA. ASPR - Appendix E, encourages use of the DCAA services to the greatest extent practicable for protection of Government interests. In addition, services of qualified cost analysis and engineering personnel are available to the ACOs administering progress payments.

Within the Navy, some ACOs requested DCAA reviews of requests for progress payments, but not on any systematic basis. The other military departments did not request reviews since they generally assumed that the contractor accounting system and costs were under constant surveillance and periodic audit because of DCAA residencies established at contractor plants. In accordance with the Defense Contract Audit Manual, paragraph 9-301.3, progress payment audits are usually performed only upon request by the contracting officer.

Local Navy management in some cases, agreed that they should utilize the services of DCAA to a greater extent. The Air Force management also concurred that greater use could be made of DCAA postaudit of progress payment billings.

DSA Manual Number 8105.1 includes special procedures for processing first progress payment requests. It provides that:

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