DEFENSE PROCUREMENT IN RELATIONSHIPS BETWEEN GOVERNMENT AND ITS CONTRACTORS

HEARING

BEFORE THE

SUBCOMMITTEE ON PRIORITIES AND ECONOMY IN GOVERNMENT

OF THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

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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 9:50 a.m., in room 318, Russell Senate Office Building, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire.

Also present: Loughlin F. McHugh, senior economist; Richard F. Kaufman, general counsel; Robert D. Hamrin, professional staff member; Michael J. Runde, administrative assistant; and George D. Krumbhaar, Jr., minority counsel.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The subcommittee will come to order. Admiral, I want to apologize for being late this morning. My plane got in late. I am very sorry. I appreciate so much your coming.

We are honored to have you as a witness before this committee. Admiral H. T. Rickover is Director of the Division of Naval Reactors, Energy Research and Development Administration and Deputy Commander for Nuclear Propulsion, Naval Sea Systems Command, U.S. Navy. I think we all know of Admiral Rickover's tremendous contributions to the country over more than half a century of military service. He is widely recognized as the father of the nuclear navy. Because of his extensive experience, Admiral Rickover has been a valuable source of ideas and observations to the Congress in matters relating to nuclear power, our defense posture, and weapons acquisition as well as in other areas. We value his views.

Today, the subcommittee is beginning a new series of hearings emphasizing Defense Department/defense industry relationships. Admiral Rickover has testified to Congress on this subject before. He has been outspoken in his criticism of defense operations in areas where he felt improvements were needed. He has never been one to adhere strictly to the party line but rather speaks from personal conviction. Since Admiral Rickover is in an excellent position to observe relations between the Pentagon and industry on a day-to-day basis, we want to explore with him today in more detail any problems that he may see.

After Admiral Rickover concludes his testimony we will hear a summary of a staff investigation of the Renegotiation program and

we will then hear from our other scheduled witnesses, members of the Renegotiation Board.

Admiral, I know you did not have much notice for this hearing and that you do not have a prepared statement. You will recall that you testified before this subcommittee some years ago, in 1968, as well as more recently, and that you said on the earlier occasion that the Government was losing vast sums annually because of mismanagement of the defense procurement program.

I am convinced that we are still losing huge amounts of money for the taxpayer because of waste and other abuses in military purchasing, that these abuses are costing the taxpayer hundreds of millions of dollars each year. We would like to know your view on the magnitude of this problem today. So, go right ahead.

STATEMENT OF ADM. HYMAN G. RICKOVER, DEPUTY COMMANDER FOR NUCLEAR PROPULSION, NAVAL SEA SYSTEMS COMMAND, ACCOMPANIED BY T. L. FOSTER, ASSOCIATE DIRECTOR FOR FISCAL MATTERS, NUCLEAR POWER DIRECTORATE; AND D. T. LEIGHTON, PROGRAM MANAGER FOR SURFACE SHIP NUCLEAR PROPULSION

Admiral RICKOVER. Thank you, Mr. Chairman, for your very kind words which I will try to fulfill.

I believe the great difficulty in conducting defense business is most of the top officials come from industry. They naturally have an industry viewpoint which can be easily understood. It is difficult for a man who has lived his life in one department entering into another to shed the misconceptions he had for most of his life. This is readily understandable. Since most of the positions are filled by business people, naturally, we are going to have a business flavor in the Government.

On top of that, there is a great deal of layering in the Defense Department which makes it difficult for individuals to have their views presented properly, far more so in the Defense Department than any organization I know.

I think when the overhead of any organization gets as large as it is in the Defense Department it is inevitable that you will have a deficiency. One of the things I could say right now, there should be a concerted attempt to reduce the amount of layering in the Defense Department.

The next is the fact that industry officials have ready access to officials of the Defense Department whereas that is not the case with those who have to do the work. So frequently Defense officials are presented with a one-sided view and since this is in accordance with their own previous convictions it is very difficult for those who have been in Government who stick strictly to the purpose of their jobs to break through that curtain.

Time and again I have had senior officials tell me it is important that we do so and so because otherwise we would not have a strapping defense industry and to take certain financial actions along that line.

My point is if our defense industry needs bolstering by special appropriations, it is not up to any individual to create his own interpretation of what the law should be.

Take the case of claims. Everyone in the Defense Department is trying to do the right thing, but if you have a certain view the most important thing is to maintain a strong defense industry and I firmly believe in that too. Therefore, we should take certain actions that evade the law. Take claims—my opinion is any claim made against the Government by a contractor should be completely substantiated and should be attested approved by him in a legal manner that he claims full responsibility for the claims he makes against the Government. When we try to do that, we are not very successful because there is great pressure by the officials in the Defense Department to settle claims quickly. We can settle claims quickly if we give the contractors what they ask for. Contractors have learned over a period of many years that by having claims drag on by submitting over-inflated claims after awhile the Government in its desire to settle because there is pressure on the individuals concerned to settle, will generally agree to a great extent with what the contractor wants.

In talking about the Navy specifically, the Navy does not like to be charged with having a large backlog of claims. Until about a year ago this backlog was about $1.3 billion. It has now been reduced to about half that amount.

One way to avoid having a claim over a claim is to change the name to a request for equitable adjustment. So when a contractor puts it into those words it is no longer a "duck." It looks like a duck, walks like a duck, quacks like a duck, but it is no longer a claim. So we have a lot of these and the contractor exercises a great deal of ingenuity in putting in claims. I believe it has come within the purview of this subcommittee where there was a case that a contracting officer decided the claim was worth some $900,000.

Chairman PROXMIRE. Admiral, is there any statistics on the amount of so-called requests for equitable adjustment and how those have changed over the past few years? Can you get that for us?

Admiral RICKOVER. I think this is a rather recent phenomena. I cannot tell you offhand but I know there are two large pending requests for equitable adjustment before the Navy right now. The Navy has properly gone back to at least one of the contractors and asked that he certify this, that the official sign this request, certify that it is legal, the usual Government formula. The contractor has refused to do that.

Chairman PROXMIRE. What are those specifically and how much are they?

Admiral RICKOVER. Sir.

Chairman PROXMIRE. What are those claims for equitable adjustment?

Admiral RICKOVER. I am talking only of shipbuilding claims.

Chairman PROXMIRE. Would you identify them?

Admiral RICKOVER. I would rather not do that.

Chairman PROXMIRE. Can you tell us how much they are?

Admiral RICKOVER. I suggest you go back to the Navy, but they are in the neighborhood of hundreds of millions of dollars. I suggest you go to the Navy for that information. I don't think it is my prerogative to give you this sort of information.

May I continue?

Chairman PROXMIRE. Yes, indeed.

Admiral RICKOVER. The contracting officer's decision was a certain claim was worth $900,000. That went to additional reviews in the Navy and it is finally up to $12 or $15 million. Then, an official of the Navy went to this particular claimant and had a private discussion with him and thought it should be up to $18 million. He went out and consulted with people. He was alone apparently in a room with the contractor. He consulted his conferees and they finally agreed to go up to $18 million. Therefore, the claim which was originally considered to be $900,000, went through all legal and contractual operations of the Navy Department, and was settled for $18 million. Contractors have learned this trick. They know that various people might brag of settling claims for only 30 cents on the dollar. They know by upping their claims two or three times, they will get really more than they need, and this is what is being done.

For example, I know of one case I have personally been involved in where a contractor submitted a claim which was adjudged by the contracting officer to be worth about $7 million. The contractor's claim was for $38 to $40 million. The Navy looked at this claim and pointed out to the contractor that there were a number of things wrong with the claim, pointing out where the elements were wrong. The contractor withdrew those parts and substituted others and it was still $38 million. This was done five times. Every time the Navy pointed out where his claim was in error, the contractor agreed, withdrew it and substituted other parts.

Chairman PROXMIRE. Have these been concentrated primarily with the Litton submarine contracts?

Admiral RICKOVER. Mr. Chairman, I would prefer not to get into any companies or personalities because I am trying to talk this morning about a general situation. I think what I am saying you might think of one company but it is applicable to other companies as well. I do not want my testimony to be considered a diatribe against any particular company. I am talking about the general situation. I believe that if you pass laws which are strict enough, enact legislation, under all circumstances no matter what you call a claim, if he writes and wants money from the Government he must certify and he must understand that he can be subject to criminal penalties if he certifies improperly or wrongly. I think this is one of the most important things you can do to prohibit claims from being called anything but claims.

Now, for example, Mr. Leighton, who is sitting at my left hand discussed the issue of one of these——

Chairman PROXMIRE. Don't we already have a False Claims Act and why doesn't that work?

Admiral RICKOVER. Yes, you have it for poor people. You don't have it for corporations.

Chairman PROXMIRE. Explain that.

Admiral RICKOVER. Most of the laws in this country seem to protect the rich but require the poor to strictly comply.

Chairman PROXMIRE. Do you mean they simply do not enforce the law against the big corporations?

Admiral RICKOVER. I think that justice should be blind and the scale of justice should not be weighted against any one individual.

Chairman PROXMIRE. You are saying we have a strict law.

Admiral RICKOVER. You will remember the antitrust cases several years ago where officials of corporations had to go to jail. That was a very salutary thing. But today what happens, he pleads nolo contendere and he agrees the thing was wrong, he did not do it and he is fined $5,000 or $10,000 and his fine is paid for by the corporation. Today he suffers no penalty.

For example, there was a recent case where an official of a large company did things considered wrong by the Government. The company let him go. Then he was hired back as a vice president and adviser. I will give you another case.

I have currently a request from a large corporation to grant them relief under Federal 85–108, which provides that—85–104, which I am sure you had something to do with. You were instrumental in limiting that to $20 million without concurrence of Congress.

Well, this corporation which we have been supporting with about 10 percent extra over the costs in order to maintain competition comes in now and wants a guarantee we will do 60 percent of our business with them and give them 20 percent over the competition. In addition, there are requests for relief under this Public Law 85–104. I happened to read in the newspaper the other day that the president of this company who has been in it 3 years, stated he was no better off than the union people working in his company and the newspaper reported he was getting $300,000 a year pay. He was getting $500,000 worth of insurance and he was getting annuities, and here this poor chap now wants relief under this public law.

It has been suggested and I agree whenever any corporation comes to Congress or any branch of Congress and requests relief, which shows he has not done a good job, he should be limited in his pay to what a Senator or Congressman gets, at least as high as the President gets. If he has demonstrated inefficiency I don't see why we should keep on maintaining him in that position.

As you may remember from previous testimony, I said if any corporation official was so poorly off he could not take care of his family, if he would let me know, I would send him a loaf of bread every day.

I think at this point, because I know your time is limited, I would like to make some specific suggestions on claims, if I may.

Chairman PROXMIRE. Go right ahead. I wish you would.

Admiral RICKOVER. Require responsible contractor officials to certify all claims no matter what they are called. Prohibit contractors from changing claims substantively after they have been submitted to the Government.

I mentioned that one contractor changed his claim five times and even when it went to the Contract Board of Appeals, he still changed it twice; so he should not be permitted once he submits a claim and he really wants the Government to show him what is wrong with the claim and then change it. That should be prohibited. Once he submits it, that should be it.

Enforce the False Claims Act. Prosecute individuals who submit false claims on behalf of the contractor. That should apply not only to the signing official but to any individual in that company who helps prepare a claim which is found to be false. I think that would be a very fine step because many individuals are loyal to their corporations but should they know they would be faced with a prize on sentence if they engage in that, that may prove their loyalty is greater to their country than to their company.

Settle claims strictly on legal merits even if this results in lengthy litigation. That is a real problem. I consider as an employee of the Government I am bound by the laws to settle claims legally and not on the basis is it good for industry? Is it going to weaken the defense industry? That is not my job. That is Congress' job. Congress is a duly elected representative of the people and it can at any time decide to give relief to any company, as you have done in the past. I may not have agreed with you, but I do recognize in our form of democratic government Congress is the ultimate decisionmaker. You are charged with a responsibility for appropriating funds and also responsible to your electorate whom you have to face every 2 or 6 years to justify your position. Appointed officials get no taxing authority. When appointed officials do this they are exercising taxing authorities without the responsibility of facing an electorate. Do you understand my point?

Chairman PROXMIRE. Yes, indeed.

Admiral RICKOVER. I don't know if you agree with me on that.

Chairman PROXMIRE. Can you give us any ball park figure of roughly how much the Government is losing by payment of claims that are either falsely or unjustifiably or excessively made against the Government?

Admiral RICKOVER. I cannot give you the exact figures.

Chairman PROXMIRE. Just a rough notion of what we are talking about.

Admiral RICKOVER. Suppose a man claims $100 million from the Government. Suppose he settled for $40 million. There is something wrong in the difference between $40 and $100 million. Perhaps it is oversimplified but this is an easy way to look at it. The man submitted a claim for $100 million and he is willing to settle for $40 million. I am sure you are familiar with this and you handled one where relief was asked for $160 million and he was finally willing to make a handshake settlement for $62 million.

Chairman PROXMIRE. But what you are saying goes beyond that. My point is the $62 million or in the case of the $100 million claim settled for $40 million, the amount actually paid is what concerns me particularly and your arguments. On the basis of everything you have told us, it is likely to be substantially excessive.

Admiral RICKOVER. I can't give you exact figures but I can say a minimum of 30 percent.

Chairman PROXMIRE. A minimum of 30 percent excess.

Admiral RICKOVER. I would say the settlements are a minimum of 30 percent.

Chairman PROXMIRE. So it would be several hundred million dollars a year?

Admiral RICKOVER. I am only familiar with one aspect of it. Of course, contracts can be drawn which can be made cost-plus and frequently are so that you don't have that problem. This is one way the shipbuilders have recommended that their contracts be cost-plus and then we will have no claims. That is easy. That means that they don't have to be very efficient in running their business.

Chairman PROXMIRE. Let me ask you this, Admiral. I am convinced we are still losing huge amounts of money through waste and other abuses. These abuses are costing the taxpayer hundreds of millions every year. Can you give us any magnitude for that?

Admiral RICKOVER. I would agree with that statement. You are not only considering claims but also you are going to reconsider the Renegotiation Board and this is a big sieve. That is probably the biggest sieve you have in government. It has been run in an inept manner. I think this is another place because that is the final area where Congress can step in and see the people who make excessive profits have been removed. That was set up by Congress as the last safeguard, but instead of acting as a safeguard it is acting as a wide road. In fact, business in my opinion is very happy to have the Renegotiation Board because it puts a stamp of legality on their operations. I am sure you have been in on some of that.

Chairman PROXMIRE. I agree with that wholeheartedly. This morning we are having testimony from the General Accounting officers who studied three conspicuous cases. Then we have the officials of the Renegotiation Board who will testify.

Incidentally, some of those men as you recognize are able, conscientious men and have done their very best. When you speak of the Renegotiation Board there have been some who have left the Renegotiation Board whose discharge of responsibilities have not been up to the standards you and I would expect.

Admiral, we have heard a lot about improper influence exercised on high Government officials to obtain special privileges for themselves. How important do you think that problem is in the Defense Department and how does it work? How do the defense companies put pressure on Government officials? Can you give us some examples?

Admiral RICKOVER. It is the sort of philosophy you develop in life. I don't think people are consciously doing anything wrong. I think they want to do the best they can, but if the Navy is pressured to settle claims quickly by superiors, that word gets down. Now you consider the position of a subordinate who is constantly pressured to settle claims quickly, he is dependent on his civilian or military superior and his military superior generally does not understand contractual situations, generally does not understand what it is all about, but he is still there because he is an admiral and has rank. The pressure is put on the subordinates by people who control their promotion, deferment, assignment and there is a subtle pressure to go along because they have learned just like you have in Congress, if you want to get along you go along. That is true not only in the military but it is true in all life.

Chairman PROXMIRE. I note David Packard, for whom I have admiration as a man who has done well, not only in the private sector but he had many admirers when he was Under Secretary of Defense. But not long ago he was lobbying in the Pentagon to get the Lockheed claim settled. What effect does this intervention have at the highest levels? Is this what you mean by improper approaches or improper influence?

Admiral RICKOVER. I am not sure of the issue you are raising about Mr. Packard. I know Mr. Packard and had very fine relations with him and he helped me a great deal and I considered him a fine man, but I cannot talk about an individual case.

Chairman PROXMIRE. Is this the kind of example, a man with tremendous prestige and top contacts including the President and Congress comes in and lobbies for a particular settlement?

Admiral RICKOVER. Let me try to put it in a broader aspect. I said two or three times people from business come in to discuss matters and they do so in what is called a broadmanner from the philosophical standpoint of what should be good for business and so on. It is proper and they can't help but be influenced.

Then, there is pressure put on the subordinates to go along. Furthermore, frequently no records are kept of this conversation. This is another point I would like to make. Whenever any officials of the Government discuss financial matters with any outside people, there should be records kept of the conversations. That is true not only of those officials but it should be true of military people and others who have dealings connected with claims.

Chairman PROXMIRE. Shouldn't those records be made available to the public?

Admiral RICKOVER. I don't think so.

Chairman PROXMIRE. Why not? It is the public's business.

Admiral RICKOVER. You are getting into the Freedom of Information Act on which I think Congress has been far too broad.

Chairman PROXMIRE. What good is the record if it is not disclosed?

Admiral RICKOVER. When there is a record, it can ultimately be disclosed if it comes to a legal case; but if you are going to require every official in Government to say everything he does in Government—do you do that in your office? You don't go around and tell about all your dealings in your office. How do you think you can do that?

Chairman PROXMIRE. I am perfectly willing to have my office bugged or monitored—it probably is.

Admiral RICKOVER. No, I don't think that is the issue. I think the very fact that you require them to keep records of wherever the expenditures of Government money are to be involved, particularly in the nature of claims, you should require that records be kept.

When an official of the Government discusses a claim with the company, he should have the contracting officer present at the meeting to keep records. Frequently there have been cases where that is not so.

Chairman PROXMIRE. To your knowledge, have shipbuilding officials been meeting privately with high Government officials, outside normal lines of communications, to settle their claims, and have Government officials actually made commitments to the contractors at these meetings?

Admiral RICKOVER. There is nothing wrong with any official meeting privately. There is no law that stops them from meeting and, as far as commitments are concerned, you don't know what goes on at these meetings. You can't say it is commitment but there must be in some cases agreement of mind.

Chairman PROXMIRE. Except within the framework you have described. No. 1, you say there should be a record and No. 2 you say the officials who know what is going on should be there and it should not be done in an atmosphere in which the outside top officials can bring great pressure without the capability of the people who have the power to understand what the situation is.

Admiral RICKOVER. I thoroughly agree. I would like to make some recommendations along that line, if I may.

Government employees and industry officials should not be permitted to swap sides and continue to deal in the same areas with their former colleagues. Existing legislation in this regard should be strengthened. You know what has happened recently with the man in charge of all shipbuilding claims in the Navy. He went to work for a private legal firm. That firm is still handling shipbuilding and this is contrary to the code of laws of the American Bar Association.

I pointed this out to the Defense Department officials and they have taken it up with the American Bar Association. I don't call them the ABA. I call them the ABPA, American Bar Protective Association.

The Department of Defense should strictly enforce the ABA's Canon of Ethics. Safeguards should be established covering informal dealings between senior government contractors' officials.

The minimum representation—this is what I have been talking about—the minimum representation should include a prohibition against discussing contractual matters in the absence of response contractors.

A requirement to keep formal records of any and all discussions among senior government and contractor officials pertaining to government contracts—I think that will put some brakes on it. I imagine there discussions with government officials where the Government keeps no records but the contractor does. Therefore, he can come back later and say I had such and such an agreement. That should be absolutely prohibited.

The point is this, Mr. Chairman: It is easy to treat government money as a largesse. I think any government official should spend government money the way he would spend his own money. I will tell you the picture I have. I always have the vision in my mind of Congress passing laws to take care of corporations that are in trouble. You know what Mr. Regan, the head of Merrill Lynch said 2 or 3 years ago when some brokerage firms were failing. He asked what is wrong with that.

That is the essence of the capitalist system. But that only applies to little people. There are somewhere around 12,000 bankruptcies a year, tailors and mom-and-pop grocery stores. They fail and lose their money.

I don't see anyone in Congress including yourself who gets up and weeps for the little people, but when a corporation gets in trouble with its high-paid executives, everybody worries about them. They retain all their rights and privileges and as you know, what they believe is to capitalize gains and governmentize losses.

The losses are paid by the Government and they continue to get their high salaries. Again, I advert to whenever a company comes in and asks for relief, there should be a requirement that the officials get the maximum salary and emoluments including post office bills as Senators.

Chairman PROXMIRE. What about inflation in this shipbuilding industry? The Defense Department is asking Congress this year for about $2.3 billion to pay for cost overruns on ships already under construction. A breakdown of that $2.3 billion shows that half of it is being attributed to inflation and the other half to engineering changes, poor estimates, the stretchouts and so forth.

How can we justify passing those extra costs on to the taxpayer when I understand the contracts provide for a reflection of the in-

creased labor costs and the increased material costs and the escalation clauses?

Admiral RICKOVER. Mr. Chairman, the shipbuilding industry is probably the best taken care of industry in the United States. Their contracts, as you said, provide for escalation. A contract is made for a ship with a provision for labor costs and so on escalating. They will be paid the amount which is computed by the Department of Labor. They get together various statistics which the Defense Department follows.

That means of all companies in the United States, they are in a favored position. For example, they even get paid every week or 2 weeks.

Chairman PROXMIRE. The progress payments?

Admiral RICKOVER. Yes; the progress payments. The progress payments are based on rates of inflation.

Chairman PROXMIRE. And they are indexed the way Brazil is?

Admiral RICKOVER. The index keeps changing regularly. This is done by the Department of Labor according to law and the Defense Department has no control over these indices. They have their rules and we follow them. In this connection, I don't think I have ever heard of any company in the United States that in the time of deflation has ever returned money to the Government. If you hear of any, I would like to have a discussion with you on it. If you put your staff on this, perhaps after 100 years they may find one.

They take contracts for various reasons and they may lose money on a contract. Therefore, they want to go to the claims route and say it is the Government's fault. One company recently, and I testified about it, claimed that a good deal of their losses were due to changes. We have tried time and again to have the companies when we do make a change, to reprice it right away.

The companies frequently do not want to do that. They would rather have it drag on, because, if it drags on long enough, the people in the Government who were there and who are familiar with all the aspects will be gone, so ultimately the claim gets settled in a manner. It is a nuisance and it gets settled in a broad manner.

The reason this particular yard lost money is they were on fixed-price contracts and there were practically no changes, but they dredged up claims. One contracting official of a shipbuilding company recently told Mr. Leighton, and as I said that before, who is sitting at my side, Mr. Leighton asked him why he did. He said, "You don't understand. If we put in these claims, we have a toehold on getting more money whether it is justified or not justified."

Furthermore, and this is a fault of Congress in my opinion, a corporation can put in its annual statement—the money it has asked for claims as an asset, even though there may be no justification for it. So, this is a good thing for stockholders or people who buy stock. This shows the company is in a better position than it is.

Again, if you compare the annual reports of some of these corporations including what they tell the Navy in the annual reports, they are doing swell, but when they come to the Navy, they are doing very badly.

Chairman PROXMIRE. Can you give me a general answer on whether that $2.3 billion in cost overruns in your judgment is or is not justified, and if so, how much?

Admiral RICKOVER. The money is to cover the contract commitments, including claims.

Chairman PROXMIRE. That $2.3 billion then includes the inflation element?

Admiral RICKOVER. Yes.

Chairman PROXMIRE. It includes the claims?

Admiral RICKOVER. Yes.

Chairman PROXMIRE. And requests for so-called equitable adjustment?

Admiral RICKOVER. Anything that the Navy sees begins to cover all of that.

Chairman PROXMIRE. How much of this would you say is justified?

Admiral RICKOVER. Considering what they are going to pay for claims, it is all justified. We have to live. We have to get along. We have to build ships.

Chairman PROXMIRE. I know you have to do it, but how much could we say is properly owing to these firms? Can you make an estimate on that? You gave us an estimate of about 30 percent of the claims was excessive.

Mr. LEIGHTON. If I may comment, please, I am Mr. Leighton. I work for Admiral Rickover. Of the $2.3 billion, and we don't have the breakdown here, is in the claims category and where that is included in is the Navy's estimate of what they will have to pay to settle certain claims. Most of the money is to cover the escalation articles you referred to a moment ago.

Chairman PROXMIRE. They say less than half or about half of it is attributed to inflation and the rest is engineering changes, stretchouts, and so forth.

Mr. LEIGHTON. A warship takes a long time to build. During that time, there are necessary changes in the ship due to changes in the threat, due to changes in technology, et cetera. Under the contracts the Government has, if the Government imposes a change on the shipbuilder, the Government is obligated to pay for the cost of that change. If that change causes delay, the Government is responsible to pay the costs associated with that delay.

Chairman PROXMIRE. That is a very good point and I am glad you bring it up. How much of that $2.3 billion is due to incompetence, mismanagement, that kind of error which the taxpayer should not be required to pay for if we had an efficient procurement system? That is my question.

Mr. LEIGHTON. I believe Admiral Rickover is not in a position to answer that on the whole $2.3 billion because a lot of that is in programs not under his cognizance.

Chairman PROXMIRE. The largest single cost overrun in that $2.3 billion bill is $772 million for the DD–963 destroyer being built by Litton. As I understand it, that would be an add-on to the $3.6 billion cost estimate for the 30 ships, raising the cost per ship in the early estimate from $45 million each to about $145 million each—$45 million to $145 million. That is quite an increase.

For this amount of money, do we really need this program to contribute to the real needs of the fleet?

How would you say the DD–963 compares to its Russian counterpart I understand is the *Krivak* class of destroyer?

Admiral RICKOVER. We are now addressing a subject which is not at all in my sphere of competence or responsibility. I simply cannot get into that area. I am only concerned with nuclear ships. Nor can I judge which the Navy should have. There has been a statement of policy by Congress called NAVAC–8 which states it is the policy of the United States that all strike forces, that is, large ships such as aircraft carriers, nuclear frigates, shall be nuclear-powered.

I would like to add something to what I said before about certifying claims. As you know, I have been trying for 4 years to get the Navy to hire outside counsel to help them prosecute claims. We are confronted with shipbuilding where we have large batteries of claims-people and lawyers and we have very few people to fight these claims. In fact, a good deal of the time of the technical people in the Bureau in the Navy is diverted from their regular work to help fight these claims.

The Navy originally went informally to the Department of Justice and the Department of Justice said it was all right. This was after 3 years. I kept on recommending. They went to the Department of Justice and now the Department of Justice came out and said if the Navy needs additional orders, it should go to the Department of Justice and there is a provision on the law, the Department of Justice can pay up to the grand sum of $12,000 a year to hire a competent lawyer. That is the fix we are in.

Another important thing you can do is to immediately enact legislation, which is very important, to make it possible for the Navy to hire outside legal counsel to help fight the battery of claims lawyers which the corporation can have.

Chairman PROXMIRE. That is an excellent suggestion. Imagine what the cost benefit to the taxpayer would be. It would be astronomical.

Admiral RICKOVER. Will you remember several years ago I talked about one company that overcharged the Government and kept on doing it after we notified them three times? We went to the Department of Justice and what would you expect. They put in a nolo contendere charge and they were only permitted to keep two-thirds of the excess money they charged the Government.

That was pretty good for the Justice Department. You can see the way I have seen the Justice Department conduct its business, I really think it is an arm of the executive branch.

Chairman PROXMIRE. The Navy stopped building Navy combat ships in navy yards several years ago and a number of the shipyards were declared surplus. Since turning all Navy construction over to the private yards, they have been completely taken over by conglomerates like Litton and Tenneco. What happended to productivity and quality workmanship since that time?

Admiral RICKOVER. The navy yards are supposed to be lower in efficiency than the private yards, but in detailed investigations I have made probably there is no difference in efficiency. There is just about the same amount of loafing.

Chairman PROXMIRE. How about the quality of workmanship?

Admiral RICKOVER. The quality is about the same. I would say the amount of loafing runs at about 35 to 40 percent.

Chairman PROXMIRE. How about the overhead costs?

Admiral RICKOVER. You cannot compare the overhead costs between Government and private yards. The Government has to take

care of military housing and services and performs a lot of functions it did not perform or charge extra for.

I would say probably the cost for a new ship in dollars would probably be about 30 percent greater in the navy yard than a private yard, but that does not tell the whole story because there are other costs to the Government.

The Navy decided as a matter of principle about 35 percent of the total work should be done in Government yards.

Chairman PROXMIRE. Did you say that loafing amounts to about a third of the labor costs?

Admiral RICKOVER. Yes. If you could get 4 hours work from a man in the navy yard, you would be doing something.

Chairman PROXMIRE. What do you mean by loafing?

Admiral RICKOVER. Idleness.

Chairman PROXMIRE. Is this because the workers are not doing the work or the supervisors do not organize the work properly?

Admiral RICKOVER. It could be both. I could give you many horrible examples of what goes on in private yards and Navy yards. Shipbuilding is a very difficult thing to police because you have many people working in out-of-the-way places where it is impossible to supervise.

Chairman PROXMIRE. Is this because of union practices or just incompetence on the part of the people running it?

Admiral RICKOVER. No, this is not union practice. It is simply lack of productivity, frequent changes of personnel, and you must realize the shipyards have a very difficult job. It is either a feast or famine process so they have to let people go, they have to rehire them and train them all over again. It is very expensive. It is not like working on a factory floor.

Chairman PROXMIRE. You were not talking about retraining. Retraining is understandable and necessary. You are talking about people who are loafing who understand what to do but are just sitting around.

Admiral RICKOVER. That is right. I will be taken on by the unions, but it is true all over. I am making no distinctions. You are not going to gain anything one way or the other on loafing whether you go to a private or commercial yard.

Chairman PROXMIRE. In retrospect, do you think it was a mistake for the Navy to break its tradition and go out of the shipbuilding?

Admiral RICKOVER. It has not broken its tradition. The Navy does not have very much shipbuilding now and particularly for large ships where the facilities are available in a commercial yard, it is probably more economical to go to the private yards.

Chairman PROXMIRE. That is right, but there is the other element which is perhaps competition and yardstick comparison. Maybe that is not important, or is it important, that you have a Navy shipbuilding operation that you can compare and use as a standard to measure the performance of these bid conglomerates.

Admiral RICKOVER. I think ultimately if you took in the military expenditures which the Government yard is required to spend, I think you will probably find there is not much difference in efficiency but it is the policy of the Navy to retain the right to build ships wherever they want to.

Chairman PROXMIRE. That is right, but they are not doing it.

Admiral RICKOVER. They are doing some.

Mr. LEIGHTON. There is discussion of possibily assigning some new shipbulding to a Naval shipyard.

Admiral RICKOVER. Take a large aircraft carrier, that is a large ship and there is only one place where that can be done. The Navy is trying to make up for the lack of construction by assigning a certain percentage of the repair work to the yards. It is less expensive. The navy yard frequently has an emergency job to do. They will do it, but if you went to a private yard for repair work, they would immediately start comitting changes.

We asked one shipyard to develop 35-mm rolls of film. They wanted to charge us $500 but that was not enough. They wanted to have the right to submit a claim later on for the whole impact on all the ships, the 9 or 10 ships being built in that yard because they would develop two rolls of 35-mm film.

This is what we are up against. It is really a tragic situation and that is because you mentioned conglomerates. What have the conglomerates done for shipbuilding? They are not interested in shipbuilding. They would just as soon sell manure.

Chairman PROXMIRE. Don't you avoid that kind of problem in a navy yard? At least you eliminate the claims.

Admiral RICKOVER. No; the navy yard would not go out of their way to create a claim. After all, you want to do a little job like supposing a Government visitor had to go to the can and they would say they are holding up a workman and there would be a claim for all of the ships in the yard.

You could not do that under the same logic but it is exactly the same logic.

Chairman PROXMIRE. It does not take the form of a claim.

Admiral RICKOVER. We finally got them off that jag, but they insisted on a right that they could submit a claim later on for the impact that had on all the ships being built in a yard by developing two rolls of 35-mm film.

Chairman PROXMIRE. I am talking about navy yards.

Admiral RICKOVER. The navy yard did not do that.

Chairman PROXMIRE. Admiral, there seems to be numerous heads of procurement in the Defense Department, military and civilians. There are assistant secretaries for logistics and installation and assistant secretaries, comptroller, in each of the services, and there is the Deputy Secretary of Defense, Mr. Clements and the Assistant Secretary for R. & D. called the Director of D.D.R. & E.

Does this proliferation of officials make it easier for private contractors to exert influence?

Admiral RICKOVER. Yes; because they have more avenues of approach to plead their case.

Chairman PROXMIRE. Where are all of the important decisions made in all this maze of procurement decisions?

Admiral RICKOVER. I can't find out. I know decisions are being made, but frequently there are no records.

Chairman PROXMIRE. Do we really need so many procurement chiefs?

Admiral RICKOVER. Why don't you phrase that question and say "Admiral, if you were running this ——— business, would you do it that way?"

Chairman PROXMIRE. That is a much better framed question. Now answer that, Admiral?

Admiral RICKOVER. I would not.

Chairman PROXMIRE. How many would you have?

Admiral RICKOVER. I could have one guy in the Navy Department do it. He would use his subordinates to do the job. That is what he should do. In the executive branch, we have all sorts of brilliant young people—business people all over—and the minute they get their jobs, they start exercising all their prerogatives. They feel those who have been working there a long time—they need the business experience these people have—and yet the greater the number of business people we have, the more claims we have.

Have I answered your question?

Chairman PROXMIRE. Yes, you have. I understand that the Defense Department has launched its own program to improve its relations with private contractors. What disturbs me is Defense officials seem to believe the way to improve relations is to cut back on Government audits, relax protective legislation such as the Antikickback Act and do away with cost accounting standards.

Would you comment on that?

Admiral RICKOVER. I think it is wrong. I think all of these provisions that have been put into law protect the taxpayer, and I think an attempt to let business have its own way—they want to remove all these restrictions. The trouble is the provisions of the Truth in Negotiations Act is not being carried out.

May I take that one first? You passed the law in accordance with the Defense Act that contractors—where there is no competition—a contractor has to furnish his costs. Large numbers of contractors absolutely refuse to do that and they won't take the business unless we absolve the Truth in Negotiations Act.

I have taken this up with many companies for the Defense Department and each time nothing is done. The GAO finally made a study and they found some pretty high profits being made by these studies.

The theory is the Renegotiation Board will recover them, but if you have to depend on that Renegotiation Board, you had better stop. You know their record. Perhaps you can do something with them. That is the claim.

For example, one company recently was permitted to evade the Pricing Act because it was said the Renegotiation Board had considered their company incapacitated. That would mean if the Renegotiation Board certified barrels were virgins, I would not.

Chairman PROXMIRE. We are getting a good buildup for their later appearance.

Admiral RICKOVER. I am deliberately trying to do that. You were largely instrumental in enacting legislation for the Cost Accounting Standards Board. That is under severe attack now and hearings will be held in part of your committee because business does not like it. They are taking out particularly the fact the Board issued a ruling on overhead—depreciation of it—and that has been before Congress for the last 60 days.

Business is up in arms and they want to get it repealed. You don't see any of the public coming around and enacting laws for corporations' money. It is always the people who have the lobbies that can afford to have lobbyists—who can give campaign funds. Somebody somewhere, somehow—the little people—ought to have a voice.

Chairman PROXMIRE. In your opinion, that provision should not be repealed?

Admiral RICKOVER. Absolutely not. I testified on that before the Cost Accounting Standards Board and I would be very happy to testify before a committee and I hope you will be present. I hope you will make me a promise right now you will be present.

Chairman PROXMIRE. I will, indeed.

Would you say there is an effort underway to convert contracts to cost-plus and do away with fixed-fee contracts?

Admiral RICKOVER. One subcommittee had hearings on recommendations of shipbuilding to change all contracts to cost-plus. It was ruled out because of the experiences of World War II.

Chairman PROXMIRE. Do you approve of this effort?

Admiral RICKOVER. If I were head of a big conglomerate, I might, but being a citizen and responsible official of the Government, I certainly do not agree. It looks like there was a concerted attempt by the entire shipbuilding industry.

Chairman PROXMIRE. I agree, but I would like for you to tell us for the record. What is wrong with a cost-plus contract?

Admiral RICKOVER. With such a contract, what reason is there for the company to be efficient? He has no reason to be efficient. This was borne out when one shipbuilding company said they were losing money. They started cutting their overhead and they cut out 1,000 people. If they had a cost-plus contract they would not cut anything out.

The kind of contract we generally make in shipbuilding has a target price and a ceiling price. The target price is the one we expect to meet, and the ceiling price when it goes above the target. They don't make as much profit as they do on the target price, what they estimate they will finish the job for, so we give them a declining percentage of profit if they go above up to a certain point. Beyond that point they make no profit. These are the general types of contracts we have.

Chairman PROXMIRE. Is part of the loafing problem you referred to earlier the result of cost-plus contracts?

Admiral RICKOVER. Yes, sir.

Chairman PROXMIRE. Is it likely to be increased where you have a cost-plus contract?

Admiral RICKOVER. Yes, sir. The minute you have a cost-plus contract, it means the man does not have to pay as much attention to his job. This is particularly true as I stated earlier with conglomerates. The conglomerates are not interested in shipbuilding or anything else. They are interested in profits. They will make profits any way they can. They don't care what business they are. That would be like you did not put a budget ceiling on the Navy. You gave the Navy cost-plus on shipbuilding—you can't run that way.

Why do you think if a Government department which is supposed to be so inefficient does that? Why do you think that business people will be any different? Why do you put more hopes in business than you put in the Navy?

Chairman PROXMIRE. I have a final question about the Renegotiation Board. Congress established the Board to recapture excess profits on defense contracts. It is supposed to be the safety valve on the procurement program. But without reflecting on personalities, the administration of the program, as we have noted, has become seriously inept. The previous Chairman of the Board was fired a few months ago; a successor has not been named. Some people think the renegotiation program serves the defense industry more than the public.

For example, I understand the aerospace industry cited its exposure to renegotiation as a reason to be exempted from phase IV Government price controls. What are your views and your suggestions on how to improve the program?

Admiral RICKOVER. As you know, I believe I am the only one outside the Renegotiation Board who has made a similar study and make recommendations and I would like to make them.

The Renegotiation Board should be made an arm of Congress like the General Accounting Office. It is probably the worst of the regulatory bodies. You know how they are arms of business. Your Renegotiation Act should be made permanent legislation. Board members should be given long-term appointments so they are insulated from pressures. I think you know what I mean by that.

The companies get around averaging product loss. The Federal Trade Commission is trying to do something about that, getting statistics from large companies, how much they make on different product lines, and, of course, the large companies object to that because they don't want it to be known that you have more small businesses in your State than large ones. It is pretty good to know now they are subdividing one part of their business from the other which the little guy has not a chance to do.

Special article exemptions should be eliminated.

Company officials should be required to certify the accuracy of reports submitted to the Renegotiation Board. Criminal penalties should be prescribed for the submission of false or incomplete data.

The Board shall be properly staffed.

Fines should be imposed for failure to file the required reports on renegotiation.

Interest on excess profits should accrue from the time the excess profit is received.

At the present time, the longer the case is before the Board, even if they find a company guilty, they don't have to pay any interest for all the time they held the excess money.

The contractor should be required to report on long-term contracts by the completed unit or completed contract methods of the Renegotiation Board, reviewing the actual profits instead of profit estimates. This is what they have now. The Board is conducted in a very loose manner. Detailed Government audits of contractor reports should be required. Procedures should be revised so the Renegotiation Board can take advantage of the audit work already performed or being performed by Department of Defense auditors.

We have a large number of Government auditors. I believe the Renegotiation Board has 30 auditors to cover about $30 billion worth of work. I believe there is somewhere around $25 billion they never even consider. If I were a corporation, I would love that because they put the stamp of legality on whatever they do.

Requiring contractors to report profits on long-term contracts on a completed contract basis would facilitate the use of renegotiation procedures.

These are my general recommendations.

Chairman PROXMIRE. In general, I think these recommendations are very constructive and helpful. There is one that is quite sensational. I just wonder how it will make out making the Renegotiation Board an arm of Congress, you say.

Admiral RICKOVER. Yes, sir.

Chairman PROXMIRE. If it were an arm of Congress supposing you were President of the United States and you had your Renegotiation Board completely out from under your control and under the control of Congress, how could you be responsible, then, for discharging your duties with respect to an appropriate defense posture and also with respect to protecting the taxpayer?

Admiral RICKOVER. The Renegotiation Board is a recoupment Board. It does not affect policy. Its reason for existing is to collect for the Government money which it has been overcharged. That is all it is. I think the Executive would be very happy that someone takes it over and sees that Government funds are not wasted. It has nothing to do with appropriations or authority. I don't see where it derogates the authority of the Executive.

Chairman PROXMIRE. I am just trying to think of a precedent or example. The GAO is quite different. The GAO is the congressional watchdog. They can go in and determine if the law is being carried out and tell us whether it is or not, but the Renegoitation Board has an executive function in a sense. It does as you say, recoup excessive payments, and that is quite different than simply advising Congress on whether or not——

Admiral RICKOVER. I don't see any difference between that and the Cost Accounting Standards Board.

Chairman PROXMIRE. The difference it seems to me there is an execution of the law function in the Renegotiation Board, a function, which is constitutionally beyond the reach of a Congress which has the authority to enact legislation, but the Executive has the authority to execute it.

Admiral RICKOVER. The Cost Accounting Standards Board was enacted by legislation of the Executive. It is exactly the same sort of thing. Your Renegotiation Board does not make any laws. It simply sees to it that money that was appropriated is properly spent.

You remember the executive branch wanted the Cost Accounting Standards Board to be put in the Bureau of the Budget. Why do you think that was, so it would be controlled by the Bureau of the Budget and Congress wisely did not permit that. They came to you and recommended and you wisely did not.

It seems to me, with the vastness of the executive branch, with the many influences that are in it, it would be wise to make general.

Chairman PROXMIRE. It is very interesting and one I would like to study. It would certainly be a clear change. We, obviously, need a change in this agency. Almost everybody recognizes it is not working now.

Admiral RICKOVER. You should make it permanent and not renew it every 2 years. You will not get good people on that Board if they

know they have a job that is only going to last 1 year or 2 years. You cannot do that.

Chairman PROXMIRE. Admiral, I want to thank you very much. You have been most responsive and helpful. I can't tell you how much I appreciate it.

Admiral RICKOVER. I would like to touch on one other subject.

Chairman PROXMIRE. Yes, indeed, go right ahead.

Admiral RICKOVER. That is independent research and development. Do you know that the Defense Department hands out $700 to $800 billion a year on research and development? This money is handed out generally to large contractors and it is generally handed out on the basis of how much work the contractor does. There is no control of the work. Under $2 million it can be granted by interim—anyone in the Defense Department is authorized. Anything over that is considered anathema. I have not seen one case in my field and this is after 15 years with independent research and development has helped the Defense Department. There may be some of course. You have the same situation with the National Science Foundation. You have set up these groups of people who can really appropriate money. I read in the paper you were against studies of love. Do you remember that?

Chairman PROXMIRE. I am all for the studies. I don't think the taxpayer should have to pay for it. We are being drowned in sex and love in the private sector. I am not in favor of love being paid for by the taxpayer.

Admiral RICKOVER. Some love is paid for indirectly by the taxpayer.

Chairman PROXMIRE. I am sure it is. [Laughter.]

Admiral RICKOVER. To be serious, why do you permit these organizations like the National Science Foundation, the Department of Defense to actually become taxing outfits on the Government. Why don't you cut their appropriations on that stuff. The National Science Foundation started in the Civil War when Abraham Lincoln appointed two or three people to advise him on science. Now it has become a huge outfit with a large staff. I think if you traced it through, you might find that many of the staff sometimes get grants or their friends get grants for all sorts of worthless purposes.

May I read two or three you did not find?

Chairman PROXMIRE. Yes, indeed, I would be delighted.

Admiral RICKOVER. Research on help-giving, $68,000; origin of diamonds, $50,000; relationship between arousal and aggression of humans, $44,000; factors affecting attitudes toward others—that is only $32,000—pattern of interpersonal attraction—that could be male or female, $66,000; development of goals accounting system, $141,000; cross-cultural parallels in bison kilocytes, $6,000—that is a cheap one; comparative study of adolescent political involvement, $109,000. That is because those guys will vote someday so they are worth a lot of consideration. Monitoring of the San Diego primate population, $79,000; application of psychometric techniques on citizens' perceptions, $82,000. Now what in the devil is the National Science Foundation getting into this kind of tripe. Why should the taxpayers and Congress without being consulted—this is typical. You can find many more.

Here it is the country is really in a dire situation with the energy, its future, its foreign policy, and so on. We need to save money as much

as possible and here we are letting individuals all on their own and in the R. & D. The shipbuilder decides to design a commercial pamphlet. He uses the information he has on the Department of Defense nuclear ships to design it and we have to pay him money for that. The same shipbuilder develops a welding machine at 100-percent Government expense. He turns it over to another branch of his company and thereafter he charges the Government patent rights. He never could have had it without the Government. He charges the royalty on the units for the patents.

The Government hands over this money. It does not have the patents, it does monitor it, but it is covered under the broad assumption this contributes to defense. Anything contributes to defense. You could give a farmer some money to develop a better grain. Anything benefits defense if you want to take that broad attitude. But it seems to me Federal officials should be enjoined from having the right to essentially levey.

Chairman PROXMIRE. Thank you very much, Admiral. I want to get back to one specific part of this. In your talk about independent research and development compared to the regular R. & D., we spend $8, $9, $10 billion in R. & D. Why is it the contractors are so anxious to maintain this independence. There does not seem to be an explicit connection.

Admiral RICKOVER. Why not spend it on commercial research? Most of the money goes to big companies. The little defense contractor does not get any.

I sent a letter to the Comptroller General covering my details and views and I would like to supply it for the record.

Senator PROXMIRE. Yes, indeed.

[The letter follows:]

U.S. ATOMIC ENERGY COMMISSION,
Washington, D.C., Nov. 1, 1974.

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

DEAR MR. STAATS: In a letter dated September 27, 1974, Mr. R. W. Gutmann of your staff requested my comments on alternative approaches to the treatment by the Defense Department of contractor independent research and development costs (IR&D). The fourteen alternative approaches ranged from removal of all Defense Department controls over IR&D, to strict control of these costs through grants or contracts. I am responding directly to you because I believe IR&D is an important subject meriting your personal attention.

First, I want to comment on some of the underlying assumptions about IR&D and defense procurement that these approaches appear to make and with which I disagree. For example, there seems to be an assumption that without IR&D, weapons development will be adversely affected. Certainly, some technological developments in weaponry may have flowed from work funded under IR&D. But since World War II, the great majority of weapons technology has flowed from Government-directed defense work. During this period, most defense research and development has been funded directly by the Government through in-house laboratories and through contracts and grants to private industry and educational institutions. In over 50 years of naval experience, I have not found direct funding of research and development to be stifling to technological or scientific creativity. Thus, a change in the treatment of IR&D, in my opinion, would not hamper the development of weapons technology.

There also appears to be an inherent assumption that the Government has an obligation to subsidize contractors' independent research and development programs. For example, one disadvantage listed for a direct grant system of funding IR&D is that "contractors could be reluctant to use *their own funds* for research if they are not sure of getting grant funds for further work." (italics mine).

The question inevitably arises that if the research is not sufficiently attractive to be funded either by the contractor, or directly by the Government, why should the Government pay for it indirectly?

Much of the debate over IR&D within the defense community is being conducted with a basic misconception about defense procurement. There is a continuous search for the correct management formula or the ideal organizational structure under which defense procurement dollars automatically will be well spent without having to resort to Government surveillance. Unfortunately, my experience has been that research and development and procurement do not lend themselves to simple, automatic policies. I find, for example, when dealing in these areas that research is not easily differentiated from development; some work can legitimately be classified in either category. Proper administration of research and development comes not from more precise definitions of these terms, but from better knowledge and closer technical control of the projects being undertaken.

Independent research and development and bid and proposal costs (B&P) are often interchangeable. Companies may treat certain costs as either IR&D or B&P for accounting purposes. This principle is even recognized in the Armed Services Procurement Regulation which permits companies to recover costs for B&P over the negotiated ceiling as long as the ceiling on IR&D costs is reduced by a like amount, and vice versa.

There is essentially no competition in most defense procurement. The only truly competitive procurements are formally advertised procurements, and they represent typically about eleven percent of prime contract dollars per year. On the other hand, over half of all defense procurement is placed under sole source or follow-on, non-competitive conditions. In this atmosphere, there is little real incentive for defense contractors to cut costs, and to manage closely such overhead programs as IR&D. On the contrary, current Defense Department profit policies reward high costs with high profits, and provide a positive incentive for inefficiency and lax management.

Finally, fixed price type contracts do not ensure low prices; nor do they protect the Government's interests sufficiently to make Defense Department controls over IR&D unnecessary. Fixed price contracts and subcontracts awarded under non-competitive conditions do limit to some extent the Government's exposure to cost overruns. But they give a contractor little incentive to submit the lowest reasonable bid price. Thus, fixed priced contracts are not a substitute for effective competition. In fact, as I am sure you are aware, there is no magical mix of contract types that can substitute for real competition or, in the absence of such competition, for Government surveillance of contractor operations.

What disturbs me the most is that the GAO proposals, like much of the current debate, tend to consider IR&D only from the contractors' point of view. Little if any attention is being given to IR&D as it affects the user—the Defense Department. Yet, these are important considerations, particularly in a period of budget stringency. For example:

The Navy is short of critically needed research and development funds. In fiscal year 1973, the last year for which figures are available, the Defense Department paid $441 million for contractor independent research and development work. In contrast, the total Navy exploratory development budget for fiscal year 1975 is under $300 million. Many important submarine research projects have had to be canceled, deferred, or cut back in such areas as advanced sonars, communications, weapons, navigation, and nuclear propulsion due to a lack of money. Yet contractors are able to pursue their own research and development projects because of the Defense Department's largesse with funds.

While hundreds of millions of defense dollars each year are spent for IR&D, the benefits accruing to the military from this work are uncertain. In my opinion, whatever benefits have accrued from this program in past years have not been worth the cost. Certainly this is true in the areas in which I have direct knowledge.

The Government has little control over IR&D programs. The Defense Department cannot actively supervise or even closely monitor the work; it cannot eliminate unnecessary duplication; and it cannot direct that certain projects be undertaken or performed.

The Government receives neither rights to technical data nor patent rights from work performed under IR&D. On the contrary, if a product or process developed under IR&D is patented by the contractor, the Govern-

ment may have to pay a royalty for use of the patented item. I encountered one case where a contractor developed an automatic welding machine under an IR&D program, for which 99 percent of the costs were paid by the Defense Department. The welding machine was then marketed to defense suppliers who passed on the royalty costs to the Government in the price of their work. In this case, the Government paid for developing the invention and continues to have to pay for the rights to use it.

In addition to these drawbacks to IR&D from the Government's point of view, the present IR&D system is actually anti-competitive. Companies doing defense business are able to develop inventions at Government expense which they may then use in their commercial work. This gives them a competitive advantage over non-defense firms which are not eligible for such a subsidy.

The present system of evaluating contractor independent research and development programs is ineffective. The law requires that the Defense Department make an affirmative determination that the work has a potential military relationship before IR&D costs can be accepted. But under these criteria, almost any research project, no matter how remote, could be shown to have a potential military relationship.

Finally, the reviews of contractor IR&D programs tend to be superficial. IR&D programs, for which the Government pays less than $2 million, are not reviewed technically; they are controlled only by a negotiated ceiling. Programs over $2 million receive technical reviews, but these are often conducted by people with little knowledge of the work. Even in the nuclear propulsion field, I am not routinely asked to evaluate contractor research programs, and as a consequence the Defense Department has funded IR&D projects which duplicated work I was doing, or which were directed toward commercial, not military application.

I believe that we need to recognize the Government's interests and abolish the practice of subsidizing contractor IR&D. I recommend that a system similar to that employed by the Atomic Energy Commission be adopted. Specifically:

1. Treat IR&D costs on a contract by contract basis. IR&D costs would be unallowable *except* where the contracting agency made an affirmative determination that an IR&D project provided sufficient benefits to the contract to warrant the cost.

2. Allow contractors to submit to the Defense Department any military-related research projects which they want the Government to finance completely. The Defense Department would then contract directly for whichever of these projects it desires to pursue. The funds would be provided as a separate line item in the RDT&E appropriation.

3. Allow B&P costs if the subject matter of the bids and proposals is applicable to defense work. B&P costs for non-defense work would be unallowable. Place a ceiling on the allowable B&P expenses such as one percent of the total direct material and direct labor costs of the contract work.

4. Reserve and protect Government rights to technical data and patents commensurate with the percentage of the research costs borne by the Government, regardless of whether funding or those costs is direct or indirect.

Contractors would undoubtedly dislike this sytem as it would greatly reduce the Government's funding of their own pet projects. But the question for the Congress must boil down to this: If the ordinary citizen were given up to 500 million dollars a year for research and development work, would he turn that money over to defense contractors to spend as they saw fit in the hope something useful would result? Or would he direct that money toward finding solutions to specific problems standing in the way of better weapons systems? There is no question in my mind but that the Department of Defense would get far more for its money if it were spent on specific defense projects where responsible officials had to review, approve, justify and defend the expenditures. This system would also permit Congress to review and oversee these expenditures—a possibility which is currently precluded.

I know you take seriously your responsibility to look "to greater economy or efficiency in public expenditures." In my view, the present IR&D system does not provide either economy or efficiency. That is why I recommend greater control over research and development work accomplished with public funds.

I appreciate the opportunity to comment to you on this subject.

Sincerely,

H. G. RICKOVER.

Chairman PROXMIRE. Is there anything else you have to add?

Admiral RICKOVER. I could talk to you a lot more but you have the Renegotiation Board witnesses.

Chairman PROXMIRE. Thank you very much.

Last year following hearings I conducted in my appropriations subcommittee, I borrowed two examiners from the General Accounting Office and put them to work full time on several cases decided recently by the Renegotiation Board involving Mobil Oil Co., McDonnell Douglas and the Northrop Corp. The two examiners, Bernard Trescavage and Woodliff Jenkins, have just about completed their 4-month investigation, and I would like them to step forward and briefly summarize their findings. Gentlemen, I understand you have a number of charts to illustrate your findings and you may use your time as you see fit. They will all be put in the record.

I want to make it clear these two witnesses are not speaking for the General Accounting Office. They are on the payroll of the Joint Economic Committee and they are speaking as staff experts before our committee.

Gentlemen, please identify yourselves for the record.

STATEMENT OF WOODLIFF JENKINS AND BERNARD TRESCAVAGE, AUDITORS, JOINT ECONOMIC COMMITTEE

Mr. JENKINS. I am Mr. Woodliff Jenkins.

This staff study is an abbreviated report on the renegotiation of Mobil Oil, McDonnell Douglas and Northrop Corp. which were the topics of discussion during the July and October 1974 hearings before the Senate Subcommittee on Appropriations (Renegotiation Board). The full report will discuss in more detail the bases of the final opinions for the 5 fiscal years discussed here. It will also discuss the degree to which the filings were evaluated and the results of the Board's study on evaluations of conglomerates by product-line and segments.

Our study concludes that oil company filings need to be fully investigated so that the Board can assure itself that special advantages afforded contractors who deal in raw materials are not abused.

Chairman PROXMIRE. Was the Mobil case fully investigated in this case?

Mr. JENKINS. I hope to cover that further in my statement.

Our study shows that a significant amount of profit could be attributable to these special advantages. This possibility should have led to questions about the amounts involved and their propriety.

On McDonnell Douglas and Northrop, the tables show the profitability of the contractors on a segmented basis (divisions or former companies) and hypothetical excessive profits, if, after the application of the statutory factors, the Board determined the level of profitability to be the industry averages. Application of the statutory factors and the range of low and high returns of the industry were not considered in computing these hypothetical excessive profits. However, the amount of profits retained by these contractors is substantially higher than the industry averages.

The Renegotiation Act of 1951 provides for certain special advantages that are to be afforded contractors whose business with the

Government involves raw materials found in nature. These special advantages are commonly called the raw material exemption and the raw material cost allowance.

The raw material exemption provides that "any contract or subcontract for the product of a mine, oil or gas well, or other mineral or natural deposit, or timber, which has not been processed, refined, or treated beyond the first form or state suitable for industrial use" is exempt from renegotiation. The regulations of the Renegotiation Board state that a raw material is an exempt product until it has reached its "dispersal point," the point at which a substantial portion of the product is treated, refined, or processed to produce various end products for the ultimate consumer. The regulations also include a list of products which the Board has determined are exempt from renegotiation under the act. Included in this so-called raw materials exemption list is crude oil, not "processed or treated further than the processing or treating customarily occurring at or near the well." Under this provision, then, the sale of crude oil to the Government would clearly not be subject to renegotiation.

The raw material cost allowance provides a similar advantage to the contractor that is an integrated producer, that is, one that produces or acquires a raw material in the exempt state and further processes, refines, or treats it beyond the exempt state to produce an end product which is being sold to the Government. In such cases, the integrated producer, for purposes of renegotiation, is allowed to claim as an item of cost the value of the raw material "at its last exempt state." This value is to be in "such amounts as, in the opinion of the Board, fairly represents a properly applicable allowance."

The stated purpose and intent of the raw material cost allowance is to allow the integrated producer an item of cost "substantially equivalent" to the amount that the contractor could have realized had he sold the product in the exempt state, that is, the amount which would have been excluded from renegotiation under the raw material exemption. In determining the propriety of the amount claimed as a cost allowance, the Board is to duly consider the "established sale or market price," when there is a representative market for the material in the exempt state, and any other factors which are necessary to reflect the purpose and intent of the exemption.

The raw material cost allowance thus permits the integrated producer to use the fair market value of the raw material in the exempt state as an item of cost. This item of cost includes a profit over his actual costs and, in effect, shields from consideration the profit that would have been earned had the raw material been sold in the exempt state.

In considering fiscal year 1951 oil company cases, the Board adopted a policy [1] that the raw material cost allowance would also include the fair market value of transporting crude oil to the refinery. This decision was apparently predicated on the fact that at that time worldwide crude oil prices were based on U.S. prices, that is, foreign crude prices were set so that the price of the crude plus transportation to the United States would be competitive with the U.S. crude prices.

[1] Mobil supplied the staff with an undated and unsigned document which it said was an instruction from the Board regarding fiscal year 1951 oil company filings. This document contains the above policy, but the Board could not find any record of it. None of the current Board officials had ever heard of the document.

The Board's early policy on the raw material cost allowance has remained unchanged in spite of the drastic changes which have occurred since then in the manner in which foreign crude prices are established: Namely, the use of tax reference prices—foreign posted prices—arbitrarily set by the producing country so that it will be assured of receiving a given amount of income tax and royalty revenue on its oil.

The Board's Office of General Counsel is currently reviewing the Board's regulations on the raw material exemption and raw material cost allowance and their appropriate application to the oil industry. One objective of this review is to determine if the fair market value of transporting crude oil to the refinery is properly includable as part of the raw material cost allowance.

In its fiscal year 1972 filing with the Board, Mobil reported a $0.5 million loss on total renegotiable sales of $114.3 million; $95.2 million of the renegotiable sales were made by the parent corporation at a reported profit of $2.5 million. The remaining $19.1 million of renegotiable sales were made by 23 Mobil subsidiaries which filed separately. Since very little backup information was submitted by the subsidiaries and since the bulk of the renegotiable sales were made by the parent, we concentrated our efforts on the parent's filing.

The parent's renegotiable sales consisted entirely of refined petroleum products sold domestically, including gasoline, aviation gasoline and military jet fuel.[1] In computing profits on its sales, the parent did not specifically compute a raw material cost allowance, but the manner in which the contractor claims it costed its crude into the the refinery has the same effect. That is, Mobil claims it costed crude oil into its refinery at the fair market value of the crude plus the fair market value of transporting the crude to the refinery. The profits included in these costs at the refinery gate are then attributable to the activities before the refinery gate which Mobil claimed were exempt from renegotiation. The net effect of this technique is that the profits shielded by the raw material cost allowance are included in the profits of the exempt activities.

If the Board is satisfied that a contractor did not earn excessive profits, it issues the contractor a clearance. Clearances may be issued after a case has been assigned to a region for full investigation or cases may be cleared without assignment. According to the Board's regulations, cases may be cleared without assignment if the Board can readily decide on the basis of information in the filing that the contractor did not earn excessive profits. In such cases the conclusion is to be so obvious from the filing that further proceedings in the region are unnecessary.

The Mobil fiscal year 1972 case was cleared without assignment in spite of the following facts:

1. No attempt was made to explore the reasonableness of Mobil's assertion that some of its activities were exempt from renegotiation.

2. The Board had in its possession at the time a letter from a Department of Defense contracting officer in which he stated his belief

[1] Foreign sales of refined products to the Government were reported as renegotiable sales by the 23 subsidiaries of $19.1 million, on which a loss was claimed.

that Mobil earned excessive profits on one of its fiscal year 1972 contracts.

3. No effort was made to determine the method used by Mobil to cost crude oil into the refinery nor was there any effort made to verify that these costs in fact represented market value.

4. The Internal Revenue Service had been holding the tax returns of major oil companies open for a number of years because it suspected—and ultimately proved—that companies were transferring oil within their families at prices higher than market value.

5. One Board member asked that the case be assigned to a region for a fuller investigation because Mobil had reported sizable profits to its stockholders, while reporting losses to the Board.

The decision to clear the case without assignment was apparently based on the contractor's reported profits, accepted at face value, and the fact that the contractor had been cleared for fiscal year 1967 with higher profits after assignment to a region. In the 1967 case, the region did inquire about the contractor's method of costing crude into the refinery and was told that foreign crude was costed into the refinery at foreign posted prices, less 10 percent, plus transportation to the refinery. We could find no evidence that any attempts were made to ascertain whether these prices represented fair market value. In fact, the Board did not verify that foreign posted prices were higher than market value until May 1974—after it cleared the Mobil fiscal year 1972 case without assignment.

Using the data available in the parent's filing, the staff attempted to approximate the profit on renegotiable sales which might be shielded by the raw material cost allowance.

Our analysis yielded the results shown in table 1.

[Table 1 follows:]

TABLE 1.—MOBIL OIL CORP. (PARENT), FISCAL YEAR 1972, PROFITS ON RENEGOTIABLE BUSINESS UNDER VARIOUS ASSUMPTIONS

Assumptions	Sales [1] (thousands)	Profits (thousands)	Return on sales (percent)	Return on capital [2] (percent)	Return on net worth [2] (percent)
1972 FTC industry average returns			8.4	6.6	10.9
1. Mobil's filing	$95,218	$2,470	2.6	1.5	2.0
2. Transportation excluded from cost allowance	95,218	6,332	6.6	3.8	5.2
3. Actual profit with no cost allowance	95,218	15,922	16.7	9.6	12.9

[1] Does not include $19,000,000 of sales to the Government by Mobil subsidiaries. Renegotiable sales for Mobil Oil Corp. and subsidiaries total $114,000,000. The data submitted by the subsidiaries did not permit an analysis of profits under the above assumptions.

[2] Staff computation. Capital and net worth allocated to renegotiable business on basis of sales.

Note: Effects of cost allowance claimed by Mobil: Profit attributable to cost allowance: $15,922,000 minus $2,470,000 equals $13,452,000. Mobil cleared with a return on sales that was twice the FTC industry average.

Mr. JENKINS. As indicated, profits shielded by the cost allowance could be as much as $13.4 million. Actual profits could thus be as high as $15.9 million, which is twice the 1972 industry average return on sales per Federal Trade Commission statistics.

The analysis of profit in table 2 indicates that crude oil profits shielded by the cost allowance could be as high as $9.6 million and shielded transportation profits could be as high as $3.8 million. These

figures were then used to develop the upper part of the table which demonstrates the effect of the cost allowance on renegotiable costs and profits.

[Table 2 follows:]

TABLE 2.—MOBIL OIL CORP. (PARENT), FISCAL YEAR 1972 EFFECTS OF RAW MATERIAL COST ALLOWANCE ON RENEGOTIABLE PROFIT

[In thousands of dollars]

	No cost allowance	Crude oil profits allowed	Crude oil and transport profits allowed
Sales	95,218	95,218	95,218
Cost and expenses	76,963	88,981	92,843
Adjustments from book to tax accounting basis	2,310	(118)	(118)
Total costs and expenses	79,273	88,863	92,725
Operating profit (loss)	15,945	6,355	2,493
Other income and (deductions), net	(23)	(23)	(23)
Net profit for renegotiation before income taxes	15,922	6,332	2,470

Analysis of profit

[In thousands of dollars]

Total profit	15,922
Profit with crude oil allowance	6,332
Crude oil profit	9,590
Profit with crude oil allowance	6,332
Profit with crude oil and transportation allowance	2,470
Transportation profit	3,862
Refinery profit	2,470

Mr. JENKINS. By including crude oil profits in the cost allowances "Total Costs and Expenses" are increased by $9.6 million and profit, are decreased by the same amount. Adding transportation profits to the cost allowance increases "Total Costs and Expenses" by another $3.8 million and decreases profits by the same amount.

It should be carefully noted that the profits used in the above analyses are estimates only, based on total profits of the parent allocated to renegotiable business on a sales ratio. A large portion of the additional profit allocated to renegotiable business is attributable to foreign crude oil and the transportation of that crude to the refinery. Mobil maintains that only a small part of this foreign crude actually found its way into its domestic refinery operation which is the operation reported as being renegotiable in the parent's filing. If this be true, then our estimates of renegotiable profits could be reduced substantially.

Chairman PROXMIRE. Mr. Trescavage?

Mr. TRESCAVAGE. The McDonnell Aircraft Corp. and the Douglas Aircraft Co. merged in April 1967, to become the McDonnell Douglas Corp. In the corportation's first year of operation, the Renegotiation Board determined excessive profits in the amount of $5 million. The 1968 and 1969 years were cleared. While the McDonnell Co. had earned excessive profits in the years immediately before 1967, the Douglas Co. had been cleared.

For the years 1967 through 1969, the contractor filed as the McDonnell Douglas Corp., and some data for each of the former companies

was obtained and evaluated. The instructions for filing which were sent to the contractor at that time stated the contractor should furnish schedules showing operating results by principal products or divisions if they are engaged in more than one type of renegotiable business or operate on a divisional basis. For the contractor's years now under investigation, the Board will try to obtain data on a divisional basis.

The McDonnell Douglas and Northrop Corp. filings were evaluated on an overall basis. As previously mentioned, the Board is presently studying the matter of evaluating contractors on a product-line basis.

Table 3 shows profit returns on sales, capital, and new worth—after $5 million refund determintion—and industry averages for 1967 and prior year returns for the two companies before the merger.

[Table 3 follows:]

TABLE 3.—McDONNELL DOUGLAS, FISCAL YEAR 1967—PROFIT RETURNS ON SALES, CAPITAL AND NET WORTH FOR McDONNELL DOUGLAS CORPORATION AND INDUSTRY AVERAGES (1967) AND PRIOR YEAR RETURNS FOR McDONNELL COMPANY AND A SIMILAR CONTRACTOR

	Sales	Profit to capital percent	Net worth
Industry averages: [1]			
Federal Trade Commission	4.8	7.5	23.3
Internal Revenue Service	3.4	4.3	14.9
After $5,000,000 refund:			
Final opinion:			
McDonnell Douglas	7.8	29.4	[5] 59.0
McDonnell segment [2]	8.3	32.4	82.3
Douglas segment [2]	6.6	24.9	38.0
Regional accounting report:			
McDonnell Douglas [3]	7.6	28.6	87.8
McDonnell segment [2]	8.4	31.1	94.2
Douglas segment [2]	5.8	22.0	76.2
Prior years (before merger): [6]			
McDonnell—Fiscal year ending June 30, 1966 (after $27,000,000 refund) [4]	8.3	32.0	63.0
McDonnell—Fiscal year ending Dec. 31, 1966 (after $7,000,000 refund)	8.7	28.0	55.0
Grumman:			
1965 (after $7,500,000 refund)	5.6	21.2	69.5
1966 (after $11,000,000 refund)	5.9	25.3	71.2

[1] FTC statistics are before Federal income taxes. IRS statistics include income earning companies only.
[2] Staff computed returns based on data available in the files.
[3] After $5,000,000 refund determination but before 3 addendums to the accounting report. The 3d addendum reduced the consolidated net worth from 89 percent to 61 percent before the refund is applied. The regional renegotiation determined the excessive profit to be $7,000,000 which was subsequently reduced to $5,000,000 after the 1st 2 addendums.
[4] Regional board determination was $45,000,000.
[5] Before refund and during the regional board processing, the contractor felt the return should be 49 percent, the accountant felt it should be 89 percent (before 3d addendum), the regional panel felt it should be 61 percent based on the contractor's approach or 77 percent on a cost of sales ratio. Headquarters felt the returns should be the same as shown by the regional panel.
[6] Douglas Aircraft was cleared at Nov. 30, 1965, Nov. 30, 1966, and Apr. 30, 1967 with returns on sales at 3.4 percent 5.7 percent and 5.2 percent, respectively.

Mr. TRESCAVAGE. During the western regional board's processiug of the filing, the accounting division in the regional board would not accept the contractor's approach to identify certain liabilities to non-renegotiable business which would reduce the return on renegotiable net worth from 89 to 61 percent.

The accounting division decided that its approach was supported in several ways, including the GAO report entitled, "Defense Industry Profit Study." In that report, the most feasible way found to allocate capital to government business was to identify assets—receivables, in-

ventories, and so forth—to government business and to then allocate net worth on the allocation of assets ratio.

The contractor was reluctant to enter into an agreement for a $5 million refund determination unless its approach was accepted. Subsequently, the regional board rejected the accounting division's findings and adopted the contractor's approach. One regional panel member who accepted the contractor's approach over the accounting division's approach stated he did so because:

> First, the excessive profit determination would not have changed regardless of which method was used.
>
> Second, the contractor said its records supported its position, although the contractor was not asked for the data.
>
> Third, the return on capital was regarded as more important than net worth and the return on capital changed little under either method.

Chairman PROXMIRE. Let me ask you some questions about this one, because this one seems to be an extraordinary profit in relationship to capital, in relationship to net worth and, of course, the sales margin is far greater than the industry average.

Is it a fair conclusion that the overall McDonnell Douglas profit to capital is 29 percent and net worth is 59 percent return; is that right?

Mr. TRESCAVAGE. Yes, on a consolidated basis, 29 percent.

Chairman PROXMIRE. This is after a $5 million refund from the Federal Government?

Mr. TRESCAVAGE. Yes; sir.

Chairman PROXMIRE. This is based on your estimate?

Mr. TRESCAVAGE. No, these were figures gotten from the board files. They are from the top line of the McDonnell Douglas Corp.

Chairman PROXMIRE. In your view, based on the law, is there any kind of guideline that the Board could use in determining what would be an appropriate profit and what would be an excessive profit? It would seem to a layman that a 59-percent return on net worth for McDonnell Douglas overall disregarding the fact that for the McDonnell Corp.'s return is much greater, that that is really excessive. That is more than half of your net worth returned in 1 year in profit.

Mr. TRESCAVAGE. Certainly the industry averages should be used as touchstones so to speak. I want to emphasize in these computations that we have not applied the statutory factors. Once these are applied, the contractors conceivably would benefit in terms of more profit.

Chairman PROXMIRE. The IRS averages are based on actuarial returns and that shows a return on net worth was around 15 percent in the industry, 4.3 percent in profit, loss and capital and 3.4 for sales. There is an enormous difference here.

Mr. TRESCAVAGE. On the Internal Revenue Service statistics, Mr. Chairman, those are companies with income only. Those don't include any loss companies. These are profitable companies.

Chairman PROXMIRE. So it would be lower. The 14.9 percent would be high.

Mr. TRESCAVAGE. Yes, sir.

Chairman PROXMIRE. You say these are just touchstones, the return on net worth and the return on profit to capital and return on sales. There is not a statutory bite here? There is no specific definition of

what is an excess profit that we could assess to determine whether the judgment of the Board was right or wrong.

Mr. TRESCAVAGE. The statute directs the Board to consider the statutory factors, Mr. Chairman. The Board must subjectively apply the factors, such as reasonableness of costs and profits, in a determination of these cases. What this does show is that when we break down the corporation into its segments, there is a vast difference between the McDonnell segment and the Douglas segment. It shows their profitability in terms of what they have made over the industry averages.

Chairman PROXMIRE. Tell us a little bit about that. Why should the Board have taken notice of the fact when you break down the McDonnell segment from the Douglas segment, McDonnell enjoyed almost 82.3 percent return on net worth and so forth?

Mr. TRESCAVAGE. Mr. Chairman, McDonnell Douglas was considered on an overall basis. The data was not separately evaluated in terms of the McDonnell segment and Douglas segment in this particular case.

Chairman PROXMIRE. If you have another case, go right ahead.

Mr. TRESCAVAGE. Table 4 shows profit returns on sales, capital and net worth for the corporation and industry averages for 1968.

[Table 4 follows:]

TABLE 4.—McDONNELL DOUGLAS, FISCAL YEAR 1968, PROFIT RETURNS ON SALES, CAPITAL, AND NET WORTH FOR McDONNELL DOUGLAS AND INDUSTRY AVERAGES (1968)

[In percent]

	Profit to—		
	Sales	Capital	Net worth
Industry averages: [1]			
Federal Trade Commission	6.0	8.8	26.6
Internal Revenue Service	4.8	[2] 6.4	[2] 19.0
Final decision (no refund):			8
McDonnell Douglas	7.6	26.2	4.7
McDonnell segment	9.1	[3]	[3]
Douglas segment	5.5	[3]	[3]
Regional accounting report:			
McDonnell Douglas	7.6	[4] 19.9	[4] 71.4
McDonnell segment	9.1	[4] 23.8	[4] 85.5
Douglas segment	5.5	[4] 14.3	[4] 51.2

[1] FTC statistics are before Federal income taxes. IRS statistics include income earning companies only.
[2] Regional board adjusted returns on capital to 7.2 percent and net worth to 27.7 percent to make data comparable to McDonnell Douglas.
[3] Data not available to compute these returns. Final opinion reflects returns using the contractor's approach.
[4] Returns are based upon an adjusted cost of sales approach. Regional accounting division rebutted the contractor's approach. Staff computed the returns based on data in the files.

Mr. TRESCAVAGE. During 1969, the regional accounting division was again opposed to the contractor's approach. The contractor's approach was accepted by the regional board and the statutory board.

Chairman PROXMIRE. Then this shows in 1968 the McDonnell Douglas net worth return was roughly twice the industry average on a net worth basis and about three times the industry average on a profit to capital percent basis and about 30 percent higher on the sales basis. Is that about right?

Mr. TRESCAVAGE. Yes, Mr. Chairman. There was an attempt made in 1967 to go back and get Segment data in terms of capital and net worth.

Chairman PROXMIRE. As I understand it, the Renegotiation Board got nothing on the segments.

Mr. TRESCAVAGE. To compute these particular returns here.

Chairman PROXMIRE. They also required no refunds?

Mr. TRESCAVAGE. They cleared them with no refunds.

Chairman PROXMIRE. Break down no segments?

Mr. TRESCAVAGE. That is right.

Chairman PROXMIRE. Go ahead.

Mr. TRESCAVAGE. Table 5 shows profit returns on sales, capital and net worth for McDonnell Douglas Corp., Northrop Corp., and industry averages for 1969.

[Table 5 follows:]

TABLE 5.—McDONNELL DOUGLAS AND NORTHROP CORP.—FISCAL YEAR 1969, PROFIT RETURNS ON SALES, CAPITAL AND NET WORTH FOR McDONNELL DOUGLAS CORP., NORTHROP CORP. AND INDUSTRY AVERAGES (1969)

[In percent]

	Profit to—		
	Sales	Capital	Net worth
Industry averages: [1]			
Federal Trade Commission	5.5	6.4	18.9
Internal Revenue Service	4.2	[2] 4.7	[2] 12.8
Final decision (no refund):			
McDonnell Douglas	6.3	20.7	42.5
McDonnell segment	7.3	[3]	[3]
Douglas segment	5.1	[3]	[3]
Regional accounting report:			
McDonnell Douglas	6.3	[4] 13.7	[4] 46.4
McDonnell segment	7.3	[4] 15.1	[4] 51.2
Douglas segment	5.1	[4] 11.6	[4] 39.3
Final decision (no refund):			
Northrop Corp. (consolidated)	7.3	15.2	31.4
Northrop Corp. (parent only)	8.5	[3]	[3]
Aircraft division	14.9	[3]	[3]
Regional accounting report:			
Northrop Corp. (consolidated)	8.0	16.6	54.1
Northrop Corp. (parent only)	9.5	[3]	[3]
Aircraft division	16.4	[3]	[3]

[1] FTC statistics are before Federal income taxes. IRS statistics include income earning companies only.
[2] Regional Board adjusted returns on capital and net worth to 5.6 percent and 23.8 percent to make data comparable with McDonnell Douglas and Northrop Corp.
[3] Data was not available to compute these returns using McDonnell Douglas' approach. Data for Northrop Corp., was not detailed enough.
[4] Returns are based upon the use of an adjusted cost of sales approach. The returns for the 2 segments were computed by staff using data in those files.

Chairman PROXMIRE. McDonnell Douglas 1969 case compared with the Northrop 1969 case?

Mr. TRESCAVAGE. Yes, sir.

Chairman PROXMIRE. Go ahead.

Mr. TRESCAVAGE. Both were fiscal year 1969 cases.

Chairman PROXMIRE. There is a regional breakdown. The last figure there on table 5 shows a regional figure. There is no breakdown by the Board, is that right, for Northrop Corp. consolidated and parent owned?

Mr. TRESCAVAGE. Yes, sir, some data was submitted on assets but not enough to compute returns on capital and net worth for the parent company or for the aircraft division.

Chairman PROXMIRE. Let's spend a minute to see if we can understand why from the standpoint of the public interest there should be a breakdown here. As I understand it, the only figures you have there in that regional accounting report, the last number relates to profit on sales and it shows an Internal Revenue Service return of about 4.2 percent—Federal Trade Commission 5.5 percent. When you break it down, you see about three times that percentage for the aircraft division. Is it a fair observation that this should be an indication to the Board here in Washington they should take a close look at it and ask for a close breakdown which they did not do; is that correct?

Mr. TRESCAVAGE. I believe so, Mr. Chairman. In this particular case, it was a separate product line shown to be much more profitable than the other product lines. I have a table, for the record, that gives a more detailed breakout of Northrop into its various subsidiaries and divisions, but in this particular case the aircraft division was shown as being the profitable one far above the industry average.

Chairman PROXMIRE. Go ahead.

Mr. TRESCAVAGE. The following table shows the levels of profitability of the parent company and the subsidiaries of the Northrop Corp. for 1969. The levels of profitability of the divisions within the parent are also shown.

[The table follows:]

PROFIT ON SALES FOR NORTHROP CORPORATION (CONSOLIDATED), NORTHROP (PARENT) AND SUBSIDIARIES AND THE DIVISIONS OF NORTHROP (PARENT)—1969

[Dollar amounts in thousands]

	Renegotiable		
	Sales	Profits	Percent
No refund:			
Northrop Corp. (parent)	$234,496	[1] $19,980	8.5
Page Communications Engineers, Inc	46,597	2,070	4.4
The Hollicrafters Co	39,424	2,916	7.4
Northrop Carolina, Inc	19,405	481	2.5
Warnecke Electron Tubes, Inc	3,739	(288)	Loss.
Total	343,662	25,159	7.3.

	Divisions				
	Total	Aircraft	Nortronics	Ventura	Laboratory
NORTHROP CORP. (PARENT)					
Renegotiable sales	$234,496	$88,623	$117,079	$27,428	$1,366.
Renegotiable profits	[1] 19,980	13,232	6,586	72	90
Percent	8.5	14.9	5.6	0.3	6.5

[1] Review at headquarters reduced profit from $22,261,000 to $19,980,000. The adjustments related to additional consideration given on progress payments related to commercial work, profit of $936,000 which was earned on business performed in prior years and tentative IRS/contractor agreement on the amount of disallowance which will reduce income.

Mr. TRESCAVAGE. The following table, table 6, shows the amount of actual excessive profits and hypothetical excessive profits based upon industry averages for the McDonnell Douglas Corp., and the Northrop Corp. Amounts were separately computed for sales, capital, and net worth. Statutory factors have not been applied nor the range of low

and high returns of the industry considered in computing the hypothetical excessive profits.

[Table 6 follows:]

TABLE 6.—McDONNELL DOUGLAS AND NORTHROP CORP., EXCESSIVE PROFIT DETERMINATIONS—ACTUAL AND HYPOTHETICAL BASED ON INDUSTRY AVERAGES OF PROFITS ON SALES, CAPITAL AND NET WORTH

[In millions of dollars]

	Sales	Capital	Net worth
Final opinions:			
1967—McDonnell Douglas:			
FTC	53.3	98.0	80.8
IRS	75.9	111.9	98.8
Actual		5.0	
1968—McDonnell Douglas:			
FTC	26.4	83.3	56.9
IRS	46.2	94.7	76.5
Actual		0	
1969—McDonnell Douglas:			
FTC	11.1	60.5	48.6
IRS	29.2	67.7	61.2
Actual		0	
Northrop Corp.:			
FTC	6.2	14.6	10.0
IRS	10.7	17.4	14.9
Actual		0	

Chairman PROXMIRE. What you are showing is what the Board would recover if they used the industry average as a guideline?

Mr. TRESCAVAGE. Yes, sir.

Chairman PROXMIRE. How legitimate a standard would that be?

Mr. TRESCAVAGE. It would not be as I mentioned before, Mr. Chairman. We have not applied the statutory factors nor the range of low and high returns of the industry. Conceivably, this could be the very most that an inefficient contractor might get.

Chairman PROXMIRE. It shows the disparity?

Mr. TRESCAVAGE. Yes, sir, it shows the disparity.

Chairman PROXMIRE. Let's see if we understand it now. It would show that the amount that could be recovered if you applied that would be how much with respect to 1967, 1968, and 1969; can you tell us? Can you read table 7 to us so we understand that?

Mr. TRESCAVAGE. We apply the industry averages to each one of the years of those corporations. If we use the sales base of FTC, the recovery would be $53.3 million. Using capital by itself, $98 million. Using net worth, $80.8 million. Using the IRS statistics, the recovery would be $75.9 million using sales, $111.9 million using capital, and $98.8 million using net worth.

Chairman PROXMIRE. The actual amount they did reclaim was in 1967 they picked up $5 million, and in 1968 nothing, 1969 nothing, and Northrop Corp. picked up nothing.

Mr. TRESCAVAGE. Yes, sir.

The following table, table 7, shows the returns on sales, capital, and net worth after the hypothetical excessive profits, based on sales, is eliminated.

[Table 7 follows:]

TABLE 7. McDONNELL DOUGLAS AND NORTHROP CORP., EXCESSIVE PROFIT DETERMINATIONS—ACTUAL AND HYPOTHETICAL BASED ON INDUSTRY AVERAGES OF PROFITS ON SALES AND AFTER DETERMINATION PROFIT ON SALES, CAPITAL AND NET WORTH

	Amount (millions)	Percent profit to—		
		Sales	Capital	Net worth
Final opinions:				
1967—McDonnell Douglas:				
FTC	$53.3	4.9	18.0	36.2
IRS	75.9	3.5	12.8	25.6
Actual	5.0	7.8	29.4	59.0
1968—McDonnell Douglas:				
FTC	26.4	6.1	20.6	38.4
IRS	46.2	4.9	16.5	30.7
Actual	0	7.6	26.2	48.7
1969—McDonnell Douglas:				
FTC	11.1	5.5	18.0	37.0
IRS	29.2	4.3	13.8	28.3
Actual	0	6.3	20.7	42.5
Northrop Corp.:				
FTC	6.2	5.6	11.4	23.7
IRS	10.7	4.3	8.7	18.1
Actual	0	7.3	15.2	31.4

Chairman PROXMIRE. See if you can explain this to us a little.

Mr. TRESCAVAGE. Mr. Chairman, we have to relate table 7 to table 6. In the first column, if we had used the industry average of the return on sales as the level of profitability and reduced the contractor's profits to equate to those returns, these returns are what the contractor would be left with when that remaining profit is put over sales, capital, and net worth. In using the industry average as a touchstone and using the sales as being the conservative approach in terms of the amount of excessive profits that could be recovered, this shows the profitability of these contractors after a reduction of excessive profits in the amounts of $53.3 million, $75.9 million, and so on.

Chairman PROXMIRE. That shows if you took the return on sales as a criteria and reduced their profits to the industry average, then they they still would be well above the industry average with respect to profit, capital and net worth?

Mr. TRESCAVAGE. Yes, sir.

Chairman PROXMIRE. Let's go back to Mobil Oil which is a little more complicated. Take a couple of minutes on that. The hour is getting late and I want to give the Renegotiation Board an opportunity to be heard.

A complicating element here as I understand it is there is an exemption in the law and the exemption refers to the raw material for the crude oil, and the temptation, of course, under the law, is to put all your costs in the area that is exempt—I mean put all your costs in the area that is not exempt, in the area that is covered and not to include your cost in the area that is exempt.

Would you explain these tables in terms of what the options might be just as we had them on the other two companies?

Mr. JENKINS. Let me stress again these are hypothetical amounts, estimated by essentially allocating——

Chairman PROXMIRE. Why did you have to do it hypothetically? Why couldn't you get factual figures?

Mr. JENKINS. The facts that are known are not sufficient enough to know for sure exactly what is going on.

Chairman PROXMIRE. In other words, there weren't any facts in the Board's file; is that right?

Mr. JENKINS. They had the data which the contractor submitted. There was substantial data but without other information to go with it we really could not determine exactly what these figures should be.

Chairman PROXMIRE. The Board did not request the additional data.

Mr. JENKINS. No, sir, this case was cleared without assignment.

Chairman PROXMIRE. If the Board would be in position to evaluate whether or not the profit was excessive they should have had the additional data. At least that would be my conclusion.

Mr. JENKINS. I think the point of this table, Mr. Chairman, is this is really one conclusion a logical person could make from the information in the filing. I think it should have sent up a red flag more or less and warranted some explanation to see if in fact this was the case.

Chairman PROXMIRE. After all we have a legislative purpose here. It us under the law that this is done. It is legal and legitimate from the standpoint of Mobil. They acted in good conscience and I guess they did what any prudent person would do to maximize his profits. I guess we could eliminate the exemption—perhaps there is some in—or perhaps we could have some kind of accounting procedure that would have to be followed which would prevent a transfer of costs from the exempt to the nonexempt and thereby artificially reducing the nonexempt; is that right?

Mr. JENKINS. I think the key matter is somewhere along the line to make sure this exemption is properly applied. The Board has to be assured that the oil going into the refinery is valued at the fair market value which is the yardstick you have to use to measure what is an allowable cost under the raw material cost allowance. This apparently has never been done.

Chairman PROXMIRE. Did the Board give that assurance at the time they cleared this?

Mr. JENKINS. No, sir, I believe the case was cleared solely on the figures in the file plus the fact thot in the previous case of Mobil Oil in 1967, they were cleared.

Chairman PROXMIRE. How about one final common sense reaction? After all, you could argue that the actual profit of Mobil, even with everything included, on net worth is not great by most standards, 12.9 percent is not like the very high returns we saw a minute ago with McDonnell Douglas and Northrop.

Mr. JENKINS. Let me say these figures on capital and net worth were our computations and based on strictly an allocation of capital and net owrth on a sales basis, which is not the most scientific method of doing it.of doing it.

Chairman PROXMIRE. The return on net worth, No. 3, which I take it is with all the cost it is with all the costs, is 12.9 percent, average FTC of 10.9 percent. I guess what you are saying is this Renegotiation Board should have looked at this, should have taken all of the factors into consideration which they did not do. They may well have concluded there was not excess profit but at least they should have had the data available to judge whether or not it was or not; is that correct?

Mr. JENKINS. Yes, sir, that is a fair statement and we do not intend to imply there are excessive profits here. The point is the information in the case warranted a fuller investigation before coming up with any conclusions.

Thank you very much.

Chairman PROXMIRE. Thank you very much. Now, the long-awaited appearance of the Renegotiation Board. The final witnesses are Acting Chairman Rex M. Mattingly, Goodwin Chase, and Norman B. Houston.

Mr. Mattingly has a brief written statement. You may read your statement, Mr. Mattingly, and then we will have some questions.

STATEMENT OF HON. REX M. MATTINGLY, ACTING CHAIRMAN, RENEGOTIATION BOARD, ACCOMPANIED BY GOODWIN CHASE AND NORMAN B. HOUSTON, BOARD MEMBERS; AND GEORGE LENCHES, DIRECTOR, OFFICE OF PLANNING AND ANALYSIS

Mr. MATTINGLY. Mr. Chairman, we are pleased to be here at your request to give you a status report on the work of the Renegotiation Board. We appreciate your interest and hope that we will be able to be responsive to your inquiries.

I am appearing here as Acting Chairman of the Renegotiation Board, having been so designated on December 1, 1974, upon the resignation of William S. Whitehead as Chairman. Mr. Whitehead subsequently retired as a member of the Board, effective December 31, 1974. Mr. D. Eldred Rinehart, another Board member, retired as of the end of January 1975. Thus, for the second time in less than 2 years, the Board is again operating with only three members.

The previous such three-member board situation occurred it the summer of 1973, when Richard T. Burress, Chairman, and Lawrence E. Hartwig, Board member, retired simultaneously. Mr. Chase and Mr. Houston became Board members on October 10, 1973.

I understand that nominations for the two vacant Board member positions will be announced shortly.

As Acting Chairman of the Renegotiation Board, my primary consideration has been to restore an atmosphere of cooperation to achieve greater efficiency at all levels of the Board. I have sought to reestablish firm control over all aspects of the Board's activities so as to enable us to move forward with both the resolution of pending issues and the processing of pending cases.

In this respect, I am happy to report, I have received full support from my colleagues on the Board as well as from our staff.

The hearings you conducted, Mr. Chairman, last year in your capacity as chairman of a subcommittee of the Committee on Appropriations of the U.S. Senate brought to the public attention a number of issues that preoccupied the Board during much of last year.

One of these, the question of an appropriate technique for the evaluation of filings by contractors with complex corporate or economic structure, became, as you know, the subject of a top level study in August 1974, when Mr. Houston was designated by the Board to study and report on the Board's policy on product lines and conglomerates.

Mr. Houston was assured full access to the top staff of the Board for whatever assistance they could provide to him in the conduct of his study. On March 18, 1975, Mr. Houston distributed to Board members and office directors, copies of his report.

Mr. Houston's report is a very serious study of an extremely complex area and it requires, and is receiving, careful analysis. As of this moment, the Board has not taken formal action on Mr. Houston's document. As you recall, Mr. Chairman, the issues involved in Mr. Houston's report were raised publicly in connection with our discussion of the *McDonnell Douglas* case, and later, of the *Northrop* case. Pending a clarification of Board policy, the Board has not taken final action on any follow-on years of these two contractors.

There are, of course, other contractors whose filings involve these "conglomerate" issues. In order to retain a tight control over the disposition of such cases, the Board issued instructions to its regional boards to review cases assigned to them and to reclassify all cases involving multiproduct lines or complex organizational structures as class A cases—if they're not already so classified—so as to insure that no such case will be disposed of without final review by the Board itself.

Another issue that received some publicity during last year's hearings was the Board's handling of a filing by Mobil Oil Corp.

Chairman PROXMIRE. Does this mean you are going to examine these companies' product lines, with the breakdown of McDonnell and the McDonnell sector and so forth of their operations, or just the overall?

Mr. MATTINGLY. From the study?

Chairman PROXMIRE. Yes.

Mr. MATTINGLY. That will be done.

Chairman PROXMIRE. Will it be done on an ad hoc basis or will you in all cases go into a breakdown?

Mr. MATTINGLY. I am not sure at this time as to the course the Board will follow as a result of the study.

Chairman PROXMIRE. I thought you issued instructions with respect to this.

Mr. MATTINGLY. We issued instructions that the study be made.

Chairman PROXMIRE. You have not issued instructions as a result of the study?

Mr. MATTINGLY. No, sir. We only received that on March 18, a couple weeks ago.

Chairman PROXMIRE. You say in order to retain tight control over such disposition of the Boards' activities assigned to them and reclassify all cases involving multiproduct lines or complex organizational structures as class A cases if they are not already so classified.

Mr. MATTINGLY. That is, cases that have product lines will come back to the statutory Board so we can take a close look at them before they are cleared.

Chairman PROXMIRE. Will they then be examined on that basis?

Mr. MATTINGLY. Yes.

Chairman PROXMIRE. So this is a change in policy. From now on you will examine each of these cases on a product line basis?

Mr. MATTINGLY. Yes; but I would not say it is a change in policy.

Chairman PROXMIRE. You have not done it before. We have examples where it has not been done.

Mr. MATTINGLY. All I am saying is the policy has not been adopted yet. We only received the report on March 18.

Chairman PROXMIRE. The instructions were to the regional office and the policy of the Washington Board has not been adopted. You will have the information available if you want to study it, but whether or not you will proceed to make an analysis based on the product line and the breakdown by sector has not yet been determined.

Mr. MATTINGLY. We have every intention, I think, of doing exactly that.

Chairman PROXMIRE. When you say we, you are speaking of the other two members, too?

Mr. MATTINGLY. I hope so.

Chairman PROXMIRE. Is that right, Mr. Chase?

Mr. CHASE. I hope so.

Mr. HOUSTON. Yes.

Mr. MATTINGLY. May I continue?

Chairman PROXMIRE. Yes; go ahead.

Mr. MATTINGLY. Upon my becoming Acting Chairman, we immediately put special emphasis on a vigorous pursuit of a study relating to the petroleum industry. An ad hoc committee consisting of the heads of the Offices of Review, Accounting and General Counsel has met repeatedly with representatives of the Internal Revenue Service, with particular emphasis on the establishment of appropriate transfer prices for crude; it has held discussions with the staff of the Federal Energy Administration regarding pricing techniques used in the oil industry; and it has met with top officials of the regional boards to discuss with them the issues as they may appear in old company filings now assigned to such boards for full-scale renegotiation.

The ad hoc committee also traveled to the corporate headquarters of Mobil in an attempt to clarify pending issues. Since the October 2, 1974, hearing, the Board has not cleared or otherwise finally processed cases involving major oil companies. We are convinced that in the near future we will be able to clarify all pertinent issues and to proceed further with the processing of these filings.

The foregoing issues are, of course, only the tip of the iceberg as far as the work of the Board is concerned. On December 24, 1974, the Board published its regulations concerning the application of standards published by the Cost Accounting Standards Board in filings with the Board by contractors. The publication of these regulations was the result of very extensive work by our staff and I am happy that it was accomplished after full consideration was given to both the requirements of contractors and the needs of the Government.

The application of CASB standards in renegotiation will require further attention including modification of the forms used by contractors for filing purposes and, of course, the instructions that accompany these forms.

The staff has done extensive work on a general revision of our booklet containing the forms and instructions, including a public hearing under the auspices of the Industry Advisory Council of OMB, on January 9, 1975. There is still more work to be done, but we are confident that we are moving in the right direction.

In the actual operation of the Board, certain recent changes in procedures such as the DOD 100 program which was mentioned repeatedly in prior congressional hearings, have contributed to an increase in the backlog. In order to move the backlog, ad hoc committees were appointed by the Board to look into the causes of, and propose remedies for, the backlog situation.

One such ad hoc committee looked into the problem of excessive aging of cases in the eastern regional board and has already made several recommendations to the Board. Another ad hoc committee is reviewing the operations of the screening process, with special emphasis on criteria that will increase both its objectivity and efficiency.

All in all, the Board has put considerable effort into managing our limited personnel resources to insure that the functions of the Board are carried out as efficiently as possible.

All recent activities of the Board and its staff have been time-consuming and required extensive application of top personnel resources. The Board—and I personally—feel that under the given circumstances it was of utmost importance to concentrate the Board activities toward solving its problems internally and to get it back on the track of carrying out its primary functions of assuring the public that excessive profits on defense and space contracts are in fact eliminated as required by law.

I think I can speak for my colleagues as well when I say that in recent months we have made great strides in that direction and we are now looking forward to the future with confidence in our ability to perform our function as the President, the Congress, and the people of the United States expect us to do.

That concludes my formal statement, Mr. Chairman. We will be glad to answer any of your questions to the best of our ability.

Chairman PROXMIRE. Thank you, Mr. Mattingly. I will start off with you, sir. You were present during Admiral Rickover's testimony. That was one of the most emphatic indictments of an agency that I have heard in a long time. You heard what he had to say about the renegotiation program.

Before getting into the staff findings in the case, I would like each of you to reply to the admiral's comments. As you know, he has 50 years of experience in procurement. He has followed renegotiations since the inception of the Board. He believes that the Board has been giving the semblance but not the substance of effective renegotiation and that the Board has been sanctifying the high profits of large defense contractors without knowing whether they are excessive.

What is your response?

Mr. MATTINGLY. Admiral Rickover does have a lot more experience than I do. I have to admit that. Personally, I got here a little late and I did not hear all of his testimony. I would like to have an opportunity to review his testimony and prepare answers for the record.

Chairman PROXMIRE. Would you give me your reaction to the assertion I make? I think I am reflecting the admiral's view that the Board has been giving a semblance but not the substance of effective renegotiation and sanctifying high profits of the contractors?

Mr. MATTINGLY. I don't think I could agree with that in view of the tools with which we have to operate. Possibly with further congressional authority in certain areas, we could take a look at these companies in a different way and come up with more excessive profits.

I think from 5½ years' experience I have had on the Board, we have been recovering what I would consider proper amounts of excessive profits based on statutory criteria, court precedents that we have to consider and that sort of thing.

Chairman PROXMIRE. I want to get into that a little later.

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

RESPONSE OF HON. REX M. MATTINGLY TO CHAIRMAN PROXMIRE'S REQUEST FOR COMMENTS ON THE RECOMMENDATIONS OF ADMIRAL RICKOVER REGARDING RENEGOTIATION

Having reviewed the testimony of Admiral Rickover, I believe I would agree with most of the substantive recommendations of the Admiral, such as making the Act permanent, giving fixed-term appointments to Board members, eliminating the commercial exemption, providing penalties for late or incomplete filings, increasing the Board's staff, and charging interest on excessive profits determinations from a date earlier than presently provided for by law. Other recommendations of the Admiral, such as taking advantage of the work of DOD auditors, renegotiating on a completed contract basis under certain circumstances, are, and have been, Board practice for quite some time.

I do not believe I could agree with one recommendation of the Admiral, to wit, to make the Board an arm of Congress. Renegotiation, that is, the recoupment of excessive profits on defense and space contracts and related subcontracts, is, in my opinion an executive function and, even if it were constitutional to put it under the Congress, I still would think that its rightful place is in the Executive branch.

Needless to say, I do not agree with the characterizations applied to renegotiation by the Admiral such as, sieve, etc. While the performance of the Board may not have been perfect, I do believe that over the years the Board has done a more than adequate job in recouping excessive profits, and I am proud to have been a member of this Board during five or more of its most critical years.

Chairman PROXMIRE. Mr. Chase, what is your response to Admiral Rickover's statement?

Mr. CHASE. I was back in the hall and could not hear much of what the Admiral said, but on the basis of your summation I categorically agree with the Admiral's comments.

Chairman PROXMIRE. That is helpful. That was a general question. I will get into specific criticisms by Admiral Rickover in a minute. Mr. Houston?

Mr. HOUSTON. I too would like an opportunity to review the Admiral's testimony before making any specific comments. I can't quite agree with some of the adjectives the Admiral used in connection with the Board, but I certainly think he has highlighted some of the problems which, in my opinion, have been the result of the legislative and managerial restrictions imposed upon the Board by the Congress and in an inadequate staff to deal with both the short- and long-term problems of renegotiation.

Chairman PROXMIRE. Mr. Chase, let me ask you why you agree with the criticism. What is wrong with the Board?

Mr. CHASE. I don't think we have time this morning to engage in dialog that lengthy.

Chairman PROXMIRE. Do the best you can in 2 or 3 minutes.

Mr. CHASE. It is basically what I said at your July and October hearings. We are woefully understaffed to meet the mandate of Congress, in my judgment. We do not have a functionally structured Board with adequately defined lines of responsibility. Clearly to me, the lines of communication are suffering at the expense of an efficient and well-run organization.

I am aware of the need to review regulations promulgated by the Board to effectively update them, the administrative orders, and the general orders. We need a standards of practice manual and all manner of good management procedures, Mr. Chairman.

Chairman PROXMIRE. Why don't we have those? Why hasn't this been done?

Mr. CHASE. From its beginning in 1951, the Renegotiation Board has been given little attention by either the Congress or the executive branch. The problem transcends party lines. It is the nature of the agency.

Chairman PROXMIRE. We hope we can give it a lot more attention in the future. We have given it some in the past few months.

Mr. CHASE. Yes.

Chairman PROXMIRE. Let me ask you this, Mr. Mattingly, and I will ask each of you gentlemen if you favor the elimination of the standard commercial article exemption?

Mr. MATTINGLY. Yes.

Chairman PROXMIRE. Do you all agree on that?

Mr. CHASE. Yes.

Mr. HOUSTON. Yes.

Chairman PROXMIRE. Do you think the act should be made a new award?

Mr. MATTINGLY. Yes.

Chairman PROXMIRE. Do you favor an increase in staffing?

Mr. MATTINGLY. Yes.

Chairman PROXMIRE. How much of an increase in staffing is necessary? This can be overdone. At the same time, there is a colossal amount of work that can be done. I think it is easy to show a good cost-benefit ratio here to the taxpayer.

Mr. MATTINGLY. I think the way it stands right now, we need a 50-percent increase.

Chairman PROXMIRE. How big is your staff now?

Mr. MATTINGLY. It is limited to 200. It is 189 and there are 11 vacancies.

Chairman PROXMIRE. In the last year it has gone down in spite of the fact that our military is spending more money than before at least in dollar amounts and the physical amount of procurement is not much different than it has been, but the staff of the Board has gone down.

As I understand, the peak of the staff was in the Korean war period when it was around 600 or 700?

Mr. MATTINGLY. Yes.

Chairman PROXMIRE. Now it is only 190?

Mr. MATTINGLY. The ceiling is 200, actually.

Chairman PROXMIRE. You said you had 189 on board. If you increased it to 50 percent, you would go to about 300 which would be half of what you had and you had a far smaller procurement operation. Is there enough to do this kind of a job when you have over a million people in the Pentagon and you have several million people working in the defense industry and you have a great responsibility with a real opportunity to serve the taxpayer.

Mr. MATTINGLY. I think it would depend on the depth of the audits that we would get into. Some of the work might be a duplication

of other government audit agencies. From a practical standpoint, I feel the numbers we mentioned would be adequate.

Chairman PROXMIRE. Could I ask you Mr. Chase what do you think would be an adequate staff and how would you structure it in terms of auditors, lawyers and so forth.

Mr. CHASE. We have an excellent staff with good professional background, Mr. Chairman. The Board directed staff to prepare a responsible report on what it would require to increase and improve quantitatively and qualitatively the examinations of these filings in the field, in the regions and at the statutory board level.

That report was carefully and scientifically done and is an excellent start. I would say Mr. Mattingly's representation of staff percentage increase is accurate.

Chairman PROXMIRE. What does the report show?

Mr. CHASE. It shows a staff increase of approximately 90.

Chairman PROXMIRE. You called that a start. You would not say that would be the ultimate size?

Mr. CHASE. I would want to take that step progressively, Mr. Chairman. The reason being the resources of the Renegotiation Board are highly professional and we would not want to heartily engage personnel without being selective. I feel this would require concentrating on management goals, selection expertise, and then implementation.

Chairman PROXMIRE. What has been done to follow up on that study? Have you gone to OMB and asked for staff or more adequate budget?

Mr. CHASE. Yes, we have.

Chairman PROXMIRE. Have you asked for 50 percent, have you asked for the extra 90 or 100 positions?

Mr. MATTINGLY. Yes.

Chairman PROXMIRE. What has been the reaction of the OMB?

Mr. MATTINGLY. They are still taking it under advisement.

Chairman PROXMIRE. In other words, it was not granted for the 1976 budget?

Mr. MATTINGLY. No, sir. I suppose it would be handled as an amendment or supplemental. It would be an amendment to the budget.

Chairman PROXMIRE. When was this study available? Was it available last fall? Could you have made your request at that time when the budget was being put together, the 1976 budget?

Mr. MATTINGLY. There were some indications to OMB at that time.

Chairman PROXMIRE. They denied the increase apparently?

Mr. MATTINGLY. Yes.

Chairman PROXMIRE. Did they give reasons for denying it?

Mr. MATTINGLY. They have the overall view of the total Federal requirements. That is their responsibility.

Chairman PROXMIRE. If they are interested in reducing a deficit, this is one way of doing it.

Mr. MATTINGLY. We can only propose what we feel is right and then, with the overview of the entire Federal expenditures and revenues, they have to decide for themselves and we get along the best we can.

Chairman PROXMIRE. Do you agree with the other two gentlemen, Mr. Houston?

Mr. HOUSTON. I certainly do. As Mr. Mattingly and Mr. Chase have stated, we have submitted requests to amend the 1976 budget which has not as yet been acted upon by the Congress.

I think as far as the numbers are concerned, we must think in terms of a manageable number under our present kind of organizational situation. Under our present legislation, we are a so-called weak executive agency, a plural executive. As anyone with either Government or private industry managerial experience knows, you can't have five chief executives trying to run an organization.

We need the kind of authority that would exist in the so-called strong executive type organization, as in well-managed agencies of the Federal Government.

[The following additional comments of Mr. Houston were subsequently supplied for the record in the context of the above interrogation by Chairman Proxmire:]

As you may recall, Mr. Chairman, my concern as to the adequacy of the Board's resources was expressed in those hearings which you conducted last year. Subsequent events have only increased my concern in this area. The requests submitted to OMB were for immediate increases as well as an amendment to the 1976 budget and were considered minimum requirements. I sincerely hope favorable action will be forthcoming soon as it will take time to locate the type of quality personnel required and to make them an effective element in the renegotiation process. As far as numbers are concerned, I agree with Mr. Chase, we must think in terms of a manageable, responsible figure. In regard to the weak executive type agency, under the present Renegotiation Act, the Chairman of the Board is distinguished from the rest of the Board members only in that he can divide the Board into divisions of one or more members for the purpose of processing a case. I am suggesting here, and have so recommended to the Board, that any restructuring of the agency must start at the top.

Chairman PROXMIRE. Chairman Mattingly, will you submit the staffing report recommendation to the committee? Would that be available?

Mr. MATTINGLY. On the budget?

Chairman PROXMIRE. The study that made the report on the need for staffing for 90 additional positions.

Mr. MATTINGLY. I can give you a breakdown for the additional positions right now.

Chairman PROXMIRE. I want the study that justified it. You have a few figures on that sheet of paper.

Mr. MATTINGLY. I would be perfectly happy to do so if I had the authority.

Chairman PROXMIRE. Would you check the authority and we will see what we can do to procure that. We would like to have it. Who do you have to check with, your counsel?

Mr. MATTINGLY. I would thing both counsel and OMB.

Chairman PROXMIRE. Is your counsel here?

Mr. MATTINGLY. Yes.

Chairman PROXMIRE. Can your counsel advise us?

Mr. LAMBERT. My name is David M. F. Lambert. We are permitted to furnish information on budget matters which are pending at OMB if requested during a congressional appropriations hearing.

Chairman PROXMIRE. The Renegotiation Board is no longer under the jurisdiction of the subcommittee which I chair, but it is under the

jurisdiction of another subcommittee on which I serve, so you would say you would comply with the request of the Appropriations Committee.

Mr. LAMBERT. Yes.

Chairman PROXMIRE. You would not comply with a request of the Joint Economic Committee?

Mr. LAMBERT. That is a technical point. We are restrained by OMB Circular A–10 in discussing proposed budget matters which are still under review by OMB.

[The following information was subsequently supplied for the record in the context of the above paragraph:]

Paragraphs 3 and 4 of OMB Circular A–10 provide restrictions on the disclosure by Agency Heads of Agency budget estimates and of Presidential recommendations until made public by the President. Consequently, the OMB has advised the Board that it may not submit staff papers relating to its request for 96 additional positions until the President has taken action on the Board's request.

Chairman PROXMIRE. This restriction by OMB brings us to the other and interesting point Admiral Rickover made that you should be an arm of the Congress as was done with the Cost Accounting Standards Board. Mr. Mattingly, how do you feel about that?

Mr. MATTINGLY. I have no basis for having an opinion on that one way or the other without having a great deal more information. I just cannot answer at this time. I would be glad to pursue it and make any suggestions.

Chairman PROXMIRE. I hope you will give us your consideration. It seems to me from the standpoint of staffing you would be in a better position. You have been turned down once now by the OMB and you may be turned down again. You are unable to communicate with us on the study you made perhaps because at least you are unable to do it freely and quickly because the OMB may have an objection.

Mr. MATTINGLY. It is a new concept and I would like to take a look at it.

Chairman PROXMIRE. Mr. Chase?

Mr. CHASE. I would object to that structuring, Mr. Chairman.

Chairman PROXMIRE. Why?

Mr. CHASE. On the ground I believe that the function of the Renegotiation Board is properly a function of the executive branch of government. I think where the weakness lies is that the Board is not constituted as it should be or given the oversight by the Congress, that it should, notwithstanding my knowledge and respect for the years you have——

Chairman PROXMIRE. One way of getting oversight would be to make it a direct responsibility.

Mr. CHASE. I think it would function best in the executive branch of government.

Chairman PROXMIRE. I made that argument to some extent with Admiral Rickover and I thought he knocked it down pretty effectively.

Mr. CHASE. I have high respect for Admiral Rickover, but I can't agree with that. I was so far back in the hearing room I had great difficulty hearing much of what he said.

Chairman PROXMIRE. His argument was we ought to try this. It has not worked in the executive branch. It is a function——

Mr. CHASE. But I say it can function well in the executive branch.

Chairman PROXMIRE. The GAO has worked very well and they are in the position of being able to take action with respect to excessive payments.

Mr. CHASE. But the Renegotiation Board is not really an investigative function in my opinion. It is a judgmental function, and we make our determinations after applying the statutory factors. We have a highly technical and professional staff processing contractor filings prior to Board determinations. I believe it would be far better in the executive branch if the Board was properly constituted and given continuing oversight by the Congress of the United States.

Mr. HOUSTON. May I comment briefly on that?

Chairman PROXMIRE. Yes.

Mr. HOUSTON. As Mr. Mattingly pointed out we need more information and have to give the matter a lot of thought but, offhand, I would support the position taken by Mr. Chase. I feel the renegotiation process, as Admiral Rickover himself characterized it, is really at the tail end of the procurement process. However, in order to be effective, the Board should remain independent of Congress and certainly of the procurement process in order to arrive at objective determinations of excessive profits which, after all, are in large part, corrections of the procurement process deficiencies. I believe this can best be accomplished by keeping the agency in the executive branch.

In contrast to the Board being made an arm of Congress at this time, I think it should be given a chance as a different kind of organization within the executive branch.

Chairman PROXMIRE. What is your reaction to the recommendation members be given fixed terms so that they might have some independence of the White House?

Mr. MATTINGLY. I would support that, Mr. Chairman, reconstituted on a 3 to 2 party basis and with fixed terms.

Chairman PROXMIRE. Mr. Chase.

Mr. CHASE. I concur with that, Mr. Chairman.

Chairman PROXMIRE. Mr. Houston.

Mr. HOUSTON. I concur.

Chairman PROXMIRE. Do you agree you should have the power of subpena and fines should be imposed on contractors who fail to file required reports by the Board?

Mr. MATTINGLY. Yes.

Chairman PROXMIRE. Is that unanimous?

Mr. CHASE. Yes.

Mr. HOUSTON. Yes.

Chairman PROXMIRE. Have you requested the Congress to give you the subpena power?

Mr. MATTINGLY. Well, it is not before Congress at this time.

Chairman PROXMIRE. Why don't you request it?

Mr. MATTINGLY. We will if we can.

Chairman PROXMIRE. Who would stop you from doing it?

Mr. MATTINGLY. The legislation has to go through OMB.

Chairman PROXMIRE. I am talking about your requesting it so we would have a basis for reaction. It is much easier for us up here if we get the experts who are responsible for discharging the job to tell us you need the subpena power and a Senator can put in legislation for

it and we would be off to a much better start than if somebody put it in without a request by the Board. It is very helpful you gentlemen responded that way.

Mr. MATTINGLY. We would be happy to do that if it were at all possible.

Chairman PROXMIRE. Do you have to get OMB for this?

Mr. MATTINGLY. Yes.

Chairman PROXMIRE. It sounds more and more like you should be an arm of Congress.

When did you ask OMB for this power?

Mr. MATTINGLY. About a week ago.

Chairman PROXMIRE. Are they taking it under consideration? Have they said no?

Mr. MATTINGLY. No, they have not said no. They are taking it under consideration.

Chairman PROXMIRE. Did you agree interest on excess profits should accrue from the time any excess profit is received rather than from the time the contractor enters into an agreement with the Board or an order becomes final? That was a point made by Admiral Rickover.

Mr. MATTINGLY. I agree with that. This is money they have had in their till and they have had the use of it.

Chairman PROXMIRE. Have you asked for that change in the law?

Mr. MATTINGLY. Yes, sir, although not exactly in the same terms.

Chairman PROXMIRE. When did you ask for it?

Mr. MATTINGLY. At the same time as we asked for the others.

Chairman PROXMIRE. What was their response to that?

Mr. MATTINGLY. It is under consideration.

Chairman PROXMIRE. I take it if you gentlemen disagree at all in this area, speak up. I take it you agree with the Chairman.

Mr. CASE. Yes.

Chairman PROXMIRE. By the way, what is the size of the Board's present backlog in terms of dollars? I understand the backlog represents about $88.5 billion sales to contractors dating back to 1966. This amount of defense contractor business has not yet been processed by the Board; is that correct?

Mr. LENCHES. My name is George Lenches, Director of the Office of Planning and Analysis. The figure you have cited has been developed internally at the request of Mr. Chase. I personally don't know it to be a fact, but I think it is accurate.

Chairman PROXMIRE. Eighty-eight and a half?

Mr. CASE. $88.5 billion in sales have not yet been processed.

Mr. LENCHES. Are pending.

Chairman PROXMIRE. Going back to 1966?

Mr. LENCHES. Yes.

Chairman PROXMIRE. Any excess profits during this long period of almost 10 years now—of course, some of it might be 9 years and it might have started in 1966—so with interest rates running around anywhere from 7 to 10 or 12 percent, that is a colossal enrichment for a contractor.

Mr. LENCHES. Mr. Chairman, may I make a remark here?

Chairman PROXMIRE. Even if the Board decides a refund is required, contractors have the use of that money for years and years and years.

Mr. LENCHES. That is the point I would like to comment on. In the screening process I think the filings the Board is reviewing, which are included in this $88 billion you are referring to, are very likely contractor filings for 1972, 1973, and 1974, not 1966.

In the field operations, I think the filings under active review are likely to be for fiscal years 1970 and 1971. In the headquarters review operation, which comes after the field, it is likely to be contractor's fiscal years 1970 and 1971 again. Of course, I am not denying that there may be an isolated case that goes as far back as the 1960's.

Chairman PROXMIRE. I wish you would give us for the record the amount roughly in sales that have not been processed for 1966, 1967, 1968, 1969, and 1970, and so forth, so we have the full picture in front of us. Can you do that?

Mr. MATTINGLY. Yes, sir.

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

Distribution of $88 billion in renegotiable sales by contractor's fiscal year filings

[Dollars in millions]

Contractor fiscal year:	*Renegotiable sales*
66	$18
67	1,090
68	2,097
69	4,368
70	11,153
71	21,420
72	27,294
73	20,415
74	383

Chairman PROXMIRE. Doesn't the size of the backlog demonstrate millions of dollars are being lost because under the present law the Government can't file charges until after the contractor processing?

Mr. MATTINGLY. Yes, sir, it is possible.

Chairman PROXMIRE. Doesn't the backlog indicate you need more staff and could pick up the million dollars the Government is losing?

Mr. MATTINGLY. It is possible. It is not always the lack of staff that is holding up some of these cases.

Chairman PROXMIRE. Not always but in many cases.

Mr. MATTINGLY. In many cases, it could be.

Chairman PROXMIRE. What else is holding these up?

Mr. MATTINGLY. Information that we are seeking. There are also court actions involved in some cases, and claims, and this sort of thing. I would be glad to send you a statement on this point.

[The following additional comments of Mr. Mattingly were subsequently supplied for the record in the context of the above interrogation by Chairman Proxmire:]

The backlog of uncompleted cases is high in all three functional areas of the Board, the screening operation, the regional operation, as well as the headquarters review operation. The reasons for the high level of the backlog are as follows:

As stated in the Board's annual report for fiscal 1973, during that fiscal year the Board undertook an expansion of its screening procedures. As a result, the screening of filings slowed down temporarily and the backlog in the screening process rose. By fiscal 1974 the new screening procedures became well established and the Board undertook the processing of filings accumulated during the previous year.

The screening of the accumulated filings necessarily resulted in a sudden rise in assignments to the field, because many of these filings involved large contractors with numerous subsidiaries that are traditionally assigned to the field. Also, by fiscal 1974, the Board had fully developed a special program for screening DOD 100 contractors. This program, which involves a more thorough screening of filings by contractors appearing on the Defense Department's 100 largest contractors' list, has further increased the number of assignments involving large contractors of complex corporate structure.

The regional boards have not been able to increase their production at a rate commensurate with the rate of increase in assignments, especially because of the high concentration of large contractors among the filings assigned to them. As a matter of fact, their output declined under the influx of these complicated filings. Thus, the regional backlog was bound to rise. This rise in the backlog was further stimulated by the fact that, by fiscal 1974, the Board has a full-fledged DOD 100 program in the regional operations as well. That program, involving expanded investigation of filings by contractors on the DOD 100 list, was bound to slow down regional production.

This inevitable side effect of the DOD 100 program, i.e., the slowing down of production, also manifested itself in the screening process, where the rate of output has also declined considerably since the institution of this program. This decline is a partial explanation of the presently high screening backlog. Other reasons involve the pyramiding effects of several filings of a contractor going through the renegotiation process at the same time; under Board procedures, a filing for a subsequent fiscal year of a contractor cannot be finally disposed of until, and unless, it has been determined that the investigation of the earlier year's filing would not result in significant modifications in the makeup of the subsequent year's filing. The relatively large number of cases pending in the Court of Claims has a similar effect, as the Board is careful not to close a subsequent year while a prior year's data is being investigated and argued before the Court.

Chairman PROXMIRE. I would ask Mr. Chase for his comments about the backlog.

Mr. CHASE. There were discussions here and I did not hear you.

Chairman PROXMIRE. I want to know comments you have about the size of the backlog and its significance and how much we are losing and how much we could pick up if we had vigorous action.

Mr. CHASE. I am confident you want a responsible answer but I am not a prophet. We do not have the staff to bring the backlog reasonably up to date. We don't like to perform unless we perform well. I know you could not run a business with that kind of a backlog. We have a problem, Mr. Chairman, of dealing with some of these people who are now out of business, who have liquidated or distributed excessive profits or earnings to shareholders which are difficult if not impossible to trace. Obviously, it would be in the interest of the Government if we had our backlog within a reasonable timeframe. Does that answer your question?

Chairman PROXMIRE. Yes, sir, thank you. That is helpful.

In your prepared statement, Mr. Mattingly, you referred to the report of Board member Houston. I would like to have a copy of it and I would like to know if the Board recommends examination of large conglomerates on a product line basis? Can you give us that?

Mr. MATTINGLY. We have not made any decisions or policy statements at this time.

Chairman PROXMIRE. This is the study and that is being made available to the committee right now?

Mr. MATTINGLY. There are two copies. It is very extensive and if you have the opportunity to read it you will see it is an extremely complex issue, and I would like to compliment Mr. Houston on developing it.

Chairman PROXMIRE. Also on the same subject I understand a letter was sent from the Board on January 21 of this year to the chairman of the Western Regional Board, directing it to collect regional data on costs of goods sold McDonnell Douglas on 1970 and 1971 filings which are currently pending; is that correct?

Mr. MATTINGLY. Yes, sir.

Chairman PROXMIRE. Why isn't divisional data collected on all contractors for 1970 and 1971? Why only McDonnell Douglas?

Mr. MATTINGLY. I would not say that is a true statement. There are many companies in the regions for which divisional data is being collected.

Chairman PROXMIRE. It is not true in the sense McDonnell Douglas is the only one but it is true in the sense you do not require all contractors to file?

Mr. MATTINGLY. I don't think we have the authority to begin with to require everybody to keep records in that manner.

Chairman PROXMIRE. That requires you to do it?

Mr. MATTINGLY. That we could require them to do it. It would be helpful if they did all report on a product line basis.

Chairman PROXMIRE. Why don't you request in all cases where you do have the authority that they file? Have you done that?

Mr. MATTINGLY. We are getting the information as far as types of contracts are concerned and have been for a long time the fixed price, cost plus fixed fee, cost plus incentive fee type contracts, and things like that.

Chairman PROXMIRE. What is your reaction to this, Mr. Chase? Do you think you have the authority to do this, and if so, why is it not being done?

Mr. CHASE. I know we have the authority, Mr. Chairman, and it goes beyond that. It is a requirement.

Chairman PROXMIRE. Why isn't this being required, then?

Mr. CHASE. I am sorry to say I can't answer that question.

Chairman PROXMIRE. Why not? You are a member of the Board. You know a great deal about this. We have great confidence in you. What have you done to get it?

Mr. CHASE. I offered a resolution and it failed for lack of a second.

Chairman PROXMIRE. A resolution on the Board?

Mr. CHASE. Yes.

Chairman PROXMIRE. What was the nature of the resolution?

Mr. CHASE. That we examine sales, costs, and profits of the filing by product line and profit center.

Chairman PROXMIRE. Mr. Mattingly and Mr. Houston, why didn't you support that resolution?

Mr. HOUSTON. As I recall, Mr. Chase offered a resolution to reaffirm the Board's authority as it now stands. I would have seconded that motion if it had been properly considered by the Board. The reason it was not seconded was that Mr. Chase passed the memorandum out at the Board meeting. We had an agenda. It was not on that agenda. There was no opportunity to study and consider it. At the same time, the product line study was under review and this was directly connected to it. We had not had an opportunity as a Board to discuss the product line study. I am not saying at all that I don't support the request by Mr. Chase that the Board reaffirm its authority

to do this. I think what he is saying is consistent with the recommendations that I have made in the study, but I think it was just a matter of the timing of his resolution that it was not taken up by the Board. I think that should be made clear.

Chairman PROXMIRE. Are you saying you would have no objection to this and you might very well support it if it is brought up again now that the study has been made and now that the material is available?

Mr. HOUSTON. I have no objection at all to the principles set forth. Now as to the specific wording of Mr. Chase' proposed resolution, it is a matter I would like to discuss and review. It is simply too important and complicated an issue to treat otherwise and no one knows that more than I who conducted the study.

Chairman PROXMIRE. I can't for the life of me understand why there is not unanimous support for this type of action. Why shouldn't you have this information. It does not mean you take adverse action against any company. It means you know what you are doing. You have the breakdown. You were able to look at each segment and tell if an excess profit was made in that segment. Then you might conclude as a matter of policy it is not wise to pose a refund request. At least you would have the information.

Mr. HOUSTON. I personally hope there will be unanimous support for that type of resolution. At this time, the only point I am trying to make is that when something is presented with specific words that require some discussion and definition, I think we need an opportunity to discuss the matter and the benefit of staff review.

Chairman PROXMIRE. May I ask, Mr. Chase, again, did you give your fellow board members an opportunity to know what you were going to bring up?

Mr. CHASE. I feel very strongly one of the reasons that causes our backlog is we have not definitively and substantively enunciated the policy and this study has been going on for 8 long months. It just seems to me it is time we bite the bullet. I don't quarrel with anyone about examining the contents of a resolution but it was a very simple resolution. It simply said we would reaffirm the right of the Board——

Chairman PROXMIRE. Would you expect to bring that resolution up again soon with notice to the board members so they will have an opportunity to act on it?

Mr. CHASE. I certainly will, after they scrutinize it.

Mr. MATTINGLY. You may have misunderstood me. I was only referring to a contractor who might have a dozen different products and does not keep his product lines segregated as far as costs and profits are concerned. I simply said I know of no authority we have to compel him to keep his records that way.

Chairman PROXMIRE. Perhaps it would be desirable, depending on the size of the contract and so forth, to have some legislation to give you that.

Mr. MATTINGLY. You are exactly right.

Chairman PROXMIRE. Would you make some kind of formal request on that if you could, consider it and consider the possibility of sending a letter to us so we would know what you mean and formulate something that would give you that authority?

Mr. MATTINGLY. We impose a lot of work on small contractors, therefore, any change which would require more work should be carefully considered.

Chairman PROXMIRE. Make your study and do it as rapidly as you can. As you know, I have been fighting to strengthen this Renegotiation Board for years.

There are two vacancies on the Board and the staff has not changed yet and it is business as usual. Would you say it has been reinvigorated and it is fighting more to cure inflation and, if so, how?

Mr. MATTINGLY. I would not want to preempt the President. I think those vacancy nominations will be coming up on the Hill shortly.

Chairman PROXMIRE. What is the nature of the reinvigoration of the Board? What will it have that it did not have before? What can we look forward to?

Mr. MATTINGLY. I would certainly not want to indicate the President's view, but my view would be to get this backlog cleaned up to get more money back to the Treasury, and have people who know they are going to be there next year; it is hard to get people when they know a position is going to expire every year or 2 years or 3 years.

Chairman PROXMIRE. To date we have not had the vacancies filled. Not even the vacancies are filled.

Mr. MATTINGLY. We have been doing everything to expedite work with existing staff.

Chairman PROXMIRE. Would you comment on some of the charts displayed here. I am interested in your determination of the excess profits and the profits the defense contractor is being allowed to retain by the Board. First is Mobil Oil Corp. where you have the exception that covers certain raw materials. And the GAO made the study in which they found that applying profits on a reasonable basis they could, and applying costs reasonably, it turned out the sales would be twice as great for Mobil as for the industry average and Mobil's filing showed the ratio of profit to sales was actually three times that of the industry average. There is a colossal disparity there. Wouldn't the Renegotiation Board be far better off if they requested this data?

Apparently, the GAO was available to put this together without the kind of authority you have. Would it not have been better if you required that this information be made available to you? Take table 1 of Mobil.

Mr. MATTINGLY. It is very difficult for me to give an answer to those tables. I had not been privy to them before today. Actually, I would like to have the opportunity to take their figures and study their methods for arriving at them and send an analysis to you.

Chairman PROXMIRE. We would be happy to have that.

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

Tables 1 and 2[1] purport to show the effects of the cost allowance claimed by Mobil. These tables indicate that on renegotiable business of $95.218 million the profit on the refinery activity amounts to $2.470 million, the profit on the transportation activity amounts to $3.862 million, and the profit on the crude oil operation amounts to $9.590 million, for a total profit of $15.922 million, which amounts to 16.7% return on sales with no cost allowance.

[1] See tables 1 and 2, pp. 26 and 27, respectively.

A comment at the botton of Table 1 states that "Mobil cleared with a return on sales that was twice the FTC industry average." The note refers to the tabulation which shows that the average return on sales for petroleum refineries in 1972 according to the Federal Trade Commission was 8.4% compared to the 16.7% for Mobil without cost allowance.

The comment quoted above is not appropriate because it does not recognize the specific provisions of the Renegotiation Act of 1951 as amended (50 US App 1211) ("The Act") which provides in Section 106(b) for a cost allowance where a contractor processes raw material to and beyond an exempt state. Therefore, even if the 16.7% profit reported in Table 1 was accurately determined to be the profit absent the cost allowance (we question the validity thereof later), it would reflect a profit which the Board by the provisions of the Act is prohibited from considering. It follows that it would be unlawful for the Board to make a judgment as to the reasonableness or excessiveness of profits based upon the concept presented in the note to Table 1.

With respect to the validity of the profit figures, we reviewed with your staff he methods that they employed in arriving at the above amounts. A large portion of the profits ascribed to the transportation and crude oil operations is based on your staff's allocations of the dividends received by Mobil Oil Corporation from its foreign subsidiaries to those operations. While we do not agree with certain other assumptions and allocation procedures employed by your staff in arriving at the above amounts of profit, we will confine ourselves in this response primarily to the issue of dividends, since we believe it is the most important.

We would like to state initially that the concept of the cost allowance required under the Act is fully described in Section 1453 of the regulations and has no relationship to the treatment of dividends in renegotiation. It is unfortunate that two such unrelated issues were commingled in the development of the charts, leaving the erroneous impression that the actual profits, without considering the cost allowance, were 16.7% on sales. In reality, such high profits are due primarily to your staff's allocation of dividends.

During the 1972 Mobil received dividends of $687 million from 42 foreign affiliates. Of this amount, transportation subsidiaries generated $177 million, and the remaining $510 million was received from other foreign subsidiaries. The renegotiable sales of Mobil Oil Corporation amounted to approximately 2.4% of total sales. Therefore, your staff determined that 2.4% of the $177 million in transportation subsidiary dividends, or approximately $4 million and 2.4% of the $510 million in dividends from other foreign subsidiaries, or approximately $12 million could be credited to renegotiable activities. These adjustments would increase renegotiable profits by approximately $16 million.

In our opinion it is not appropriate to consider the dividends received by Mobil Oil Corporation from its many foreign subsidiaries as being allocable in part to renegotiable business because Section 102 of the Act states that "* * * The provisions of this title shall be applicable (1) to all contracts with the Departments specifically named in Section 103(a), and related subcontracts to the extent of the amounts received or accrued * * * or after the first day of January 1951 * * *." Since dividends earned by a contractor on its investments in other companies do not represent receipts based on contracts with Departments named in the Act, they are not subject to renegotiation. Since the function of renegotiation is to determine whether excessive profits have been earned on renegotiable sales, we have no basis for concern over the amount of dividends a contractor may receive based on its investment in other companies.

With respect to the approximately $12 million adjustment for the non-transportation foreign subsidiaries, we understand from the contractor that approximately 85% of the crude oil used by Mobil Oil Corporation was obtained from domestic wells, which are owned by Mobil Oil Corporation, and only 15% from foreign subsidiaries located primarily in Kuwait, Venezuela and Nigeria. Therefore, very little of the crude oil sales of the foreign subsidiaries which generated the profits that resulted in dividends paid to Mobil Oil Corporation were actually made to Mobil Oil Corporation. We believe this is important because crediting to renegotiable work 2.4% of *total* dividends received from all foreign subsidiaries erroneously implies that the sale of crude oil and other services by the foreign subsidiaries were solely to Mobil Oil Corporation rather than to other buyers throughout the world.

We disagree with the principle of crediting 2.4% of the dividends received by Mobil Oil Corporation to the renegotiable business. However, even if it were

appropriate, we believe the concept should extend only to the specific foreign affiliates from whom Mobil Oil Corporation purchased crude, that is primarily Kuwait, Venezuela and Nigeria, and then only to the percentage of this foreign crude that was actually used by Mobil Oil Corporation as distinct from other users. Even if it is assumed that the entire crude oil output of these three foreign affiliates was used by Mobil Oil Corporation, the dividends of these companies amount to $38 million. Therefore, 2.4% of such dividends represent about $1 million applicable to renegotiable work, in contrast to the $12 million used by your staff.

The remaining tabulations, i.e., Tables 3 through 7,[2] reflect separately for McDonnell Douglas, Northrop and Grumman for various years, the returns on sales, capital and net worth as well as the same average ratios for the industry as reported by the FTC and the IRS. The data in Table 6 report what the determination of excessive profits could have been if the determinations had been based entirely upon the aforementioned industry averages. The results of such computations are compared with the Board's actual determination of excessive profits, if any.

This presentation implies that the matter of judging the reasonableness or excessiveness of a contractor's renegotiable profit is based entirely upon a comparison with industry averages.

Section 103(e) of the Renegotiation Act provides in part that:

"* * * In determining excessive profits favorable recognition must be given to the efficiency of the contractor or subcontractor, with particular regard to attainment of quantity and quality production, reduction of costs, and economy in the use of materials, facilities, and manpower; and in addition, there shall be taken into consideration the following factors:

"(1) Reasonableness of costs and profits, with particular regard to volume of production, normal earnings, and comparison of war and peacetime products;

"(2) The net worth, with particular regard to the amount and source of public and private capital employed;

"(3) Extent of risk assumed, including the risk incident to reasonable pricing policies;

"(4) Nature and extent of contribution to the defense effort, including inventive and developmental contribution and cooperation with the Government and other contractors in supplying technical assistance;

"(5) Character of business, including source and nature of materials, complexity of manufacturing technique, character and extent of subcontracting, and rate of turnover; * * *."

It is apparent from the statutory language that no formulae or preestablished ratios can be used to determine whether profits are, or are not, excessive in any given case. However, various analytical techniques are used to facilitate comparisons in the development of the cases. Ultimately, the determination in each instance must reflect the judgment of the Board.

The statute does not speak in terms of basing determinations of excessive profits solely upon average earnings for an industry. In part, the statute speaks in terms of "normal earnings" a term substantially different from the average earnings of an industry in a particular year.

The approach taken in the aforementioned tabulations is not proper under the above-described provisions of the Renegotiation Act and excessive profits shown in the tables are thus tabulated on an erroneous presumption.

Mr. MATTINGLY. We have to apply statutory factors to contractors. We have a number of such factors; possibly they may have applied them, but I would certainly like the opportunity——

Chairman PROXMIRE. The very simple point these charts make at least in the *Mobil* case, not that it is apparent that the refund should have been required. In this case I think there is a strong case that it should not have been in this case, and I may be wrong but the important thing is the Renegotiation Board did not ask for all the facts before they made the judgment.

[2] See tables 3 through 7, pp. 28–34, respectively.

Mr. MATTINGLY. I think the examination techniques of 1967 were carried right on throughout the 1972 year. I just can't answer definitely at this time.

I want to say we are now in a very intensive way out to establish all the facts we can about the petroleum industry.

Chairman PROXMIRE. Here is the petroleum industry and here is a case where they simply were not required to provide information that might have had a bearing on your judgment. Mr. Chase, would you like to comment?

Mr. CHASE. Let me talk to Mr. Davis for a minute.

Mr. Chairman, are you asking me to respond to your previous question?

Chairman PROXMIRE. Yes, sir, about Mobil.

Mr. CHASE. The genesis of my dissent was the lack of information to make a determination to clear Mobil without assigning it to the field. The Mobil Oil Co., as I recall, reported to its shareholders that it made a 25.1 percent return on net worth and 15.2 return on sales of about $9 billion. Conversely they filed with the Board that they lost money both on renegotiable business and non-renegotiable business. I thought that was just not an economic fact of life.

Chairman PROXMIRE. So you asked to get the data so you could find out?

Mr. CHASE. So we could make a responsible determination. I don't know how you can decide whether or not there are excessive profits unless you know what the elements of the costs of goods sold are, and we had none of that information.

Chairman PROXMIRE. The figures you give are far more compelling. I take it you are talking about different years. He said a 25 percent net worth return. This is the overall profit they reported to their stockholders; is that right?

Mr. CHASE. Not 2 years; only 1972. Otherwise that is right.

Chairman PROXMIRE. This is just the parent company only.

Mr. CHASE. Referring back to your remarks, Senator Proxmire, the Renegotiation Board has the authority to examine under the present act, not the authority to require separate filings. We have the authority to make a complete examining under the act. That is not in question.

Chairman PROXMIRE. Why did you, Mr. Mattingly and Mr. Houston, disagree with what seemed to be a proper request? You have the reported gain to the stockholders and losses reported to you.

Mr. MATTINGLY. I think the profits reported were book profits. We renegotiate on the income tax basis. That might be one disparity. There was a loss as the filing came through the office of review, some half million dollars.

Chairman PROXMIRE. The GAO people who now work for the committee shifting their cost from the area accepted to the area not accepted, and therefore able to show a loss. It is the easy thing to do unless you get all the data and can discipline them.

Mr. MATTINGLY. I just cannot analyze their figures at this time.

Chairman PROXMIRE. Yes, and I am not asking you to do it. I am just asking why as a matter of principle, when you have this kind of conflicting difference you require and explore the reasons for it.

Mr. MATTINGLY. I don't know how to relate the question you are asking.

Chairman PROXMIRE. I am talking about why we don't get further information to determine whether GAO construes this as right or wrong.

Mr. MATTINGLY. I can assure you we will have sufficient information in the future.

Chairman PROXMIRE. Mr. Houston?

Mr. HOUSTON. I can only say that after research and study of the renegotiation process as it relates to data, possible segmentation, and so forth, if I were to be transplanted back to that time, my action might have been different, but that case is closed.

As the time I went along with the historical position of the Board, with the information presented and with the recommendation of the staff. It seemed reasonable and sufficient for the decision which was made.

Chairman PROXMIRE. At this time did you have the profit of Mobil Oil reported to their stockholders, 25 percent return on their net worth?

Mr. HOUSTON. I don't believe that is in the record.

Chairman PROXMIRE. Mr. Chase apparently had it. Did you call that to Mr. Houston's attention?

Mr. CHASE. Mr. Chairman, I referred to no dollar amount when I made my dissent at the Board meeting. I just said that Mobil Oil Co. reported substantial profits and earnings to its stockholders in the year of review and it seemed to me we had the responsibility of obtaining the detail of the elements of the goods sold and getting such information as would make it possible for us to make a responsible determination. To say I said the exact 25 percent, I am not sure. Much of the information we obtained I developed at a later date.

Chairman PROXMIRE. Let me ask you about the McDonnell-Douglas Northrop situation. Here you have a situation where IRS shows average profit on sales of 4.5 percent for the indsutry. McDonnell-Douglas enjoys a profit of 6.3 percent. Industry return on their net worth, 12.8; McDonrell-Douglas, 42.5. There are colossal discrepancies here, three or four times the industry average.

Apparently the refund required was pretty infinitesimal. In 1969 it was zero. This is just an example of trying to get at what the Board is really doing. It would seem to almost anybody this is an excessive profit and yet no refund was required at all.

Mr. Chase, I think you can perhaps speak with more authority on this. You have done a lot of work on this. What is your answer?

Mr. CHASE. Now you have diminished my creditability by referring to me as an expert. I am really not an expert. The Board did not examine by product line. It took the position that everything was aerospace, thus averaging the low and reasonable profits of one product line with the excessive profits of another dissimilar product line. I had a different viewpoint.

I don't know what more I can say about it. I just feel we should have examined the cost of goods sold by segments and profit centers but the other Board members did not choose to do so. You can't determine excessive profits unless you are aware of the elements of the cost of goods sold by profit center or major product line.

Chairman PROXMIRE. Does the Board ever look at the Department of Labor or IRS statistics?

Mr. CHASE. Yes, indeed.

Chairman PROXMIRE. Is it not appropriate? Mr. Chase apparently feels it should be allowed to ask for a segmental basis which might have some kind of review required.

Mr. MATTINGLY. At the present time we are using the FTC–IRS statistics as a flag on any company. After that, it gets into a great deal of things in applying the factors; as I mentioned earlier it gets into court cases, Government-furnished equipment and plant, and other things so numerous I can't relate them all.

Chairman PROXMIRE. We have had hearings on that in past years. If the Government does furnish equipment, then, of course, the opportunity to have a bigger return on net worth is very great indeed. There you have a profit to capital percent which would modify, and you have all of these categories and in every case showing very much higher profits than the industry average.

Mr. MATTINGLY. That is true, but we also have to consider similar court cases and the statutory factors.

Chairman PROXMIRE. As I understand it, one of the points here again is Mr. Chase wanted a segmental breakdown and that would have given you a much better insight. Apparently, he asked for that information and you gentlemen disagreed. You did not get product line basis.

Mr. MATTINGLY. We thought we did not need that type of breakdown to make our judgments. This was a merger of two aircraft giants that had the same four-digit SIC number. The identity of McDonnell and Douglas became lost after the merger and we looked at McDonnell Douglas as one unit.

Chairman PROXMIRE. Look at the *Northrop* case. It shows the aircraft division, segmented 16.4 percent return, four times the Internal Revenue return figure for 1969.

Mr. MATTINGLY. That company had a number of divisions and we had sales and profit data for each division. There was one division that showed a profit.

Chairman PROXMIRE. Isn't the division that showed a far higher profit the one that sold to the Government?

Mr. MATTINGLY. Other divisions sold to the Government, too, that had minimal profits or losses. In the aggregate, there were no excessive profits. If we only considered the aircraft division and there were no others to consider, I am sure there would have been excessive profits.

Chairman PROXMIRE. Where you have this breakdown that shows the very high profits in the aircraft division which was the principal supplier to the Federal Government, five times the industry average in relationship to sales, therefore, it would seem to me you could get the information.

Did you investigate it?

Mr. MATTINGLY. We investigated all the divisions.

Chairman PROXMIRE. Did you investigate if there should be a refund?

Mr. MATTINGLY. We considered the high profits of one division, the minimal profits and losses of other divisions, and in the aggregate, the company was given the clearance.

Chairman PROXMIRE. Mr. Chase, would you comment on the *Norfolk* case?

Mr. CHASE. This is a dichotomy of one Board member's viewpoint, mine, against the others. The inconsistency of the Board's position was when Mr. Whitehead appeared before this subcommittee and said in effect that the renegotation process is different when the product lines are dissimilar. At that same time he talked about the McDonnell Douglas various product lines as being the same; aerospace. I took the position, if you will recall, Senator, that a missile is not a jet airplane. An escape hatch system is not a manned orbiting laboratory. They are separate product lines in aerospace and should be analyzed separately.

Returning to the statement made by Mr. Whitehead with respect to similar product lines, in the instance of Northrop, that is inconsistent because product lines are indeed dissimilar; chemicals, jet aircraft, electronics and so on. They are completely different. The segments were all broken out, and yet notwithstanding my dissent, they cleared Northrop.

Does that answer your question?

Chairman PROXMIRE. Yes.

Gentlemen, we heard from Admiral Rickover this morning about as emphatic and serious indictment of an agency that I have heard in the years I have been in the Senate. You know Admiral Rickover is an expert and you gentlemen seem to agree with what Admiral Rickover said is correct.

Further, the Renegotiation Board has acquiesced in every material part of the charges against it.

The Renegotiation Board is supposed to be a safety valve on the Defense Department, in a way to recapture excess profits. Instead the Board seems to function as an escape hatch or sieve, as Admiral Rickover put it, allowing tens of millions of dollars to be lost to Government every year.

Last year the Board asked for subpena powers and changes in the law regarding interest charges on excess profits. Last week. Now, what takes so long for a Government agency to learn it is a cripple among aerospace giants?

The backlog of cases amounts to $88 billion and the Board stumbles along with 190 people, including secretaries, typists, and janitors. Defense costs are going up. The Renegotiation Board is not a captive of the industry. it has become a passive witness to its excesses. It permits contractors to obtain profits two to four times the average returns in the same or similar industry.

It seems to me we either move on the suggestion to put the Board inside the legislative branch, completely reform the Board and the act under which it operates, or do away with the fiction that we have a mechanism to recapture excessively excess profits.

In my judgment, the changes need to be made this year. If they are not made this year we might as well give up the ghost and give the Renegotiation Board a decent and reasonable burial.

Gentlemen, thank you very much. I appreciate your appearance. While I have been critical of the Board and what the Board has done, I respect you as individuals.

Mr. MATTINGLY. Senator, could we have the figures and the methods?

Chairman PROXMIRE. Yes, we will be delighted to provide that. We don't have to ask OMB for that.

Mr. CHASE. Mr. Chairman, may I make a comment that I think would be appropriate?

Chairman PROXMIRE. I wish you would.

Mr. CHASE. I believe it would be tragically unjust if the defense contractors of discussion here today are branded for the ineptness and inadequacies of the Renegotiation Board and its passive attitude. They are fine companies. They have corporate integrity. I think it would be grossly unfair if they are tinged with irresponsibility here.

Chairman PROXMIRE. I appreciate that very much. I think whatever we said—Admiral Rickover said nothing critical of the companies. In fact, I think I said at one point, after all if you were the chief executive officer of a company, you have a responsibility to your stockholders to make money and you have other responsibilities, too. I didn't criticize what they are doing. They are obeying the law; I criticize us, the Congress and the renegotiating law.

The subcommittee will hold hearings on the fiscal year 1976 budget on April 3. Our leadoff witness will be Secretary Simon. This year for the first time the administration has supplied Congress with a detailed set of 5-year budget projections, together with a discussion of future economic conditions and we expect to have hearings on the significance of those projections.

The subcommittee will stand adjourned.

[Whereupon, at 12:55 p.m., the subcommittee adjourned, subject to the call of the Chair.]

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