Audit Report

OFFICE OF THE INSPECTOR GENERAL

THE RELEASE OF MORRISON KNUDSEN CORPORATION FROM THE PERFORMANCE GUARANTEE ON THE AOE-6 CONTRACT

Report Number 92-073 April 10, 1992

This version of Audit Report No. 92-030 excludes proprietary and For Official Use Only information.

Department of Defense

The following acronyms are used in this report.

CAS.....Cost Accounting Standard
DCAA.....Defense Contract Audit Agency
FAR.....Federal Acquisition Regulation
NAPS.....Navy Acquisition Procedures Supplement
NASSCO.....National Steel and Shipbuilding Company
NAVSEA.....Naval Sea Systems Command
SG&A.....Selling, General and Administrative

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

April 10, 1992

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)

SUBJECT: Report on the Release of Morrison Knudsen Corporation from the Performance Guarantee on the AOE-6 Contract (Report No. 92-073)

We are providing this final report for your information and use. We performed this audit because our audit of the "Acquisition of the AOE-6 Fast Combat Support Ship" (Project No. 9AL-0070) identified factors that we believed needed further review. DoD Directive 7650.3 requires that all audit recommendations be resolved promptly. Therefore, the Assistant Secretary of the Navy (Research, Development and Acquisition) must provide final comments by June 10, 1992. See the "Status of Recommendations" section at the end of the finding for the recommendations you must comment on and the requirements for your comments. If appropriate, you may propose alternative methods for accomplishing desired improvements. Recommendations are subject to resolution in accordance with DoD Directive 7650.3 in the event of nonconcurrence or failure to comment.

The courtesies extended to the audit staff are appreciated. If you have any questions on this audit, please contact Mr. Rayburn H. Stricklin at (703) 614-3965 (DSN 224-3965) or Mr. Robert K. West at (703) 614-1415 (DSN 224-1415). The planned distribution of this report is listed in Appendix E.

Robert J. Lieberman
Robert J. Lieberman
Assistant Inspector General
for Auditing

Enclosure

cc: Secretary of the Navy

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Office of the Inspector General

AUDIT REPORT NO. **April 10, 1992**
(Project No. 9AL-0070.01)

THE RELEASE OF MORRISON KNUDSEN CORPORATION

FROM THE PERFORMANCE GUARANTEE ON THE AOE-6 CONTRACT

EXECUTIVE SUMMARY

Introduction. On January 23, 1987, the Navy awarded a $290.1 million competitive, fixed-price-incentive contract for the lead AOE-6 Class ship, with options for three follow-on ships to the National Steel and Shipbuilding Company (NASSCO). *

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* On January 15, 1987, Morrison Knudsen Corporation (Morrison Knudsen), NASSCO's parent company, guaranteed the performance of the AOE-6 contract. The Navy awarded the contract to NASSCO only after receiving the performance guarantee. Furthermore, the Navy was relying on the performance guarantee to provide NASSCO with adequate financing to ensure performance of the contract.

In November 1988, Morrison Knudsen informed the Secretary of the Navy that it wanted to get out of the shipbuilding business and to limit its liability under the performance guarantee. On April 12, 1989, the Navy and Morrison Knudsen entered into an agreement that discharged Morrison Knudsen from the performance guarantee.

Objective. The audit's overall objective was to evaluate whether the Navy adequately protected DoD's interests in releasing Morrison Knudsen from a performance guarantee on the AOE-6 contract.

Audit Results. The Navy did not obtain sufficient financial consideration when it released Morrison Knudsen Corporation from a corporate guarantee for performance on the AOE-6 contract. As a result of the release from guarantee, the Navy may have to pay as much as * more than it would have had to pay for the same number of ships it could have received under the contract with the performance guarantee.

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* Company confidential or proprietary information deleted.

Internal Controls. Internal controls were not in place for establishing and rescinding performance guarantees. Also, internal controls relating to documenting determinations of contractor responsibility were not adhered to. Our review of internal controls is discussed in Part I of this report.

Potential Benefits of Audit. The principal benefits that will be realized from this audit are better financial protection for the Navy when entering into performance guarantees and better documented determinations of contractor responsibility and contract files. Additional details are included in Appendix C.

Summary of Recommendations. We recommended the institution of procedures and controls for establishing, modifying, and rescinding performance guarantees. We also recommended adherence to procedures for properly documenting determinations of contractor responsibility and contract files.

Management Comments. The Navy partially concurred with Recommendation 1.a. and fully concurred with Recommendations 1.b., 1.c., 1.d., and 2. The Navy disagreed with the finding that the Navy did not obtain sufficient financial consideration for NASSCO to complete the AOE-6 contract when it released Morrison Knudsen from the performance guarantee. We have requested comments from the Assistant Secretary of the Navy (Research, Development and Acquisition) by June 10, 1992. The complete text of the Navy's comments is in Part IV of this report.

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This report was prepared by the Acquisition Management Directorate, Office of the Assistant Inspector General for Auditing, DoD. Copies of the report can be obtained from the Information Officer, Audit Planning and Technical Support Directorate, (703) 614-6303.

PART I - INTRODUCTION

Background

In October 1986, the Naval Sea Systems Command (NAVSEA) received four proposals for construction of the AOE-6 Fast Combat Support Ship. The National Steel and Shipbuilding Company (NASSCO), a wholly-owned subsidiary of Morrison Knudsen Corporation (Morrison Knudsen), submitted the lowest offer. On January 23, 1987, the Navy awarded a $290.1 million competitive, fixed-price-incentive contract for the lead ship, with options for three follow-on ships, to NASSCO. NAVSEA exercised the option for the first follow-on ship, the AOE-7, in November 1988 and exercised the option for the second follow-on ship, the AOE-8, in December 1989. NAVSEA will not exercise the option for the third follow-on ship, the AOE-9, because OSD rescinded funds for the AOE-9 in January 1991.

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* As a result, NAVSEA requested that Morrison Knudsen, NASSCO's parent company, provide a corporate guarantee on contract performance. On January 15, 1987, Morrison Knudsen guaranteed performance of the AOE-6 contract. The guarantee was executed by the president of Morrison Knudsen. The Navy awarded the AOE-6 contract to NASSCO only after it received the performance guarantee. The Navy was relying on the performance guarantee to provide NASSCO with adequate financing to ensure performance on the contract.

In November 1988, Morrison Knudsen informed the Secretary of the Navy that it wanted to get out of the shipbuilding business and to limit its liability under the performance guarantee. Morrison Knudsen was considering having the AOE-6 ships completed at Avondale Industries, Incorporated, or allowing NASSCO to complete the contract as an employee owned company. Morrison Knudsen contended that the performance guarantee only required that it ensure that the ships were completed, but not necessarily at NASSCO.

On April 12, 1989, the Navy and Morrison Knudsen entered into an agreement that discharged Morrison Knudsen from the performance guarantee. The Navy considered that the agreement provided NASSCO with adequate financing to complete the AOE-6 contract.

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* Company confidential or proprietary information deleted.

Objective

The overall audit objective was to evaluate whether the Navy adequately protected DoD's interests in releasing Morrison Knudsen from a performance guarantee on the AOE-6 contract. The audit was initiated because our audit of the "Acquisition of the AOE-6 Fast Combat Support Ship," Project No. 9AL-0070, identified factors on the Navy's release of Morrison Knudsen from the performance guarantee on the AOE-6 contract that we believed needed further review.

Scope

This economy and efficiency audit was conducted from August through September 1991 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD, and accordingly included such tests of internal controls as were deemed necessary. We obtained and reviewed data and information, dated from January 1987 through September 1991, to accomplish our objective. We interviewed cognizant Navy and contractor officials involved in the Navy's decision to release Morrison Knudsen from the AOE-6 performance guarantee. A list of activities visited or contacted is in Appendix D. An investigator from the Office of the Assistant Inspector General for Departmental Inquiries, a contract specialist from the Technical Assessment Division of the Office of the Assistant Inspector General for Auditing, and a lawyer from the DoD Office of General Counsel assisted us in our audit. Our audit was hindered because the Navy did not have a business clearance memorandum or other memorandums documenting why the release of Morrison Knudsen from the performance guarantee was considered to be in the Government's best interest.

Internal Controls

We assessed internal controls applicable to the Navy's actions and negotiations that led to the Navy releasing Morrison Knudsen from the AOE-6 performance guarantee. We also reviewed internal controls applicable to the financial responsibility determination that was made before the award of the AOE-6 contract. The audit identified material internal control weaknesses as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. Internal controls were not in place for establishing and rescinding performance guarantees. Also, internal controls relating to documenting determinations of contractor financial responsibility were not adhered to. Recommendations 1. and 2., in this report, if implemented, will correct these weaknesses. A copy of this

report is being provided to the senior official responsible for internal controls within the Department of the Navy.

Prior Audits and Other Reviews

In May 1991, the Under Secretary of Defense for Acquisition tasked the Navy to review the circumstances surrounding the Navy's release of Morrison Knudsen from the performance guarantee on the AOE-6 contract to determine whether any false representations may have been made to obtain the release and whether the Navy had the right to reinstate the guarantee in light of the projected cost growth in completing the contract. On September 6, 1991, the Assistant Secretary of the Navy (Research, Development and Acquisition) responded to the Under Secretary stating that the Office of the General Counsel of the Navy had concluded that the Navy was not aware of any false representation by Morrison Knudsen in negotiating the release, and that Morrison Knudsen had complied with its obligations under the release agreement. The Assistant Secretary stated that the General Counsel had concluded that there was no basis for reinstating the guarantee.

PART II - FINDING AND RECOMMENDATIONS

PERFORMANCE GUARANTEE

The Navy did not obtain sufficient financial consideration for NASSCO to complete the AOE-6 contract when it released Morrison Knudsen Corporation from a corporate guarantee for performance on the contract. The situation existed because the Navy underestimated NASSCO's projected loss on the AOE-6 contract. Poor contracting practices on the part of Navy officials, as well as an absence of guidance pertaining to performance guarantees, also contributed to the situation. As a result of the release from guarantee, the Navy may have to pay as much as * more than it would have had to pay for the same number of ships it could have received under the contract with the performance guarantee.

DISCUSSION OF DETAILS

Background

In response to Morrison Knudsen's announcement that it wanted to get out of the shipbuilding business, the NAVSEA Contracts Directorate and General Counsel of the Navy reviewed the terms of the performance guarantee to determine whether the Navy would have to release Morrison Knudsen from the performance guarantee. NAVSEA concluded that the Navy had a valid and enforceable guarantee, but that the guarantee did not necessarily provide for performance at NASSCO.

In attempting to obtain a release from the performance guarantee, Morrison Knudsen set forth several alternatives for the Navy to consider. One alternative was that Morrison Knudsen would assign the AOE-6 contract to Avondale Industries, Incorporated (Avondale), and have Avondale complete the ships. A second alternative was to arrange for the sale of NASSCO to its employees through an Employee Stock Ownership Plan.

The Assistant Secretary of the Navy (Shipbuilding and Logistics) determined that an assignment to Avondale was not in the Navy's best interest. The Assistant Secretary reportedly wanted to retain NASSCO as a viable shipyard because of concerns about industrial mobilization needs for yards capable of constructing major auxiliary ships. The Assistant Secretary was also concerned about Avondale's ability to meet its existing and projected commitments if new work were added.

On December 23, 1988, the NAVSEA Deputy Commander for Contracts informed Morrison Knudsen that a transfer of the AOE-6 Class

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* Company confidential or proprietary information deleted.

construction contract to Avondale was unacceptable. The Deputy Commander stated that the addition of the AOE-6 Class ships to Avondale's work load would result in disruption of other Navy shipbuilding programs at Avondale.

On February 2, 1989, Avondale informed Morrison Knudsen that it was no longer interested in pursuing the AOE-6 contract assignment. According to the NAVSEA Contracting Officer that was responsible for negotiating the release agreement, Morrison Knudsen considered Avondale's position to be a negotiation position rather than a final termination of the negotiations. As a result, NAVSEA considered the Avondale option to remain open to Morrison Knudsen.

The NAVSEA Counsel discussed the performance guarantee issue with the Justice Department to determine whether any antitrust laws would be violated if Morrison Knudsen assigned the contract to Avondale. The Navy concluded, based on a meeting with the Justice Department, that Morrison Knudsen assigning the contract to Avondale probably did not violate any existing antitrust laws. The Navy did not believe that Morrison Knudsen would be required to provide more funds than would have been required to complete the AOE-6 Class ships at Avondale.

On February 28, 1989, the NAVSEA Deputy Commander for Contracts informed Morrison Knudsen that NAVSEA would be willing to consider modifications to the "uncapped" performance guarantee as long as there was adequate consideration. The Navy expressed two primary concerns: that the ships be built and that the ships be built at NASSCO to maintain a West Coast shipbuilding yard and a competitive base for follow-on auxiliary ships. NASSCO was the only remaining construction yard for auxiliary ships on the West Coast.

The Navy decided that if it were to release Morrison Knudsen from the performance guarantee, it would need to secure consideration from Morrison Knudsen that would reasonably ensure successful completion of the AOE-6 contract at NASSCO after the establishment of the Employee Stock Ownership Plan and provide for the long-term financial viability of NASSCO as a ship construction and repair yard. A critical factor in reaching an agreement to release Morrison Knudsen involved determining the amount of additional capital that NASSCO would require to reasonably ensure completion of the AOE-6 contract. To determine that amount, the Navy established a cost review team and tasked the team with reviewing NASSCO's cost estimates for the AOE-6 Program. The Navy also contracted with KPMG Peat Marwick to assess whether the Morrison Knudsen proposals provided NASSCO with the financial ability to complete the AOE-6 contract and ensure the long-term viability of NASSCO.

After receiving input from the Navy cost review team and KPMG Peat Marwick, the NAVSEA Contracts Directorate concluded that the total contribution required to maintain NASSCO's viability was about * . The * was composed of a * preferred stock and * credit arrangement, * to cover taxes on the TAH-20 hospital ship contract, and a * assumed settlement on request for equitable adjustments that NASSCO had submitted on Navy repair contracts.

On April 12, 1989, the Navy and Morrison Knudsen entered into an agreement that discharged Morrison Knudsen from the performance guarantee. The Navy considered that the agreement provided NASSCO with adequate financing to complete the AOE-6 contract.

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Evaluation of the Navy's Decision to Release Morrison Knudsen from the Performance Guarantee

The Navy did not obtain sufficient financial consideration for NASSCO to complete the AOE-6 Class contract when it released Morrison Knudsen from a corporate guarantee for performance on the contract. As discussed later, NASSCO subsequently experienced serious financial difficulties and NAVSEA could not

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1/ On June 27, 1991, the terms of the agreement were modified to increase the * line of credit to * instead of having the * line of credit replaced with * of preferred stock and * of credit.

* Company confidential or proprietary information deleted.

find NASSCO financially capable to exercise the option for the fourth ship on the AOE-6 contract.

There were several reasons why the Navy did not obtain sufficient consideration when it released Morrison Knudsen from the performance guarantee on the AOE-6 contract. The primary reason was that the Navy's analysis of capital requirements underestimated NASSCO's projected loss on the AOE-6 Class contract. Poor contracting practices on the part of Navy officials and an absence of guidance pertaining to performance guarantees also contributed to the situation.

Navy's analysis of the projected loss on the AOE-6 contract. The Navy established a cost review team to review NASSCO's AOE-6 cost projections. The Navy cost review team's analysis was key to determining the basis for the Navy's position that the projected total additional capital required to complete the AOE-6 contract and maintain NASSCO's viability was about * . The cost review team included a team leader, who was the business manager from the AOE-6 Program Office, and several representatives from the NAVSEA Cost Estimating and Analysis Division. The team also received support from the Supervisor of Shipbuilding, Conversion and Repair, San Diego, and the resident auditors from the Defense Contract Audit Agency (DCAA) office at NASSCO.

The cost review team estimated that NASSCO would incur a minimum loss of * and a maximum loss of * on the AOE-6 contract. NASSCO had forecasted a profit of * . After reflecting selling and general and administrative expenses as overhead instead of as part of profit and adjusting the forecast for the cost of money, NASSCO showed a projected loss of * ("Forecast B"). The Navy adjusted NASSCO's projection for inflation indexes and derived a projected "Forecast B Adjusted" loss of * . The projected * "Forecast B Adjusted" loss was used as a basic assumption in the subsequent KPMG Peat Marwick analysis. On February 3, 1989, the Navy cost review team issued a report, "AOE Cost Projection Review," which summarized the results of its review. An excerpt from that report, which shows the projected minimum, maximum, "Forecast B," and "Forecast B Adjusted" losses, is shown in Appendix A.

In January 1989, the Navy hired KPMG Peat Marwick to assess whether Morrison Knudsen's proposals provided NASSCO with the financial ability to complete the AOE-6 contract and ensure the long-term viability of NASSCO as a ship construction and repair yard. The result of KPMG Peat Marwick's analysis was another key input into the Navy's decision to release Morrison Knudsen from

the performance guarantee. KPMG Peat Marwick took financial data and put it in a format that represented a cash flow analysis and also did some sensitivity analysis using a model based on specific assumptions. The NAVSEA Contracts Directorate directed KPMG Peat Marwick to use the * "Forecast B Adjusted" loss in its analysis. KPMG Peat Marwick did not adjust the "Forecast B Adjusted" data. Also, KPMG Peat Marwick did not make any projections using the cost review team's maximum projected loss or any other projected loss figure. At a September 10, 1991, meeting with us, KPMG Peat Marwick described its review as a "limited in scope" analysis. However, in an April 13, 1989, NAVSEA briefing to the Assistant Secretary of the Navy (Shipbuilding and Logistics), the NAVSEA briefing charts inaccurately referred to the KPMG Peat Marwick assessment as a "complete financial assessment."

KPMG Peat Marwick concluded, based on its analysis, that the final * capital requirement agreed to by NAVSEA and Morrison Knudsen adequately addressed NASSCO's needs with respect to capital requirements, existing and potential tax liabilities, existing NASSCO debt, and the purchase price of NASSCO by NASSCO employees and senior management. KPMG Peat Marwick identified the major variables that influenced capital requirements as new business and performance on the AOE-6 contract. *

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* The KPMG Peat Marwick report also stated that KPMG Peat Marwick relied on NASSCO's representations about its plans, expectations, and disclosure of any significant information that might affect the ultimate realization of the projected outcomes. KPMG Peat Marwick qualified its report by stating that "No attempt was made to audit or verify any information received."

Concerns with the Navy's analysis. We believe that the Navy's reliance on the * projected loss as a basic assumption in its analysis was arbitrary and inappropriate. The * projected loss was computed using NASSCO's labor hours. When the cost review team adjusted "Forecast B" to derive "Forecast B Adjusted," it did not adjust NASSCO's labor hours even though it had documented concerns about NASSCO's labor hours. The cost review team had derived its own labor hour

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2/ Although KPMG Peat Marwick did not issue a report until May 26, 1989, which was after the release decision, KPMG Peat Marwick had briefed the Navy on the results of its analysis before the release decision.

* Company confidential or proprietary information deleted.

figures by adjusting NASSCO's labor hours for inefficiencies resulting from NASSCO increasing its work force with "unskilled" labor and its inexperience with gas turbines. These proved to be valid concerns because, in August 1991, the Navy indicated that

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* . The labor hours derived by the cost review team approximated those derived by the Price Analysis Team, which had made an estimate before contract award. The cost review team's labor hours were reflected in its maximum estimate, not in the "Forecast B Adjusted" estimate * projected loss) that was used in the subsequent KPMG Peat Marwick analysis.

Based on our request, the NAVSEA Cost Estimating and Analysis Division recalculated the "Forecast B Adjusted" using the cost review team's labor hours. The projected loss, computed using the cost review team's labor hours, was about * , which was significantly greater than the * loss derived using the NASSCO labor hours.

We discussed the February 3, 1989, cost review team report with the members of the cost review team. The cost review team maintained that it only projected a range and concluded that the "Forecast B Adjusted" loss of * was within that range. The team did not make any conclusions as to the reasonableness of the * "Forecast B Adjusted" projected loss.

The NAVSEA Contracting Officer that was responsible for negotiating the capital requirements necessary to release Morrison Knudsen from the performance guarantee said that the Contracts Directorate decided to use the * projected loss as a basic assumption in its analysis, based on a review of other information that had been provided by the AOE-6 Program Office but was no longer available. The NAVSEA Deputy Commander for Contracts contended that the * projected loss was a "credible" estimate. He recalled that the Contracts Directorate was looking for a number within a range and settled on the * projected loss figure. However, he also did not have documentation justifying his "credible" estimate.

We believe that the Navy's use of the "Forecast B Adjusted" projected loss was too arbitrary. Although the * projected loss was within the minimum and maximum projected ranges, it was much closer to the minimum projected loss (*) than the maximum projected loss (*). Also, there were indicators that the Navy should not have been as arbitrary but should have been more

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* Company confidential or proprietary information deleted.

conservative in its negotiation. *

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* . These indicators, which address NASSCO's financial capability, are discussed in Appendix B.

Contracting practices. The Navy did not apply sound contracting practices in evaluating and negotiating the release from guarantee. Federal Acquisition Regulation, subpart 4.8, requires that the contract files provide a complete background as a basis for informed decisions at each step in the acquisition process. The Federal Acquisition Regulation also requires that documentation in the contract files sufficiently provide a complete history of transactions to support actions taken and provide information for reviews and investigations.

Although the Federal Acquisition Regulation and the Navy Acquisition Procedures Supplement require that contracting officials document negotiations with contractors, the Navy had no business clearance memorandum or other documented contracting officer's determination that the release of Morrison Knudsen from the performance guarantee was in the Government's best interest. There were various reports, such as the NAVSEA cost review team report and KPMG Peat Marwick report, but there was no decision memorandum or position paper that pulled all of the factors relating to the release decision together. More specifically, Navy officials did not document either their prenegotiation objectives or the results of negotiations that led to Morrison Knudsen being released from the performance guarantee. Furthermore, the performance guarantee was not referenced in the AOE-6 contract or addressed in the business clearance memorandum for the AOE-6 contract.

Additionally, at the time of the release decision, there was no documented legal opinion as to NAVSEA Counsel's conclusions on the release decision. NAVSEA Counsel provided us with a memorandum, dated September 26, 1991, that retroactively documented the advice that Counsel contended it provided to the Contracting Officer and the AOE-6 Program Manager at the time of the release decision. NAVSEA Counsel also provided us with a draft memorandum that was described as having been prepared at the time of the release decision; however, it had never been reviewed for accuracy or finalized. NAVSEA Counsel's documentation did not address whether NASSCO's payment of * in dividends to Morrison Knudsen in June 1987 was consistent with Morrison Knudsen's status as the guarantor on the AOE-6 contract, and if it was not, what additional remedies might have been available.

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* Company confidential or proprietary information deleted.

Guidance on performance guarantees. We could not identify any specific guidance regarding performance guarantees in the Federal Acquisition Regulation, DoD Federal Acquisition Regulation Supplement, Navy Acquisition Procedures Supplement, or any other regulation or directive. The Federal Acquisition Regulation contains specific guidance and controls over other means of providing the Government with financial protection, such as performance bonds. In the absence of any guidance, the Navy made and documented the decision as it deemed appropriate.

Effects of the Release Decision

After releasing Morrison Knudsen from the performance guarantee, * * * . As a result of not exercising the third option under the NASSCO contract, the Navy estimated that the additional funding needed to procure a fourth ship under a competitive, single ship procurement would be about * over what would have been needed to fund a fourth ship under the NASSCO AOE-6 contract. With the performance guarantee, the Navy had a commitment from Morrison Knudsen to deliver up to four ships at the price specified in the contract.

In response to the draft report, the Navy maintained that it did not exercise the option for the fourth ship because OSD rescinded funds for the fourth ship. However, even before OSD rescinded the funds, NAVSEA had determined that it was not appropriate to exercise the option because * * . OSD's decision to rescind the funds for the FY 1991 AOE-6 Class ship (fourth ship) was based on concerns about production delays and cost overruns at NASSCO.

The Navy's release of Morrison Knudsen from the performance guarantee also exposed DoD to an additional * of cost risk. * * * . On March 15, 1991, the Secretary of the Navy granted a $25 million increase to the contract price without consideration under Public Law 85-804. Public Law 85-804 provides for granting extraordinary contractual relief when such relief will "facilitate the national defense." In granting the extraordinary contractual relief, the Secretary stated that NASSCO's financial condition would not allow it to complete the AOE-6 and AOE-7 without Public Law 85-804 relief. The extraordinary contractual relief was granted to provide interim relief for NASSCO's negative cash flow situation, pending the Navy's completion of its evaluation of NASSCO's AOE-6 contract claims. The contract modification for the extraordinary

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* Company confidential or proprietary information deleted.

relief stipulated that it would be the Government's sole discretion as to whether the $25 million price increase remained as a permanent increase to the contract price.

Fortunately, the potential $25 million loss related to the Public Law 85-804 relief did not materialize. On December 26, 1991, the Navy and NASSCO settled the outstanding AOE-6 contract claims, amounting to $459.8 million, for $239 million. On March 4, 1992, the AOE-6 Contracting Officer stated that the entitlement on the contract claims obviated the need for the Public Law 85-804 relief. He stated that the $25 million (Public Law 85-804 relief) was no longer without consideration, because the claims settlement now provided a basis for the $25 million.

Financial Responsibility

In reviewing the events leading up to the establishment of the performance guarantee, we also found that the Navy did not adequately document its determination of NASSCO's financial responsibility before awarding the AOE-6 contract to NASSCO. Federal Acquisition Regulation, subsection 9.105-2, states that "documents and reports supporting a determination of responsibility, including any pre-award survey reports . . . must be included in the contract file."

A NAVSEA Price Analysis Team report, dated January 9, 1987, projected that NASSCO underbid the contract to the point where it would incur a significant overrun resulting in a * loss on the AOE-6 contract. On January 14, 1987, the Source Selection Authority recommended that the Contracting Officer perform a preaward survey paying special attention to NASSCO's ability to withstand the impact of an overrun. In a January 20, 1987, letter to the Source Selection Authority, the Contracting Officer declared NASSCO financially responsible based on a review of financial statements provided by NASSCO. The Contracting Officer also stated that Morrison Knudsen's performance guarantee provided further assurance that NASSCO would have the financial ability to perform the contract. The Contracting Officer recommended that an on-site preaward survey not be performed. The Source Selection Authority concurred with the Contracting Officer's recommendations. However, the AOE-6 business clearance memorandum indicates that a financial preaward survey was completed on January 22, 1987. At the time of our audit, the Navy was unable to locate the January 22, 1987, document and could not provide any evidence that the financial preaward survey referenced in the business clearance memorandum was ever done.

On February 19, 1987, about 1 month after the Navy awarded the AOE-6 contract to NASSCO, the AOE-6 Contracting Officer requested

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* Company confidential or proprietary information deleted.

a recommendation from a contract specialist within NAVSEA's Contracts Directorate on the financial responsibility of NASSCO. On February 20, 1987, the Contract Specialist issued a memorandum to the Contracting Officer recommending that NASSCO be considered financially responsible. The Contract Specialist reported that NASSCO was financially responsible based on a review of audited 1983, 1984, and 1985 financial statements and an unaudited financial statement for the period ended November 23, 1986. The financial statements were not in the contract file, and the Contracting Officer could not locate them. The Contracting Officer stated that the Contract Specialist's financial review was done before the contract award but documented after the contract award. The Contract Specialist said that he assumed that the Contracting Officer performed an earlier review, but later wanted another review performed to verify the initial determination of financial responsibility.

We believe that the projected overrun on the AOE-6 contract and the Navy's concern about NASSCO's financial capability warranted a well documented decision of financial responsibility. We also believe that the situation warranted a legal review of the performance guarantee before contract award. We found that the Contracting Officer did not request a legal review of the performance guarantee before the award of the AOE-6 contract.

Conclusion

We believe the manner in which Navy officials made and documented the release from guarantee decision left much to be desired and, as a result, reflects adversely on the Navy. More seriously, the decision could cost the Navy * . The Navy's analysis was inadequate, and the Navy did not properly document the basis for the decision that was made. Also, poor contracting practices and poor documentation were evident from the Navy's initial determination of NASSCO's financial responsibility. Unlike what actually occurred, the unusual nature of the release decision combined with the financial risk in the decision made it imperative that the Navy clearly document the basis for the decision. Because there was no indication that the individuals involved in the release decision were motivated by personal gain, and because of the lack of guidance concerning performance guarantees, we do not believe that there are sufficient criteria to warrant a recommendation in this audit report for disciplinary action against specific individuals.

Purportedly, in the decision to release Morrison Knudsen from the performance guarantee, the Assistant Secretary of the Navy

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* Company confidential or proprietary information deleted.

(Shipbuilding and Logistics) was motivated by an objective to retain NASSCO as an alternative source of supply and part of the industrial mobilization base. If this was the case, it should have been adequately documented.

If the Navy plans to continue to use performance guarantees as a means of providing the Government with financial protection, we believe that regulatory controls are needed. The Navy should set up specific guidance and internal controls for establishing, modifying, and rescinding performance guarantees.

RECOMMENDATIONS FOR CORRECTIVE ACTION

1. We recommend that the Assistant Secretary of the Navy (Research, Development and Acquisition) revise the Navy Acquisition Procedures Supplement to include procedures for establishing, modifying, and rescinding performance guarantees. As a minimum, the procedures should:

a. Require that a performance guarantee be referenced in the contract and addressed in the business clearance memorandum.

b. Specify the level of approval authority for establishing a performance guarantee.

c. Require that Government counsel review the performance guarantee for legal sufficiency before the guarantee is executed.

d. Require a documented justification by the contracting officer, reviewed by legal counsel, and approved by a level above the contracting officer, that the Government's interests are protected before a performance guarantee is rescinded or modified.

2. We recommend that the Deputy Commander for Contracts, Naval Sea Systems Command, issue a memorandum to contracting officers emphasizing the requirements for timely and properly documented determinations of contractor responsibility and properly documented contract files.

MANAGEMENT COMMENTS

The Assistant Secretary of the Navy (Research, Development and Acquisition) partially concurred with Recommendation 1.a. and fully concurred with Recommendations 1.b. through 1.d. The Navy disagreed with the part of Recommendation 1.a. that performance guarantees be referenced in contracts stating that a performance guarantee must be executed by a third party and be a stand-alone instrument that is enforceable on its own merits. The Navy

stated that referencing a performance guarantee in the contract adds no value and may add confusion. On Recommendations 1.b. through 1.d., the Navy agreed that more specific guidance in the Navy Acquisition Procedures Supplement (NAPS) would improve establishment and administration of performance guarantees. The Navy stated that it planned to modify NAPS, subsection 1.690.5, "Types of Contract Actions Requiring Business Clearance," to require that performance guarantee execution, modification, or recision be reviewed and approved in a similar manner and at the same level as would be required for other business transactions of like magnitudes.

The Navy also concurred with Recommendation 2. and stated that a memorandum emphasizing the requirements for timely and properly documented determinations of contractor responsibility and properly documented contract files would be issued by March 31, 1992.

The Navy did not agree with the finding that the Navy did not obtain sufficient financial consideration for NASSCO to complete the AOE-6 Class contract when it released Morrison Knudsen Corporation from the performance guarantee. In a memorandum forwarding the detailed Navy comments, the Assistant Secretary of the Navy (Research, Development and Acquisition) stated that the primary basis for the DoDIG judgment concerning the Navy's underestimation of NASSCO's projected loss was that NASSCO experienced serious financial problems after the release of Morrison Knudsen from the performance guarantee. The Assistant Secretary stated that, based on several independent reviews, the Navy believed the amount of the capital that the Navy accepted was appropriate for the agreement with Morrison Knudsen. The Assistant Secretary also stated that the financial problems NASSCO later encountered resulted from events that resulted in claims that were eventually settled for $239 million under the contract. The Assistant Secretary stated that since these claims have been resolved, NASSCO's financial position appears favorable, * * .

In its comments, the Navy stated that the DoDIG attributed NASSCO's financial difficulties solely to inadequate funding flowing from the Morrison Knudsen performance release settlement. The Navy also stated that the DoDIG failed to adequately consider the implications imposed by potential execution of the AOE-6 contract at Avondale Industries, Inc., on the release decision. The Navy also nonconcurred with the DoDIG statement that the Navy used poor contracting practices. The Navy stated that a business clearance memorandum would have affected documentation of the release decision, but it did not

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* Company confidential or proprietary information deleted.

agree that the lack of a clearance resulted in poor contracting practices. The Navy stated that additional documentation would have added historical value, but it would not have resulted in added management oversight and would not have affected the decisionmaking process or the actual decisions.

The Navy also nonconcurred with the DoDIG conclusion that as a consequence of the release from the performance guarantee, the Navy may have to pay as much as * more than it would have had to pay for the same number of ships it could have received under the contract with the performance guarantee. The Navy stated that the DoDIG incorrectly reasoned that an unsatisfactory guarantee release settlement made NASSCO financially non-responsible for any future contractual options.

The complete text of the Navy's comments is in Part IV of the report.

AUDIT RESPONSE TO MANAGEMENT COMMENTS

We believe that the Navy's planned actions for Recommendations 1.b. through 1.d., and 2. are fully responsive to the recommendations. The Navy's planned actions for Recommendation 1.a. are partially responsive. We ask that the Navy, in response to the final report, provide estimated completion dates for the actions identified in its response to Recommendations 1.a. through 1.d.

We also ask that the Navy reconsider its position on Recommendation 1.a. that performance guarantees should not be referenced in contracts. The Navy stated that such a reference would add no value and may actually cause confusion. In our opinion, the lack of any reference to a third party may have the opposite effect. For example, if a contract containing no such reference is reassigned after contract award to a new Contracting Officer and to a new corporate contracts administrator, the knowledge that performance of that contract has been guaranteed by a third party may be lost. Also, precedence for references to the responsibilities of third parties exists in the Federal Acquisition Regulation (FAR). For example, FAR 28.106-4 directs the inclusion of clause 52.228-2, "Additional Bond Security," in contracts when bonds are required. Also, FAR 23.203-6 directs the inclusion of clause 52.228-11, "Pledges of Assets," in contracts that require the submission of bid guarantees, performance, or payment bonds.

We disagree with the Navy's comments to our finding that the primary basis for our judgment concerning the Navy's underestimation of NASSCO's projected contract loss was that

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* Company confidential or proprietary information deleted.

NASSCO experienced serious financial problems after the release of Morrison Knudsen from the guarantee. As stated in the finding, the primary basis for our judgment was that our evaluation indicated that the Navy's analysis was inadequate. We believe the Navy's reliance on the * projected loss as a basic assumption in its analysis was arbitrary and inappropriate. This projected loss figure was computed using NASSCO's labor hours even though the cost review team had documented concerns about NASSCO's labor hours. Using the cost review team's labor hours, the projected loss would have been about * . Therefore, based on the information that was available at the time of the decision, we do not believe that the Navy obtained sufficient financial consideration for NASSCO to complete the AOE-6 contract.

The Navy's comments indicate that its conclusion that the capital accepted by the Navy was appropriate and was based on several independent reviews. We assume the Navy's comments are referring to the Navy cost review team's and KPMG Peat Marwick's analyses. However, the cost review team only projected a range and concluded that the "Forecast B Adjusted" loss of * was within that range. The cost review team did not make any conclusions as to the reasonableness of the * projected loss. Also, as stated in the finding, the Navy directed that KPMG Peat Marwick use the * projected loss figure in its analysis. KPMG Peat Marwick made no attempt to audit or verify any information received. Furthermore, KPMG Peat Marwick described its work as a "limited in scope" analysis.

The Navy's comments imply that NASSCO's financial problems were attributed solely to problems that gave rise to the NASSCO claims. This is inconsistent with documentation that we reviewed relating to NAVSEA's request for Public Law 85-804 relief for NASSCO.

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We disagree with the Navy's comments that the report failed to consider the implications imposed by potential execution of the contract at Avondale Industries, Inc. We believe that the finding adequately discusses the Navy's concerns on this issue.

We stand by our position that the Navy did not apply sound contracting practices in evaluating and negotiating the release from guarantee. The unusual nature of the release decision warranted particularly careful documentation. Furthermore, we question the Navy's statement that additional documentation would not have affected the decisionmaking process or the actual decision. We believe that a well documented analysis might have surfaced the same concerns that we identified with the Navy's analysis during our audit. The Contracting Officer should have ensured that complete documentation was in order.

The Navy took exception to our conclusion that as a result of the release from the performance guarantee, the Navy may have to pay as much as * more than it would have to pay for the same number of ships it could have received under the contract with the performance guarantee. Our statement was not absolute, but was qualified with the word "may." We believe, based on our review of the facts available at the time of the release decision, that the agreement exposed the Navy to considerable risk. With the performance guarantee, the Navy had a commitment from Morrison Knudsen to deliver up to four ships at the price specified in the contract. Also, as stated in the finding, even before OSD rescinded the funds, NAVSEA had determined that it was not appropriate to exercise the option for the fourth ship because *

Finally, the Navy's response states that NASSCO's financial position now appears favorable *

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STATUS OF RECOMMENDATIONS

		Response Should Cover			
Number	Adressee	Concur/ Nonconcur	Proposed Action	Completion Date	Related Issues*
1.a.	Assistant Secretary of the Navy (Research, Development and Acquisition)	X	X	X	IC
1.b.	Assistant Secretary of the Navy (Research, Development and Acquisition)			X	
1.c.	Assistant Secretary of the Navy (Research, Development and Acquisition)			X	
1.d.	Assistant Secretary of the Navy (Research, Development and Acquisition)			X	
2.	Deputy Commander for Contracts, NAVSEA				

*IC = material internal control weakness

PART III - ADDITIONAL INFORMATION

Appendix A - Navy Cost Review Team's Minimum and Maximum Ranges, "Forecast B," and "Forecast B Adjusted"
Appendix B - Indicators of NASSCO's Financial Capability
Appendix C - Summary of Benefits Resulting From Audit
Appendix D - Activities Visited or Contacted
Appendix E - Report Distribution

APPENDIX A: NAVY COST REVIEW TEAM'S MINIMUM AND MAXIMUM RANGES "FORECAST B," AND "FORECAST B ADJUSTED"*

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APPENDIX B: INDICATORS OF NASSCO's FINANCIAL CAPABILITY

NASSCO's financial strength. In April 1989, NASSCO's

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* . NASSCO paid * in dividends to Morrison Knudsen in June 1987. The NAVSEA Deputy Commander for Contracts stated in a December 23, 1988, letter to Morrison Knudsen that:

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DCAA audit report. DCAA Report No. 4221-8E176001, "Report on Review of Financial Capability and Cash Flow Forecasts," September 23, 1988, stated that NASSCO's financial situation

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Duff and Phelps report. A Duff and Phelps Financial Consulting Company report on NASSCO, dated December 13, 1988,

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Duff and Phelps Financial Consulting Company was an independent appraiser hired by the trustee for the Employee Ownership Plan.

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* Company confidential or proprietary information deleted.

Morrison Knudsen's Chief Counsel's comments. On March 7, 1989, after the Navy had decided not to award the T-AO fleet oiler ship contract to NASSCO. Morrison Knudsen's Chief Counsel wrote a letter to the NAVSEA Deputy Commander for Contracts

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APPENDIX C: SUMMARY OF POTENTIAL BENEFITS RESULTING FROM AUDIT

Recommendation Reference	Description of Benefit	Type of Benefit
1.	Internal Control. Will help ensure that the Navy's interests are protected when establishing and rescinding performance guarantees in the future.	Nonmonetary.
2.	Compliance with laws and regulations. Will ensure that proper procedures are followed in determining whether a contractor is financially responsible for performing the contract. This should provide the Navy additional protection when it enters into contracts.	Nonmonetary.

APPENDIX D: ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Washington, DC
Deputy Director (Tactical Warfare Programs, Washington, DC

Department of the Navy

Assistant Secretary of the Navy (Financial Management), Washington, DC
Assistant Secretary of the Navy (Research, Development and Acquisition), Washington, DC
Naval Sea Systems Command Headquarters, Washington, DC
Supervisor of Shipbuilding, Conversion and Repair, San Diego, CA

Defense Agency

Defense Contract Audit Agency, San Diego, CA

Contractors

National Steel and Shipbuilding Company, San Diego, CA
KPMG Peat Marwick, Washington, DC
Duff & Phelps Financial Consulting Company, Chicago, IL
U. S. Trust Company of California, N.A., Los Angeles, CA

APPENDIX E: REPORT DISTRIBUTION

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition
Deputy Director (Tactical Warfare Programs)

Department of the Navy

Secretary of the Navy
Assistant Secretary of the Navy (Financial Management)
Assistant Secretary of the Navy (Research, Development and Acquisition)
Auditor General, Naval Audit Service
Commander, Naval Sea Systems Command
Contracts Directorate, Naval Sea Systems Command
Auxiliary and Special Mission Ship Program Office, Naval Sea Systems Command
Supervisor of Shipbuilding, Conversion and Repair, San Diego

Defense Agency

Director, Defense Contract Audit Agency

Congressional Committees:

Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
Ranking Minority Member, Senate Committee on Armed Services
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
Ranking Minority Member, House Committee on Appropriations
House Committee on Armed Services
House Committee on Government Operations
House Subcommittee on Legislation and National Security, Committee on Government Operations

PART IV - MANAGEMENT COMMENTS

Assistant Secretary of the Navy (Research, Development and Acquisition) Comments

Management Comments from the Department of the Navy

THE ASSISTANT SECRETARY OF THE NAVY
(Research, Development and Acquisition)
WASHINGTON, D C 20350-1000

MAR 11 1992

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE INSPECTOR GENERAL

Subj: DRAFT AUDIT REPORT ON RELEASE OF MORRISON KNUDSEN (MK) CORPORATION FROM THE PERFORMANCE GUARANTEE ON THE AOE-6 CONTRACT (PROJECT NO. 9AL-0070.01)

Ref : (a) DODIG Memorandum, dated 30 Dec 91

Encl: (1) Navy detailed comments on subject draft audit report

In response to Reference (a), we are concerned that you found that the Navy did not obtain sufficient financial consideration for the National Steel and Shipbuilding Company (NASSCO) to complete the AOE-6 Class contract when it released MK from a corporate performance guarantee on that contract. You attribute this to our underestimate of NASSCO's projected contract loss, poor Navy contracting practices, and an absence of guidance pertaining to performance guarantees.

The primary basis for your judgement concerning the Navy's underestimation of NASSCO's projected contract loss is that NASSCO experienced serious financial problems after the release of the MK corporate guarantee. Although there is no question that problems occurred, we do not agree that these difficulties resulted from our agreement to waive MK's corporate guarantee. While additional capitalization would have put NASSCO in a better position to weather its financial difficulties, the issue is whether the amount of the capitalization accepted by the Navy was appropriate for the agreement with MK. Based on several independent reviews, we believe that to be the case. In fact, the financial problems NASSCO later encountered resulted from events which gave rise to claims that were eventually settled for $239 million under the contract. Now that these claims have been resolved, NASSCO's financial position appears favorable and the *

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* As a result, we believe that the consideration the Navy obtained from MK for release of its corporate guarantee was adequate to ensure NASSCO's performance.

In view of our experience with the MK guarantee, we are drafting revisions to the Navy Acquisition Procedures Supplement designed to systemically improve the documentation of the oversight process. We will provide a copy of our changes to you.

Our detailed comments on the draft report are at enclosure 1.

Gerald A. Cann

*Company confidential or proprietary information deleted,

Copy to:

NAVCOMPT (NCB-53)
NAVINSGEN

Final Report Reference

February 21, 1992

DODIG DRAFT AUDIT REPORT
PROJECT NUMBER 9AL-0070.01

RELEASE OF MORRISON KNUDSEN (MK) CORPORATION
FROM THE PERFORMANCE GUARANTEE ON THE AOE-6 CONTRACT

DODIG FINDING: The Navy did not obtain sufficient financial consideration for NASSCO to complete the AOE-6 Class contract when it released MK from a corporate guarantee for performance on the contract. The situation existed because Navy underestimated NASSCO's projected loss on the AOE-6 contract. Poor contracting practices on the part of Navy officials, as well as an absence of guidance pertaining to performance guarantees contributed to the situation. As a result of the release from guarantee, the Navy may have to pay as much as * more than it would have had to pay for the same number of ships it could have received under the contract with the performance guarantee.

NAVY RESPONSE TO FINDING: Nonconcur. The finding is incorrect. As noted in the DoDIG draft audit report, Navy extensively analyzed the estimate of NASSCO's capital requirement to complete performance on the AOE-6 Class contract. A cost review team was established and tasked with reviewing NASSCO's cost estimates for the AOE-6 program. Navy also contracted with KPMG Peat Marwick to independently assess whether the MK proposal provided NASSCO with the financial ability to complete the AOE-6 contract and ensure the long-term viability of NASSCO. The * settlement reached with MK was consistent with both financial analyses.

In arriving at its conclusion of inadequate consideration, the DoDIG fails to weigh two significant factors that validate the reasonableness of the NAVSEA settlement with MK. First, the DoDIG attributes NASSCO's financial difficulties solely to inadequate funding flowing from the MK performance release settlement. The DoDIG goes on to note on page 21 of its draft report that the Navy has already been required to make a $25 million payment under Public Law 85-804 to assist NASSCO as a direct consequence of the inadequate settlement. In fact, Navy was worried about NASSCO's financial viability stemming from NASSCO's claims for $460 million as a result of the late receipt of a reduction gear and other impacts. These claims were ultimately resolved for $239 million. NASSCO's financial position now appears favorable * * Furthermore, the $25 million payment, approved as interim relief to resolve NASSCO's pre-settlement cash flow problem, has now been deleted. However, since OSD had earlier transferred funding, effectively preventing the option exercise, an equitable adjustment to the option price for the AOE-9 associated with the claims was never negotiated.

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*Company confidential or proprietary information deleted.

A second matter that bore on the NAVSEA decision to settle the corporate performance guarantee issue at the amount negotiated was the financial limiting factor imposed by potential execution of the AOE-6 contract at Avondale Industries. Based on legal review, NAVSEA concluded that the performance guarantee was enforceable but the guarantee did not necessarily provide for performance at NASSCO. Because of a potentially adverse impact on the shipbuilding industrial base, Navy concluded that it was not in its best interest to allow Avondale to build the AOE Class ships. Additionally, Navy did not believe it could require MK to expend funds in excess of those required to perform at Avondale.

Navy also nonconcurs with the DoDIG statement that it used poor contracting practices. While we concur that a business clearance would have enhanced the existing documentation of the guarantee release decision, we do not agree that the lack of a clearance resulted in poor contracting practices. Significant documentation exists which demonstrates how the Navy conducted its review of the guarantee issue and what information was relied upon in the decision-making process. Those records have been reviewed by the DoDIG. Furthermore, the program manager, legal counsel, and cost estimators, in addition to contracting personnel, were involved in reviewing various aspects of the release issue and participated in the decision-making process. The Assistant Secretary of the Navy (Shipbuilding & Logistics) received multiple briefings on the guarantee release and approved the decision. Consequently, while additional documentation would have added historical value, it would not have resulted in added management oversight and would not have impacted the decision-making process or the actual decisions.

Navy concurs that more specific guidance on the placement, modification, and recision of performance guarantees is appropriate. Detailed actions are addressed later.

Finally, Navy nonconcurs with the conclusion that as a consequence of the release from the performance guarantee, it may have to pay as much * more than it would have had to pay for the same number of ships it could have received under the contract with the performance guarantee. The DoDIG incorrectly reasons that an unsatisfactory guarantee release settlement made NASSCO financially non-responsible for any future option exercises. In fact, Navy was worried about NASSCO's financial viability stemming from NASSCO's claims for $460 million as a result of the late receipt of a reduction gear and other impacts. These claims were ultimately resolved for $239 million. NASSCO's financial position now appears favorable *

* However, since OSD had earlier transferred funding, effectively preventing the option exercise, an equitable adjustment to the option price for the AOE-9 associated with the claims was never negotiated.

*Company confidential or proprietary information deleted

RECOMMENDATIONS FOR CORRECTIVE ACTION:

DODIG RECOMMENDATION 1: We recommend that the Assistant Secretary of the Navy (Research, Development and Acquisition) revise the Navy Acquisition Procedures Supplement (NAPS) to include procedures for establishing, modifying, and rescinding performance guarantees. As a minimum, the procedures should:

a. Require that a performance guarantee be referenced in the contract and addressed in the business clearance memorandum.

b. Specify the level of approval authority for establishing a performance guarantee.

c. Require that Government counsel review the performance guarantee for legal sufficiency before the guarantee is executed.

d. Require a documented justification by the contracting officer, reviewed by legal counsel, and approved by a level above the contracting officer, that the Government's interests are protected before a performance guarantee is rescinded or modified.

NAVY RESPONSE TO RECOMMENDATION 1a: The Navy concurs that more specific guidance in the NAPS will improve establishment and administration of performance guarantees. We are presently researching the matter to determine the best way to integrate the necessary coverage. We plan to modify NAPS subsection 1.690.5, "Types of contract actions requiring business clearance." This would require performance guarantee execution, modification, or recision be reviewed and approved in a similar manner and at the same level as would be required for other business transactions of like magnitudes. A copy of our procedures will be forwarded to your office upon implementation of the necessary changes.

Navy nonconcurs with the recommendation that performance guarantees be referenced in contracts. A performance guarantee, if it is to have value, must be executed by a third party separate from the contracting principals. As such it must be a stand-alone instrument that is enforceable on its own merits--similar to a financial bond. Referencing it in the contract adds no value and may actually cause confusion by introducing ambiguity as to the responsibilities of the respective parties.

NAVY RESPONSE TO RECOMMENDATION 1b: Navy concurs with the need to specify the level of approval authority for establishing a performance guarantee. This issue is directly related to the NAPS coverage that is being researched. However, we intend to require review and approval at that the same level as would be required for a business clearance of similar magnitude.

NAVY RESPONSE TO RECOMMENDATION 1c: Navy concurs with the recommendation that Government counsel review the performance guarantee for legal sufficiency before the guarantee is executed. It will be addressed in the planned NAPS change.

NAVY RESPONSE TO RECOMMENDATION 1d: Navy concurs with the recommendation to document justification by the contracting officer, review by legal counsel, and approved by a level above the contracting officer, that the Government's interests are protected before a performance guarantee is rescinded or modified. These recommendations will be integrated into the planned business clearance procedures.

DODIG RECOMMENDATION 2: We recommend that the Deputy Commander for Contracts, Naval Sea Systems Command, issue a memorandum to contracting officers emphasizing the requirements for timely and properly documented determinations of contractor responsibility and properly documented contract files.

NAVY RESPONSE TO RECOMMENDATION 2: Concur. A memorandum addressing the DoDIG recommendations will be issued by 31 Mar 92.

AUDIT TEAM MEMBERS

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Robert K. West, Project Manager
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