Audit Report

OFFICE OF THE INSPECTOR GENERAL

DOD HOTLINE ALLEGATIONS CONCERNING CONSTRUCTION OF HENRY J. KAISER CLASS (TAO 187) OILERS

Report No. 94-069 March 25, 1994

This special version of the report has been revised to omit contractor sensitive and Privacy Act data.

Department of Defense

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Acronyms

FAR	Federal Acquisition Regulation
NAVSEA	Naval Sea Systems Command

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

March 25, 1994

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)

SUBJECT: Audit Report on DoD Hotline Allegations Concerning Construction of Henry J. Kaiser Class (TAO 187) Oilers (Report No. 94-069)

We are providing this audit report for your information and use. The report discusses DoD Hotline allegations concerning the award, administration, and termination for default of Naval Sea Systems Command contract N00024-85-C-2115 for the construction of Henry J. Kaiser Class (TAO 187) oilers. We considered Navy comments on a draft of this report in preparing the final report.

Comments on the draft of this report conformed to the requirements of DoD Directive 7650.3 and agreed to the audit recommendation. Therefore, no additional comments are required. However, if you wish to comment further, please do so within 30 days.

The courtesies extended to the audit staff are appreciated. If you have any questions on this audit, please contact Mr. Richard B. Jolliffe, Program Director, at (703) 692-2999 (DSN 222-2999), or Mr. Timothy J. Staehling, Project Manager, at (703) 692-3012 (DSN 222-3012). Appendix G lists the distribution of this report. The audit team members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
for Auditing

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Office of the Inspector General, DoD

Report No. 94-069 **March 25, 1994**
(Project No. 3CA-8017)

DOD HOTLINE ALLEGATIONS CONCERNING CONSTRUCTION OF HENRY J. KAISER CLASS (TAO 187) OILERS

EXECUTIVE SUMMARY

Introduction. This audit was performed as a result of DoD Hotline allegations. The allegations relate to improprieties concerning the award, administration, and default of Naval Sea Systems Command contract N00024-85-C-2115 for the construction of Henry J. Kaiser Class (TAO 187) oilers. The May 1985 contract was for the construction of four Henry J. Kaiser Class (TAO 187) oilers and was valued at $414.5 million. The contract was terminated for default in August 1989 after $349 million was spent and no ships were delivered.

Objectives. The primary audit objective was to determine whether improprieties existed concerning the Navy contract for construction of Henry J. Kaiser Class (TAO 187) oilers. We also assessed applicable internal controls established at Naval Sea Systems Command for awarding ship construction contracts.

Audit Results. We were unable to determine whether improprieties existed concerning the contract award to a financially and technically marginal contractor because important Government contractual documents were missing. We found sufficient evidence, however, to call into question the Navy's judgment in awarding the contract. The contractor significantly underbid its competitors and was unable to perform at the awarded contract price. As a result, the contractor defaulted after overrunning the contract by an estimated $75 million (refer to Appendix C for associated procurement costs and Appendix D for a chronology of significant events). The Navy also incurred an additional $102.5 million of reprocurement costs.

Internal Controls. The audit did not identify any material internal control weaknesses. See Part I for the internal controls assessed.

Potential Benefits of Audit. The report recommendation should produce future monetary benefits by preventing the award of ship construction contracts to contractors who do not possess the financial and technical capabilities to perform the contract. However, we could not quantify the potential monetary benefits.

Summary of Recommendations. We recommended that the Assistant Secretary of the Navy (Research, Development, and Acquisition) perform a procurement management review of Naval Sea Systems Command ship construction contracts to determine that the contract awards are properly supported and documented.

Management Comments. The Navy disagreed with the finding that an erroneous business judgment was made in awarding the contract to a financially and technically marginal contractor. However, the Navy concurred with the recommendation and stated that a special procurement management review of Naval Sea Systems Command support and documentation for awarding ship construction contracts will be scheduled. See Part II for full discussion of management's responsiveness and Part IV for the complete text of the Department of the Navy comments.

Table of Contents

Executive Summary i

Part I - Introduction

Background 2
Objectives 3
Scope and Methodology 4
Internal Controls 4
Prior Audits and Other Reviews 4
Other Matters of Interest 5

Part II - Finding and Recommendation

Kaiser Class Oilers Procurement 8

Part III - Additional Information

Appendix A. Preaward Survey Announcement 28
Appendix B. Freedom of Information Act Response For Preaward Survey 34
Appendix C. Kaiser Class Oilers Procurement Costs 36
Appendix D. Chronology of Significant Events 37
Appendix E. Summary of Potential Benefits Resulting From Audit 39
Appendix F. Organizations Visited or Contacted 40
Appendix G. Report Distribution 41

Part IV - Management Comments

Department of the Navy Comments 44

This report was prepared by the Contract Management Directorate, Office of the Assistant Inspector General for Auditing, Department of Defense.

Part I - Introduction

Background

Allegations. This audit resulted from a DoD Hotline complaint alleging improprieties in the award, administration, and termination for default of Navy contract N00024-85-C-2115. The complaint generally alleged improprieties concerning the financial and technical capability of Pennsylvania Shipbuilding Company (Penn Ship) to perform the Navy contract, the nonfiling of a trust indenture, and the inadequate Navy management of the shipbuilding contract. The improprieties also involved the sale of Sun Ship, Incorporated, to a group of real estate investors who renamed the shipyard Pennsylvania Shipbuilding Company. The alleged improprieties that involve actions by Sun Ship, Incorporated, before and after the 1985 Navy award are also included in a False Claims Act suit filed with the Department of Justice. This audit addresses only the alleged improprieties related to Naval Sea Systems Command (NAVSEA) contract N00024-85-C-2115 awarded to Penn Ship.

Henry J. Kaiser Class (TAO 187) Oilers. Henry J. Kaiser Class (TAO 187) oilers (Kaiser Class oilers) (Figure 1) furnish petroleum products to operating forces at sea. The Kaiser Class oilers are constructed using noncomplex commercial specifications. The Kaiser Class oilers are manned by civilian officers and crew. As of November 1982, the Navy had four oilers under contract, and through contract N00024-85-C-2115, awarded in April 1985, the Navy increased the number of oilers under contract by four oilers.

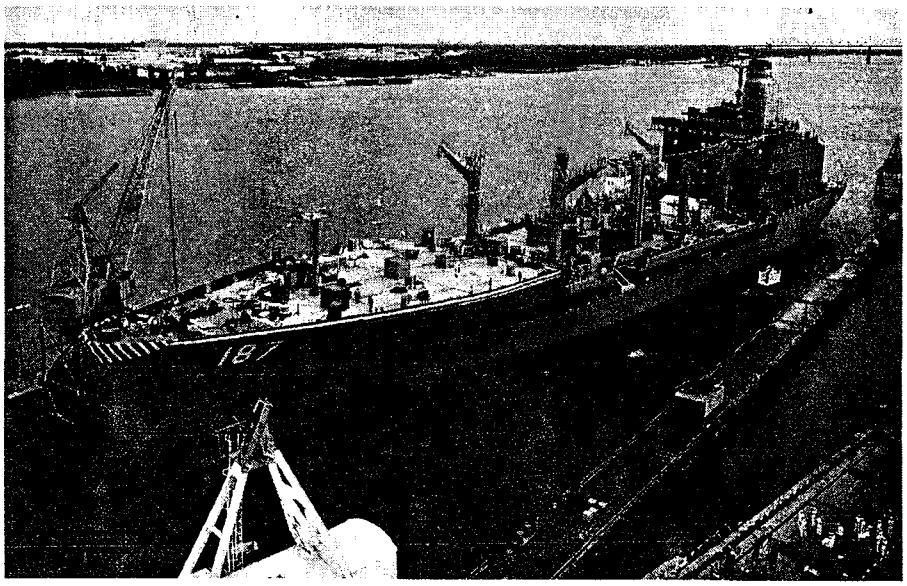

Figure 1. Completed Kaiser Class Oiler

Contract Award Criteria. Federal Acquisition Regulation (FAR) subpart 9.1, "Responsible Prospective Contractors," specifically prescribes the policies, standards, and procedures for determining whether prospective contractors and subcontractors are responsible to receive a contract award. To be considered responsible, a prospective contractor must meet the following criteria:

o The prospective contractor should have adequate financial resources, be qualified and eligible to receive a Government contract, and be able to meet the proposed delivery or performance schedule.

o The prospective contractor must have the necessary production, equipment, and facilities including the necessary organization, experience, and technical skills to perform the contract.

Contracting Officer Responsibilities. FAR 9.103, "Policy," requires the following:

o A contract shall only be awarded to a responsible prospective contractor.

o A contract award should not be made unless the contracting officer makes an affirmative determination of responsibility.

FAR 9.103 also states that the award of a contract to a contractor based on lowest evaluated price alone can result in a false economy if subsequent default, unsatisfactory performance, and late deliveries resulting in additional contractual or administrative costs occur. A contractor must affirmatively demonstrate its responsibility to perform a contract.

Buying-in. FAR 3.501, "Buying-in," defines buying-in as an improper business practice wherein a proposal is submitted below anticipated costs, with the expectation to increase the contract price after award. Also, buying-in may decrease competition or result in poor contract performance. The Government should minimize the opportunity for buying-in by seeking a price commitment covering as much of the entire program as practical and by using multiyear contracting or other safeguards available to preclude a contractor from buying-in. In addition, price or cost analysis is another form of analysis that can determine that a contractor-proposed price is fair and reasonable.

Objectives

The primary audit objective was to determine whether improprieties existed concerning the Navy contract for construction of Kaiser Class oilers. The audit evaluated Navy policies, procedures, and practices for the award and administration of the April 1985 Kaiser Class oilers construction contract in accordance with applicable criteria. We also assessed applicable internal controls established at Naval Sea Systems Command for awarding ship construction contracts.

Scope and Methodology

Audit Methodology. We reviewed NAVSEA official contract files for contract N00024-85-C-2115, awarded at $222.5 million, to Penn Ship. We examined FYs 1984 through 1993 documents relating to the Kaiser Class oilers contract award, administration, and default. We also discussed the alleged improprieties with the contracting officer, the administrative contracting officer, the Naval Investigative Service, the Defense Contract Audit Agency, and the Fraud Section, Commercial Litigation, Department of Justice.

Audit Period, Standards, and Locations. We performed this economy and efficiency audit from May through November 1993 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included such tests of internal controls as considered necessary. We did not rely on any computer-processed data or statistical sampling procedures to perform the audit. Appendix F lists the organizations visited or contacted during the audit.

Internal Controls

We reviewed the events surrounding the award, the nonfiling of the trust indenture, and the administration of NAVSEA contract N00024-85-C-2115. In addition, we evaluated internal controls by reviewing contract N00024-85-C-2115 files to determine whether the official files contained proper documentation and support for contractor determination of responsibility, preaward surveys, negotiation memorandums, financial assessments, and technical capability reviews, as prescribed by the FAR. The audit disclosed no material internal control deficiencies related to the award and administration of the NAVSEA April 1985 Kaiser Class oilers contract.

Prior Audits and Other Reviews

Inspector General, DoD, Report No. 92-073, "The Release of Morrison Knudsen Corporation from the Performance Guarantee on the AOE-6 Contract," April 10, 1992. The report stated that the Navy relied upon a performance guarantee from Morrison Knudsen and subsequently released Morrison Knudsen from the performance guarantee. Further, the Navy did not obtain sufficient financial consideration when it released Morrison Knudsen from the performance guarantee. The Navy, by releasing Morrison Knudsen, may have to pay an additional $142 million for the same number of ships.

The Navy recognized the need for changes to the business clearance requirements within the Navy Acquisition Procedure Supplement. The changes provided further guidance to contracting officers to appropriately include performance guarantees in insured contracts. In making this determination,

individual contracts will be analyzed on a case by case basis. Contracting officers will consider the dollar value of the contract, the risk of contractor nonperformance, and the anticipated complexity of the contract administration.

Other Matters of Interest

The Defense Contract Audit Agency issued several audit reports concerning Penn Ship. As early as 1987, one Defense Contract Audit Agency audit report predicted the possible business failure of Penn Ship. Other Defense Contract Audit Agency audit reports stated that Penn Ship indirect costs were overstated by $3 million and that general and administrative costs were also overstated by $1 million. In addition, the Defense Contract Audit Agency questioned $100,000 to $500,000 of nonallowable costs included in Penn Ship progress payment submissions to the Navy. The Defense Contract Audit Agency also questioned incurred costs of $2 million to $4 million in manufacturing overhead. Further, the Defense Contract Audit Agency identified duplicate billings totaling $50,000, based on a review of 25 sampled purchase orders.

The Naval Investigative Service conducted an investigation from April 1989 through July 1991 concerning allegations involving Penn Ship. The investigation addressed allegations that Penn Ship progress payment submissions included incurred costs for employee payroll deductions, which Penn Ship did not remit to the appropriate organizations in a timely manner. Penn Ship withheld the deductions beyond the normal 45-day billing cycle before making payment. Penn Ship also withheld payments to vendors while the Navy continued to make progress payments based on incurred costs. In addition, Penn Ship claimed financial and cash flow problems, and allegedly, funds were used to establish a sister company with monies received from the oilers contract.

Based upon the Defense Contract Audit Agency reviews of Penn Ship, the Naval Investigative Service provided the Assistant U.S. Attorney, Philadelphia, a brief of the investigation. The Assistant U.S. Attorney, Philadelphia, declined prosecution subject to Penn Ship making the payments that were past due and the Navy promising to resolve the questioned costs.

Part II - Finding and Recommendation

Kaiser Class Oilers Procurement

NAVSEA awarded a Kaiser Class oilers contract to a financially and technically marginal contractor. The contract award occurred because NAVSEA did not adequately act on negative preaward evaluations of the contractor and did not take adequate or appropriate measures to protect the Government's interest. As a result of the award to a marginal contractor, NAVSEA subsequently terminated the Kaiser Class oilers contract for default and incurred an additional $102.5 million of reprocurement costs.

Background

Contracting officers shall obtain sufficient information needed to make a positive determination of responsibility before making award. This determination is provided through a preaward survey. FAR 9.106, "Preaward Surveys," states that the preaward survey evaluates the prospective contractor capability to perform the proposed contract. Preaward surveys should determine whether any unfavorable information concerning the prospective contractor exists. Also, preaward surveys evaluate and document the contractor's technical, production, quality assurance, financial, and accounting system capabilities to support whether the contractor should receive a proposed contract award.

In addition to preaward surveys, contracting officers should use records and experience data, including discussions within the contracting offices, audit offices, and contract administration offices. Information from bids and proposals, questionnaire replies, financial data, and other sources, such as suppliers, publications, financial institutions, and business and trade associations, should be used to support the determination of responsibility. Supporting documents and any applicable certificates of competency must be included in the contract files to support the determination of responsibility.

Preaward surveys are generally performed on the lowest bidders and on those bids that fall within the range of award. A determination that the prospective contractor is responsible is established when the contracting officer signs the contract.

Contract Preaward Evaluation

The Penn Ship target costs and price proposals were unreasonably low compared with the other proposals. The contracting officer should have analyzed the price difference between the Penn Ship proposal and the next lowest competitor to verify that Penn Ship costs were compatible with the solicitation requirements.

Target Costs Proposed. In October 1984, NAVSEA received target cost proposals on the Navy solicitation for the construction of Kaiser Class oilers (a proposed nine-ship acquisition) from five shipbuilders: Avondale Shipyards, Incorporated (Avondale); Bethlehem Steel Corporation (Beth Steel); General Dynamics Corporation, Quincy Shipbuilding Division (GD Quincy); National Steel and Shipbuilding Company (National Steel); and Penn Ship. Penn Ship submitted the lowest proposed target costs ($771 million) compared with the four other shipbuilder proposed target costs that ranged from $979.1 million to $920.6 million. The Penn Ship proposed target costs were $242.8 million (23.9 percent) lower than the NAVSEA independent cost estimate and $208 million below the proposal of the incumbent shipbuilder, Avondale. The other four shipbuilder proposed target costs ranged from 3.4 to 9.2 percent below the independent cost estimate (Figure 2).

Dollars (hundred of thousands)

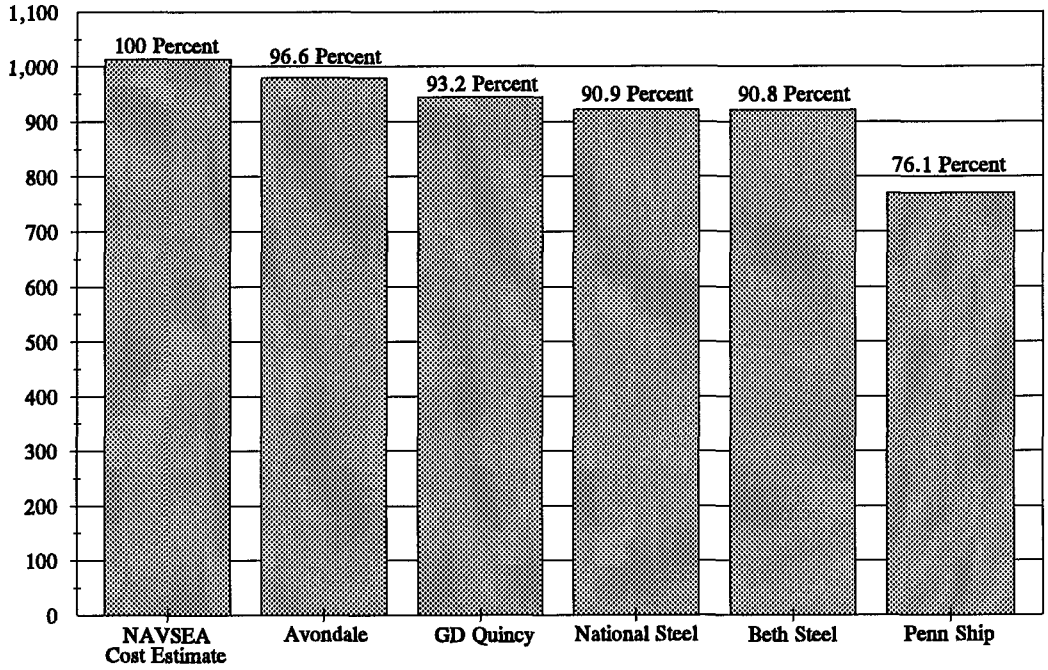

Figure 2. Target Costs Proposed by Shipbuilder

Proposed Target Price. The contracting officer compared the target prices of the five proposals and determined that none of the proposals submitted were outside of the competitive range; however, each proposal required clarification in certain areas. Each offerer was given the opportunity to participate in discussions held during December 1984. Target prices proposed ranged from $848.1 million to $1.04 billion for the nine-ship construction (Figure 3).

Dollars (hundred of thousands)

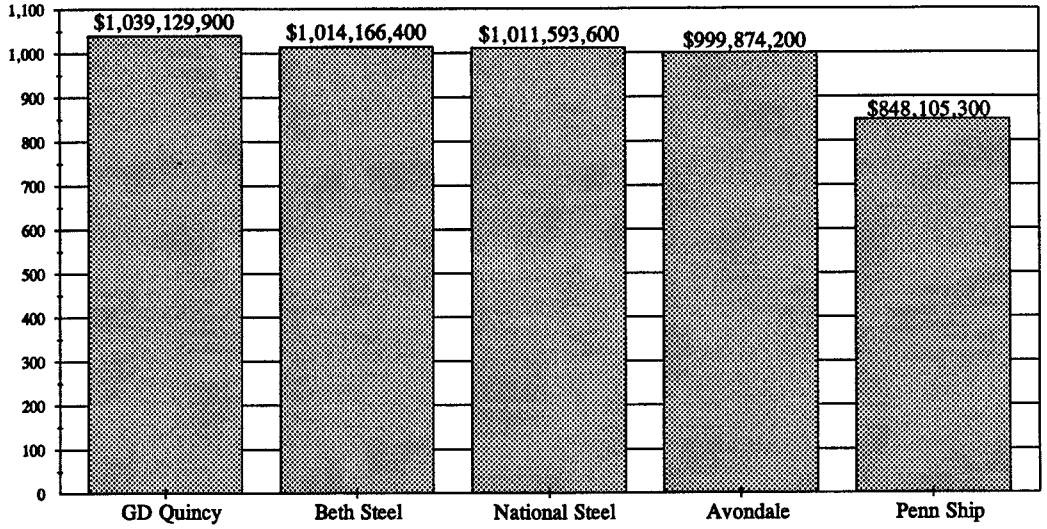

Figure 3. Target Prices Proposed by Shipbuilder

Best and Final Price Proposals. All five offerers submitted best and final price proposals ranging from $819.9 million to $1.01 billion (Figure 4). The Penn Ship best and final price proposal was $147 million (15 percent) below the best and final price proposal of Avondale, which designed the Kaiser Class oilers and built the first four oilers.

Dollars (hundred of thousands)

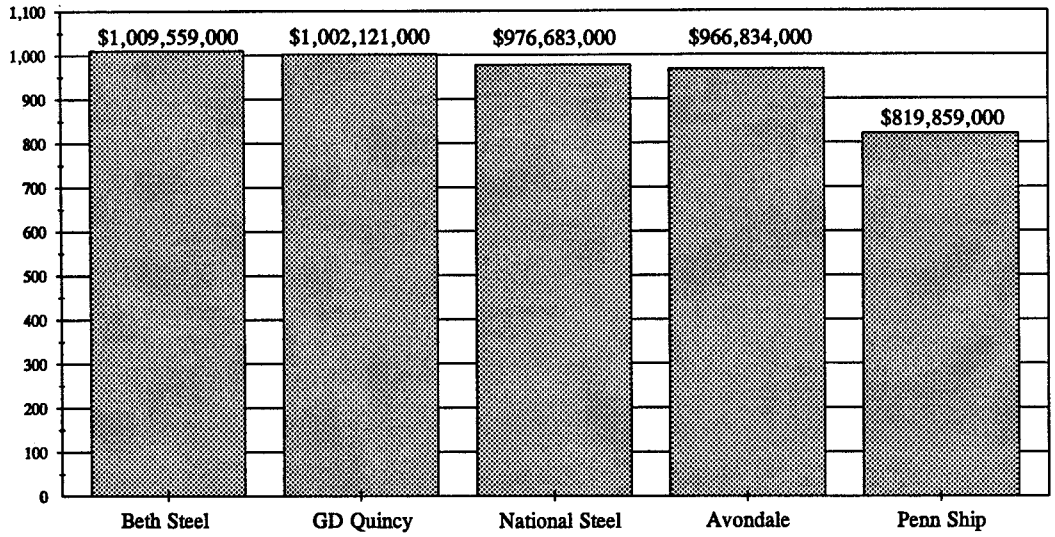

Figure 4. Best and Final Prices Proposed by Shipbuilder

NAVSEA Analysis of Best and Final Price Proposals. NAVSEA Cost Estimating and Analysis Division performed an analysis of the best and final price proposals and concluded that the Penn Ship proposal was understated by $57.7 million. The analysis indicated that the Penn Ship proposal was deficient in production and design labor hours and optimistic in the projected 88-percent production learning curve. The production learning curve is directly related to the difference in construction costs between the first ship and the follow-on ships. A smaller production learning curve would have resulted in greater cost reductions in the construction of follow-on ships than a larger learning curve. The analysis indicated that "Penn Ship has not built a series of new ships to this complexity recently and demonstrated this rate of learning. A rate of 92 percent would be more attainable and is still liberal." Penn Ship had not performed a major shipbuilding contract since the facility was owned by Sun Ship, Incorporated, in 1982, and only performed conversion and repair work for the Navy under Penn Ship management. The analysis also concluded that Penn Ship estimates for labor hours and materials were overly optimistic and unrealistic. The design and overhead amounts were also too low and overly optimistic. In our opinion, based on review of the Navy analysis of the Penn Ship best and final price proposal, the Navy had significant concerns with the ability of Penn Ship to perform the Kaiser Class oilers contract within its low bid.

Source Selection Authority Determination. On February 8, 1985, the NAVSEA Kaiser Class oilers Source Selection Authority determined that the Penn Ship proposal conformed to the solicitation requirements and that Penn Ship had proposed the overall lowest total target price. The Kaiser Class oilers Source Selection Authority determination was based on the following:

> The RFP [request for proposal] provides that "...award will be made to that responsible offerer whose proposal, conforming to the solicitation requirements, will be most advantageous to the Government, price and other factors considered. Proposals that meet the minimum requirements of the solicitation will be evaluated for award on the basis of the overall lowest total Target Price proposed for the maximum possible quantity of basic and option ships. My determination of ranking is on that basis."

The NAVSEA contracting officer documented in the business clearance memorandum, dated April 12, 1985, that none of the best and final price proposals submitted were determined to be outside of the competitive range. The contracting officer also documented that, based on price analysis, the price proposed by Penn Ship was fair and reasonable. Neither the NAVSEA Cost Estimating and Analysis Division analysis of the Penn Ship proposed best and final price proposal nor the NAVSEA independent cost estimate were considered in the April 12, 1985, business clearance memorandum.

Policy on Contract Awards. FAR 9.103(c), provides that contract awards do not need to be made based solely upon lowest price. A contractor must affirmatively demonstrate its responsibility to perform a contract. An award based on lowest evaluated price alone can be false economy. The results may be subsequent default, unsatisfactory performance, and late deliveries resulting in additional contractual or administrative costs.

Cost Realism. In our opinion, the Penn Ship proposed target costs and price were unreasonably low and were not in a competitive range when compared with the other shipbuilders' best and final price proposals. The contracting officer should have analyzed the $147 million price difference between the Penn Ship proposal and the next lowest competitor to verify that Penn Ship costs were compatible with the solicitation technical requirements and that the proposal was not submitted below anticipated costs, possibly to achieve a buying-in. NAVSEA Cost Estimating and Analysis Division analysis of the Penn Ship best and final price proposal indicated that the proposal technical requirements were deficient and that the Penn Ship projected production learning curve was optimistic.

To evaluate the extent of NAVSEA analyses of the technical and financial assessments of Penn Ship, we requested the Kaiser Class oilers Program Office, Combat Support, Ocean, Research, and Surveillance Programs, NAVSEA, to provide the contractor technical and financial risk assessments, the program cost estimates, and the independent cost estimates. The NAVSEA Program Office was unable to provide any of these documents.

Navy Preaward Survey. During January 22 and 23, 1985, NAVSEA conducted a preaward survey of Penn Ship. The preaward survey contained an indepth analysis of the technical qualifications, as well as the financial capabilities, of the contractor to perform the Kaiser Class oilers contract. The preaward survey was an integral part of justifying the Navy Kaiser Class oilers award to Penn Ship. Appendix A presents the NAVSEA announcement and the scope of the preaward survey to be performed at Penn Ship.

We reviewed the Penn Ship Kaiser Class oilers contract files and conducted interviews with NAVSEA contracting officers. Based upon our review and discussions with NAVSEA contracting personnel, we identified Navy concerns regarding the financial ability of Penn Ship to perform the Kaiser Class oilers contract.

On June 9, 1993, we requested NAVSEA to provide documentation of the results of the preaward survey conducted at Penn Ship, as referred to in the April 12, 1985, NAVSEA business clearance memorandum, related to contract N00024-85-C-2115. NAVSEA was unable to provide documentation of the preaward survey results.

Preaward Announcement. A NAVSEA January 17, 1985, preaward announcement memorandum specifically states that a preaward survey would be conducted at Penn Ship during January 22 and 23, 1985. The preaward announcement memorandum also states that Penn Ship should be prepared to discuss information concerning management, technical, production, material, facilities, services, financial, and other capabilities during the survey (Appendix A).

Freedom of Information Act Request. On December 4, 1991, NAVSEA responded to a Freedom of Information Act request for a copy of the preaward survey conducted at Penn Ship. NAVSEA responded that a preaward survey was never documented and filed. The NAVSEA response further indicated that

a complete preaward survey was not considered necessary, and only the financial analysis portion of the preaward survey was conducted (Appendix B). The NAVSEA response to the Freedom of Information Act request is contrary to the NAVSEA January 17, 1985, preaward announcement memorandum and the NAVSEA April 12, 1985, business clearance memorandum.

NAVSEA Business Clearance Memorandum. The NAVSEA April 12, 1985, business clearance memorandum states that a preaward survey was conducted at the Penn Ship facility to assess Penn Ship management, facilities, and financial capabilities. The business clearance memorandum further states that the preaward survey concluded that Penn Ship management clearly supported a positive responsibility determination.

Inspector General, DoD, Opinion. The NAVSEA April 12, 1985, business clearance memorandum and the January 17, 1985, preaward announcement memorandum to Penn Ship both describe a more indepth analysis than just a financial analysis. Discussions with NAVSEA contracts personnel confirmed that a NAVSEA preaward survey team conducted an indepth technical and financial analysis at Penn Ship during January 22 and 23, 1985, that was not documented in the contract files.

Navy Financial Responsibility Review. NAVSEA contracting office personnel prepared a financial responsibility review dated February 11, 1985. The review concluded that Penn Ship was in a positive financial condition. However, the review stated the Penn Ship debt ratio was highly leveraged. A highly leveraged company is limited in its ability to acquire additional financing. The review also disclosed that the parent of Penn Ship, Capital Marine Company, and a Capital Marine Company subsidiary, Levingston Industries, were near bankruptcy.

Independent Public Accounting Review and Analysis

Independent Review and Analysis. The Navy had additional concerns about what problems Penn Ship would encounter if Capital Marine or Levingston ultimately declared bankruptcy. The Navy acted on these concerns by contracting with a major public accounting firm to perform an independent review and analysis of the Navy preaward evaluation of Penn Ship. The independent public accounting firm did not perform an indepth financial examination of Penn Ship. The independent review and analysis, dated April 19, 1985, did not reveal any evidence that disagreed with the Navy financial review. The independent review and analysis did identify issues requiring ongoing attention and constant monitoring if a contract was awarded to Penn Ship. These concerns were related to intercompany transfers, the Penn Ship production learning curve rate, skill mix and labor build up, cost and schedule performance, and most importantly, the Penn Ship projected cash flow for 1986 and subsequent years. Eventually, all of the concerns identified in the independent review and analysis became factors in Penn Ship's inadequate performance, resulting in contract default.

Review Recommendations. Although the independent review and analysis disclosed nothing to disagree with the Navy findings and conclusions or to recommend against award to Penn Ship, the independent review and analysis did provide recommendations in the event of award. The independent review and analysis concluded that the Navy should pay close attention to, and monitor, all intercompany transfers; be provided with interim financial reviews of Penn Ship; monitor cost and performance reports; obtain outyear cash flow projections for analyses during the contract period; review overhead; and monitor labor buildup, skill mix, and the Penn Ship production learning curve.

Navy Actions on the Independent Review and Analysis. Based on the Navy and the independent public accounting firm review, the Navy requested the president of Capital Marine (parent of Penn Ship) to discuss what possible choices Penn Ship would have if financial problems of between $15 million to $20 million occurred after award of a Kaiser Class oilers contract. The president responded in a memorandum to the Navy that, if outside financing was not available, Penn Ship could seek an equity investor secured by Levingston and Penn Ship assets. The president further stated that Capital Marine assets and he could not personally support losses of between $15 million to $20 million.

In a March 1985 Penn Ship memorandum to the Navy, the president of Penn Ship stated that extraordinary events would have to take place for Penn Ship to encounter substantial out-of-pocket expenses on the Kaiser Class oilers contract. The president further stated that any losses encountered could be covered from the sale of shipyard assets. Penn Ship offered to place its assets in an irrevocable trust indenture with Fidelity Bank of Philadelphia for the benefit of the Navy, if awarded the Kaiser Class oilers contract. The trust indenture would provide a security interest in the entire Penn Ship facility and would limit Penn Ship total liability to $20 million.

Performance Bond FAR Requirements

The FAR requirements for a performance bond state that a performance bond is normally required to secure performance and fulfillment of contractor obligations under a contract. FAR 28.103-2, "Performance Bonds," prescribes that a performance bond may be required when necessary to protect the interest of the Government. In addition, the FAR requires that the solicitation shall contain the appropriate performance bond FAR clause when a performance bond is necessary. The Kaiser Class oilers solicitation did not contain the FAR clause requiring a performance bond. Therefore, the FAR clause was not included in the proposals received from the five shipbuilders. We reviewed the Navy supplement to the FAR and were unable to identify any Navy criteria requiring the use of a performance bond. In addition to not locating any references to the use of performance bonds, we were unable to locate

the reference and prescribed policy for the use of trust indentures as substitutes for performance bonds in the FAR, the Defense Federal Acquisition Regulation Supplement, or the Navy FAR supplement.

Secretary of the Navy Concerns

Performance Bond. The Secretary of the Navy had concerns regarding the Penn Ship ability to sustain a large incurred loss based on Penn Ship's working capital and asset structure. The Secretary desired a performance bond to cover the possibility of Penn Ship sustaining a large financial loss. NAVSEA Contracts Directorate reviewed different alternatives to obtain a performance bond and found the alternatives to contain high litigative risks. One alternative involved modifying the request for proposal to include a performance bond. This would have required amending the solicitation and possibly lengthening the award. A second alternative would have required Penn Ship to provide a performance bond directly, which would have required a one-time deviation from the FAR requirement. The second alternative would not have been deemed prejudicial to the other offerers. However, if Penn Ship was unable to obtain an acceptable bond, and as a consequence, NAVSEA refused to award the contract to Penn Ship, a high probability existed that Penn Ship would have protested any alternative award.

Trust Indenture. The trust indenture, dated March 26, 1985, was prepared by Penn Ship attorneys and was used by NAVSEA to satisfy the concerns regarding Penn Ship's financial responsibility. The contracting officer documented in the April 12, 1985, business clearance memorandum that the "NAVSEA counsel reviewed the proposed indenture and concluded that, while the indenture is not equivalent to a bond, it does afford some of the same kinds of protection." Also, the independent review and analysis stated that, "The trust indenture is a creative means of ensuring Penn Ship's intent, which management correlates with performance capability, but it is not a performance guarantee, like a bond."

Trust Indenture

We attempted to ascertain the sequence of events regarding the trust indenture and whether the Navy's security interests were ever perfected through the legal filing of the trust indenture. We interviewed the NAVSEA contracting officer and the NAVSEA legal counsel, who stated they were not sure who would be responsible for determining whether the trust indenture was filed. We also requested the trustee, Fidelity Bank, to provide a copy of the trust indenture and to identify who would be responsible for filing the trust indenture. The trustee, Fidelity Bank, would not discuss the trust indenture. Based on our review, it appears that the trust indenture security instruments were, for some unknown reason, never legally filed and perfected.

We attempted to ascertain from NAVSEA whether the Navy's normal practice was to require a trust indenture and whether or not obtaining a trust indenture was a condition for contract award. We also sought an explanation of how the Government's interest was protected and why the Navy settled for a Penn Ship drydock over other assets, such as real estate, described in the trust indenture.

On October 12, 1993, NAVSEA responded to the inquiries. NAVSEA stated that it was not normal Navy practice to require a trust indenture and that the solicitation did not require a performance bond or other performance guarantee as a condition of award. NAVSEA further stated that the Navy was a second-position lien holder on the assets listed in the trust indenture and first-position lien holder on the drydock. NAVSEA also stated ". . . had the Navy attempted to collect on the trust indenture, it would have received little or nothing because of the Navy's second position and Penn Ship's financial status at that time."

Contract Award

Kaiser Class Oilers Contract Award. On May 6, 1985, NAVSEA awarded contract N00024-85-C-2115 for the Kaiser Class oilers to Penn Ship for $222,476,849. The contract called for the construction of two oilers, Kaiser Class oilers 191 and 192, and two options for one oiler each. The contract did not contain (or consider) a trust indenture or require Penn Ship to obtain a performance bond. NAVSEA exercised the options in February 1986 for oiler 194 and in February 1987 for oiler 196. The options increased the Kaiser Class oilers contract by $96,984,329 in 1986 and $95,025,450 in 1987. See Appendix C for details on procurement costs and delivery dates.

Upon the award of the Kaiser Class oilers contract, Penn Ship was to notify the trustee, Fidelity Bank, to execute and file the instruments and documents contained in the trust indenture. At that time, the trust indenture should have been recorded, thus protecting the Navy interest.

Audit Reports On Financial Conditions. In November 1986, the Defense Contract Audit Agency conducted a risk vulnerability analysis of several contracts under its purview, including the Kaiser Class oiler contract awarded to Penn Ship. The risk vulnerability analysis was performed on the Kaiser Class oilers contract to determine the extent to which the Government was susceptible to inappropriate material costs and to identify improprieties that would result in significant adverse impact to the Government. The analysis predicted an anticipated overrun of $37 million for oilers 191, 192, and 194. This analysis was made before the award of the second option for oiler 196.

The second option, for oiler 196, was awarded during February 1987. In November 1987, the Defense Contract Audit Agency reported that Penn Ship's financial condition had seriously deteriorated within the last 9 months (since February 1987).

Exercise of Options

We believe NAVSEA attempted to alleviate the Penn Ship deteriorating financial deficiencies by awarding the second option for oiler 196. The oiler 196 award permitted Penn Ship to partially recover its increased overhead and general and administration costs over four ships through the submission of progress payments.

After the award of the second option, for oiler 196, Penn Ship informed the Navy in September 1987 that it was experiencing severe financial problems and was accumulating subcontractor payments in an overdue status. In July 1987, the Supervisor of Ship Construction, Conversion, and Repair briefed NAVSEA that the cash flow provided by the contract would not be sufficient to meet the operating expenses of Penn Ship. In mid-1987, Penn Ship costs, as compared to its performance trends, showed that the company would lose a significant amount on the Kaiser Class oilers contract. In addition, Penn Ship did not have any other available work to offset the projected losses. In late 1987, Penn Ship notified NAVSEA that projected cost overruns on the Kaiser Class oilers contract would put the company out of business by December 10, 1987.

In our opinion, exercising the second option for oiler 196 in February 1987 was not in the best interest of the Government. NAVSEA should have evaluated the Penn Ship ability to complete the first three Kaiser Class oilers before awarding the second option for a fourth oiler. Penn Ship was not financially responsible based on the Defense Contract Audit Agency 1986 projected $37-million overrun for the first three Kaiser Class oilers.

Penn Ship Technical Performance

During performance of the Kaiser Class oilers contract, Penn Ship had numerous technical difficulties. In several project overviews performed during 1987, the Supervisor of Shipbuilding, Conversion, and Repair stated that Penn Ship middle and upper management had minimal experience in building ships. Also, Penn Ship attempted to integrate purchased engineering drawings from Avondale (the incumbent shipbuilder) and apply a method of Japanese unit construction techniques. Penn Ship unfamiliarity in implementing the unit construction techniques resulted in substantial rework and rewelding.

NAVSEA questioned the numerous ship assembly misalignments and the structural integrity of rewelds performed on the units. A large number of the ship assembly disconnects and late arrivals of assemblies required Penn Ship to perform numerous engineering corrections to assemble the units.

Penn Ship Production Management

Penn Ship had difficulties in efficiently managing production and was unable to pinpoint production process choke points or develop adequate solutions. Penn Ship was unable to control its labor and overhead rates under the Kaiser Class oilers contract. The labor and overhead rates had increased from the original bid amounts of $ * per hour and * percent to $ * per hour and * percent, respectively. As of September 1987, 6 months after award of the second option for $95 million, the Navy estimated the cost overrun for the four Kaiser Class oilers (191, 192, 194, and 196) to be approximately $97.6 million.

Contract Modifications

On June 16, 1988, the Navy modified the Kaiser Class oilers contract with Penn Ship through modification P00005. The contract was modified to a firm-fixed price of $331.4 million without escalation provisions for the construction of the first two Kaiser Class oilers, 191 and 192. The modification represented an increase in contract costs of $108.9 million from $222.5 million. The Navy then transferred the two Kaiser Class option oilers, 194 and 196, to Avondale for completion. At the time of the transfer, Penn Ship had only purchased materials for the two option oilers 194 and 196.

During January 1989, the Navy modified the Kaiser Class oilers contract with Penn Ship through modification P00011. The modification provided an advance payment of $17 million to Penn Ship to satisfy subcontractor payments that had accumulated in an overdue status. The advance payment was established in a special bank account and $10 million of the $17 million was made available for immediate release.

Contract Administration

In addition to reviewing the official NAVSEA contract files, we attempted to review the administrative contracting files for contract N00024-85-C-2115, awarded to Penn Ship. The administrative contract files contain the day to day Supervisor of Shipbuilding, Conversion, and Repair administration of contract N00024-85-C-2115. On June 9, 1993, we requested the NAVSEA Supervisor of Shipbuilding, Conversion, and Repair Management Group, who is

*Contractor confidential or proprietary data has been deleted.

responsible for the Supervisor of Shipbuilding, Conversion, and Repair offices and detachments, to assist in locating the official administrative files. The Supervisor of Shipbuilding, Conversion, and Repair Management Group stated he did not know where the administrative files were located and that the NAVSEA contracting officer is responsible for the administrative files. The contracting officer and the Supervisor of Shipbuilding, Conversion, and Repair Management Group were unable to locate the administrative contracting files.

Contractor Default

Contract modification P00017, dated August 28, 1989, terminated the Kaiser Class oiler contract with Penn Ship for default and canceled the trust indenture dated March 26, 1985. The contract was terminated because Penn Ship was unable to complete performance under the terms and conditions of the contract primarily due to the lack of financial resources. Modification P00017 established the drydock as sole security for all reprocurement costs including advance payments, overpayments, and interest expense not to exceed $19 million. The modification also provided that Penn Ship was liable for additional reprocurement costs to the extent of 50 percent of any excess cash flow (limited to $5.09 million) generated by Penn Ship during a 13-month period from August 1989 through September 1990. The Navy has paid more than $400 million for the two Kaiser Class oilers, 191 and 192, that were never completed. See Appendix C for details. The Navy received in full satisfaction of all liabilities from Penn Ship a 700-foot floating drydock with an estimated resale value of $20 million.

Current Status of Kaiser Class Oilers

The Navy has expended $641 million in payments to Penn Ship and two subsequent contractors for the four Kaiser Class oilers. The Navy received the two option oilers, 194 and 196, from Avondale. The subsequent contract for completion of the two original Kaiser Class oilers, 191 and 192, was terminated. See Appendix C on the cost and Appendix D for a chronology of significant events associated with the procurement of the four Kaiser Class oilers.

Proposals for Kaiser Class Oilers Completion. NAVSEA solicited proposals for the completion of the Kaiser Class oilers, 191 and 192. Tampa Shipbuilding Company (Tampa) and Avondale submitted proposals for the completion of the oilers. An industrial mobilization base decision was made to award the contract to Tampa. The Tampa proposal was $6 million higher than that of Avondale. NAVSEA increased the fixed-price portion of the oilers contract to Tampa by $3 million for Tampa to establish a $3 million irrevocable letter of credit under the oilers contract. The award was made to Tampa for $49 million, knowing that Tampa was a financially unstable company, as stated in the NAVSEA award justification. In addition, Tampa had experienced severe financial difficulties and had not shown a profit for several years before the award of the oilers completion contract.

Kaiser Class Oilers Transferred to Tampa Shipbuilding Company. Upon transfer from Penn Ship to Tampa in 1990, the two original Kaiser Class oilers, 191 and 192 (Figure 5), were estimated by the Navy to be 85 percent and 65 percent complete, respectively. Once the partially complete oilers were delivered to Tampa, the original Tampa contract was increased several times including increases of $45 million through the FY 1993 DoD Appropriation Act, increasing the contract ceiling price, including materials and labor costs, to approximately $166 million.

Figure 5. Incomplete Kaiser Class Oilers 191 and 192 at Tampa Shipyard

In August 1993, NAVSEA terminated the contract for default because Tampa failed to make progress on the contract. Tampa was experiencing cash shortage problems and operating losses before being awarded the Kaiser Class oilers contract. The problems also continued during the completion work of the oilers. The Navy stated it had paid Tampa an estimated $102.5 million of the $166 million oilers contract. In total, the Navy has paid about $400.3 million to Penn Ship and Tampa for two incomplete oilers that were initially contracted at $222.5 million.

Kaiser Class Oilers Transferred to Avondale. In 1988, the two option Kaiser Class oilers, 194 and 196, in the form of materials only, were transferred to Avondale. The two oilers were completed and delivered to the Navy fleet in March and December 1991. The Navy paid $190.3 million to Avondale and $51.2 million to Penn Ship, or an average of $120.7 million, for the two completed option oilers versus the initial average contract price of $96 million.

Recommendation, Management Comments, and Audit Response

We recommend that the Assistant Secretary of the Navy (Research, Development, and Acquisition) perform a procurement management review of Naval Sea Systems Command support and documentation for awarding ship construction contracts to determine that:

1. Preaward evaluations and business clearance memorandums properly support the contract award,

2. Business clearance memorandums are properly supported by preaward evaluations, and

3. Contract files are properly documented and support the contract award.

Navy Comments. The Navy concurred and stated that a special procurement management review of Naval Sea Systems Command support and documentation for awarding ship construction contracts will be scheduled in the third or fourth quarter of FY 1994.

Management Comments and Audit Response on the Finding

Navy Comments on Contract Preaward Evaluation. The Navy disagreed that NAVSEA awarded the Kaiser Class oiler contract to a financially and technically marginal contractor. The Navy also disagreed that NAVSEA did not adequately act on negative preaward evaluations and did not take adequate or appropriate measures to protect the Government's interest. The Navy stated that a preaward survey was performed before award and the assumptions and circumstances presented at the time of award appeared to be reasonable. The Navy further disagreed that Penn Ship cost and price proposals were unreasonable when compared with the other shipbuilder proposals and stated that the Penn Ship proposed price was considered aggressively priced but not unreasonable. The Navy further stated that a major assumption crucial to Penn Ship pricing strategy was that Chester, Pennsylvania, was considered a labor surplus area at the time of contract award and that Penn Ship relied upon this fact in calculating the availability of a skilled work force.

The Navy claimed that, based upon assumptions at award, it would have been far more difficult to justify an additional $146.9 million award to the next low offerer. The Navy also stated that NAVSEA had concerns regarding Penn Ship's pricing; however, the Navy believed that potential overruns would be covered by the target cost to ceiling price spread.

Audit Response. We agree with the Navy that the Penn Ship proposal was aggressively priced; however, we also consider the proposal priced below anticipated costs. We disagree with the Navy that the proposal was reasonable when compared with the other shipbuilder proposals. As stated in the finding,

the Penn Ship proposed target costs were $242.8 million (23.9 percent) lower than the NAVSEA independent cost estimate and $208 million below the proposal of the incumbent shipbuilder, Avondale. The NAVSEA independent cost estimate was formulated based on Avondale actual incurred costs from building the first Kaiser Class oilers. We believe that the contracting officer should have analyzed the $146.9 million price difference between the Penn Ship proposal and the next lowest competitor. The contracting officer should have verified that Penn Ship costs were compatible with the solicitation technical requirements. We believe the proposal was submitted below anticipated costs to achieve a buying-in.

The NAVSEA Cost Estimating and Analysis Division analysis of the Penn Ship best and final price proposal indicated that the proposal technical requirements were deficient and that the Penn Ship projected production learning curve was optimistic. Further, the NAVSEA Cost Estimating and Analysis Division analysis of the Penn Ship best and final price proposal concluded that the proposal was understated by $57.7 million and that labor hours, overhead, and material costs were overly optimistic. Neither the NAVSEA Cost Estimating and Analysis Division analysis of the Penn Ship proposed best and final price proposal nor the NAVSEA independent cost estimate were considered in the April 12, 1985, business clearance memorandum.

We agree with the Navy that Penn Ship relied on the availability of a surplus skilled labor force in pricing their proposal; however, the independent public accounting review and analysis of the Penn Ship proposal dated April 19, 1985, recommended that the Navy monitor Penn Ship's skill mix and labor buildup during performance of the oiler contract. In addition, the independent review and analysis recommended Navy oversight on various concerns regarding the oiler contract award with Penn Ship. Eventually, all of the concerns identified in the independent review and analysis became factors in Penn Ship's inadequate performance, resulting in contract default.

As indicated by the Navy comments, the Navy had concerns at contract award regarding the Penn Ship price proposal and expected cost overrun to occur that would be covered by the target cost to ceiling price spread. However, the Navy did not act on the various negative indicators and awarded the oilers contract to Penn Ship. As a result of the Navy award decision, the Navy paid an additional $151.9 million over the original contract ceiling price ($489.8 million) with only two oilers delivered as of November 1993 instead of four.

Navy Comments on Performance Bond FAR Requirements. The Navy claimed that the finding failed to mention that FAR 28.103-1 states that agencies generally shall not require performance and payment bonds for other than construction contracts.

Audit Response. We agree with the Navy that FAR 28.103-1 prescribes that agencies generally shall not require performance and payment bonds for other than construction contracts. However, FAR 28.103-1 does allow the use of a performance bond for other than construction contracts when protecting the Government's interest is necessary.

As indicated in the finding, the Secretary of the Navy had concerns regarding the financial ability of Penn Ship and desired a performance bond to protect the interest of the Government. However, after reviewing different alternatives requiring a performance bond, NAVSEA concluded that obtaining a performance bond contained high litigative risk or required resolicitation of contract award.

Navy Comments on the Exercise of Options. The Navy disagreed that the award of the option for TAO 196 oiler was not in the best interest of the Government. The Navy stated that the information available at the time indicated that Penn Ship was bringing its contract cost problems under control and could deliver the oilers within the ceiling price.

The Navy also disagreed with the finding conclusion that the contract modification raised the contract price by $108.9 million. The Navy stated that the finding conclusion is misleading and does not discuss the fact that the ultimate liability to the Government was never increased. The Navy further stated that the contract modification was beneficial in that two of the four oilers were delivered without additional costs to the Government.

Audit Response. We strongly disagree with the Navy that the February 1987 award of the option for the TAO 196 oiler was in the best interest of the Government. As stated in the finding, in November 1986, the Defense Contract Audit Agency predicted a cost overrun of $37 million for oilers 191, 192, and 194. In mid-1987, the Penn Ship costs, as compared with performance trends, showed that the company would lose a significant amount on the Kaiser Class oilers contract and was experiencing a severe cash flow shortfall. In addition, Penn Ship did not have any other available work to offset the projected losses. In late 1987, Penn Ship notified NAVSEA that projected cost overruns on the Kaiser Class oilers contract would put the company out of business by December 10, 1987. NAVSEA should have evaluated the Penn Ship ability to complete the first three Kaiser Class oilers before awarding the second option for a fourth oiler.

We disagree with the Navy that the June 16, 1988, modification P00005 to the oiler contract did not increase the liability to the Government. The modification increased the contract price by $108.9 million over the original contract target price ($222.5 million) and $68.5 million over the contract ceiling price ($262.9 million) for TAO oilers 191 and 192. We agree with the Navy that the modification was beneficial in that the two option oilers of the four oilers were delivered; however, we disagree that the option oilers were delivered without additional cost to the Government. The Navy incurred an additional $14.5 million in costs over the original contract ceiling price ($226.9 million) for the two option oilers, TAO 194 and 196. Furthermore, the two option oilers were completed by Avondale, the next lowest offerer to the original contract solicitation.

Navy Comments on Contractor Default. The Navy also disagreed with the report statement that the Penn Ship drydock was the sole security for all reprocurement costs not to exceed $19 million. The Navy stated that this was a misleading statement and that the settlement was based in part on taking title to

the drydock. Crandell Dry Dock Engineers, Incorporated, estimated the drydock value to be in excess of $30 million. It was determined that Penn Ship still owed the Navy $5 million in addition to the drydock after default. The $5 million was determined to be uncollectible at time of settlement due to superior liens. The Navy further stated that the only way the Navy would have collected the excess reprocurement costs ($5 million) would have been to allow Penn Ship to liquidate assets. The sharing arrangement served as an incentive to preclude a bankruptcy, which would have endangered the assets assigned to the Navy.

Audit Response. We disagree with the Navy that our statements concerning the Penn Ship default and reprocurement costs not to exceed $19 million are misleading. The Navy assertion that the value of the drydock was estimated by Crandell Dry Dock Engineers, Incorporated, to be over $30 million is wrong. In September 1984, Crandell Dry Dock Engineers, Incorporated, estimated the fair market value of the drydock to be only $20 million. Crandell Dry Dock Engineers, Incorporated, concluded that several important considerations reduce the resale value of the drydock. The drydock was designed and constructed to meet the specific site conditions and usage requirements of the shipbuilder 10 years ago. The special features of the drydock, such as the transfer capability, would be of little use to most prospective buyers resulting in a reduced resale value. The extremely high load-per-foot lifting capacity, although attractive, is not required for lifting and repairing ships. We have revised our statement on the resale value of the drydock from $19 million to $20 million based on further review.

We agree that the Navy and the contractor agreed to limit the recovery of reprocurement costs to $19 million and additional reprocurement (excess) costs to $5 million. However, as to the excess reprocurement costs ($5 million), the Navy and contractor agreed that Penn Ship would be liable for additional reprocurement costs to the extent of 50 percent of any excess cash flow (limited to $5.09 million) generated by Penn Ship during a 13-month period from August 1989 through September 1990. The Navy and contractor agreement also required Penn Ship to use its best efforts during this 13-month period to liquidate its assets and liabilities so as to maximize excess cash flow. The Navy commented that this amount was uncollectible at the time of settlement due to superior liens. This statement is also questionable. According to the requirements of modification P00017, dated August 28, 1989, the Delaware Valley Branch Office, Defense Contract Audit Agency, reviewed Penn Ship for evidence of excess cash flow and issued an audit report, dated October 31, 1991. The Defense Contract Audit Agency report stated that Penn Ship had a $3.2 million positive excess cash flow for the period that would have resulted in a recovery of $1.6 million of excess reprocurement costs. The unsigned and undated NAVSEA close-out business clearance memorandum did not consider the October 31, 1991, Defense Contract Audit Agency audit report, but indicated that Penn Ship did not have a positive cash flow. We attempted several times to obtain a signed and dated copy of the NAVSEA close-out business clearance memorandum from the contracting officer; however, none was provided.

Before contract default (modification P00017) on April 3, 1989, Penn Ship paid off a $5 million mortgage owned to Fidelity Bank (the trustee of the trust indenture), secured by a 1000-ton derrick barge. The barge (1984 fair market value of $4.4 million) was later sold in July 25, 1991. Further, after contract default, in January 1992 Penn Ship sold 6.74-acres of land for $1.8 million. Both the barge and the land were assets pledged under the trust indenture, dated March 26, 1985. Modification P00017 canceled the trust indenture.

Navy Comments on Prior Audits and Other Reviews. The Navy stated that on June 12, 1992, an advance change to the Navy Acquisition Procedures Supplement pertaining to special business clearance requirements was issued by the Director of Procurement Policy, Assistant Secretary of the Navy (Research, Development, and Acquisition). The change set forth the business clearance approval levels for the establishment, modification, or recession of a guarantee of performance, and did not establish a requirement for performance guarantees on Navy contracts.

Audit Response. The Office of the Assistant Secretary of the Navy (Research, Development, and Acquisition) memorandum for distribution, "Inclusion of Performance Guarantees in Insured Contracts," August 7, 1992, states that contracting officers are further advised that, due to the potential sensitivity of performance guarantees, it may be appropriate to include or refer to performance guarantees in the insured contract.

Part III - Additional Information

Appendix A. Preaward Survey Announcement

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
4200/N00024-84-R-2223(Q)
SEA 0224/408
JAN 17 1985

Pennsylvania Shipbuilding Company
Foot of Morton Avenue
Chester, PA 19013

Gentlemen:

Subj: PRE-AWARD SURVEY REGARDING REQUEST FOR PROPOSAL NO. N00024-84-R-2223(Q) FOR SECOND FLIGHT T-AO 187 CLASS SHIPS

Pursuant to Paragraph 23. on page 270 entitled "Pre-Award Survey" in the section of the subject solicitation entitled "Instructions, Conditions, And Notices To Offerors", you are hereby notified that the Government intends to conduct a pre-award survey at your facility. The pre-award survey will be conducted in accordance with Federal Acquisition Regulation (FAR) 9-100. The pre-award survey will commence on 22 January 1985.

Information concerning management, technical, production, material, facilities, services, financial and other abilities will be requested from your company during the conduct of the pre-award survey. A more specific listing of the type of information that will be required is contained in Enclosure (1) to this letter entitled "Required Pre-Award Survey Information". It is requested that you be prepared to present and discuss the data listed on Enclosure (1) at the time of the survey. Information requested from you will be concerned with, but will not necessarily be limited to the subjects listed in Enclosure (1).

If you have any questions regarding this matter, please contact
* at (202) 692-7517.

Sincerely,

*

Enclosure:
(1) Required Pre-Award Survey Information

*Privacy Act data has been removed.

REQUIRED PRE-AWARD
SURVEY INFORMATION

MANAGEMENT AND TECHNICAL GROUP

A. Management Organization and Systems

1. Organization (Corporate)
2. Corporate Affiliations
3. Management Information and Control Systems
4. Management Understanding or Solicitation
5. Master Scheduling
6. Surge Responsiveness/Capability
7. Security Clearance/Industrial Security
8. Past Performance

B. Labor Relations/Employment Practices

1. Organization and personnel
2. Past employment and hiring experience
3. Hiring plans
4. Labor market
5. Training programs
6. Employee relations
7. Indirect Labor Resources
8. Affirmative Action Plan

C. Technical (Design) Organization and Personnel

1. Organization
2. Workload/Workforce (by discipline)
3. Special Skill Requirements/Availability
4. Facilities
5. Understanding of solicitation
6. Surge capability
7. Quality Control (Software)
8. Performance Record

D. Technical Control Systems/Procedures

1. Planning and scheduling
2. Estimating and progressing
3. Work specifications and procurement specifications
4. Subcontractor technical control
5. Standardization
6. Configuration and data management, change control
7. Drawing/specifications review procedures
8. Performance record

1 Enclosure (1)

E. Tests, Trials and Logistics Support

1. Test and Trials Organization
2. Planning and Scheduling
3. Production Technical Support
4. Logistics Support Planning
5. Special Test Requirements/Equipment
6. Test Facilities and Laboratories
7. Surge capability
8. Performance Record

F. Quality Assurance and Reliability/Maintainability

1. Organization, personnel and training
2. Plan and procedures
3. Metrology
4. Non-destructive testing
5. Subcontractor quality control
6. Material control (QA)
7. Surge capability
8. Performance record

PRODUCTION AND MATERIAL GROUP

G. Production Organization

1. Organization
2. Workload/Workforce (by trade and skill)
3. Complex Work/skills
4. Surge capability
5. Supervisor training
6. Shop Training progams
7. Subcontractor control
8. Performance record

H. Production Planning and Control

1. Planning, scheduling and estimating
2. Production control
3. Production quality control
4. Production progressing
5. Surge capability
6. Production Material Control (Interference, surplus, GFM, CFM, special)
7. Production safety and protection of property
8. Performance record

2

I. Material Organization and Systems

1. Organization
2. Personnel and training
3. Purchasing procedures
4. Subcontracting procedures
5. Material quality control
6. Monitoring and progressing
7. Surge capability
8. Performance record

J. Material Planning, Scheduling and Control

1. Material identification, scheduling and inventory control
2. Long lead material control
3. Receipt inspection and control
4. Storage, protection and disposal (Government, contractor and special materials)
5. Material handling equipnent
6. Surplus Government material
7. Logistics support
8. Performance record

FACILITIES AND SERVICES GROUP

K. Plant Facilities and Management

1. Organization and personnel
2. Maintenance plans and procedures
3. Building, grounds and utilities
4. Dry dock
5. Berths, outfitting piers and waterfront
6. Shops, ship assembly areas and erection areas
7. Navigation Access
8. Performance record

L. Waterfront Services

1. Pier/dock services
2. Weight handling equipment
3. Transportation
4. Fire protection - ship
5. Protection of Government property
6. Crew accommodations
7. Industrial Security
8. Performance record

3

M. Protection of property

1. Care of ship (housekeeping)
2. Protection of Government property
3. Fire protection organization, system and plan
4. Protection of remote storage and work areas
5. Protection of waterborne support facilities
6. Environmental controls
7. Industrial Security
8. Performance record

N. Safety

1. Organization, personnel, programs
2. Hazardous material control
3. Hazardous work control
4. Medical facilities and services
5. Police protection
6. Disaster plan
7. Safety training
8. Performance record

FINANCIAL RESPONSIBILITY

O. Background

1. Balance sheet and statement of income and retained earnings for accounting year 1984 prepared and certified by an independent public accountant for Penn Ship, Penn-Texas, Capital Marine, and Levingston Industries

2. Interim financial statement for the period 1 October 1984 through 31 December 1984 for Penn Ship, Penn-Texas, Capital Marine, and Levingston Industries

3. Backlog and dollar value of major incomplete Government contracts and orders on hand

4. Backlog and dollar value of commercial contracts

5. Agings of accounts receivable

6. Agings of accounts payable with individual accounts past due 90 days or more designated

7. An explanation of the financial relationship between Penn Ship and Capital Marine

8. Contemplated financing for all Government and commercial work during the period of contract performance

4

P. Proposal

1. Specific inputs for and the methods used to calculate Penn Ship's past quarterly overhead rates, and the current and projected overhead rates (contained in the Best and Final Proposal) along with a detailed examination of the composition of Penn Ship's overhead pools (such as salaries and wages, repairs and maintenance, supplies, utilities, fixed costs, employee benefits and other) and how costs were or will be collected for these pools for the past quarterly, and current and projected periods (contained in the Best and Final proposal)

2. Details regarding the methodology used to project the overhead rates for the life of the program as contained in Penn Ship's Best and Final proposal

3. Detailed information regarding the terms and conditions of Penn Ship's new labor union agreement and how the new agreement impacts Penn Ship's labor rates and the pricing submitted in Penn Ship's Best and Final proposal

4. Details regarding the methodology used to project the labor rates for the life of the program as contained in Penn Ship's Best and Final proposal

5

Appendix B. Freedom of Information Act Response For Preaward Survey

DEPARTMENT OF THE NAVY

NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. [illegible]

5720
OPR 09T53/9F040643

04 DEC 1991

*

This letter responds to your April 11, 1989, Freedom of Information Act (FOIA) request for a copy of a pre-award survey relative to TOA contracts awarded Pennsylvania Shipbuilding (Penn Ship) on or about May 7, 1985.

As * explained to you in a November 19, 1991, telephone conversation, we were unable to locate a pre-award survey. Moreover, we were advised by the cognizant contracting office that no pre-award survey was ever created.

I do note, however, that the first paragraph of the enclosed NAVSEA memorandum regarding the financial responsibility of Penn Ship references a pre-award survey conducted at Penn Ship on 22 and 23 January 1985.

The contracting office explains that only the financial analysis portion of the pre-award survey was conducted. No pre-award survey form was filled out and filed. A complete pre-award survey was not considered necessary on contract N00024-85-C-2115. The contract was with a company that had several other government contracts. Their facilities and equipment were well-known and considered adequate. The only potential problem was whether Penn Ship had the financial resources to handle the additional contract. Therefore, the financial analysis was conducted and the company was found to have sufficient resources. While the initial financial analysis process was referred to as a pre-award survey, no pre-award form was filled out.

While we were unable to locate a pre-award survey, we were able to locate three documents (a blank pre-award survey form; a memorandum concerning Penn Ship's financial responsibility; and an independent audit conducted by Peat, Marwick, Mitchell & Co.) that may be of interest to you.

Per your request, we are sending you the clearly releasable portions of those three documents. As discussed in the telephone conversation, portions of the documents would be exempt from disclosure under subsection (b)(5) of the FOIA as they contain predecisional opinions, recommendations and evaluations. Moreover, the documents contains information that may be proprietary to Penn Ship and exempt from disclosure under subsection (b)(4) of the FOIA. As you are aware, we cannot

*Privacy Act data has been removed.

release such information until we give Penn Ship an opportunity to submit justification for withholding any information they may deem confidential or proprietary.

Please note this is not a denial of your request. We are sending you the clearly releasable portions. If you want us to continue processing the financial responsibility memorandum or the audit report, we will conduct a line-by-line review and you will be charged $25 per hour for this review, regardless of whether any additional information is deemed releasable.

Please let me know if you are still interested in pursuing your request. If I have not received written confirmation by December 30, 1991, I will close your request file without further action. You may, of course, submit a new request at any time.

We are assessing the following fees for services performed in responding to your request:

Search	$50.00
Review	25.00
Copy	4.80
Total	$79.80

Please forward a check for $79.80, along with a copy of this letter, to the Commander, Naval Sea Systems Command (SEA 09T5), Washington, DC 20362-5101. Please make your check payable to the Treasurer of the United States.

If you have any questions concerning this matter, please contact * at 703-602-3841/42.

Sincerely,

*

Enclosures

2

*Privacy Act data has been removed.

Appendix C. Kaiser Class Oilers Procurement Costs

The following represents actual procurement costs including contract modifications for the four Kaiser Class oilers originally awarded to Penn Ship and then subsequently transferred to Avondale and Tampa.

	Contractors						
Oilers	Penn Ship[1]	Avondale[2]	Tampa[3]	Total[4]	Original Contract Price[5]	Planned Delivery Date	Actual Delivery Date
191	$174,475,615[6]		$ 48,080,864	$222,556,479	$122,898,713[6]	Apr. 1988	Unfinished[7]
192	123,354,411[6]		54,385,450	177,739,861	99,578,136[6]	Aug. 1988	Unfinished[7]
194	43,943,652	$ 81,808,477		125,752,129	96,984,329	Apr. 1989	Mar. 1991
196	7,215,806	108,473,551		115,689,357	95,025,450	Dec. 1989	Dec. 1991
Total	$348,989,484	$190,282,028	$102,466,314	$641,737,826	$414,486,628		

[1]The amounts shown are the actual amounts paid to Penn Ship before contract default.

[2]The amounts shown are the actual amounts paid to Avondale for the completion of Kaiser Class oilers 194 and 196.

[3]The amounts shown are the actual amounts paid to Tampa for completion of Kaiser Class oilers 191 and 192 before contract default. The contract was modified several times, adjusting the total contract price to $166,000,000 but only $102,466,314 was spent.

[4]Represents Penn Ship, Avondale, and Tampa total costs paid as of September 1, 1993, for the procurement of four Kaiser Class oilers. The original contract price was $414,486,628.

[5]The amounts shown are the original negotiated prices with Penn Ship for the four Kaiser Class oilers procurement.

[6]The original contract awarded on May 6, 1985, for the Kaiser Class oilers 191 and 192 was for $222,476,849. Navy costs expended on the two Kaiser Class oilers 191 and 192 were $297,830,026, or an overrun of $75,353,177.

[7]As of August 25, 1993, NAVSEA terminated the contract with Tampa for the completion of Kaiser Class oilers 191 and 192.

Appendix D. Chronology of Significant Events

The following is a chronology listing significant events that occurred as part of the Kaiser Class oilers 191, 192, 194, and 196 procurement.

Date	Event
May 6, 1985	NAVSEA awarded contract N00024-85-C-2115 (fixed-price-incentive) for two Kaiser Class oilers (191 and 192) with two one-ship options, to Penn Ship for $222,476,849.
February 27, 1986	NAVSEA exercised the first option for oiler 194 through modification P00001, increasing the contract target price by $96,984,329 to $319,461,178.
February 12, 1987	NAVSEA exercised the second option for oiler 196 through modification P00003, increasing the contract target price by $95,025,450 to $414,486,628.
June 16, 1988	NAVSEA modified contract N00024-85-C-2115 through P00005. The two option oilers 194 and 196 were transferred to Avondale for completion at a total price of $216,000,000. The fixed-price-incentive contract with Penn Ship was converted to a firm-fixed-price contract for $331,400,000.
January 26, 1989	NAVSEA established a special bank account and advance payment provisions of $17,000,000 through modification P00011 on contract N00024-85-C-2115.
April 27, 1989	NAVSEA issued a stop work order to Penn Ship through modification P00013 on contract N00024-85-C-2115.
August 28, 1989	NAVSEA terminated the contract with Penn Ship for default through modification P00017.
November 16, 1989	NAVSEA issued letter contract N00024-90-C-2300 to Tampa for the completion of Penn Ship Kaiser Class oilers 191 and 192.
February 2, 1990	NAVSEA reduced the Penn Ship contract by $31,389,297 by modification P00018.
June 29, 1990	NAVSEA definitized letter contract N00024-90-C-2300 with Tampa for $49,000,000.

Appendix D. Chronology of Significant Events

Date	Event
March and December 1991	Avondale delivered Kaiser Class oilers 194 and 196, respectively, to the Navy.
January 13, 1992	NAVSEA modification P00020 to contract N00024-85-C-2115 fully and finally released Penn Ship of its contractual liabilities.
November 1992	FY 1993 DoD Appropriations Act increased contract N00024-90-C-2300 with Tampa by $45,000,000.
August 25, 1993	NAVSEA terminated contract N00024-90-C-2300 with Tampa for default.
November 1993	The Navy has not made an official determination as to the disposition of the uncompleted Kaiser Class oilers 191 and 192.

Appendix E. Summary of Potential Benefits Resulting From Audit

Recommendation Reference	Description of Benefit	Amount and/or Type of Benefit
Page 21	Economy and Efficiency. Contract awards properly supported by documented preaward evaluations and business clearance memorandums will validate that prospective contractors are financially and technically responsible to perform ship construction contracts.	Unquantifiable. The potential monetary benefits cannot be quantified because we only reviewed the Kaiser Class oilers acquisition.

Appendix F. Organizations Visited or Contacted

Office of the Secretary of Defense

Deputy Comptroller (Management Systems), Office of Comptroller of the Department of Defense and Chief Financial Officer, Washington, DC

Department of the Navy

Naval Sea Systems Command, Arlington, VA
- Combat Support, Ocean, Research, and Surveillance Programs, Naval Sea Systems Command, Arlington, VA
- Supervisor of Shipbuilding, Conversion, and Repair, Brooklyn, NY
- Supervisor of Shipbuilding, Conversion, and Repair, Tampa Detachment, Tampa, FL

Naval Investigative Service Command, Washington, DC
- Resident Agency Orlando, FL

Defense Organizations

Defense Contract Audit Agency, Alexandria, VA
- Delaware Valley Branch, Mid-Atlantic Region, Media, PA
- Tampa Bay Branch, Eastern Region, St. Petersburg, FL

Non-Defense Federal Organization

Fraud Section, Commercial Litigation, Department of Justice, Washington, DC

Non-Government Organization

Tampa Shipbuilding, Incorporated, Tampa, FL

Appendix G. Report Distribution

Office of the Secretary of Defense

Director of Defense Procurement
Comptroller of the Department of Defense
Principal Deputy Under Secretary of Defense (Acquisition and Technology)
Deputy Under Secretary of Defense (Acquisition Reform)
Deputy Under Secretary of Defense (Logistics)

Department of the Army

Secretary of the Army
Auditor General, Department of the Army

Department of the Navy

Secretary of the Navy
Assistant Secretary of the Navy (Financial Management)
Assistant Secretary of the Navy (Research, Development, and Acquisition)
Comptroller of the Navy
Commander, Naval Sea Systems Command
Auditor General, Naval Audit Service

Department of the Air Force

Secretary of the Air Force
Assistant Secretary of the Air Force (Acquisition)
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Air Force Audit Agency

Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency

Non-Defense Federal Organizations

Office of Management and Budget
National Security and International Affairs Division, Technical Information Center, General Accounting Office

Chairman and Ranking Minority Member of Each of the Following Congressional Committees and Subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, 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

Department of the Navy Comments

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

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

Subj: DEPARTMENT OF DEFENSE INSPECTOR GENERAL PROPOSED DRAFT AUDIT REPORT ON THE HOTLINE ALLEGATIONS CONCERNING CONSTRUCTION OF HENRY J. KAISER CLASS OILERS (PROJ. NO. 3CA-8017)

Ref: (a) Department of Defense Inspector General memo of 8 December 1994, subject as above

Encl: (1) Department of the Navy Response to Draft Audit Report

I am responding to the proposed draft audit report forwarded by reference (a) concerning the DoD Hotline allegations related to improprieties in the award, administration, and termination for default of a Naval Sea Systems Command contract for the construction of Henry J. Kaiser Class oilers.

The Department of the Navy concurs with the report's recommendation. Our detailed response to the audit is provided as enclosure (1).

Copy to:
NAVINSGEN
NCB-53

DEPARTMENT OF THE NAVY RESPONSE
TO
PROPOSED DODIG DRAFT REPORT OF DECEMBER 8, 1994
ON
DOD HOTLINE ALLEGATIONS CONCERNING CONSTRUCTION
OF HENRY J. KAISER CLASS OILERS
(3CA-8017)

Finding:

NAVSEA awarded a Kaiser Class oilers contract to a financially and technically marginal contractor. The contract award occurred because NAVSEA did not adequately act on negative preaward evaluations of the contractor and did not take adequate or appropriate measures to protect the Government's interest. As a result of the award to a marginal contractor, NAVSEA subsequently terminated the Kaiser Class oilers contract for default and incurred an additional $102 million of reprocurement costs.

Department of the Navy Position:

Non-concur. The Navy does not agree with the findings contained in the draft audit report, project number 3CA-8017. The findings begin with the statement that "...NAVSEA awarded a Kaiser Class oiler contract to a financially and technically marginal contractor." The findings further state that "...NAVSEA did not adequately act on negative preaward evaluations and did not take adequate or appropriate measures to protect the Government's interest." The report concludes that the termination and subsequent reprocurement costs were the result of the award "to a marginal contractor."

The Navy performed a pre-award survey prior to award of the Penn Ship contract. Although well aware that the contract was aggressively priced, NAVSEA went to great lengths to confirm Penn Ship's ability to perform. Penn Ship was not able to complete the contract; however, the assumptions and circumstances presented at the time of award appeared to be reasonable, although not without risk. The report states that "The Penn Ship costs and price proposals were unreasonable compared with the other proposals." At the time of the evaluation, the prices submitted by Penn Ship were considered to be aggressive but not unreasonable. The audit report does not discuss two of the major assumptions crucial to Penn Ship's pricing strategy. Chester, Pennsylvania was a labor surplus area at the time of contract award. Penn Ship relied upon this fact in calculating the availability of a skilled work force. This availability, coupled with a union agreement that provided for a "two-tiered" wage rate,[1] enabled Penn Ship to develop an extremely competitive price proposal. After contract award, some of these assumptions did not materialize as during performance a labor shortage developed in the Philadelphia area. Penn Ship was forced to import skilled labor from out of the area and unilaterally raise wage rates to attract skilled labor.

ENCLOSURE(1)

Based upon the assumptions at award, it would have been far more difficult to demonstrate that the taxpayers should have potentially spent an additional $146.9 million to go to the next low offeror. It is true that NAVSEA had concerns regarding Penn Ship's pricing; however, it was believed that the potential overruns could be covered by the target cost to ceiling spread. The proposed prices, at ceiling, exceeded the NAVSEA pre-bid cost estimate in all cases. Although it was anticipated that the target cost would be overrun, the contract, for four ships, was projected to be marginally profitable.

The draft report states that "The FAR requirements for a performance bond state that a performance bond is normally required to secure performance and fulfillment of contractors obligations under a contract. FAR 28.103-2, 'Performance Bonds,' prescribes that a performance bond may be required when necessary to protect the interests of the Government." The audit report fails to mention the earlier citation, specifically FAR 28.103-1, where "generally, agencies shall not require performance and payment bonds for other than construction contracts" (see definition of construction in FAR 36.102).

The audit report states that award of the option for T-AO 196 was not in the best interests of the Government. Information available at the time indicated that Penn Ship was bringing its contract cost problems under control and could deliver the ships within the ceiling price. At the time, this action appeared to be in the Government's best interests.

The audit report discusses the modification to the Penn Ship contract that transferred T-AO 194 and T-AO 196 to Avondale and firm-fixed priced T-AO 191 and T-AO 192. The report concludes that the contract price was raised by $108.9 million. It is extremely misleading in that it does not discuss the fact that the ultimate liability to the Government was never increased. In fact, the Government's liability for four ships included escalation, target to ceiling spread and a number of changes to the contract. Although the audit report infers that the $108.9 million increase was gratuitous, it made no change in the Government's liability and, in fact, was quite beneficial in that two of the four ships were delivered without additional costs to the Government.

The audit report discusses the terms of the Penn Ship default and states that the Penn Ship drydock was the sole security for all reprocurement costs not to exceed $19 million. This statement is misleading. The settlement was based, in part, on the Navy taking title to the Penn Ship floating drydock. The value of the drydock was estimated by Crandell Marine Surveyors to be in excess of $30 million. For settlement purposes, the Navy and the contractor agreed to the $19 million figure. After the calculations, which included $19 million for the drydock, it was determined that Penn Ship would still owe the Navy approximately $5 million. This amount was uncollectible at the

time of settlement due to superior liens. It was determined that the only way the Navy would have a chance to collect the excess reprocurement costs would be to allow Penn Ship to liquidate assets. The sharing arrangement served as an incentive to preclude a bankruptcy filing which would have endangered the asset assigned the Navy.

In addition to the Finding and Recommendation, we would like to comment on the section entitled "Prior Audits and Other Reviews." The draft audit report discusses changes to the Navy Acquisition Procedures Supplement (NAPS) regarding performance guarantees. The report states that these "...changes provided further guidance to contracting officers to appropriately include performance guarantees in insured contracts." On 12 June 1992, an advance change to the NAPS pertaining to special business clearance requirements was issued by the Director of Procurement Policy, ASN (RD&A). This change sets forth the business clearance approval levels for the establishment, modification or recision of a guarantee of performance, and did not establish a requirement for performance guarantees on Navy contracts.

Recommendation:

Recommend that the Assistant Secretary of the Navy (Research, Development and Acquisition) perform a procurement management review of Naval Sea Systems Command support and documentation for awarding ship construction contracts to determine that:

1.) Preaward evaluations and business clearance memorandums properly support the contract award,
2.) Business clearance memorandums are properly supported by preaward evaluations, and
3.) Contract files are properly documented and support the contract award.

Department of the Navy Position:

Concur. The Navy will schedule a special procurement management review of Naval Sea Systems Command's support and documentation for awarding ship construction contracts in 3rd/4th Quarter FY94.

[1]The "two-tiered" wage rate agreement consisted of maintaining current wage rates for current employees while new or rehires started at a considerably lower rate. This arrangement was agreed to by the union representing shipyard employees. The Supervisor of Shipbuilding and DCAA reviewed the agreement and verified its impact on the pricing proposal.

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