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SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS

STATEMENT

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BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

HOUSE ARMED SERVICES COMMITTEE

ON

NAVY SHIPBUILDING AND ITS IMPACT ON

THE DEFENSE INDUSTRIAL BASE IN A TIME OF FISCAL UNCERTAINTY

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Chairman Wittman, Ranking Member Cooper, and distinguished members of the Subcommittee, thank you for the opportunity to appear before you today to address Department of the Navy (DoN) shipbuilding and its impact on the defense industrial base in a time of fiscal uncertainty. The US defense industrial base is a strategic national asset, providing our Navy, Coast Guard, and other federal agencies the highly capable seagoing platforms required to meet the Nation's Maritime Strategy. It is essential that the industrial base be sized and shaped to meet current and known future requirements, with a measure of surge capacity should times of conflict or other urgent needs demand it. Further, it is essential that industry invest the capital, train and retain the skilled work force, and maintain the competitive posture required to build and maintain our Navy's complex warships in the most cost effective manner possible.

The US Navy places great weight on the health of the industrial base as a factor in the development of shipbuilding procurement plans, always balanced carefully against operational requirements and cost effective acquisition.

This statement provides a review of the process for formulating the Navy's shipbuilding plan, discusses how the Navy assesses, monitors, and takes into account impacts to the industrial base, and summarizes the current state of the Navy shipbuilding and combat systems industrial base at a major supplier level. Finally, the statement discusses financial incentives used by the Navy to support the industrial base, particularly in the area of facilities capitalization.

Shipbuilding Plan Formulation

In the development of shipbuilding plans, programs, and budget, the Navy carefully balances operational requirements against available resources, and includes industrial base considerations as a key component of the overall decision process. The most publicly recognizable product of this process for shipbuilding has become the Navy's annual long range shipbuilding plan.

Section 231 of Title 10, United States Code, as amended by Section 1021 of the National Defense Authorization Act for Fiscal Year (FY) 2012 (Public Law 112-81) requires the Secretary of Defense to submit to Congress an annual, long range plan for construction of combatant and support vessels for the Navy. The time span covered by this plan is 30 years.

Developed in coordination with Navy, Marine Corps, Joint Staff, and the Office of the Secretary of Defense (OSD), the 30 Year Shipbuilding Plan outlines the number and type of ships the Navy will need to best meet the requirements of the National Security Strategy and the Maritime Strategy over the next three decades. The plan accounts for the Navy's current battle force inventory, retirement and recapitalization plans for these ships, and current plans for the acquisition of new ships and new ship classes needed to fulfill the demands of the National Security Strategy. The plan then balances needs against expected resources and assesses the risks associated with the Department's ability to fund future ship requirements. Finally, the plan carefully considers the shipbuilding design and industrial base necessary to build and maintain tomorrow's Navy.

The plan is spelled out in three distinct phases: near term, mid-term, and far-term. The near term is the first ten year period of the plan and includes the current Future Years Defense Program (FYDP). The requirements underpinning this phase are the need to provide a balance of ships that is fiscally achievable and lay the foundation for the 21st century fighting force while simultaneously sustaining critical industrial capacity. Given known ship capability and quantity requirements, cost estimates are judged to be most accurate in this period.

The mid-term phase is the second ten year period. The requirements underpinning this section are based on the Quadrennial Defense Review (QDR), intelligence estimates of future threats and operating environments. The objective in this phase is to make adjustments to the plan in order to balance the mix of ships, unit costs, projected budget resources, and industrial base concerns. Cost estimates for the force structure defined for this period become less accurate over time as the threats become less clear, industrial base issues become more uncertain, technologies continue to evolve, and requirements change.

The far-term phase is the final ten year period. The requirements during this period are not as well defined as those for the near or mid-term. The number, type, and capabilities of ships are estimated based on anticipated Joint and Navy war-fighting requirements. Cost estimates are notional due to the uncertainty of business conditions affecting the shipbuilding industry and estimates associated with inflation and deflation indices. In the report, the far-term phase largely addresses the recapitalization of today's legacy ships and ships procured at the beginning of the near term of reporting.

Industrial Base General Considerations

Navy warship design and construction is arguably the Nation's most complex heavy industry. The range of capabilities that characterize today's fleet; spanning from undersea warfare to the launch and recovery of aircraft at sea, from gas turbine to nuclear propulsion, from close-in weapon systems to intercontinental ballistic missiles, and related control systems, sensors, and communication systems; all designed for extended operations at sea under extreme conditions ranging from high sea state to live fire, require an industrial base with extraordinarily diverse manufacturing capabilities underpinned by unique design and engineering skills. Compounding the inherent technical challenges, ships are procured at very low annual production rates requiring significant capital investment and infrastructure (dry docks, bridge rail cranes, etc.). Depending on ship type, production of a single ship requires from five to as long as ten years to complete, with ship unit costs measured in the billions. Yet, research and development (R&D) investment is relatively low, and given the resources required to produce a first of class warship, shipbuilding programs do not have the opportunity to build full-scale prototypes. Accordingly, developmental risks that other major programs are able to retire through the build and test of a prototype unit must be retired through the production of the lead ship of each new ship class.

The Navy's shipbuilding plan must account for these unique characteristics when considering the effect of the plan on the industrial base. To this end, the Navy assesses

the industrial base sector-by-sector (aircraft carriers, submarines, surface combatants, amphibious ships, auxiliary ships, etc.) and tier-by-tier (major, mid-tier, and smaller shipyards); monitoring the health of the shipbuilders, major suppliers of integrated warfare systems (IWS) and command, control, communications, computers and intelligence (C4I) systems, and major suppliers of key components (hull, mechanical, electrical systems) and commodity materials (steel, pipe, cable, etc.). In doing so, the Navy examines not only production labor employment, but also engineering capabilities, facility capabilities and efficiency, overall health and demographics of the workforce, and, as warranted, financial strength.

At the most fundamental level of analysis, the Navy utilizes industry and internal assessments of production workload for its major shipyards and key mid-tier yards to assess the impact of shipbuilding procurement options (across the range of likely competitive outcomes) on these yards. The objective of this analysis is to arrive at a plan which provides stability for the industrial base while meeting the Navy's prioritized shipbuilding requirements. Stability translates into retention of skilled labor, improved material purchasing and workforce planning, strong learning curve performance, and the ability for industry to invest in facility improvements; all resulting in more efficient ship construction and a more affordable shipbuilding program. Design efforts for new or modified classes of ships are also similarly phased to the extent possible to sustain the health of the engineering workforce. When operational requirements or budget constraints threaten to counter this objective, DoN and DoD leadership are careful to thoroughly evaluate alternatives to arrive at the plan that provides the best balance across requirements, affordability, and the industrial base.

In addition to basic workload and production line assessments, the Navy looks for other methods where feasible to help sustain the industrial base. In the past, through measures such as multi-year procurement of the DDG 51 Class and VIRGINIA Class, the DDG 1000 Swap/DDG 51 Restart Agreement, the Littoral Combat Ship dual block buy, and the re-design of the Mobile Landing Platform, the Navy has worked with the shipbuilding industry to try to maintain stability in procurement, balance workloads, improve affordability, and induce more efficient utilization of industrial base capacity. With particular concern for the auxiliary shipbuilding sector, which straddles Navy and commercial shipbuilding, and is weakened by the current low demand for both Navy auxiliary and commercial ships, the Navy has offered use of the Shipbuilding Capabilities Preservation Agreement (SCPA). Such an agreement, which permits the contractor to claim certain indirect costs attributable to its private sector work as allowable costs on Navy shipbuilding contracts, is intended to improve the competitiveness of the shipyard as it competes in the private sector for commercial work. These and similar efforts continue as part of the proposals in the FY 2013 President's Budget request and the 30 Year Shipbuilding Plan.

Sector-By-Sector Summary

At present, the shipbuilding industrial base is generally stable although consolidations at both the prime and sub-tiers are occurring. At the prime level, shipyards and major tier-one suppliers remain in relatively good financial health.

An example of consolidation at the prime level was Northrop Grumman divesting its shipbuilding business in March 2011. The resulting new company, Huntington Ingalls Industries (HII), is moving forward with a proposed plan to close its Avondale shipyard in 2013 and centralize its operations in the region at its Pascagoula shipyard. This internal business decision by HII reflects their determination that such consolidation is appropriate in view of their future workload projections based on the Navy's long range shipbuilding plan, and necessary in view of their need to reduce operating costs to be competitive for future shipbuilding contracts.

There has also been significant consolidation at the sub-tiers. For example, in the 1990s four domestic companies manufactured naval main reduction gears. Today, only two domestic suppliers remain.

Consolidation presents both risks and rewards for the Navy shipbuilding program. Whereas it may entail a decrease in industrial base capability and/or capacity and a potential lessening of competition, for those remaining suppliers it may also bring about the possibility to realize greater economies of scale, greater retention of skilled labor, and higher and more efficient equipment utilization rates which contribute to more affordable shipbuilding. In allocating its shipbuilding budget and performing the associated contracting actions, the Navy looks for the efficiencies inherent to an industrial base optimally sized and shaped for current and projected workload, but also guards against irreversible actions which would leave the Nation wanting for critical skills, capacity, or competition within our shipbuilding industrial base.

Aircraft Carrier Industrial Base:

New construction as well as the Refueling and Complex Overhaul (RCOH) of aircraft carriers are accomplished exclusively at HII Newport News Shipyard. The current shipbuilding plan of one RCOH every three years and one new carrier procurement every five years maintains sufficiently stable production to sustain a level workload and a highly skilled workforce that supports complex aircraft carrier work. Near term objectives to align FORD Class carrier delivery schedules with Nimitz Class decommissioning schedules (sustaining an eleven-carrier force) result in a slower initial rate of production for the FY 2013 carrier, CVN 79. In view of the need to incorporate lead ship lessons learned into an optimal build plan for the FORD Class, however, and the added complex workload associated with the decommissioning of USS ENTERPRISE (CVN 65) during this period, it is expected that this CVN 79 production ramp will provide greater opportunity to improve overall cost on the program. However, certain sectors of the aircraft carrier vendor base will require close monitoring, particularly those sole-source vendors who rely on aircraft carrier orders to remain viable.

Submarine Industrial Base:

The submarine industrial base comprises two shipbuilders, General Dynamics Electric Boat and HII Newport News Shipyard. Submarine design and construction workload is at its highest level in over two decades, including six VIRGINIA Class submarines under construction, design work for the next block of VIRGINIA Class submarines, design efforts to reduce total ownership cost, and development and design of the OHIO Class Replacement SSBN. Although the FY 2013 President's Budget request delays one FY 2014 VIRGINIA Class submarine to FY 2018 and delays the OHIO Replacement Program acquisition profile by two years (resulting in lead ship procurement in 2021 vice 2019), projections are that the submarine industrial base will continue to steadily expand beyond the end of this decade. Pending Congressional approval, the FY 2013 President's Budget requests multiyear procurement for nine FY 2014-2018 VIRGINIA Class submarines, which should provide the opportunity to mitigate the impact of deferring the FY 2014 submarine. Separately, the two year delay to the lead boat of the OHIO Replacement Program should provide opportunity to complete that program's Design for Affordability effort, enabling the program to meet its affordability requirements.

Surface Combatant Industrial Base:

The surface combatant industrial base comprises two first tier shipbuilders, General Dynamics Bath Iron Works (BIW) and HII Ingalls Shipbuilding (Ingalls). Six ships of two destroyer classes are under construction at these two shipyards; three DDG 1000 Class ships are being built at BIW (with co-production by Ingalls), and three DDG 51 Class ships are under construction (DDG 112 and 115 at BIW, DDG 113 at Ingalls). An additional two destroyers have been awarded (DDG 114 at Ingalls and DDG 116 at BIW). This backlog provides workload stability at both yards, enables efficient re-start of DDG 51 construction, facilitates performance improvement opportunities at both shipyards, and maintains two sources of supply for future Navy surface combatant shipbuilding programs. Pending Congressional approval, the FY 2013 President's Budget requests multiyear procurement for nine FY 2013-2017 DDG 51 destroyers, which should further stabilize the combatant industrial base.

Amphibious and Auxiliary Ship Industrial Base:

Tier one shipyards constructing amphibious and auxiliary ships include HII Ingalls Shipbuilding, HII Avondale Shipyard, and General Dynamics National Steel and Shipbuilding Company (NASSCO). Sustaining stable workload in this sector has been challenging.

Ingalls is currently constructing the lead ship of the AMERICA (LHA 6) Class and three LPD 17 Class ships (LPD 24, 26, 27). Further, the Navy recently awarded Ingalls the detail design and construction contract for LHA 7. This workload, in conjunction with other construction activity, maintains stable amphibious ship production at Ingalls through the 2017 timeframe.

HII Avondale is delivering LPD 23 this month, and is constructing LPD 25. HII has announced that it will close its Avondale facility following the delivery of LPD 25 in 2013.

GD NASSCO is completing construction of its final T-AKE Class Dry Cargo Auxiliary ship in October 2012, following which its workload will ramp down rapidly, leaving only three Mobile Landing Platforms (MLPs) in its new construction backlog. MLP 1 will deliver in the spring 2013, with MLP 2 delivery in early 2014. The FY 2013 President's Budget requests funding to modify MLP 3, awarded in 2012, into an Afloat Forward Staging Base (AFSB) variant and to procure a fourth MLP in FY 2014 as an AFSB variant. Funding in 2013 is necessary to ensure AFSB is delivered in time to meet the decommissioning schedule for the interim AFSB, USS PONCE, and to avoid the dedication of other higher-cost, less-suited fleet combatants to the AFSB mission. Funding in 2013 is also necessary in order to leverage ongoing MLP production, which will ensure this capability is delivered at the lowest possible cost. The MLP AFSB is the only auxiliary ship in the Navy's shipbuilding plan until 2016. With the pending closure of Avondale shipyard, constructing MLP 3 and 4 is critical to the viability of the remaining auxiliary shipbuilder and to ensuring that the shipbuilding industrial base remains capable of building affordable auxiliary ships in the future.

Future amphibious and auxiliary shipbuilding includes the Fleet Replenishment Oiler (T-AO(X)), to be competed in FY 2016; the LHA 8, planned for procurement in 2017; and the LSD 41/49 Class Replacement program, LX(R), planned to begin in FY 2018. The Navy will continue to work closely with this industrial base sector and Congress as we bridge the 'soft gap' between current amphibious and auxiliary shipbuilding programs and these future programs.

Shipbuilding Engineering Design Industrial Base:

The surface ship engineering design industrial base is relatively stable with DDG 51 Class Flight III, CVNs 78 and 79, MLP AFSB variant, T-AO(X), LX(R), LHA 8 and other design work. This design base is spread out amongst the multiple shipyards across the Nation performing surface ship new construction. Surface ships of all classes are almost continually being built to replace older ones that must be retired. Over the course of the shipbuilding and conversion plan, a portion of this engineering design workforce will be engaged in design work to support ongoing new construction as well as supporting design upgrades to in-service ships.

However, in recent years the Navy has been especially concerned with the submarine engineering design industrial base. With Virginia Class Block upgrades (including Virginia payload module) and Ohio Replacement program design the submarine design efforts are extremely robust.

Second Tier Shipbuilding Industrial Base:

The second tier industrial base is robust. Second tier shipyards are building the Littoral Combat Ship (LCS), Joint High Speed Vessel, Ocean Class AGOR Ship, Oceanographic Research Ship (T-AGS 66), and the Ship to Shore Connector (SSC).

The LCS 1 variant is a steel monohull and aluminum super structure design built by the Lockheed Martin-led industry team at Fincantieri's Marinette Marine Corporation in Marinette, Wisconsin. The LCS 2 variant is an aluminum trimaran hull design built by the General Dynamics (for LCS 2 & 4) and Austal USA (for LCS 6 and follow)-led industry team at the Austal USA shipyard in Mobile, Alabama. Leveraging the stability provided by their respective 10-ship block buy awards, the LCS shipbuilders have committed significant capital investment toward the modernization of their facilities and training of their workforce to ensure their ability to meet the fixed price target costs. Pending the outcome of future competitive awards, the workload at each of these shipyards remains stable through (at least) 2017.

The next two Ocean Class AGOR ships are being built by Dakota Creek Industries (DCI), Anacortes, Washington. The Ship to Shore Connector program detail design and construction contract for the test and training craft and up to eight additional craft was awarded to Textron Marine and Land Systems in Slidell, Louisiana in July 2012.

Ship Combat Systems:

The combat systems industrial base has remained stable with ongoing combat systems development work for DDG 1000, LCS, AEGIS and Ship Self Defense System (SSDS). Raytheon is the lead Combat Systems Integrator for DDG 1000 and large deck amphibious ships. Lockheed Martin is the lead Combat Systems Integrator for AEGIS, and both General Dynamics and Lockheed Martin maintain combat system integration roles for LCS.

The Navy has fully embarked on utilizing competition to manage future combat system integration costs. As an example, combat system integration work for future AEGIS development work is now under competition with multiple bidders. The Navy is pursuing fair and open competition in the fielding of open, modular, and extensible systems. This strategy enables the Rapid Capability Insertion Process (RCIP) and the integration of new technology without costly software changes, helps manage Commercial Off-The-Shelf (COTS) obsolescence, and encourages commonality and reuse. The Open Architecture approach to development allows new business models, reduces manning and training, test and evaluation efforts, combat system certification efforts, and operating and support infrastructure. The RCIP builds off the successful submarine Acoustic Rapid COTS Insertion (ARCI) model where modular open systems are fielded in a full and open competition market.

The Navy is also actively managing combat system risk for equipment procurement, with comprehensive research recently completed on the producibility of

each Combat System element for AEGIS in support of the DDG51 production re-start. During the restart of DDG 113, the Navy instituted a rigorous change control process that performs a thorough review of the availability and manufacturing status of each combat system item and make plans for redesign as required to continue to meet future shipbuilding requirements.

The Navy's submarine force continues to enhance the combat system industrial base with procurement of the Submarine Warfare Federated Tactical Systems which encompass combat control, sonar, and imaging systems. Several prime contractors, including Lockheed Martin, Raytheon, and General Dynamics integrate the efforts of nearly two hundred subcontractors, many of them small businesses spread among more than thirty states. Additionally, the submarine force has a team dedicated to leveraging the flexibility of small businesses to address known capability gaps and help these small businesses partners with the government and major defense contractors.

Over the last two decades, the pace of innovation and expansion in the microelectronics, communications, and information technology markets has been very rapid. A wide variety of vendors are now qualified to design and build an array of products used within new or upgraded combat systems, such as microprocessors, consoles, displays, and communications equipment. A robust global commercial electronics industrial base supports these vendors. Second tier suppliers of assembled components tend to serve both commercial and defense customers. Third tier suppliers of individual components such as integrated circuits frequently supply identical products for both commercial and defense use. At the fourth tier, such as design tools and reused intellectual property, there is frequently minimal awareness of final end use in defense products. In essence, the industrial base has become largely global below the level of the prime contractors.

The Navy has also actively embarked on programs to simplify the maintenance of combat systems by taking advantage of new commercial toolsets and implementing automated testing to reduce costs and improve overall testing capabilities. These initiatives will all lead to improved operational and maintenance capabilities by the sailor on the deckplates and improved operational testing capabilities for combat systems.

Together, this active combat systems industrial base, maintenance and testing initiatives, and active ongoing competition for future work ensures the Navy will continue to field combat systems and ships that are affordable and lay the foundation for the 21st century fighting force while simultaneously sustaining critical industrial capacity for combat systems.

Navy Shipyard Facility Investment Incentives

Modernizing facilities and equipment at shipyards that build Navy vessels can lead to improved efficiency, ultimately reducing the cost of constructing ships. Over the past 10 years large shipyards have invested more than \$1.9 billion in facilities and equipment using both public and corporate funds. Investments have fallen largely into four categories: improving efficiency, developing new shipbuilding capabilities,

maintaining existing capabilities, and restoring capabilities. Examples of each category include the following:

Improving efficiency—General Dynamics BIW built a new facility—the Ultra Hall—that improves efficiency by allowing shipbuilders to access work space more easily in a climate-controlled environment.

Developing capabilities—HII—Newport News built a replacement pier that allowed shipbuilders to work on two aircraft carriers simultaneously due to a Navy scheduling conflict.

Maintaining capabilities—General Dynamics Electric Boat invested to repair docks in order to maintain the shipyard’s ability to launch and repair submarines.

Restoring capabilities—HII—Ingalls Shipbuilding invested to restore Ingalls full shipbuilding capacity and capability following Hurricane Katrina, resulting in a modernization of their facilities.

To incentivize investments, the Navy has provided support to most major shipyards with four mechanisms: (1) released money early from the reserve of contract funds normally held back to ensure ships are delivered according to specifications, (2) accelerated asset depreciation schedules, (3) tied a portion of the contractor's fee to investing in new facilities and equipment, and (4) adjusted the contract share-line to give the contractor more of the savings if costs decrease.

Through investments to improve efficiencies and develop new capabilities, major shipyards modernized their facilities and equipment, thus transforming their shipbuilding processes. Some of these investments completely changed the physical layouts of shipyards. For example, BIW completed a Land Level Transfer Facility in 2001, replacing an inclined-way transfer facility used since 1890. The Land Level Transfer Facility allows the shipyard to construct ships in larger, more fully outfitted units on any one of three construction lanes. Another example includes General Dynamics NASSCO’s facility expansion project, which fundamentally changed the layout of the shipyard to increase production capacity, throughput, and efficiency. In particular, NASSCO added new production lanes to reduce shipyard congestion, allowing builders to move units around the shipyard with reduced bottlenecks, and added a modern blast and paint facility to improve paint process efficiency while reducing emissions.

Another vehicle the Navy utilizes to incentivize facility investment is through a general policy under the Federal Acquisition Regulation (FAR). Under the policy, contractors are usually required to furnish all facilities and equipment necessary to perform government contracts. When a contractor furnishes facilities and equipment to perform a contract, the government recognizes the costs associated with these items by paying depreciation and facilities capital cost of money costs allocated to the contract. Depreciation and facilities capital cost of money costs are indirect contract costs, or costs incurred for the general operation of the business that are not specifically applicable to

one product line or contract. By recovering depreciation costs, the contractor recoups the cost of an asset—a facility or a piece of equipment—over the asset’s estimated useful life. Facilities capital cost of money acknowledges the opportunity cost for a contractor when it uses its funds to invest in facilities and equipment in lieu of other investments such as relatively risk-free bonds. Facilities capital cost of money is determined by multiplying the net book value of the contractor’s capital assets by a cost-of-money rate, which is a rate tied to the U.S. Treasury rate.

With respect to Navy shipbuilding, a shipyard’s indirect costs, including depreciation and facilities capital cost of money, are allocated to the Navy’s shipbuilding contracts at the shipyard in accordance with the Cost Accounting Standards. When a shipyard makes facilities and equipment investments, all ships under contract during the life of those assets are allocated a portion of the assets’ indirect costs. Therefore, if the number of ships under construction at a given time in a shipyard increases, the indirect costs per ship decrease, and if the number of ships under construction at a given time in a shipyard decreases, the indirect costs per ship increase.

Summary

The DoD’s 30 Year Shipbuilding Plan provides a framework for promoting stability in the shipbuilding industry and supporting decision making for long term capital investment and workforce planning. Industrial base considerations are an important element that factor into the formulation of this plan. The Navy monitors and considers the health of major suppliers, the component supply base and commodity materials. In reviewing the health of the Navy’s shipbuilding industrial base, the Navy examines not only production labor employment, but also engineering capabilities, facility capabilities and efficiency, the overall health and demographics of the workforce, and the financial strength of key industry partners. In addition to these considerations, the Navy has applied other methods where feasible to promote long-term stability through MYP contracts, encourage shipyards to compete for commercial workload via SCPAs, and has used other innovative strategies to promote capital investment. The result is DOD’s plan; which takes into account the Navy’s current battle force inventory, retirement and recapitalization plans for these ships, and current acquisition plans. The Navy will continue to assess the industrial base for risk as it executes this shipbuilding plan and will address industrial base matters with industry and Congress in the course of programming future years’ shipbuilding budgets, formulating industrial base policies, and implementing acquisition strategies.