U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL

REPORT ON AUDIT OF

IMPLEMENTATION OF THE ACCOUNTABILITY RULE

Report No.: DOE/IG-0339
Date of Issue: January 21, 1994

Eastern Regional Audit Office
Oak Ridge, TN 37830

DOE F 1325.8
(8-89)
EFG (07-90)

United States Government **Department of Energy**

memorandum

DATE: January 21, 1994

REPLY TO ATTN OF: IG-1

SUBJECT: INFORMATION: Report on "Audit of Implementation of the Accountability Rule"

TO: The Secretary

BACKGROUND:

In 1991, the Department's procurement regulations were revised to hold contractors liable for many costs that were historically assumed by the Department. The objective of this revision was to improve the overall performance of contractors by increasing their financial risk for inappropriate actions while providing the contractors with the opportunity to earn increased fees. The Department standardized the determination of the level of risk assumed by the contractor and provided that contracts which involved higher levels of risks be placed in higher categories and be eligible for higher award fees. The Department also adjusted the fee schedule for inflation which had occurred since 1982. This revision to the procurement regulations is commonly referred to as the "Accountability Rule." The purpose of the audit was to determine whether the implementation of the Accountability Rule resulted in improved performance and increased financial risk for contractors. The attached report is being sent to inform you of our finding and recommendations.

DISCUSSION:

Our audit of five contractors and four Departmental field offices disclosed that, in Fiscal Year 1992, the Department spent $22.8 million in increased contract fees and $2.5 million in administrative costs to implement the Accountability Rule with no conclusive evidence that the Accountability Rule was achieving its objectives. An additional $4 million was paid to these contractors to adjust for inflation which had occurred since 1982. However, we did not consider this a cost of implementing the Accountability Rule. The primary cause of this condition was that the Department had not fully evaluated the potential costs and benefits of the Accountability Rule prior to its implementation.

The key report recommendation was that the application of the Accountability Rule to additional contractors be deferred until a cost-benefit analysis was conducted to determine whether the program was cost-effective. We also recommended that the Department develop improved guidance for those contractors already covered by the Accountability Rule.

The Office of Procurement, Assistance, and Program Management has initiated a cost-benefit analysis of the Accountability Rule program and has revised certain policies and procedures. However, the Office of Procurement, Assistance, and Program Management has deferred action on the other report recommendations until completion of the cost-benefit analysis. Details of the finding are the subject of part II of the report. Management and auditor comments are in part III.

John C. Layton

John C. Layton
Inspector General

Attachment

cc: Deputy Secretary
Acting Deputy Director, Office of Procurement, Assistance and Program Management

REPORT ON AUDIT OF
IMPLEMENTATION OF THE ACCOUNTABILITY RULE

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U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL
OFFICE OF AUDITS

REPORT ON AUDIT OF IMPLEMENTATION OF THE ACCOUNTABILITY RULE

Audit Report Number: DOE/IG-0339

SUMMARY

In 1991, the Department of Energy procurement regulations were revised to motivate contractors to improve their performance in the operation and management of Departmental facilities. The Department attempted to realize this objective by increasing the accountability and liability of contractors and providing contractors with the opportunity to earn increased fees. The Department standardized the determination of the level of risk assumed by the contractor and provided that contracts which involved higher levels of risks be placed in higher categories and be eligible for higher award fees. The Department also adjusted the fee schedule for inflation which had occurred since 1982. These revisions to the procurement regulations are commonly referred to as the "Accountability Rule." The objective of the audit was to determine whether the implementation of the Accountability Rule resulted in improved performance and increased financial risk for management and operating contractors.

Our audit disclosed that the Department had spent $25.3 million in Fiscal Year 1992 to implement the Accountability Rule with no conclusive evidence that the Accountability Rule was achieving its objectives. For five contracts, the Department had spent $22.8 million in increased contract fees and $2.5 million in administrative costs without any appreciable improvements in contractor performance. (An additional $4 million was paid these contractors to adjust for inflation; however, we did not consider this a cost of implementing the Accountability Rule.) Furthermore, the contract costs disallowed and recovered under the Accountability Rule were insignificant. The primary cause was that the Department had not fully evaluated the potential costs and benefits of the Accountability Rule prior to its implementation. The audit also disclosed a number of issues pertaining to the Accountability Rule that needed to be resolved.

Management agreed to conduct the cost-benefit analysis that we recommended to determine the cost effectiveness of the Accountability Rule. It did not agree to suspend further application of the Accountability Rule until a basis is developed for measuring its benefits.

Office of Inspector General

Office of Inspector General

PART I

APPROACH AND OVERVIEW

PURPOSE AND OBJECTIVES

For over 40 years, the Department and its predecessor organizations had followed a policy that reimbursed management and operating contractors for practically all costs incurred by contractors in the performance of the contracts. In 1991, the Department amended the Departmental acquisition regulations to hold profit-making contractors liable for many costs that were historically assumed by the Department. The objective of this revision was to improve the overall performance of contractors by increasing their financial risk for inappropriate actions.

The purpose of the audit was to review the implementation of the Accountability Rule by management and operating contractors. Specifically, the objective of the audit was to determine whether the implementation of the Accountability Rule resulted in improved performance and increased financial risk for selected management and operating contractors.

SCOPE AND METHODOLOGY

The audit was performed from August 13, 1992, through February 5, 1993, at the Office of Procurement, Assistance, and Program Management, Washington, DC; and the locations listed in the following table.

DOE and Contractor Activities

DOE Contractors	DOE Offices
Martin Marietta Energy Systems, Inc. (2 contracts)	Oak Ridge
EG&G Idaho, Inc.	Idaho Falls
EG&G Rocky Flats, Inc.	Rocky Flats
Mason and Hanger-Silas Mason Company	Albuquerque
Wackenhut Services, Inc.	Rocky Flats

We reviewed the implementation of the Accountability Rule as it related to the allowability of contract costs for Fiscal Year 1992 for six contracts with five management and operating contractors. Energy Systems had two management and operating contracts, one for three facilities in Oak Ridge, Tennessee, and another for uranium enrichment facilities in Kentucky and Ohio. The estimated costs of these six contracts for Fiscal Year 1992 exceeded $3.7 billion. The audit included an analysis of actions taken by the Department through January 31, 1993, to resolve potential avoidable costs.

The following specific methodologies were used:

- Researched the rulemaking process for revisions to the Department procurement regulations;
- Examined applicable Departmental regulations and acquisition letters;
- Reviewed pertinent provisions in the Department contracts with selected management and operating contractors;
- Reviewed operations office and contractor policies and procedures for identifying, reporting, and reviewing avoidable contract costs;
- Examined records and reports prepared by contractors for the reporting of avoidable costs;
- Interviewed Departmental and contractor officials who had direct authority and responsibility for the implementation of the Accountability Rule;
- Analyzed contracting officers' determinations of potential and actual contract fees; and
- Assessed the direct costs to implement and administer the provisions of the Accountability Rule.

The audit was made according to generally accepted Government auditing standards for performance audits, and it included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objective. We assessed the significant internal controls with respect to the contract award and administration of the Accountability Rule provisions. We also assessed the contractors' compliance with applicable Departmental regulations and contractual requirements. We noted an internal control weakness resulting from a lack of sufficient policies and procedures to ensure the effective implementation of the Accountability Rule. Also, we noted major deviations from the Departmental acquisition regulations in the provisions incorporated in two contracts with Energy Systems. The internal control weakness and deviations in contract clauses are discussed in part II of this report. Because our audit was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed.

The firm of Irving Burton Associates, Inc., participated with the Department's Office of Inspector General in conducting the audit. An exit conference was held on October 25, 1993, with the Director, Office of Contractor Management, Office of Procurement, Assistance and Program Management.

BACKGROUND

For over 40 years, the Department and its predecessor organizations had followed a policy that reimbursed management and operating contractors for practically all costs incurred by contractors in the performance of the contracts. These reimbursements included costs relating to nuclear incidents, fines and penalties, loss of or damage to Government property, and the mismanagement of facilities and programs. The only exceptions were those costs that could be directly attributed to willful misconduct or lack of good faith by a top contractor official.

In January 1990, the Department changed its policy on fully indemnifying management and operating contractors for all contract costs, and it issued for public comment a proposed rule that revised the Departmental acquisition regulations to expand the risks and accountability of profit-making management and operating contractors for their actions in operating the Departmental facilities. The Department developed guidelines that held management and operating contractors rather than the Government responsible for costs that could have been avoided by the actions of a prudent contractor. This new policy is commonly referred to as the "Accountability Rule," and it added another type of unallowable costs referred to as "avoidable costs." Specifically, a contractor could be held liable for the following types of avoidable costs if they resulted from negligence or willful misconduct by contractor or subcontractor personnel:

- Fines and penalties;
- Unnecessary or excessive direct program costs; and
- Damage, destruction, loss, and theft or unauthorized use of Government property.

Under the Accountability Rule, the Department essentially relied on contractor self-reporting to identify avoidable costs. The advantage to a contractor for reporting avoidable incidents is that such contractors are to be more favorably considered with regard to performance for award fee purposes.

In connection with the adoption of the Accountability Rule, the Department also revised the fee structure to provide for significant increases in the fees that could be earned by management and operating contractors. The increased fees were provided to compensate contractors for greater financial risks assumed under the Accountability Rule and to make an adjustment for inflation since 1982. The contractors' liabilities for avoidable cost were limited to the amount of fees (both basic and award fees) earned by the contractors during the period when the avoidable events occurred.

Incorporation of Rule Provisions in Contracts

At the time of the audit, the Accountability Rule requirements had been incorporated into 16 of 31 profit-making management and operating contracts. The initial Departmental contracts to incorporate the Accountability Rule were with Energy Systems. The two contracts with Energy Systems (DE-AC05-84OR21400 and DE-AC05-76OR00001) were modified in March 1991 to incorporate the Accountability Rule, and the effective date for these provisions was October 1, 1991. The contract with EG&G Rocky Flats was signed in August 1991, but the Accountability Rule provisions were retroactive to April 1, 1991. Subsequently, the Department modified existing contracts or negotiated new contracts with management and operating contractors to implement the Accountability Rule.

Prior Audits and Inspections

In October 1991, the General Accounting Office issued a report entitled "Tightening Fee Process and Contractor Accountability Will Challenge DOE" to the Chairman of the Senate Committee on Governmental Affairs. The General Accounting Office review concluded that the Department's Albuquerque Operations Office's use of performance objectives for determining award fee did not result in effective evaluations of contractor performance and that the Department's implementation of the new Accountability Rule would be difficult until the Department developed new management procedures and provided technical training for its staff. In addition, the General Accounting Office concluded that contractors might be eligible for increased compensation (fees) long before the Department is able to fully implement the Accountability Rule. As directed by the Committee Chairman, The General Accounting Office did not obtain Departmental comments on the report.

The Department's Office of Inspector General also reviewed the implementation of the Accountability Rule as part of a general management inspection of the Department's Nevada Operations Office. In a May 1992 report, the Office of Inspector General stated that while no recommendations were made regarding the Accountability Rule it had advised senior Departmental officials of its concerns as to whether sufficient staff would be provided to administer the rule. Subsequently, a Departmental official stated that while it planned to rely in part on contractor "self-reporting," the Department also planned to realign organizations and add resources and procedural controls to increase oversight of contractors' operations.

OBSERVATIONS AND CONCLUSIONS

The audit disclosed that the Department spent significant funds in Fiscal Year 1992 to implement the Accountability Rule with no conclusive evidence that the Accountability Rule was achieving its objectives. The Department paid increased fees of $22.8 million (exclusive of $4 million for inflation) for five management and operating contracts and incurred $2.5 million in administrative costs relating to the Accountability Rule. Notwithstanding the increased expenditures, award fee evaluation scores in Fiscal Year 1992 for five contracts did not indicate any significant improvements in contractor performance. Furthermore, under six contracts with estimated Fiscal Year 1992 costs of over $3.7 billion, the contractors had reported only $975,810 in avoidable costs, an insignificant amount compared to

$3.7 billion. These conditions existed because the Department had not evaluated the cost-effectiveness of the Accountability Rule prior to its implementation. Further, other unresolved contributing factors identified during the audit were that the Department had not: (1) issued sufficient implementing policy guidance, (2) established baseline or benchmark data, (3) developed contract provisions that significantly increased the contractors' liabilities, (4) devised a fee structure that fully motivated contractors to improve performance, (5) precluded inequities in the contract provisions negotiated with contractors, and (6) provided sufficient staffing of the Department's operations offices. Please see page 9, "Finding and Recommendations," for details.

The internal control weakness in implementing policies and procedures identified during the audit is significant enough for the Department to include the weakness with other weaknesses in its yearend assurance memorandum on internal controls.

PART II

FINDING AND RECOMMENDATIONS

Realizing Objectives of the Accountability Rule

FINDING

In 1991, the Department implemented the Accountability Rule to expand the risk and accountability of profit-making management and operating contractors for their actions in managing Departmental facilities. The Accountability Rule also revised the fee structure to compensate contractors for greater financial risk and to provide incentives for improved performance. However, after 18 months of implementation, we found that the Department had no conclusive evidence that the Accountability Rule was achieving its objectives. Although the Department had increased fees paid to the contractors by $22.8 million (exclusive of $4 million for inflation) for five contracts and had funded $2.5 million in annual expenses to administer the Accountability Rule for six contracts, it had not received any measurable benefits in return for this investment. No significant improvements were evident in contractor performance, and the extent of changes in contractor liability were minimal. The primary cause of this condition was that the Department had neither determined whether the Accountability Rule was cost effective nor whether it provided significant and measurable benefits to the Department. The audit also disclosed unresolved factors that impeded the accomplishment of program objectives. These were: (1) shortcomings in implementing guidance and direction, (2) lack of baseline or benchmark data, (3) the use of contract provisions that had not significantly increased or altered the contractors' liabilities, (4) a fee structure that did not maximize the incentives for contractors to improve performance, (5) negotiation of contract deviations that significantly reduced the liability of a management and operating contractor, and (6) failure of the Department to augment the staff of its operations offices.

RECOMMENDATIONS

We recommend that the Deputy Director, Office of Procurement, Assistance, and Program Management:

1. Suspend the application of the Accountability Rule to additional management and operating contractors until a basis is developed for measuring benefits derived from the application of the Accountability Rule and a cost-benefit analysis is conducted to show that the program is cost effective;

2. For contracts covered by the Accountability Rule:

   a. Revise award fee process to:

      (1) Provide for specific incentives for cost reduction by incorporating into the award fee process a factor to rate the management and operating contractors on cost reductions resulting from initiatives they identify and implement; and

      (2) Incorporate an award fee criteria that will provide contractors with specific incentives to effectively manage and control contract costs.

   b. Issue policy and procedural guidance for the Department's operations/field offices to cover, at a minimum:

      (1) Costs categories to be included in computing avoidable cost incidents;

      (2) A reporting threshold of $5,000 for all excessive direct program costs and losses and damage of Government property; and

      (3) Exclusion of fixed-price subcontractors from the Departmental Accountability Rule provisions.

3. Reevaluate the provisions of the Department's contract (DE-AC05-84OR21400) with Energy Systems at the next renewal in order to delete those contract provisions that substantially deviate from the Accountability Rule provisions contained in the Departmental acquisition regulations.

MANAGEMENT REACTION

Management agreed to conduct the recommended cost-benefit analysis. However, management did not agree to suspend further application of the Accountability Rule until a basis was developed to measure the benefits of the program. Further, management indicated that the extent of actions to be taken on recommendations 1, 2(a)(1), 2(a)(2), and 2(b)(1) and 3 were largely dependent on the results of a planned cost-benefit analysis and other actions. Part III of the report provides detailed management and auditor comments.

DETAILS OF FINDING

OBJECTIVES OF THE ACCOUNTABILITY RULE

On July 19, 1991, the Department amended its acquisition regulations and issued the Accountability Rule. One of the Department's primary objectives in implementing the new rule was to emphasize the importance it placed on the responsibility and accountability of management and operating contractors for excellent performance, particularly in the areas of environment, health and safety, in managing and operating Department facilities.

Under the Accountability Rule, profit-making management and operating contractors are accountable and liable for certain costs that were historically borne by the Department and its predecessor organizations. Another type of unallowable costs, referred to as "avoidable costs," was established consisting of fines and penalties, losses or damage to Government property, and other excessive or unnecessary direct program costs. At the same time, the Department substantially increased the potential fees that contractors could earn to compensate them for the increased financial risk being assumed under the Accountability Rule. Contracts which involved higher levels of risks were to be placed in higher categories and be eligible for higher award fees. The major increase occurred in the basic fee which now equals the full amount of standard fee that may be paid under a cost-plus-fixed-fee contract. Prior to the Accountability Rule, the basic fee was limited to a range of 0 to 50 percent of the standard fee for a cost-plus-fixed-fee contract. Under the Accountability Rule, the Department also adjusted the fee schedule for inflation which had occurred since 1982. The contractors included in this audit were paid $4 million to adjust for inflation; however, we did not consider this a cost of implementing the Accountability Rule.

The objective of these revisions to the acquisition regulations was to motivate contractors to improve their performance and avoid unnecessary costs by exercising prudent management actions. Departmental officials believed that unnecessary costs could be avoided or minimized if contractors were made financially liable for costs resulting from negligence or willful misconduct by contractor or subcontractor employees.

BENEFITS ENVISIONED FOR THE ACCOUNTABILITY RULE UNREALIZED

After 18 months and the expenditure of $25.3 million (exclusive of $4 million for inflation) to implement and administer the Accountability Rule, the Department had no conclusive evidence that the objectives for the program were being achieved. The Department could not document any significant improvements in contractor performance during this period. Also, the impact of the Accountability Rule upon the financial liability of contractors was minimal.

Contractor Performance

The Department's operations offices and contractors had undertaken various initiatives as part of the implementation of the Accountability Rule attempting to positively affect the performance and costs of contractors. Senior Department and contractor officials, to varying degrees, had emphasized and devoted resources to furthering the effective implementation of the Accountability Rule.

Although the Department had taken these initiatives, there was no information available to readily measure the impact of these actions. Further, the Department had no evidence that confirmed any substantive change in contractor performance or showed whether the Accountability Rule had any impact on the performance of the contractors. The only comprehensive data available for assessing contractor performance were those generated under the award fee performance evaluation process. While the Department had undertaken actions to improve the objectivity of this evaluation process in recent years, including establishing tighter evaluation standards, the evaluation process still contained many subjective factors that have a major impact upon the final rating score. Nevertheless, this evaluation process produced the only data that were readily available for measuring the overall performance of a contractor.

The performance evaluation scores for five of the six contracts included in the audit did not indicate any significant change in contractor performance, or any improvements resulting from implementation of the Accountability Rule. The sixth contract with EG&G Rocky Flats was not converted to a cost-plus-award-fee contract until April 1, 1991. We compared award fee rating scores for Fiscal Years 1991 and 1992 that the Department assigned to the five contracts.

AWARD FEE PERFORMANCE RATING SCORES

M&O Contractor	FY 1991	FY 1992	Improvement (Decline)
Energy Systems-Oak Ridge	85.5	83.5	(2.0)
Energy Systems-Uranium Enrichment	83.5	84.2	.7
EG&G Idaho	86.6	87.0	.4
Mason and Hanger	88.9	86.8	(2.1)
Wackenhut Services	84.6	83.2	(1.4)

As the chart shows, there were no significant changes or improvements in contractor performance between the two fiscal years. In fact, the overall performance ratings declined for three of the five contractors. Since these ratings represent the only documented basis for judging contractor performance, they did not support a conclusion that the Accountability Rule achieved the objective established by the Department.

Impact Upon Financial Liability

Under the Accountability Rule, the Department envisioned that contractors would be held responsible for their actions in operating Departmental facilities. The contractors' risk and accountability were expanded to hold them responsible for costs that could have been avoided. The Department's operations offices encouraged each contractor to submit periodic reports on potential avoidable cost events.

The impact of the Accountability Rule upon the financial liability of contractors for Fiscal Year 1992 was also questionable. In FY 1992, contractors reported 578 avoidable cost incidents. Details for each contractor are shown in the following table.

AVOIDABLE COST INCIDENTS REPORTED BY M&O CONTRACTORS FOR FISCAL YEAR 1992

M&O Contractor	Avoidable Costs Incidents	Avoidable Costs Dollar Value
Energy Systems - Oak Ridge - Uranium Enrichment	290	$776,260
EG&G Idaho	84	149,370
EG&G Rocky Flats	95*	**
Mason and Hanger	13	36,305
Wackenhut Services	96	13,875
Totals	483	$975,810

Note: * Excluded from total.
** Incidents not costed at the time of audit.

As shown above, the 483 incidents involved $975,810 in avoidable costs. This is an insignificant amount in relation to the $3.7 billion expended by these five M&O contractors.

The Department's operations offices had not completed their reviews and evaluations of all potential avoidable cost incidents applicable to Fiscal Year 1992 contract costs. However, the operations offices had identified avoidable cost incidents not reported by the contractors. While the final costs for most of these incidents had not been determined, they did include some significant incidents involving millions of dollars. To illustrate, the Rocky Flats Office had identified a potential avoidable cost event relating to a $10 million cost overrun by EG&G Rocky Flats for a waste management project. Also, the Oak Ridge Operations Office had identified an environmental cleanup matter with estimated costs of about $1 million that Energy Systems could have avoided by following applicable regulations.

The contractors did not always agree that the incidents identified by operations office personnel necessarily constituted avoidable cost incidents. At the time of the audit the appropriate contracting officers had not determined whether these incidents, as well as the 483 incidents reported by the contractors, involved avoidable costs. If these incidents are determined to be avoidable, costs of $975,810 associated with the incidents are to be treated as unallowable under the terms of the contracts.

Affect on Fees

The substantial increases in fees to the contractors were in sharp contrast to the record of contractor performance. The fees paid to the contractors in Fiscal Year 1992 were 51.7 percent higher (exclusive of inflation) than those paid for the prior fiscal year. The following chart compares the changes in performance ratings and the changes in fee structure by contracts between Fiscal Years 1991 and 1992.

CHANGES IN PERFORMANCE RATINGS AND FEES
BETWEEN FISCAL YEARS 1991 AND 1992 *

Contractor	Increase (Decrease) in Performance Ratings	Increase in Fees ** (000's)
Energy Systems-Oak Ridge	(2.0)	$14,162
Energy Systems-Uranium Enrichment	.7	2,223
EG&G Idaho	.4	3,038
Mason and Hanger	(2.1)	2,980
Wackenhut Services	(1.4)	397
Totals		$22,800

* Comparative data not available for EG&G Rocky Flats.

** All amounts are exclusive of inflation.

The chart shows that increases in fees awarded to contractors under the Accountability Rule were significant despite an overall drop in performance ratings, with specific declines in numerical ratings at three of the five contractors. All four contractors earned more fees in Fiscal Year 1992 than they earned in Fiscal Year 1991, even though their performance levels were substantially the same for the two periods. Further, the "Notice of Revised Proposed Rulemaking," dated August 10, 1990, for the Accountability Rule stated that "contractors would have to average a score of approximately 86 percent or higher before the total fees paid would exceed those paid under the current system." That was not the case with the contractors included in the audit. Four of the five contractors received higher fees (basic plus award fee) in Fiscal Year 1992 than they received in Fiscal Year 1991, even though their performance ratings stayed essentially the same or declined. The fifth contractor was under a cost-plus-fixed-fee contract for the first half of Fiscal Year 1991 and was, therefore, not entitled to additional fee.

Administration Costs

In addition to the increased fees, the Department also spent $2.5 million to administer the program at the locations reviewed. These administration costs were incurred by the Department's operations offices and the contractors to identify and review avoidable cost incidents. The four operations offices spent about $1.3 million, and the five contractors spent about $1.2 million. The Department funded all these costs as allowable contract costs. We based our calculations on cost estimates that the operations offices and the contractors provided us and on our computations of costs based on salaries for operations office and contractor employees who were involved in program administration. These operating expenses do not include those incurred by contractor line personnel to investigate and prepare initial reports for potential avoidable cost incidents. Nor do they include the time spent by the Department and contractor legal personnel to review and prepare position statements on individual incidents. We believe that such costs could be significant.

Concerns of the Department's Managers

The audit disclosed that the managers of three of the Department's operations offices shared our reservations about the success of the Accountability Rule. Consistent with the audit results, they questioned whether the Accountability Rule had contributed to improved performance or increased financial risk. For example, the Manager, Oak Ridge Operations Office, in advising the Assistant Secretaries for Defense Programs and Nuclear Energy of the results of its performance appraisal of Energy Systems for the 6-month period ended March 31, 1992, stated the following:

> We continue to be concerned about the contractor's inadequate initiative, the increased reliance on DOE [Department of Energy] to provide guidance on ways to perform the work, and the repetitive inability of the contractor to implement lessons learned among the three plants in Oak Ridge... and the Paducah and Portsmouth plants...
>
> A higher level of contractor performance and a greater volume of contractor-identified avoidable costs were

> expected when available fees were increased by the Accountability rule. The contractor has not improved performance nor identified a reasonable amount of avoidable costs. However, under the revised fee schedules implementing the accountability rule, we are required to pay the contractor increased basic fee and provide the potential for increased award fee...Therefore, for a performance level which declined in comparison to the last period, the contractor will earn a net increase...($8 million -- $7.6 million for Oak Ridge facilities and $408,000 for Paducah and Portsmouth facilities) in total fee. OR [Oak Ridge Operations Office] awarded the first two contracts in the Department which incorporated the accountability rule. The potential for increased fees at other DOE sites will exist as accountability rule provisions are negotiated into more contracts.

Similar concerns were expressed by the managers of the Albuquerque and Idaho Falls Operations Offices.

FACTORS HAMPERING IMPLEMENTATION OF ACCOUNTABILITY RULE

A major factor hampering effective implementation of the Accountability Rule was the lack of a detailed cost-benefit analysis. In addition, other unresolved factors must be addressed in the operation and administration of the program, if the program continues.

Cost-Benefit Analysis

The Department had not conducted a detailed cost-benefit analysis of the Accountability Rule. A cost-benefit analysis involves the identification and comparison of the costs required to implement and administer the Accountability Rule along with the measurable benefits to be realized from its application. Cost factors include increased award fees and costs of the operations offices and contractors to administer the program. The potential benefits include reductions in contract costs resulting from the elimination of fines, lost or damaged property, excessive program costs, and improved contractor performance. Data essential to conducting such an analysis had not been identified and quantified by the Department. For example, historical cost data had not been accumulated on fines, lost and damaged property, and excessive program costs.

Ideally, the Department should have tested the application of the Accountability Rule contract provisions with a limited number of management and operating contractors prior to the rule's adoption on a Department-wide basis. The Departmental Headquarters had considered a test effort but subsequently decided against such an effort due to external pressures on the Department to increase the accountability and performance of management and operating contractors.

If the Department had analyzed the costs versus benefits, and tested the application of the Accountability Rule prior to its implementation, many of the problems and obstacles now being encountered might have been avoided. To ensure that this situation does not continue, the Department needs to consider suspending the application of the Accountability Rule until a basis is developed for measuring benefits to be derived and a cost-benefit analysis conducted to show that the program is cost effective. In addition, some fundamental changes are required in the operation and administration of the program, if the program continues.

In response to a draft of this report, the Office of Procurement, Assistance and Program Management indicated that it had initiated a cost-benefit analysis of the Accountability Rule program. We were informed that the analysis would review the same information the OIG evaluated plus similar information for the past year. However, management did not believe that implementation of the Accountability Rule should be suspended until the study was completed. The analysis is expected to be completed during the first quarter of Fiscal Year 1994.

We believe conducting the study is a positive action. However, we believe that the rule should not be applied to additional management and operating contractors until a determination has been made on its cost effectiveness. To continue the application of the rule to additional contractors could be very costly to the Department if it is subsequently determined that the program is not cost effective.

Other Unresolved Factors

The audit also disclosed a number of unresolved factors that contributed to the problems encountered by the Department in implementing and realizing the benefits envisioned for the Accountability Rule. These were:

- Shortcomings in implementing policy guidance,

- Lack of baseline or benchmark data,

- Limitations on the liability of contractors,

- Use of a fee structure that did not provide real incentives for contractor to improve performance,

- Negotiation of contract deviations that significantly reduced the liability of a contractor, and

- Failure to augment the Department's staff to administer the Accountability Rule.

Implementing Policy Guidance

The Departmental Headquarters had not developed definitive policy guidance needed for the effective implementation of the Accountability Rule by operations offices and contractors. In the absence of such guidance, significant delays in implementation were encountered because of major disagreements that arose between the operations offices and contractors as to the intent or interpretation of certain contract provisions relating to the Accountability Rule. The more significant disagreements concerned the cost elements to be included in computing the amount of avoidable costs and the dollar reporting thresholds.

Cost Elements. A prerequisite to disallowing costs for avoidable cost events is a determination as to the cost elements to be included in such a determination. The Department had not identified in either its acquisition regulations or separate policy guidance what elements of costs should be included in costing an avoidable cost incident. That is, whether the costs for the incident should include only incremental or increased costs incurred as a result of the incident, or whether the incident should be costed like other unallowable cost to include direct labor, material, burden, and overhead expenses. The operations offices and contractors could not agree as to what costing method should be used for avoidable cost incidents. About 18 months after implementation of the Accountability Rule, only one of the operations offices and one of the contractors we visited had agreed on a costing method.

One contractor contended that if no additional costs such as for overtime pay or materials were incurred then no avoidable cost incident had occurred. Contractor officials believed the Departmental acquisition regulations supported their position. Subpart 970.5204-56 of the acquisition regulations defines avoidable costs and states that an avoidable cost incident occurs when "increased costs or expenses result from the negligence or willful misconduct of the contractor or subcontractor personnel."

The Departmental Headquarters and operations offices generally favored a costing method that would provide for full cost recovery such as the method used to cost all other unallowable costs. The lack of definitive guidance in this area hampered effective implementation of the Accountability Rule.

<u>Dollar Reporting Thresholds</u>. Significant costs are involved in identifying, screening, reporting, and reviewing potential avoidable cost incidents. The layers of review, number of personnel directly involved, paperwork requirements, and review processes were quite extensive at some operations offices and contractor locations. For example, each potential avoidable cost incident at one contractor location was reviewed by nine layers of management before a final decision was made to classify the incident as a potential avoidable cost incident. Some operations offices and contractors had committees to make a preliminary determination on whether an incident involved avoidable costs.

Since the cost of these reviews can be significant, processing these costs can exceed the dollar value of the avoidable cost event. To illustrate, an avoidable cost incident at one contractor involved a bullet hole in the window of a guard building. About $40,000 was spent to investigate the incident and prepare a report. The contractor reported avoidable costs of $1,471 for this incident. To preclude such situations, a dollar threshold for reporting avoidable cost events was needed. However, the Departmental Headquarters did not establish reporting thresholds for avoidable cost events until August 24, 1992, or 11 months after the implementation of the Accountability Rule. This guidance provided for a $1,000 reporting threshold for direct program avoidable costs. However, no threshold existed if the direct avoidable costs were identified by the Departmental employees. All fines, penalties, and losses or damage to capital equipment, motor vehicles, sensitive items, precious metals, and stores inventories were to be reported regardless of dollar value. A common threshold should have been established for both parties.

The Department should reconsider its policy guidance on reporting threshold for losses and damage to property. In Fiscal Year 1992, four of the contractors included in the audit had reported 483 avoidable cost incidents with a total estimated cost of $975,810. Most of the avoidable cost incidents reported by contractors in Fiscal Year 1992 involved losses and damage to property. Of the 483 incidents, 27 (6 percent) incidents had estimated costs in excess of $5,000, and they accounted for $791,181 or 82 percent of the total costs for all reported events. Had the Department limited the reporting of incidents to those in excess of $5,000, it could have avoided the processing costs for 456, or 94 percent, of the incidents.

Lack of Baseline or Benchmark Data

The Department had not developed a basis for determining whether or not the objectives of the Accountability Rule were subsequently realized. This would also require historical cost data on fines, lost and damaged property, and excessive program costs. An objective of the Accountability Rule was to reduce costs related to such matters, yet the Department had not accumulated historical cost information necessary to analyze contractor operations. Without a baseline or benchmark data, the Department cannot measure the progress being achieved under the Accountability Rule.

It should be noted that in recent years there has been increased emphasis within the Government regarding new performance measurement initiatives. These initiatives are part of a trend towards more performance measurement of the progress of Government programs. To evaluate performance of a program such as the Accountability Rule, the Department should consider developing performance indicators that focus on the level of achievement of objectives.

Limitations on Liability of Contractors

The contractor's liability for avoidable costs is limited to the fees it is paid by the Department. No corporate funds are at risk as is the case with other unallowable contract costs. In contrast, under all other allowable cost provisions, contractors are fully liable for all disallowed costs regardless of the dollar amount. The initial draft of the Accountability Rule held contractors liable for all unallowable avoidable costs up to the potential fees they could earn. This liability was changed from potential to earned fees in subsequent drafts of the Accountability Rule.

The Departmental acquisition regulations defines avoidable costs as increased costs or expenses resulting from the negligence of contractor employees. This definition could significantly limit the liability of contractors as compared to the reasonableness provisions. Under the reasonableness provisions, all the costs would be unallowable regardless of whether they involved increased or additional costs.

The ability of Departmental contracting officers to prove beyond a reasonable doubt that the act was due totally to negligence or willful misconduct of contractor employees and that the Department was not involved in any manner can be a very complex and time-consuming endeavor. Judgements will be required as to the intent of contractor employees involved in avoidable cost incidents. Undoubtedly, the more significant cases will be elevated to the courts for resolution of the legal issues involved.

Finally, the application of the Accountability Rule to fixed-price subcontracts inappropriately reduced the financial liability of subcontractors. The Departmental acquisition regulations requires that the Accountability Rule be applied to all subcontracts, regardless of whether they are cost or fixed-fee type subcontracts. Under the Accountability Rule, the liability of fixed-price subcontractors was limited to the amount of fee or profit actually earned under the subcontract. The normal liability of fixed-price subcontractors was unlimited. That is, no dollar limitation existed on the subcontractor's liability for failing to comply with the terms of the subcontract.

Fee Structure

The fee structure developed in conjunction with the implementation of the Accountability Rule placed more emphasis on basic fees rather than award fees. Providing a larger share of the fee as basic fee does not necessarily provide additional incentives for contractors to improve performance and lower contract costs, because the higher the contract costs the higher the potential basic fee. If fees are to be used to motivate contractors to higher performance levels, then increased emphasis should be placed upon award fees rather than basic fees. This was not the case with the Accountability Rule, because the major increase occurred in the basic fees. The basic fee now equals the full amount of standard fee that may be paid under a cost-plus-fixed-fee contract. Prior to the Accountability Rule, the basic fee (formerly called base fee) was limited to a range of 0 to 50 percent of the standard fee for a cost-plus-fixed-fee contract. Please see appendix A for details on the fee schedules before and after the Accountability Rule.

Cost Reduction Actions. According to a draft of the Accountability Rule, the Department's prior reimbursement practices may not have provided the appropriate incentives for contractors to minimize their costs. Such an objective could be more readily and effectively realized by tying cost reductions to award fee payments. A contractor could be provided award fees for cost reductions. Conversely, the basic and award fee for contractors could be reduced if the contractor experienced excessive cost overruns or losses or damage to Government property. The advantage of this approach as compared with the Accountability Rule is that fee determinations are not subject to appeal by the contractor as are disallowed contract costs under the Accountability Rule. Contractors may appeal to the courts unallowable cost determinations by the Departmental contracting officers.

The Departmental contract with EG&G Idaho was modified in April 1992 to include a cost reduction program. EG&G Idaho may earn additional fees for documented savings in operating costs resulting from actions that EG&G Idaho identified and implemented. The contractor is entitled to 15 percent of the operating cost savings for the fiscal year. The performance of this program is being reviewed by the Office of Inspector General to determine if effective controls exist to ensure that program objectives are achieved and that the program complies with applicable laws and regulations.

In summary, we concluded that the Accountability Rule provided no real incentives to reduce costs, but rather it encouraged the expenditure of additional funds in order to preclude avoidable cost incidents. Such cost avoidance actions could easily exceed the cost of the potential avoidable costs.

Negotiation of Contract Deviations

Four of the contracts we reviewed contained the contract clauses set forth in the Departmental acquisition regulations without any major changes or deviations. In contrast, major differences existed in the clauses in the two Energy Systems contracts. The most significant deviation in the Energy Systems contracts dealt with the factors and method to be used to determine the allowability of avoidable costs.

Subpart 970.3102-22 of the acquisition regulations provided that the contracting officer shall consider, among other factors, 10 "mitigating" factors in determining the allowability of avoidable costs (please see appendix B for a listing of the 10 mitigating factors). The contracting officer may determine that because of these mitigating factors that all or a portion of the avoidable costs may be allowed to the contractor. The Departmental acquisition regulations specifically states: "This decision will be made by the Contracting Officer." In contrast, the Energy Systems contracts state: "Avoidable costs are not incurred if any of the conditions [10 mitigating factors] identified in 970.3102-22 exist." This statement significantly reduces, if not substantially eliminates, the potential liability of Energy Systems for avoidable costs, and it shifts the responsibility for determining allowability from the contracting officer to the contractor. For example, one of the mitigating factors is the timely reporting of incidents. As long as Energy Systems voluntarily and timely informs the Departmental contracting officer of a condition that later results in the incurrence of avoidable costs, it is excused from all financial liability.

This condition resulted in the inequitable treatment of other management and operating contractors and weakened the Department's ability to fully enforce the Accountability Rule against Energy Systems. The Department agreed to the deviations to provide Energy Systems with an incentive to be the first management and operating contractor to accept the Accountability Rule. Departmental officials believed that after the initial contractor accepted the Accountability Rule it would experience fewer problems in negotiating similar requirements with other management and operating contractors. However, the Department encountered problems and delays in the subsequent negotiations with at least two contractors, because the contractors requested the same provisions as incorporated in the Energy Systems contracts. The Department did not acquiesce to the contractors' requests.

Failure to Augment Operations Office Staff

Departmental Headquarters did not provide the operations offices with additional personnel to administer the Accountability Rule. All the operations offices we visited had requested additional personnel for administration of the Accountability Rule program. However, the Departmental Headquarters had not approved the requests for additional personnel. As a result, the new workload involved with the administration of the Accountability Rule was assigned as additional duties to operations office employees. At three of the operations offices we visited, operations office officials were of the opinion that the lack of additional resources had contributed to delays in the review and investigation of avoidable cost incidents. The need for additional resources should be determined concurrent with the cost-benefit analysis.

PART III

MANAGEMENT AND AUDITOR COMMENTS

In responding to a draft of this report, the Director, Office of Contractor Management and Administration, Office of Procurement, Assistance and Program Management, agreed to conduct the recommended cost-benefit analysis of the Accountability Rule program. However, management did not agree to suspend the application of the Accountability Rule to additional contractors until it had developed a basis for measuring the benefits of the program. Further, management indicated that the extent of actions taken on recommendations 1, 2(a)(1), 2(a)(2), and 2(b)(1) and 3 were dependent on the results of the planned cost-benefit analysis or other actions. Management's comments on the recommendations and our responses follows.

Recommendation 1. Suspend the application of the Accountability Rule to additional management and operating contractors until a basis is developed for measuring benefits derived from the application of the Accountability Rule and a cost-benefit analysis is conducted to show that the program is cost effective.

Management Comments. Management stated it did not concur with the recommendation as written. Although a cost-benefit analysis was planned to be completed during the first quarter of Fiscal Year 1994, management did not agree that the program should be suspended at this time. Management was of the opinion that such an action would be premature in that insufficient information was available to conclude that the cost of the program exceeded the benefits or value of the program. Suspension of the program at the current time would be based on an assessment developed from incomplete analysis, anecdotes, preliminary and even questionable data. Suspending the program and then reinstalling the program at a later date would be labor intensive. Management did, however, state that appropriate action would be taken if the analysis indicated serious flaws in the Accountability Rule's design and implementation.

Auditor Comments. We believe management's agreement to conduct a cost benefit analysis is a positive action. However, we continue to question management's plans to apply the Accountability Rule to additional contractors. We considered all available facts and data, none of which supported the continuation of the Accountability Rule as now structured. It is important to note that our audit was the first attempt to assess the effectiveness of the program. Moreover, the managers of three operations offices had expressed strong reservations on the cost effectiveness of the Accountability Rule. Management had not developed or obtained any comprehensive data to determine the effectiveness of the program. In fact, management had not developed any criteria for measuring the benefits of the Accountability Rule. Without such a criteria, any subsequent cost-benefit analysis would be meaningless and open to subjective manipulations. While the audit covered only six contracts, we believe that the results are probably representative of the experiences of other contracts covered by the Accountability Rule.

Finally, we do not agree that it would be more labor intensive or costly to suspend further application of the Accountability Rule until a cost-benefit analysis is completed in a few months. On the contrary, it could be more costly to continue the application of the Accountability Rule to additional contractors if it is subsequently determined that the program is not cost effective. Once the Accountability Rule is incorporated into a contract, several years must pass before the contract expires and the Accountability Rule provisions may be cancelled.

<u>Recommendation 2</u>. For contracts covered by the Accountability Rule:

a. Revise award fee process to:

(1) Provide for specific incentives for cost reduction by incorporating into the award fee process a factor to rate the management and operating contractors on cost reductions resulting from initiatives they identify and implement; and

<u>Management Comments</u>. Management partially concurred with the recommendation and stated that the principle of enhanced incentivization of cost management is one that will be considered as a element of the accountability study. However, management stated that while changes may be indicated as a result of the study, it was unlikely that adjustments would be made in the award fee elements associated with accountability. The Department had several initiatives underway, separate from the accountability provisions, to develop methodologies to encourage contractors to manage program costs effectively.

(2) Incorporate an award fee criteria that will provide contractors with specific incentives to effectively manage and control contract costs.

Management Comments. Management partially concurred with the recommendation and stated that consideration will be given to additional incentives over and above those now included in performance evaluation plans.

b. Issue policy and procedural guidance for the Department's operations/field offices to cover, at a minimum:

(1) Costs categories to be included in computing avoidable cost incidents;

Management Comments. Management concurred with the recommendation and stated that Acquisition Guidance Letter Number 970-2 had been drafted. This letter addresses Accountability Rule costs, recovery of costs, and collection and accounting procedures. Further, additional guidance had been issued by the Controller regarding collection procedures.

(2) A reporting threshold of $5,000 for all excessive direct program costs and losses and damage of Government property; and

Management Comments. While management concurred with the recommendation, it stated that a final decision on this matter would be deferred until after the completion of the cost-benefit assessment.

(3) Exclusion of fixed-price subcontractors from the Departmental Accountability Rule provisions.

Management Comments. Management concurred with the recommendation and stated that the matter had been referred to the Office of General Counsel to investigate the opportunity for such an exclusion under the regulations.

Auditor Response. With regard to the management comments on recommendations 2(a)(1) and 2(a)(2), the results of the cost-benefit analysis have no direct impact upon these recommendations. The recommended actions can and should be implemented independent of the results of the cost-benefit analysis.

Recommendation 3. Reevaluate the provisions of the Department's contract (DE-AC05-84OR21400) with Energy Systems at the next renewal in order to delete those contract provisions that substantially deviate from the Accountability Rule provisions contained in the Departmental acquisition regulations.

Management Comments. Management concurred with the recommendation and stated that based on experience in other applications, the Energy Systems contract will be reevaluated, and if necessary, revisions will be negotiated.

Auditor Response. The experiences of other contractors have no direct bearing on the inequities that existed between contracts with Energy Systems and other management and operating contractors. Only the contracts with Energy Systems contained major deviations from the Departmental acquisition regulations. During the audit, management did not provide us with any logical reasons or justification for the continuation of these deviations.

DESCRIPTION OF BASIC AND AWARD FEES

The fees under a cost-plus-award-fee contract comprise two elements -- basic (formerly called base) fee and award fee. The starting point in computing the fees is to determine the cost base for the contract and the applicable (standard) fee for a cost-plus-fixed-fee contract. After the standard fee is determined, the basic and award fee is computed as a percentage of the standard fee. Before the Accountability Rule, the basic fee ranged from 0 to 50 percent of the standard fee, and depending on the basic fee percent, the award fee ranged from 100 to 200 percent. For example, if the basic fee was 50 percent, the award fee was 100 percent for a total of 150 percent of the standard fee. The lower the basic fee, the higher the award fee. The percentage of fee used for the basic and award fee was determined by the responsible contracting officer. Under the Accountability Rule, the basic fee was raised to 100 percent of the standard fee for all management and operating contracts. The potential award fee depended on the type and complexity of the Departmental facility being managed under the management and operating contract. The highest award fee, 200 percent of the standard fee, went to nuclear weapons production facilities.

Besides changes in computing the potential fees, changes were also made in the manner in which fees were earned by the contractor. Prior to the Accountability Rule, a contractor was paid the full basic fee regardless of the performance rating score received. In addition, the contractor received an award fee if the performance score exceeded 60 points. The exact amount of award fee was based on a sliding scale from 61 to 100 performance points. Under the Accountability Rule, the contractor had to receive a performance score of 75 or higher to receive the entire basic fee. If the score was less than 75, the contractor could be penalized by up to 50 percent of the total basic fee. The award fee was not earned until the contractor received a score in excess of 80 points. For each point from 81 to 86, the contractor earned 5 percent of the total award fee. From 87 to 95, the percent earned for each point varied from 6 to 9 percent. A score of 96 or above entitled the contractor to 100 percent of the award fee.

MITIGATING FACTORS TO BE CONSIDERED IN DETERMINING THE ALLOWABILITY OF COSTS

Departmental acquisition regulations Subpart 970.3102-22, "Avoidable Costs for Profit Making Contractors," provides that the Contracting Officer shall consider the following factors in determining whether all, a portion, or none of the avoidable costs will be allowed as contract costs.

1. Whether the contractor's conduct resulted from compliance with written direction from the Contracting Officer.

2. Whether the contractor's conduct occurred after specific instances of noncompliance were reported by the contractor to the Contracting Officer and necessary funding or authorization to correct the condition were unavailable.

3. Whether the act or failure to act resulted from a violation of a formal Departmental regulation or order.

4. Whether the contractor had implemented Department-approved internal control systems and procedures.

5. Whether the contractor had faithfully implemented the Department-approved property management system.

6. Whether the contractor had provided proper training for contractor employees.

7. Whether all reasonable precautions were taken.

8. Whether adequate corrective actions were taken to preclude future occurrences.

9. Whether the contractor voluntarily informed the Contracting Officer in a timely, good faith manner of the condition or activity that later resulted in the incurrence of avoidable costs.

10. Whether the contractor was newly selected to manage the facility and whether it had sufficient time to discern the problem and report it prior to the incurrence of the avoidable costs.

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