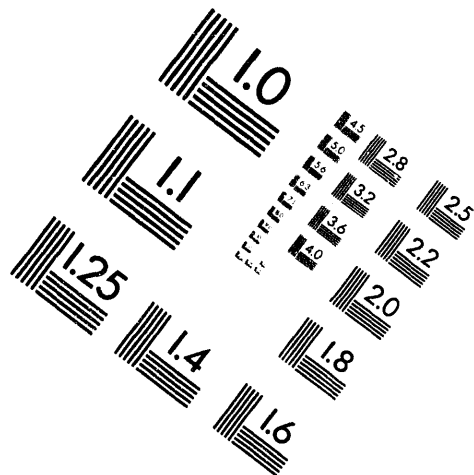


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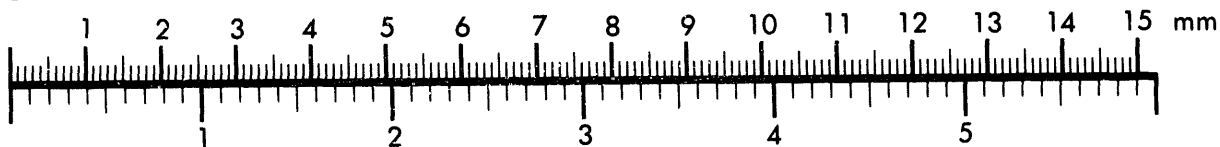
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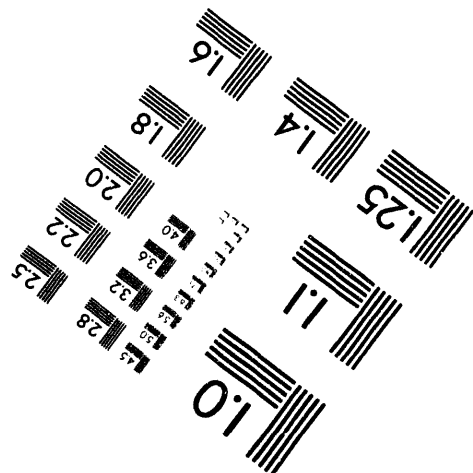
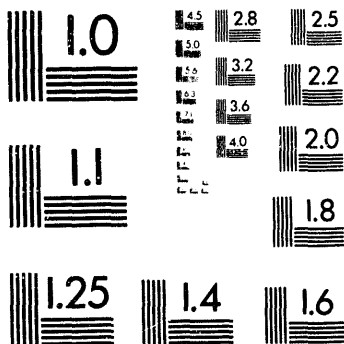
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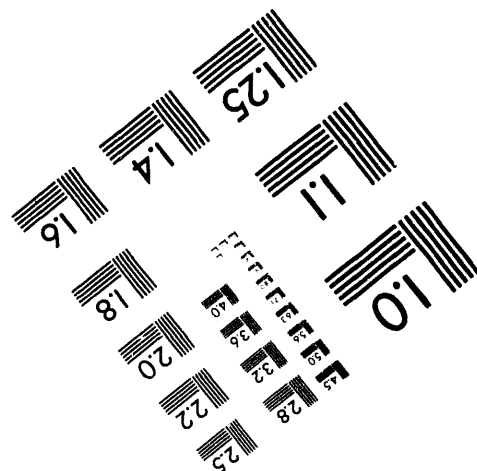
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United States Government

Department of Energy

# memorandum

DATE: July 7, 1994

REPLY TO  
ATTN OF: IG-1

SUBJECT: INFORMATION: Report on "Inspection of the Cost Reduction Incentive Program at the Department of Energy's Idaho Operations Office"

TO: The Secretary

## BACKGROUND:

On September 16, 1985, the then-Assistant Secretary for Management and Administration issued a memorandum to Operations Office officials supporting the establishment of programs which would increase the efficiency and effectiveness of the Department of Energy's management and operating contractors. Since issuing this memorandum, several Operations Offices, including Idaho, have implemented cost reduction incentive programs. The purpose of this inspection was to review the economy and efficiency of Idaho's Fiscal Year 1992 Cost Reduction Incentive Program, as well as to provide information to Departmental officials regarding any difficulties in administering these types of programs. The report is being sent to inform you of our findings and recommendations.

## DISCUSSION:

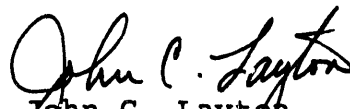
According to Idaho officials, their Cost Reduction Incentive Program was designed to motivate and provide incentives to management and operating contractors which would result in cost savings to the Department while increasing the efficiency and effectiveness of the contractors' operations. Idaho officials reported that over \$22.5 million in costs were saved as a result of the Fiscal Year 1992 Cost Reduction Incentive Program.

We found that: 1) Idaho officials acknowledged that they did not attempt a full accounting records validation of the contractors' submitted cost savings; 2) cost reduction incentive programs may result in conflicts of interest--contractors may defer work in order to receive an incentive fee; 3) the Department lacks written Department-wide policies and procedures--senior Procurement officials stated that the 1985 memorandum from the then-Assistant Secretary for Management and Administration was not the current policy of the Department; and 4) the Department already has the management and operating contract award fee provisions and value engineering program that can be used to provide financial rewards for contractors that operate cost effectively and efficiently.

As a result of our findings, we recommended that the Deputy Assistant Secretary for Procurement and Assistance Management and the Acting Associate Deputy Secretary for Field Management review cost reduction incentive programs to determine if separate programs should be continued.

We also recommended that if cost reduction incentive programs are continued, the Deputy Assistant Secretary for Procurement and Assistance Management and the Acting Associate Deputy Secretary for Field Management should establish written policy and procedures for the programs. Furthermore, we recommended that the Deputy Assistant Secretary for Procurement and Assistance Management inform Operations Office managers that the 1985 memorandum does not represent the current policy of the Department.

In commenting on our report, management officials concurred with the recommendations. The Acting Associate Deputy Secretary for Field Management stated that the Department's February 1994 Contract Reform Team Report identified his office as the lead office to develop a Department-wide incentive program for contractor cost reduction/cost avoidance programs.

  
John C. Layton  
Inspector General

Attachment

cc: Deputy Secretary  
Under Secretary  
Acting Associate Deputy Secretary for Field Management  
Deputy Assistant Secretary for Procurement and Assistance  
Management

U.S. DEPARTMENT OF ENERGY  
OFFICE OF INSPECTOR GENERAL

REPORT ON  
INSPECTION OF THE COST REDUCTION  
INCENTIVE PROGRAM AT THE DEPARTMENT  
OF ENERGY'S IDAHO OPERATIONS OFFICE

REPORT NO.: DOE/IG-0352  
DATE ISSUED: July 7, 1994

OFFICE OF INSPECTIONS  
WASHINGTON, D.C. 20585

REPORT ON  
INSPECTION OF THE COST REDUCTION INCENTIVE  
PROGRAM AT THE DEPARTMENT OF ENERGY'S  
IDAHO OPERATIONS OFFICE

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Report on Inspection of the  
Cost Reduction Incentive Program  
at the Department of Energy's  
Idaho Operations Office

I. INTRODUCTION AND PURPOSE

On September 16, 1985, the-then Assistant Secretary for Management and Administration issued a memorandum to Operations Office officials supporting the establishment of programs which would increase the efficiency and effectiveness of the Department of Energy's (Department) management and operating contractors' operations. Idaho Operations Office officials stated that based on this memorandum, they established cost reduction incentive programs with their management and operating contractors. These programs were designed to motivate and provide incentives to management and operating (M&O) contractors which would result in cost savings to the Department while increasing the efficiency and effectiveness of the contractor's operations.

The purpose of this inspection was to review the economy and efficiency of Idaho's cost reduction incentive programs, as well as provide information to Departmental officials regarding any difficulties in administering these types of programs. A primary objective of the inspection was to review the actions taken by Idaho officials to ensure that the objectives of their cost reduction incentive programs were achieved. We also reviewed Idaho's programs for compliance with Department-wide procedures for paying fees to contractors.

II. SCOPE AND METHODOLOGY

The inspection covered the period of August 1992 through November 1993. In conducting the inspection, we reviewed cost reduction incentive program files and M&O contractors' quarterly and annual incentive and award fee reports for Fiscal Years 1986 through 1992. We also interviewed officials from the office of the Deputy Assistant Secretary for Procurement and Assistance Management; the former office of Administration and Human Resource Management, as well as officials from the Idaho Operations Office. Furthermore, we interviewed M&O contractor officials who were participating in Idaho's cost reduction incentive programs. These contractors included Protection Technologies, Incorporated; Westinghouse Idaho Nuclear Company,



Incorporated; EG&G Idaho, Incorporated; and Babcock and Wilcox Idaho, Incorporated.

We also reviewed a prior Department of Energy, Office of Inspector General report, entitled "General Management Inspection of the Department of Energy's Nevada Field Office", which covered cost reduction incentive programs at Nevada. Finally, we reviewed March 24, 1992, testimony by the General Accounting Office's Director of Energy Issues, Resources, Community and Economic Development before the Subcommittee on Investigations and Oversight, Committee on Science, Space, and Technology which covered aspects of the Department's funds control process.

This inspection was conducted in accordance with the Quality Standards for Inspections issued by the President's Council on Integrity and Efficiency.

The following is the summary results of the findings of the inspection.

### III. SUMMARY RESULTS OF INSPECTION

Cost reduction incentive programs are currently a focus of attention in the Department. One of the goals of this inspection was not only to review Idaho Operations Office officials' efforts in this area, but also to provide information regarding any difficulties that may be encountered in establishing and administering these types of programs. It is our intention that this inspection report might be useful to the Department's management in considering the establishment of cost reduction incentive programs for management and operating (M&O) contractors.

DOE Idaho Operations Office and M&O contractor officials believed that Idaho's Cost Reduction Incentive Program helped focus Federal and contractor employees' attention to developing ways to operate in a more cost effective manner. Idaho's Deputy Manager, and other Idaho DOE and contractor officials, stated that the Cost Reduction Incentive Program, along with several other Idaho management initiatives, were intended to create a new business management culture of improved cost performance at the Idaho Operations Office. The Deputy Manager stated that the Cost Reduction Incentive Program was a two-year interim measure undertaken to reduce costs while the longer-term initiatives such as improving planning, validation, cost baselining and indirect costs review matured. At the end of Fiscal Year 1992, Idaho officials reported that over \$22.5 million in costs were

saved as a result of the Cost Reduction Incentive Program. Idaho officials also stated that by the end of Fiscal Year 1993, when the program was discontinued, they had identified cost savings of over \$35 million as a result of this interim program. This report does not address the results of Idaho's Cost Reduction Incentive Program for Fiscal Year 1993 performance.

In summary our findings are as follows: 1) Idaho officials did not fully validate approved cost savings; 2) cost reduction incentive programs may result in potential conflicts of interest -- contractors may defer work in order to receive an incentive fee; 3) the Department lacks written Department-wide policy for cost reduction incentive programs; and 4) the Department already has the management and operating contract award fee provisions and value engineering program that can be used to provide financial rewards for contractors that operate cost effectively and efficiently.

Regarding cost savings validation, Idaho officials modified their original cost savings validation plans, in part, because of the difficulty in validating cost savings through accounting records. They stated that they relied on Operations Office program line management to confirm that the work scope in areas associated with cost savings was not deferred and that the scope of the savings had merit. Idaho officials further stated that this approach gave them "reasonable assurance" that cost savings were valid.

Idaho officials acknowledged that they did not attempt to complete a full accounting records validation of their contractors' cost savings submitted under the Fiscal Year 1992 Cost Reduction Incentive Program. Idaho's original procedures stated that Idaho's Chief Financial Officer shall validate hard dollar savings against performance areas or cost centers. The procedures further stated that the Chief Financial Officer shall confirm through inspection of contractor's accounting records, actual costs saved, proper accounting was used, and determination of deferred work scope. Idaho officials stated that validating contractor cost savings through the accounting records was difficult because: a) costs not incurred are difficult to validate; b) in some instances Idaho and the contractor officials' definition of "performance areas" differed, thereby creating an impediment to accounting records validation; and c) contractor officials did not have cost baselines which would have enabled Idaho officials to attribute cost savings, in all cases, to specific contractor management actions.

Regarding potential conflicts of interest, Idaho officials recognized that cost reduction incentive programs may create conflicts of interest for contractors. Although Idaho officials stated that they took steps to mitigate conflicts of interest, we believe the potential still exists that contractors may defer work on projects to receive cost reduction incentive fees.

Regarding the lack of current Department-wide written policy, senior Procurement officials acknowledged that the Department does not have written Department-wide policy regarding the establishment and management of cost reduction incentive programs. One senior Procurement official stated that the Department's unwritten cost reduction incentive policy is to pay contractors fees only in return for hard dollar savings -- savings which can be validated. We also noted that the Department's February 1994 Contract Reform Team Report includes a statement that Departmental officials should develop policies and procedures to incentivize contractors to reduce cost. As a result of the Contract Reform Team Report, the Office of the Associate Deputy Secretary for Field Management was identified as the lead office for the initiative to develop a Department-wide incentive program for contractor cost reduction/cost avoidance programs.

Finally, the Department already has a number of existing requirements that M&O contractors operate cost efficiently and effectively. These requirements are included in the Department of Energy Acquisition Regulation (DEAR) and the DOE Order on value engineering. Specifically, DEAR award fee provisions state that cost efficiency and effectiveness can be an element of the Performance Evaluation Plan under which M&O contractors can be rewarded. Also, DEAR 970.09, "Contractor Qualifications," states that M&O contractors shall develop and maintain management systems to promote efficient and effective operations. Finally, DOE Order 4010.1A on value engineering programs requires that contractors reduce costs through cost avoidance or reduction.

We believe that cost reduction incentive programs appeared to have increased the focus of Idaho officials' attention on understanding operating costs. However, our reviews of cost reduction incentive programs at Nevada and Idaho have demonstrated that cost savings are difficult to validate. We believe that policies Departmental officials establish in regard to these programs should address cost savings validation. We also believe these policies should address establishing cost baselines where possible and the difficulties in "hard dollar" cost savings validation. Furthermore, we believe that it may be necessary to consider additional requirements for contractors'

accounting systems in order to effectively validate "hard dollar" savings.

We believe that the Department's February 1994 Contract Reform Team Report supports the idea that cost reduction incentive program cost savings should be "hard dollar" savings and that cost baselines should be established. Specifically, the report stated, in part, that "contractors should be allowed to share in any 'hard dollar' savings realized" under cost-savings incentives programs. The report also stated that "...In establishing its cost-savings incentives program, the Department should ... establish proper baselines and cost measurement tools to ensure that estimated savings are actually achieved."

Finally, we believe that the need for written policy is, in part, demonstrated by the fact that both Nevada and Idaho officials cited a 1985 memorandum from the then-Assistant Secretary for Management and Administration as a basis for establishing their respective programs. We were told by a senior Headquarters Procurement official that the 1985 memorandum did not represent DOE policy on cost reduction incentive programs. The official stated, however, that the concept of incentivizing M&O contractors to identify cost savings is an approach that Departmental officials are pursuing and is also one of the initiatives identified by the Department's Contract Reform Team. In establishing cost reduction incentive policies, we believe that Departmental officials should consider the existing Departmental requirements that can be used to require and motivate contractors to operate cost efficiently and effectively. In this regard, we noted that the Department's February 1994 Contract Reform Team Report included a statement that a "... government-wide program, known as Value Engineering, already exists for Federal Acquisition Regulation contracts, and provides a model that could be considered in developing a DOE-wide approach [to cost-savings incentive programs]."

The Deputy Manager, Idaho Operations Office, the Deputy Assistant Secretary for Procurement and Assistance Management, and the Acting Associate Deputy Secretary for Field Management generally agreed with the findings and recommendations in the report. The Idaho Deputy Manager stated that validating cost savings was very difficult. He also stated that continuance of on-going initiatives to improve planning, budget baselining, work authorization and indirect cost reviews, etc. is needed in order to effectively validate cost savings.

Both the then-Acting Deputy Assistant Secretary and the Acting Associate Deputy Secretary agreed that without adequate cost

baselines, approval of contractor proposed cost savings under cost reduction incentive programs would be subjective and subject to criticism.

In response to a draft of this report, the then-Acting Deputy Assistant Secretary for Procurement and Assistance Management stated that the process used by Idaho officials should be reviewed to determine if a separate program aside from the award fee is necessary. He also stated that Idaho's program appears to have merit in that costs have been reduced, but additional study and refinement is required to determine if cost reduction incentive programs are beneficial. He further stated that if cost reduction incentive programs are continued: 1) the programs should have cost baselines which would allow adequate measurement and validation of cost savings, and 2) the terms and procedures should be defined and described in the contracts or contract modifications, and that appropriate controls to eliminate deficiencies should be identified.

In addition to the comments presented above, a senior official in the Office of Field Management advised us that the Department's Contract Reform Team had recognized a need to develop initiatives to motivate contractors to reduce costs. Regarding the Contract Reform Team's findings, Idaho officials stated that the Team found that the Department's award fee system had not been effectively used by Operations Offices officials in the past to motivate contractors to reduce costs. We reviewed the Reform Team's report which includes recommendations to alter the way Departmental officials reward contractors to encourage them to operate in a cost efficient and effective manner. These recommendations included a recognition of the need for budget baselines and well defined performance objectives for contractors in order to be able to hold them accountable for cost efficient and effective operations.

The following section discusses background information on cost reduction incentive programs.

#### IV. BACKGROUND

As a result of the previously cited September 16, 1985, Assistant Secretary for Management and Administration's memorandum, a number of Operations Office officials have developed and implemented cost reduction incentive programs. We first reported on this type of program in our 1992 report entitled, "General Management Inspection of the Department of Energy's Nevada Field Office."

In this report we disclosed that Nevada Operations Office officials had implemented a cost reduction incentive program with three of its five M&O contractors. As a result of the inspection, we concluded that Nevada's program was not effectively administered and that two M&O contractors were paid \$2.3 million in fees for cost savings which were not entirely validated by Nevada Operations Office officials. We also concluded that if cost reduction incentive programs were to be continued, Departmental officials should establish minimum policies and procedures to: 1) ensure that these programs are administered efficiently and effectively; and 2) identify the source of funding for fees paid under the programs.

In a May 31, 1991, response to the Nevada Operations Office Report, the Deputy Director Office of Procurement, Assistance and Program Management (at the time), stated that:

"The program [Productivity Incentive Program], which for the most part has been in place only at Idaho and Nevada, will not be continued beyond Fiscal Years 1991. That is, introduction of the new award fee policies, and implementation of these policies in the field, will take into consideration cost avoidance, or will include separate cost incentive programs in the evaluation of a contractor's performance."

In addition to this response, the Director, Office of Procurement, Assistance and Program Management, at the time, and the then-Assistant Secretary for Defense Programs advised the Manager of the Nevada Operations Office, by memorandum, to discontinue its Productivity Incentive Program as of October 1, 1992. The memorandum stated that:

"... it has been determined that continuation of the PIP [Productivity Incentive Program] is not in the best interest of the Department and DP [Defense Programs], and shall be discontinued as of October 1, 1992. The recent Departmental changes to the Department of Energy (DOE) Acquisition Regulations covering the implementation and administration of the DOE Award Fee Contracts should provide an opportunity to appropriately reward contractors commensurate with their performance."

Although the Nevada Operations Office's Productivity Incentive Program was discontinued, cost reduction incentive programs continued to exist at the Idaho, Richland and Savannah River Operations Offices.

The following section discusses the results of the inspection of the cost reduction incentive program at Idaho Operations Office in more detail.

## V. RESULTS OF INSPECTION

### Idaho's Cost Reduction Incentive Program

Idaho officials implemented their first cost reduction incentive program called the "Quality Productivity Incentive Program" in Fiscal Year 1986. During Fiscal Year 1992, Idaho officials initiated a second cost reduction incentive program called the "Cost Reduction Incentive Program."

During the period of Fiscal Years 1986 through 1992, Idaho officials awarded over \$17 million in incentive fees to contractors under the Quality Productivity Improvement and Cost Reduction Incentive Programs in return for reported cost savings which were not entirely validated.

Specifically, during Fiscal Year 1986 through the end of Fiscal Year 1991, Idaho officials paid three contractors approximately \$14.4 million before discontinuing the Quality Productivity Incentive Program. According to an Idaho Contracting Officer, the program was discontinued in 1991 by the Idaho Operations Office Manager because: 1) cost savings submitted by the contractor were "soft dollar" savings and not verifiable; 2) actual cost savings or "hard dollar savings" were not deobligated and returned to the Department; 3) no new cost saving ideas were being presented by the contractors after several years of the program's operation; and 4) additional controls for validating and monitoring cost savings were needed.

### Validation of Contractors' Cost Savings

According to an Idaho Contracting Officer, the Cost Reduction Incentive Program, established in Fiscal Year 1992, was designed to include more internal control procedures (than the 1986 incentive program) for validating that contractors' reported cost savings were real. Specifically, the procedures stated that Idaho's Chief Financial Officer (CFO officials) shall validate hard dollar savings against performance areas or cost centers.

In response to an earlier draft of this report, Idaho officials stated that they subsequently modified their procedures,

believing that program managers were better-equipped than CFO officials to determine whether workscope was deferred or completed. Idaho officials also stated they determined that 100 percent validation of cost savings was not realistic. They stated that "reasonable assurance" as to the validity of claimed cost savings could be obtained by having CFO officials conduct an accounting record review of 70 to 80 percent of the direct cost savings claims that had been found to have merit by the cognizant program managers.

We found that for Fiscal Year 1992, Idaho officials approved \$22.6 million of \$33.5 million in cost savings (both indirect and direct costs) reported by its four participating M&O contractors. Idaho officials paid the four contractors \$3.1 million in return for the \$22.6 million in approved cost savings. Based on information provided by Idaho officials we found that Idaho officials validated \$6.8 million (30 percent of the \$22.6 million in approved cost savings) through the contractors' accounting records.

The chart on page 10 summarizes the results of Idaho's Cost Reduction Incentive Program, including the amounts of cost savings Idaho officials validated through the contractors' accounting records. The four participating M&O contractors [i.e., Westinghouse Idaho Nuclear Company (WINCO); EG&G Idaho, Incorporated (EG&G); Babcock and Wilcox Idaho, Incorporated (B&W); and Protection Technologies, Incorporated (PTI)] are included in this summary.

In response to a draft of this report, Idaho officials stated that they validated "\$11.75 million in approved indirect cost savings (EG&G and Westinghouse)" as to the merit of savings. They further stated that "Although it was difficult to validate these savings through accounting records (since costs were not incurred), support for these indirect cost savings was obtained from cognizant ID [Idaho] managers." These cost savings are included in the total cost approved for EG&G and Westinghouse shown in column C of the chart.



FISCAL YEAR 1992 ACCOUNTING RECORDS VALIDATION  
OF COST REDUCTION INCENTIVE PROGRAM 2/

(A)	(B)	(C)	(D)	(E)	(F)	(G)
<u>M&amp;O</u>	<u>Cost Savings Reported By M&amp;O (millions)</u>	<u>Total Cost Savings Approved (millions)</u>	<u>Direct Cost Savings Approved (millions)</u>	<u>Direct Cost Savings Validated by Acct Records (millions)</u>	<u>Percent of Approved Cost Savings paid Contractors</u>	<u>(C x F) Fee Paid to Contractors</u>
WINCO	\$13.6	\$ 6.2	\$3.4	\$3.4	10%	\$ 619,000
EG&G	\$16.0	13.4	4.3	\$3.4	15%	2,010,270
B&W	\$ 3.8	2.9	0	0	15%	436,305
PTI	<u>.05</u>	<u>.05</u>	<u>0</u>	<u>0</u>	15%	<u>7,155</u>
TOTAL	\$33.5	\$22.6	\$7.7	\$6.8 <u>1/</u>		\$3,072,730

NOTES:

1/ No indirect cost saving were validated by an accounting records review.

2/ The sources of the information in the chart were:

WINCO: The cost savings reported by WINCO (column B), direct cost savings approved (column D), and percentage of approved cost savings paid to the contractor (column F) were obtained from a "Determination of Amount of Incentive" prepared by an Idaho Contract Specialist. The total cost savings approved (column C) and the fee paid (column G) were obtained from an April 30, 1993, letter from an Idaho Contracting Officer to the contractor. The direct cost savings validated by accounting records (column E) was obtained from the "Accounting Record Verification of Line Management-supported WINCO Claimed Savings" dated March 26, 1993.

EG&G: The cost savings reported by EG&G (column B) and the direct cost savings validated by accounting records (column E) were obtained from a review entitled "Cost Reduction Incentive Program," dated December 11, 1992, that was performed by the Financial Analysis Branch, Performance Assessment Division, DOE-ID Office of Chief Financial Officer. The total cost savings approved (column C) and the fee paid (column G) were obtained from a February 23, 1993, letter from an Idaho Contracting Officer to EG&G. The direct cost savings

approved (column D) of \$4.3 million represents the difference between the total cost savings approved of \$13.4 and the accepted indirect cost savings of \$9.1 million identified in a December 22, 1992, memorandum signed by the Director, Finance Division. The percentage of approved cost savings paid the contractor (column F) was obtained from modification M203, signed April 3, 1992, to the EG&G contract.

B&W: The cost savings reported by B&W (column B), total cost savings approved (column C), percentage of approved cost savings (column F), and the fee paid to the contractor (column G) were obtained from a document headed "VALIDATING COST SAVINGS, COST REDUCTION INCENTIVE PROGRAMS" for B&W wherein, on February 7, 1993, an Idaho Contracting Officer approved the determination of entitlement to the CRIP savings award. Idaho officials stated that they did not perform an accounting records validation of B&W's direct cost savings; and based on the documentation we reviewed the direct cost savings were not segregated from the indirect cost savings reported by B&W officials.

PTI: The cost savings reported by PTI (column B), total cost savings approved (column C), percentage of approved cost savings (column F), and the fee paid to the contractor (column G) were obtained from a document headed "VALIDATING COST SAVINGS, COST REDUCTION INCENTIVE PROGRAMS" for PTI wherein, on January 16, 1993, an Idaho Contracting Officer approved the determination of entitlement to the CRIP savings award. Idaho officials stated that they did not perform an accounting records validation of PTI's reported cost savings; and the direct cost savings were not segregated from the indirect cost savings reported by PTI officials.

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### Idaho's Validation Process

As a result of our review of Idaho officials validation process, we noted instances in which Idaho Financial Analysis Branch officials expressed reservations about the adequacy of the accounting documentation supporting direct cost savings submitted by Idaho's two largest contractors -- Westinghouse Idaho Nuclear Company (Westinghouse) and EG&G. The following are examples of some of the difficulties Idaho officials had in validating cost savings submitted by two M&O contractors.

#### Westinghouse Idaho Nuclear Company, Inc.

We reviewed one Idaho Financial Analysis Branch report which suggested that Idaho officials "assumed" that the real cost savings confirmed that the accounting records were for the reasons stated in the Westinghouse cost savings claim. Specifically, concerning Westinghouse's claimed cost savings, Idaho Financial Analysis officials stated:

"... This lack of accounting visibility was viewed as a significant impediment to a meaningful validation of the WINCO [Westinghouse] claims. Nevertheless, because of the contractual language, wherever a positive bottom-line cost account variance was equal to or greater than the claimed savings, accounting support was assumed."

According to Idaho's Chief Financial Officer, the frustration expressed here stemmed from a procedural requirement to validate savings at the "performance area or cost element." He stated that because cost savings could have been attributed to any one of several activities which were grouped together, Idaho officials were unable to validate that cost savings resulted for the specified reason(s) stated in the Westinghouse claim.

According to the March 26, 1992, analysis performed by Idaho's Financial Analysis Branch, these officials "reviewed the 'indirect' [cost] savings ... independent of the extensive program 'direct' claim validation." During our inspection of this review, we noted that Idaho officials had difficulty in determining the indirect cost savings that they would allow Westinghouse. During the period from December 1992 to June 1993, Idaho officials changed the indirect cost savings allowed for Westinghouse from \$0 to \$2.75 million. As evidence of the changes in indirect cost savings allowed for Westinghouse, we reviewed four memorandums prepared by Idaho officials. The first memorandum dated December 22, 1992, from the Idaho Finance

Division Director to an Idaho Contracts Management Division Director included the following statement:

"WINCO [Westinghouse] proposed indirect cost savings of \$5.502 million. This amount was not approved by the Finance Division. The Finance Division did not allow any indirect cost savings. It was determined that these costs were mainly avoidable costs due to not hiring and not "hard dollar" cost savings."

In a second memorandum dated March 26, 1993, an Idaho Finance Branch official stated that:

"Based on an anlysis [analysis] of WINCO's [Westinghouse's] proposed overhead cost savings which was evaluated in the same manner as EG&G's cost savings, WINCO's [Westinghouse] overhead cost savings may be in the range of \$304,000 to \$564,000 instead of the proposed \$5,502,000 of operating funding overhead cost savings."

Westinghouse's indirect cost savings were further discussed in a third memorandum dated April 28, 1993, from the Idaho Director, Materials Processing Division to an Idaho Contracting Officer. The Director stated that:

"It has been determined that WINCO [Westinghouse] will be allowed 50% of its proposed overhead cost savings which equates to \$2,750K. This amount, coupled with the programmatic savings of \$3,440K, totals \$6,190[K] of savings which WINCO [Westinghouse] should receive credit for under the FY [Fiscal Year] 1992 cost reduction savings plan."

In contrast to the determination of \$0 to \$564,000, a fourth memorandum dated June 3, 1993, from Idaho's Director Budget and Plans Division to an Idaho Contracting Officer, the Director stated:

"The previously mentioned memo [memorandum] also stated that the Finance Division identified potential savings from overhead accounts in the amount of \$.56M [\$560,000]. However, upon subsequent review of this portion of the savings program, it was determined by ID [Idaho] senior management, [including Contract Management, Plans and Budget, Nuclear Materials Program, etc.] that WINCO [Westinghouse] should be credited with 50% of the \$5.502M claimed indirect savings. This equated to \$2.75M."

Despite Idaho officials' difficulty in validating direct cost savings and their concerns over Westinghouse officials' support

for their reported indirect cost savings, Idaho officials ultimately approved approximately \$6.2 million in cost savings, resulting in a \$619,000 incentive fee for Westinghouse.

The Deputy Manager stated that actual confirmation of the hard dollar savings in the Westinghouse accounting records occurred, although it was not always easy to determine if cost savings resulted from the cost reduction incentive program. He also stated that the validation of Westinghouse's indirect cost savings was an "...incremental and iterative review process..." and involved representatives from Idaho's Finance, Plans and Budget, Materials Processing, and Contract Management Divisions, as well as Idaho senior management.

Idaho officials also stated that the various levels of review and ultimate Idaho consensus with respect to recognition of Westinghouse's indirect cost savings initiatives demonstrates not only the difficulty of relying exclusively on financial staff to validate cost savings, but also the great lengths Idaho officials went to arrive at multi-discipline consensus with respect to the contractor's indirect cost savings claims.

#### EG&G Idaho, Inc.

We noted that Idaho Financial Analysis Branch officials had the same type of concern regarding lack of accounting record support during their attempt to validate EG&G's reported \$6.9 million in direct program cost savings. The officials stated that:

"... Contractors must also understand that they are required to provide supporting accounting records on all savings they identify. If a method of saving dollars is identified and the savings used for another authorized purpose, a new charge number should be opened to track those costs separately from the charge number where the savings will be recognized. This would help to assure proper accounting methods are being used. Additionally, plainly state that savings must be a result of an action initiated by EG&G personnel, savings resulting from outside influences are not eligible."

We also noted that Idaho's Contract and Finance Control Division approved indirect cost savings of \$9 million for EG&G while only requiring limited support to document that they validated these savings. We requested copies of the validation documentation for the indirect cost savings. According to Idaho's then Acting Chief Financial Officer, they did not have a written analysis of their validation. He stated that the only validation

documentation in the files on indirect costs was a November 2, 1992, letter from EG&G which stated that the indirect cost savings of \$9.07 million represented, in part, savings in the reduction of management employees and travel expenses. Regarding travel expenses, the Acting Chief Financial Officer stated that EG&G's travel initiative resulted in a 50 percent reduction in travel related expenses, but his staff was unable to break out the cost related to this cost reduction initiative.

The Acting Chief Financial Officer also stated that another initiative was the restructuring of EG&G's management by eliminating one layer of management. According to this official, the restructuring resulted in a reduction of indirect and direct costs. He again stated that his staff was unable to ascertain the exact amount of indirect cost related to this cost reduction initiative.

Regarding the amount of indirect cost savings approved for EG&G, the Acting Chief Financial Officer stated that the total reported indirect savings for EG&G was approximately \$20 million, but only \$9 million was submitted for consideration under the Cost Reduction Incentive Program. He stated that the reported indirect cost savings appeared reasonable, considering EG&G's estimated savings of \$20 million and the initiatives identified.

Finally, the Acting Chief Financial Officer stated that it is generally very difficult to validate indirect cost savings because you are trying to verify costs that were not incurred. He stated that prior to the submission of the reported indirect cost savings, he had emphasized to EG&G officials that these costs must be reasonable.

Despite the fact that the Financial Analysis officials had difficulty in validating that the direct cost savings observed in the accounting record review were the result of the initiatives claimed, and that a complete validation of direct and indirect cost savings was not conducted, we found that EG&G earned \$2 million in Cost Reduction Incentive Program fees for approved total direct and indirect cost savings of \$13.4 million.

In a response to a draft of this report, Idaho's Deputy Manager acknowledged that there were weaknesses in the accounting documentation supporting the cost savings and that these weaknesses made validation difficult. He stated, however, that these weaknesses should not be misconstrued as evidence that Idaho officials did not conduct a sound accounting record validation of cost savings.

### Deobligation of Savings

We also found that contrary to the program's original intent, Idaho officials did not require that contractors' cost savings be returned to the Department. Instead Idaho officials modified three of four M&O contracts to state that validated cost savings would be 'made available for deobligation' rather than 'will be deobligated.'

According to an Idaho Contracting Officer, the Cost Reduction Incentive Program, as originally envisioned, provided that all of the validated cost savings from the contractors would be deobligated and returned to DOE Headquarters' Program Secretarial Offices. We reviewed a February 27, 1992, memorandum from the Idaho Field [Operations] Office Manager to the Savannah River Field [Operations] Office Manager in which the Idaho Manager stated that:

"Differentiating this cost incentive program from others, is the absolute requirement for hard dollar savings that will be returned to DOE-HQ program offices. Under this approach, savings will not qualify for an incentive award if they are used to fund other tasks, or additional scope of work..."

We also reviewed Idaho's Fiscal Year 1992 "Cost Reduction Incentive Program Procedures for Validating Cost Savings" which supported the concept of deobligation. The procedures stated:

"During the month of October, 1992, the Chief Financial Officer [CFO] shall prepare Financial [FIN] Plan Change Number 13. This FIN plan change shall consider and segregate the total amount of net operating funds available for deobligation for the entire FY [Fiscal Year] 1992. A separate report to the Contracting Officer detailing the availability of operating funds for deobligation (snapshot of October 1, 1992) shall be provided by the CFO on or before November 2, 1992."

"... the Contracting Officer, [shall] ...advise the contractor's [contractors] in writing of the amount of incentive earned, and available. This notification shall be based on certification from the CFO [Chief Financial Officer] that funds are available to the contract, and that the funds may be withdrawn from the contractor's special bank account..."

According to an Idaho Contracting official several months after the Cost Reduction Incentive Program was initiated, contract modifications were issued to the Idaho contractors indicating that all validated cost savings would be "made available for deobligation", rather than "will be deobligated." The Contracting Officer stated that this change was made to reflect the desires of some programs to re-invest the savings at Idaho.

We reviewed a May 5, 1992, contract modification for Protection Technology which supported the concept of deobligating contractor's savings. Specifically, the contract was modified to state that:

"(e)... the Contractor shall submit a report to the Contracting Officer giving a detailed analysis of actual costs incurred ... and detail of net ('bottom line') contract operating costs savings (funds returned to DOE programs) [deobligated] for the Fiscal Years. The contractor shall show how net savings have affected its cost center accounts."

An Idaho Contracting Officer stated that some funds were deobligated, but he was not aware of the total amount of funds deobligated because of the Cost Reduction Incentive Program. A May 17, 1993, memorandum from an Idaho Budget official to the Idaho Contracting Officer provided the following explanation as to why the exact amount of deobligated funds was not known.

"The Idaho Operations Office each year works closely with HQ [Headquarters] sponsoring programs to identify funding requirements to accomplish the required scope, and makes recommendations for adjustments or reprogramming. This 'big picture' exercise involves an analysis of all uncosted funding, changing circumstances and program requirements, and the existing status of the schedule. While the big picture is understood, we did not break out the Cost Reduction Incentive Program (CRIP) separately, particularly since we were restructuring to meet the requirements of a new administration....The letters sent to the Principal Secretarial Officers (PSOs) indicated that the CRIP savings were available for withdrawal, but unless notified, would be used to fund additional workscope in FY [Fiscal Years] 1993..."

Although, Idaho officials' original intent was to return funds from cost savings to Headquarters' Program offices, an Idaho Contracting Officer stated that some Headquarters' Program officials did not want the deobligated funds returned. He stated that in January 1993 Idaho officials sent letters to



Headquarters' Program Offices advising them of savings that resulted from the Cost Reduction Incentive Program. He also stated that in instances in which Program officials elected not to deobligate cost savings, Idaho officials reprogrammed the funds for additional work scope.

In addition to Idaho's statement that some Headquarters' officials did not want deobligated funds, we also found an example in which Idaho officials made the decision not to deobligate the cost savings submitted by one contractor. In this instance, we reviewed a May 17, 1993, memorandum to an Idaho Contracting Officer in which an Idaho Budget official stated that:

"In the case of PTI [Protection Technology, Inc.], their contract is funded entirely from overhead allocations, and as a result no funding can be returned to HQ [Headquarters]. Instead, all contractors on site benefited, in the form of reduced FY [Fiscal Years] 1992 costs, due to the \$732K underrun..."

The net effect in this case was a return of funds from Protection Technology, Inc. to other Idaho M&O contractors.

#### Possible Conflicts of Interest

In addition to our observations regarding the validation and deobligation of contractors' submitted cost savings, we observed that there may be potential conflicts of interest for contractors participating in Idaho's Cost Reduction Incentive Program.

In one example, an Idaho contractor official reported to the Office of Inspector General a possible conflict of interest where one M&O contractor at Idaho allegedly could defer the work scope on projects in order to return funds to the Department, and receive an incentive fee for these returned funds.

Idaho officials found this type of conflict during their review of Westinghouse's reported cost savings. We reviewed an "Account Record Verification" document prepared by Idaho officials, in which cost savings were submitted, but the assigned work scope was not completed. Specifically, the Account Record Verification included the following statement:

"Cost savings ... for \$220,000 was calculated on the amount returned to DOE-ID without regard to the fact that the scope [of work] had not been completed. The program manager

requested additional funds to complete the scope which was estimated to cost \$60,000."

In this instance Idaho officials reduced the contractor's reported cost savings by \$60,000 to \$160,000.

In response to a draft of this report, Idaho Chief Financial Officer stated that Idaho officials recognized the potential for conflicts of interest and took specific actions to mitigate this conflict. He stated that the Cost Reduction Incentive Program clause in the contracts specifically states that the Contracting Officer may determine that the contractor shall not be entitled to incentive if the operating costs saved will become costs incurred in future periods, i.e. necessary repairs and maintenance have been deferred. He also stated that the procedures required verification by the program office officials that the budgeted activities were accomplished. He further stated that in each case, Idaho program officials did verify that the budgeted activities were accomplished before any Cost Reduction Incentive Program fee was awarded to a contractor.

We acknowledge that in the instance cited above, Idaho officials denied the reported savings, but the potential for conflicts of interest still exists where contractors can report cost savings by not accomplishing assigned work scope. In these instances, cost reduction incentive programs may motivate the contractor to defer work scope in order to receive a fee.

#### Other DOE Cost Saving Requirements

Our review of cost reduction incentive programs identified at least two existing requirements for M&O contractors to operate cost efficiently and effectively: 1) the Department of Energy Acquisition Regulation, including M&O contract award fee provisions; and 2) the DOE Value Engineering Order.

#### DEAR Requirements

Specifically, we found that M&O contractors were required to have cost efficient and effective operations, and are compensated for this requirement under their basic contract. For instance, DEAR 970.09, "Contractor Qualifications", was revised effective January 1992 to state that contractors shall develop and maintain systems of management and quality control to discourage waste, abuse and fraud, as well as, maintain management control systems which promote efficient and effective operations.

In accordance with the DEAR provision, Idaho's Deputy Manager stated that the "Management Controls" clause was inserted into EG&G's contract in the third quarter of Fiscal Year 1992, into Westinghouse's contract the beginning of Fiscal Year 1993, and into other Idaho M&O contracts at later dates.

Our review also revealed that the Department's award fee provisions for M&O contracts already provide an incentive and rewards contractors for above average performance. For instance, DEAR 970.1509, "Fee for management and operating contracts" states, in part, that management and operating contractors will be provided a fee for the entrepreneurial function of organizing and managing resources. The DEAR states that cost effectiveness of operation can be considered as an element of a contractor's award fee performance evaluation plan (plan). Specifically, DEAR 970.5204-54, "Basic and award fee" states that the plan sets forth the criteria upon which the contractor will be evaluated for performance relating to any technical, scheduled, management, and/or cost functions selected for evaluation.

The M&O contract award fee provisions resulted from Departmental officials July 1991 implementation of an Accountability Rule which was designed to increase for-profit contractors' accountability and performance in managing the Department's major facilities. As a result of the Rule, for-profit contractors were encouraged through increased potential award fees to achieve a higher level of performance which would result in more efficient and effective operation of the Department's facilities.

Procurement and other Headquarters' officials supported the concept that the objectives of the Accountability Rule would increase cost effectiveness. For example, in discontinuing the Nevada Operations Office cost reduction incentive program, the Procurement Director and the Assistant Secretary for Defense Programs stated in a memorandum to the Nevada Operations Office Manager that the implementation of the new award fee provisions of the Accountability Rule should provide sufficient "incentive" for the contractor to operate in a cost effective manner.

Further, Idaho's Award Fee Performance Evaluation Plan for EG&G appears to also support the concept that the Accountability Rule would increase cost efficient and effective contractor operations. We reviewed the Plan for the period of October 1, 1991, through March 31, 1992. The Plan stated that the objective of the award fee provisions is to afford the contractor an opportunity to earn increased fee commensurate

with the achievement of optimum contractor performance. The Plan also stated that the basic concept of award fee is to encourage contractors to work effectively to meet objectives, to control costs, and to improve the timeliness and quality of performance. The Plan further stated that the basis for earning award fee dollars above the basic fee level reflects the extent to which the contractor, on its own initiative, is actively involved in performance improvement activities and the extent to which these actions contribute to more efficient, effective, and economical operations.

Our review of EG&G's Plan disclosed that Idaho officials considered cost effectiveness in most of the identified performance areas including: Operation of the Reactor and Hot Cell Operations, Reactor Research, Technology and Support, Technology Development and Integration, Environmental Restoration and Waste Management, New Production Reactors, and Management and Administration. Specifically, the Plan stated that the following criteria would be used in assessing EG&G's performance in cost effectiveness:

- "Implement continuing productivity and quality improvement plans which enhance the cost-effectiveness of the facility programs.

- Cost-effective and consistent implementation of program activities.

- Cost-effectiveness of operations including productive/quality improvements, and value engineering.

- Demonstrate results to control direct and indirect costs, including any measurement of efficiencies used or achieved."

Finally, we discussed the concept of sharing cost savings with M&O contractors with a Headquarters' Administration and Human Resource Management official, as well as a Procurement, Office of Policy official. Both of these officials stated that DEAR 970.0901, "management controls", requires that management and operating contractors provide their best efforts in promoting efficient and effective operations. These officials stated that contractors are already paid to provide innovative initiatives to promote effectiveness and efficiency.

### Value Engineering Requirements

M&O contractors are also required to reduce costs through cost avoidance or reduction under Federal and DOE value engineering regulations, policies and procedures. Federal Acquisition Regulation (FAR) Part 48 requires the use of value engineering, as appropriate, by Federal Agencies to identify and reduce nonessential procurement and program costs. It further states that value engineering can be used to change plans, designs and specifications for Federal programs.

We found that DOE's Acquisition Regulation does not address FAR Part 48. Departmental officials have, however, implemented an Order on value engineering. DOE Order 4010.1A requires that Operations Office officials develop criteria and guidelines, submit annual budgets and reports and establish value engineering training programs. Although, DOE's Order allows for sharing of cost savings with the contractors, DOE Headquarters' Office of Procurement and Assistant Management, as well as DOE Administration and Human Resource Management officials stated that M&O contractors who participate on value engineering programs normally do not receive a "special" incentive fee for these value engineering projects.

Our review revealed that the Idaho Operations Office has a value engineering program separate from its Cost Reduction Incentive Program. According to an Idaho Civil Engineer, each Idaho M&O contractor is allocated funding by the Department in its budget for value engineering studies, training and certification. The official stated that EG&G is the lead value engineering contractor at Idaho and performs studies for the other Idaho M&O contractors. An Idaho Engineering and Construction Management Branch official stated that the management and operating contractors who participate in Idaho's value engineering program do not receive a percentage of the cost savings which are identified through value engineering activities.

We believe that increased emphasis on establishing value engineering programs without paying contractors a fee in return for cost savings should be considered in developing policy for cost reduction incentive programs. The Department already has basic policy and procedures established for value engineering programs in DOE Order 4010.1A. The Order was established according to Government-wide Federal Acquisition Regulation. We noted that the Departments February 1994 Contract Reform Team report supported the idea that Departmental officials should consider value engineering programs in developing policy for cost reduction incentive programs. Specifically, the report stated that a "...government-wide program, known as Value

Engineering, already exists for Federal Acquisition Regulation contracts, and provides a model that could be considered in developing a DOE-wide approach [to cost-savings incentive programs]."

Contractors Reported Cost Savings May be a Result of Over Budgeting by the Department

One Idaho contractor official we interviewed during the inspection stated that Idaho's Cost Reduction Incentive Program could lead contractors to inflate their budget to enable them to receive cost reduction incentive fees. We reviewed General Accounting Office (GAO) testimony which concluded that the Department needed additional controls to ensure that "potential excess funding" provided to contractors was properly administered. According to March 24, 1992, testimony provided by General Accounting Office (GAO) officials before the Subcommittee on Investigations and Oversight, Committee on Science, Space, and Technology, House of Representatives, the Department ended Fiscal Years 1991 with approximately \$9.7 billion in uncosted obligations. GAO officials stated that uncosted obligations are funds the Department provided to its contractors for goods or services that have not been received and no costs have been incurred.

GAO officials also stated that uncosted obligations are made up of committed and uncommitted funds. According to GAO officials' testimony, DOE officials define committed funds as those amounts for construction and capital equipment that contractors have legally committed to suppliers or subcontracts, as well as amounts committed internally for various reasons. GAO officials stated that uncommitted obligations "could include goods and services requisitioned, but not yet ordered." In their testimony, GAO officials recommended that these funds be analyzed to determine if they may be used to reduce future budget appropriations.

According to GAO testimony, as of September 30, 1991, Departmental officials reported \$478 million in uncosted obligations for the Idaho Operations Office. The official further disclosed that approximately, \$314.7 million of these uncosted obligations were uncommitted.

In response, in part, to the GAO testimony, Departmental officials began to analyze uncosted obligations in Fiscal Year 1992. In their analysis, Departmental officials changed the term "committed" to "encumbered", and "uncommitted" to "unencumbered"; and established definitions for these terms.

The Departmental officials' definition of unencumbered uncosted obligation:

"is that portion of the uncosted obligation balance that has not yet been encumbered by the integrated M&O contractor. The unencumbered uncosted obligation balance consists of the following categories:

Approved Work Scope consists of balances for work that is clearly defined in task or work authorizations or program direction letters...

Prefinancing is funding maintained for the purpose of ensuring continuity of contractor operations during a potential funding lapse at the beginning of the Fiscal Years ...

Remaining Unencumbered is the portion that remains after subtracting approved work scope and prefinancing and is potential excess funding resulting from project an program underruns and changing program missions..."

We reviewed the uncosted obligations for the four contractors participating in the Idaho Cost Reduction Incentive Program for Fiscal Year 1992 and found that all of the participating contractors had uncosted obligations ranging from \$202,000 to \$305 million. The unencumbered portion of the uncosted obligations for these contractors ranged from 0 to 12 percent, according to the Department's Analysis of Fiscal Year 1992 Uncosted Obligations Report.

The uncosted obligations for EG&G (Idaho) for Fiscal Years 1992 was \$305 million. Approximately \$12 million or 4 percent of these funds were for remaining unencumbered balances — which may have been "potential excess funding". We noted that during Fiscal Year 1992, Idaho officials stated that they had deobligated and/or reprogrammed \$13.4 million in cost savings for EG&G — only \$1 million more than EG&G's unencumbered uncosted obligations ["potential excess funding"]. Thus, we believe that unless valid baselines existed it would be difficult for Idaho officials to determine if all of the \$13.4 million in cost savings resulted from Cost Reduction Incentive Program or from contractors receiving excess budgeted funds.

Idaho's Deputy Manager stated that since Fiscal Years 1992 and 1993 budget requests were prepared, reviewed and approved prior to the establishment of the Fiscal Year 1992 Cost Reduction Incentive Program, the cost savings could not have resulted from over budgeting.

We concur with the Deputy Manager's statement that Fiscal Years 1992 and 1993 budget requests were approved prior to the establishment of Idaho's Cost Reduction Incentive Program. We noted, however, that Fiscal Years 1992 and 1993 budgets were prepared while Idaho's Quality Productivity Incentive Program was still in effect. Thus, the budgets for these Fiscal Years were prepared by contractors operating under a cost reduction incentive program.

#### 1985 Memorandum Used As Policy to Establish Cost Reduction Incentive Programs

During our review of both Nevada and Idaho Operations Offices' cost reduction incentive programs, we found that Operations Office officials used a 1985 memorandum issued by the then Assistant Secretary for Management and Administration to establish these types of programs. The memorandum stated that contractors who implemented ideas and techniques to improve their overall cost effectiveness could share in a percentage of these cost savings. The memorandum further stated that officials "...should negotiate structured sharing [cost savings] arrangements in addition to award fee considerations for selected overhead areas to the extent practical..." Based on our review of the memorandum it appeared that it was inconsistent with DEAR 970.1509-6, "Fee base," and the memorandum may have conflicted with Departmental officials' current unwritten policy regarding cost reduction incentive programs.

DEAR 970.1509-6 addresses the maximum fees that M&O contractors can earn without receiving approval from the Procurement Executive. The regulation states that:

"The fee schedules provide the maximum fees payable within the authority of the Head of Contracting Activity. There may be times however, when the fee schedule does not reflect an adequate compensation to the contractor... Proposals to compensate a contractor in excess of the maximum fee schedules shall be submitted to the Procurement Executive. Requests should contain documentation and state specifically why the contractor is entitled to additional fees..."

We found that EG&G's total fee earned for Fiscal Years 1986 through 1989 under Idaho's discontinued Quality Productivity Incentive Program exceeded the maximum negotiated fee pool by \$3 million without the approval of the Department's Procurement Executive. We noted, however, that the combination of fees



under Idaho's Fiscal Year 1992 Cost Reduction Incentive Program and award fees paid to Idaho's contractors did not exceed the individual contractors' negotiated maximum award fee pools.

We discussed the issue of exceeding the maximum negotiated fee pool with an Idaho Contracts Management official, who stated that the Procurement Executive's approval was not required because award fees were not the source of funding for the Quality Productivity Incentive Program. He also stated that according to the 1985 memorandum from the former Assistant Secretary for Management and Administration, a fee separate from the award fee could be paid to contractors for reported cost savings. Furthermore, he stated that the Quality Productivity Incentive Program was established in accordance with contract modifications, which provided that the fee was "separate from and in addition to" the negotiated maximum fee which was identified in the individual contractors' contracts.

A senior Headquarters Procurement official agreed with the Idaho Contracts Management official stating that the 1985 memorandum allows a fee separate from the award fee for cost reduction incentive programs. The official stated that, therefore, Procurement Executive's approval was not required by Idaho officials to exceed the maximum negotiated fee pool for EG&G under Idaho's Quality Productivity Incentive Program. He acknowledged, however, that Operations Offices officials may be using the 1985 memorandum to establish cost reduction incentive programs, but stated that the memorandum does not represent the Department's policy. We also discussed this issue with another senior Procurement official who also stated that the 1985 memorandum does not represent the policy of the Department. He stated, however, that the concept of incentivizing contractors to reduce cost is an approach that Departmental officials are pursuing and is one of the initiatives identified by the Contract Reform Team.

#### Department-wide Policy on Cost Reduction Incentive Programs

The Associate Director, Office of Procurement, Assistance and Property stated that the Department does not have written policy on cost reduction incentive programs. He stated, however, that the Department has unwritten cost reduction incentive criteria -- that only hard dollar savings are eligible as cost savings, and that the combined incentive fee and award fee earned may not exceed a contractor's negotiated maximum award fee "pool". He also stated that Headquarters' Procurement officials are aware

that cost reduction incentive programs still exist, and they intend to develop policy and procedures for cost reduction incentive programs in approximately one year.

The Associate Director, Office of Procurement, Assistance and Property stated that Headquarters' Procurement officials were aware of Idaho's Cost Reduction Incentive Program, but had not approved nor objected to the program. He stated that Idaho's program will be considered in developing policy on cost reduction incentive programs.

## VI. CONCLUSIONS

Since cost reduction incentive programs are currently a focus of attention in the Department, we believe that this inspection may be beneficial in providing information regarding some of the difficulties Departmental officials have encountered in managing these types of programs. The inspection disclosed that Idaho's Cost Reduction Incentive Program may have helped focus Federal and contractor employees' attention to developing ways to operate in a more cost efficient and effective manner.

However, our reviews of cost reduction incentive programs at Nevada and Idaho have demonstrated that cost savings submitted under these programs are difficult to validate. Also, these programs may result in potential conflicts-of-interest for M&O contractors. We believe that policies Departmental officials establish in regard to these programs should address cost savings validation and steps to mitigate potential conflicts-of-interest. We also believe these policies should address establishing cost baselines where possible and the difficulties in "hard dollar" cost savings validation. Furthermore, we believe that it may be necessary to consider additional requirements for contractors' accounting systems in order to effectively validate "hard dollar" cost savings. We believe that the Department's February 1994 Contract Reform Team Report supports the idea that the cost savings should be "hard dollar" savings. Specifically, the report stated that "...contractors should be allowed to share in any 'hard dollar' savings realized under cost-savings incentive programs."

Finally, we believe the need for policy is, in part, demonstrated by the fact that both Nevada and Idaho officials cited a 1985 memorandum from the then-Assistant Secretary for Management and Administration as a basis for establishing their respective programs. We were told by a senior Headquarters Procurement official that the 1985 memorandum does not represent DOE policy on cost reduction incentive programs. The official

further stated that the concept of incentivizing contractors to reduce cost is an approach that Departmental officials are pursuing and is one of the initiatives identified by the Contract Reform Team.

In establishing cost reduction incentive program policies, we believe that Departmental officials should consider the existing Departmental requirements that can be used to require and provide financial incentives to contractors to operate cost efficiently and effectively. We noted that the Department's February 1994 Contract Reform Team report included a statement that a "...government-wide program, known as Value Engineering, already exists for Federal Acquisition Regulation contracts, and provides a model that could be considered in developing a DOE-wide approach [to cost-savings incentive programs]."

#### VII. RECOMMENDATIONS AND MANAGEMENT COMMENTS

1. We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management and the Acting Associate Deputy Secretary for Field Management review cost reduction incentive programs to determine if separate programs should be continued. The review should include consideration of other alternatives under the existing award fee procedures, and the increased use of value engineering programs.

The Deputy Assistant Secretary for Procurement and Assistance Management and the Acting Associate Deputy Secretary for Field Management concurred with the recommendation.

2. If cost reduction incentive programs are continued, we recommend that the Deputy Assistant Secretary for Procurement and Assistance Management and the Acting Associate Deputy Secretary for Field Management establish written cost reduction incentive program policy and procedures. These policies and procedures should also address the manner in which cost savings should be validated.

The Deputy Assistant Secretary for Procurement and Assistance Management concurred with the recommendation.

The Acting Associate Deputy Secretary for Field Management concurred with this recommendation, stating that his office was identified in the Secretary's Contract Reform Team Report of February 1994, as the lead office to develop a

Department-wide program. He further stated that "...this initiative will involve developing policy guidelines and an implementation plan to identify pilot contracts and to establish controls that generate realistic cost reductions and measure savings."

3. We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management inform Operations Office Managers that the 1985 memorandum (from the then Assistant Secretary for Management and Administration) which has been used to establish cost reduction incentive programs does not represent the current policy of the Department.

The Deputy Assistant Secretary for Procurement and Assistance Management concurred with this recommendation.

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