

DOE/IG-0390



Report on

Audit of Department of Energy Management and Operating Contractor Available Fees

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memorandum

DATE: May 8, 1996

REPLY TO

ATTN OF: IG-1

SUBJECT: INFORMATION: Report on "Audit of Department of Energy Management and Operating Contractor Available Fees"

TO: The Secretary

BACKGROUND:

In December 1995, the Office of Procurement and Assistance Management proposed changes to the method used to annually calculate and negotiate for-profit management and operating contractor available fees. The objective of the audit was to determine whether the Department's proposed change to the fee structure for determining management and operating contractor fees will be cost effective.

DISCUSSION:

In 1991, the Department, through the Accountability Rule, increased contractor fees as an incentive to improve contractor performance and accountability. This action coincided with the Department's stated objective of shifting more risk for the operation of its facilities to the managing contractors. In January 1994, the Office of Inspector General issued an audit report on the implementation of the Accountability Rule which concluded that the Department paid five contractors \$23 million in increased fees with no conclusive evidence that this rule was meeting its objective. Furthermore, the report noted that the Department had not achieved any measurable benefits for its investment. The Department is crafting a new fee policy which may, depending upon how it is implemented and executed, increase fees above the amount provided through the Accountability Rule as an incentive to improve management and operating contractor performance. Prudent business practice dictates that any change, which increases costs to the Department, should be analyzed to determine if the benefits justify the cost. The Department's proposed revisions to its Acquisition Regulation could significantly increase contractors' available fees, by as much as \$218 million annually. This change, however, was not subjected to a rigorous analysis to determine the cost and benefits of the latest initiative.

A cost-benefit analysis would identify the risks assumed by the contractors, identify any other quantitative or qualitative benefits that would accrue to the Department as a result of the new fee policy, and would enable the Department to establish a benchmark and expectation level for measuring the effectiveness of performance-based contracting. If

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appropriate benchmarks are not established, the Department may be providing the management and operating contractors with substantial increases in fees with no method in place to measure actual benefits.

An exit conference was held with the Office of Procurement and Assistance Management on April 18, 1996, to discuss the results of the audit. Following this meeting, the Department elected to transmit the notice of proposed rulemaking to the Office of Management and Budget without the fee policy revisions. In subsequent comments, management indicated that the fee policy was still in an evolutionary state. Although management stated that it would review the final proposed rulemaking to ensure that its objectives were met, it did not commit to doing the cost-benefit analysis recommended in the audit report.



John C. Layton
Inspector General

Attachment

cc: Deputy Secretary
Acting Under Secretary

AUDIT OF DEPARTMENT OF ENERGY
MANAGEMENT AND OPERATING CONTRACTOR AVAILABLE FEES

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

**AUDIT OF DEPARTMENT OF ENERGY
MANAGEMENT AND OPERATING CONTRACTOR AVAILABLE FEES**

Report Number: DOE/IG-0390
Date of Issue: May 8, 1996

Capital Regional Audit Office
Germantown, Maryland 20874

U. S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL
OFFICE OF AUDIT SERVICES

AUDIT OF DEPARTMENT OF ENERGY
MANAGEMENT AND OPERATING CONTRACTOR AVAILABLE FEES

Audit Report Number: DOE/IG-0390

SUMMARY

The Department of Energy's management and operating contractors operate facilities designed to perform research and development, special production, or testing for the Federal Government. As of March 1, 1995, 32 of the 47 management and operating contracts were either cost-plus-fixed-fee or cost-plus-award-fee contracts. In Fiscal Year 1995, available fees (i.e., the maximum fees that can be paid to contractors) for the 32 contracts totaled \$438 million. The remaining 15 contracts were awarded to non-profit educational or other institutions, which were not part of this review.

In December 1995, the Department proposed to modify its Acquisition Regulation to improve contractor performance and make contractors more accountable for their actions. The proposed modification was in response to recommendations made by the Department's Contract Reform Team in 1994. The proposed revisions, drafted by the Offices of Procurement and Assistance Management and General Counsel, would eliminate the avoidable cost provisions that increased contractor risk under the Accountability Rule, but they would not eliminate the associated fee increases. The revisions also would make costs for fines, penalties, third-party liabilities, and loss of Government property unallowable unless the contractor proves it was not at fault. In return, the Department proposed to increase contractor fees above those already provided through the Accountability Rule. The objective of the audit was to determine whether the Department's proposed change to the fee structure for determining management and operating contractor fees will be cost effective. While we recognize that the fee policy was evolving during the period covered by this audit, our analysis of the proposed revisions indicated that these actions may substantially increase contractor available fees for 28 of the 32 contracts, possibly by as much as \$218 million per year. However, the Department had not developed adequate empirical or analytical evidence to support anticipated benefits of the revisions.

In 1991, the Department, through the Accountability Rule, increased contractor fees as an incentive to improve contractor performance and accountability. This action coincided with the Department's stated objective of shifting more risk for the operation of its facilities to the managing contractors. The Office of Inspector General, in January 1994, issued an audit report on this initiative. The report concluded that the Department

paid five contractors \$23 million in increased fees with no conclusive evidence that this rule was meeting its objective.

Despite the absence of measurable benefits from the Accountability Rule, the Department currently plans to increase fees above the amount provided through the Accountability Rule as an incentive to improve management and operating contractor performance. This proposed increase in contractor fees could total \$218 million per year. This estimate is based on the maximum fee calculation for each contract under the proposed revised fee structure.

Prudent business practice dictates that any initiative that carries with it such significant increases in cost to the Department should be analyzed to determine if the benefits justify the cost. However, the Department's newest proposed revision to its Acquisition Regulation was not subjected to a rigorous analysis to determine the costs and benefits of the proposal. Because of the potential impact of the proposed revisions, we recommend that the Department postpone issuance of the proposed revisions to its Acquisition Regulation until a cost-benefit analysis is completed, and it can confirm in both quantitative and qualitative terms that the revisions are cost effective and will achieve the benefits envisioned by the Department.

An exit conference was held with the Office of Procurement and Assistance Management on April 18, 1996, to discuss the results of the audit. Following this meeting, the Department elected to transmit the notice of proposed rulemaking to the Office of Management and Budget without the fee policy revisions. The Department stated in the notice that its fee policy for profit making and nonprofit contractors will be promulgated as a separate proposal.

Subsequently, on April 30, 1996, the Deputy Assistant Secretary for Procurement and Assistance Management provided revised comments on the audit report. In his response, he set forth a series of objectives that would be followed in developing the new policy. The response stated that the new proposal would not be issued until the draft fee policy objectives were met. Management comments did not specifically indicate whether a cost-benefit analysis would be performed.

Office of Inspector General
Office of Inspector General

PART I

APPROACH AND OVERVIEW

INTRODUCTION

The Office of Procurement and Assistance Management has proposed changes to the method used to annually calculate and negotiate "for-profit" management and operating contractor available fees. This proposal will increase contractor fees in exchange for the contractor's purported assumption of additional risk. In 1991, the Department, through the Accountability Rule, increased contractor fees as an incentive to improve contractor performance and accountability. Despite the lack of measurable benefits of this effort, the Department is crafting a new fee policy which will, depending upon how it is executed, increase fees above the amount provided through the Accountability Rule as an incentive to the Department's management and operating contractors. The objective of the audit was to determine whether the Department's proposed change to the fee structure for determining management and operating contractor fees will be cost effective.

SCOPE AND METHODOLOGY

The audit included an analysis of proposed revisions to the Acquisition Regulation, an assessment of whether management and operating contractor available fees would increase from Fiscal Year 1995 levels, and the extent to which the Department assessed the corresponding additional risk that would be assumed by the Department's contractors. As of March 1, 1995, 32 of the Department's 47 management and operating contracts were either cost-plus-fixed-fee or cost-plus-award-fee contracts. These 32 contractors would be impacted by the proposed changes to the Acquisition Regulation. The remaining 15 management and operating contracts were awarded to non-profit educational (where the Department may pay a management allowance rather than a fee) or other institutions under a cost, no fee arrangement. Although these contractors would also be impacted by the proposed changes, they were not authorized to earn fees at the time of our review and, therefore, were not included as a part of the scope of this audit.

In performing the review, a comparison of current and proposed Acquisition Regulation provisions was performed and discussions were held with Departmental Headquarters personnel to determine the rationale and process for making the changes. Specific discussions were held at Headquarters with representatives from Procurement's Office of Policy, the Contract Reform Team, and the Office of General Counsel.

An analysis of the proposed revision to the fee structure was conducted to quantify its impact on management and operating contractor available fees. Under the current fee policy, contractors generally used a single fee base for each of the four applicable categories of work. Using Fiscal Year 1995 categories of work for 28 of 32 cost-plus fixed-fee or cost-plus-award-fee contracts, we subdivided each category into 3 equal

amounts as permitted by the proposed revisions. Information was not available on 4 of the 32 contracts to determine the potential impact of the proposed revision on available fees. We then applied the applicable Departmental fee schedules to the modified fee bases as provided under the proposed procedures and compared the results to actual Fiscal Year 1995 fees to determine the potential effect on contractor available fees under the new rules.

An analysis was also conducted to assess the increased risk that would be assumed by management and operating contractors under the proposed revision to the Acquisition Regulation. Inquiries were made with Headquarters and field personnel to quantify the amount that is currently paid by the Department or its contractors for fines, penalties, third-party liabilities, and property liability.

The audit was performed in accordance with generally accepted Government auditing standards for performance audits, which included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the objective of the audit. We assessed the significant internal controls with respect to the compliance with Parts 915 and 970 of the Department of Energy Acquisition Regulation. We placed only limited reliance on computer-generated data during this audit and, thus, did not test the reliability of the data. Because our review of internal controls was limited, it would not necessarily have disclosed all internal control and compliance deficiencies that may have existed.

Audit work was conducted at Department Headquarters and at selected Departmental field offices. An exit conference was held on April 18, 1996.

BACKGROUND

The Department of Energy's management and operating contractors operate facilities designed to perform research and development, special production, or testing for the Federal Government. For 28 of the Department's contracts for which information was available, Fiscal Year 1995 available fees (i.e., the maximum fees that can be paid) totaled approximately \$412 million.

Since 1991, fees for the Department's management and operating contractors have increased significantly. As shown in Table 1, fees available to Lockheed Martin Energy Systems and Westinghouse Savannah River Company (two of the Department's largest contractors) increased from \$58.9 million in 1991 to \$126.1 million in 1995.

Table 1

Available Fees For Two Departmental Contracts
(in millions)

<u>Contractor</u>	<u>Fiscal Year 1991</u> <u>Available Fees</u>	<u>Fiscal Year 1995</u> <u>Available Fees</u>
Lockheed Martin Energy Systems	\$26.3	\$76.1
Westinghouse Savannah River Co.	\$32.6	\$50.0
Totals	<u>\$58.9</u>	<u>\$126.1</u>

The increase can be attributed to two key factors: (1) the 1991 implementation of the Accountability Rule and (2) a decision by the Department since 1991 to deviate from standard fee determination schedules for certain contractors by allowing their fees to be calculated on smaller, more numerous fee bases. The Department intended, in both instances, to increase fees to compensate contractors for greater financial risk.

In published reports, the Office of Inspector General and the Contract Reform Team concluded that the Department of Energy had not received measurable benefits as a result of these initiatives. The Office of Inspector General reported that after 18 months under the Accountability Rule and an increase of \$23 million in contractor fees, there was no conclusive evidence that the Department was achieving its objective. The Contract Reform Team also found that, "In application, the Accountability Rule appears to have had little measurable impact on contractor accountability or performance. At the same time, it has resulted in a significant cost increase to the Department." Another report by the Office of Inspector General in August 1995 concluded that deviations from the required fee determination schedules increased Westinghouse Savannah River Company's fees by about \$60 million over a 5-year period (April 1989 through March 1994) without the Department receiving a corresponding increase in contractor performance.

OBSERVATIONS AND CONCLUSIONS

In 1995, the Department undertook an initiative to modify its Acquisition Regulation in response to its Departmental Contract Reform Team's objective that contract operations should "work better and cost less." The Department's objective was to improve contractor performance and make contractors more accountable for their actions. The proposed revisions, drafted by the Offices of Procurement and Assistance Management and General Counsel, eliminated the avoidable cost provisions that increased contractor risk under the Accountability Rule but did not eliminate the associated fee increases. Also, fines, penalties, third-party liabilities, and loss of Government property, under the latest proposed revisions, would be unallowable unless the contractor proves, it was not at fault.

In return for the new risks assumed by the contractor, the Department proposed to increase contractor fees above those already provided through the Accountability Rule.

The Department's approach was based on the establishment of contract performance areas within each category of work. Using this new approach, contractor fee bases can be increased from 4 to 12. An analysis of the change, however, indicates that the Department's actions will substantially increase contractor fees. This initiative was undertaken even though the Department had not developed an empirical basis for concluding that the anticipated benefits of the revision would be realized.

Prudent business practice dictates that any change that increases costs to the Department should be analyzed to determine if the benefits justify the cost. However, the Department, in this case, proposed revisions to its Acquisition Regulation that could significantly increase contractors' available fees without performing an analysis of the costs and benefits of the proposed revision. Departmental officials informed us that data essential for such an analysis was neither accumulated nor requested from Departmental field offices. Headquarters Procurement did not begin to collect detailed fee calculation information until October 1995--after drafting the initial revisions to the Acquisition Regulation.

The estimated impact of the proposed revision would allow management and operating contractors to subdivide their budgets into smaller, more numerous fee bases--generally up to 12 fee bases. The practical impact would be to increase the total available fee pools to the 28 contractors by as much as \$218 million per year. Because of the potential impact, the Department should delay issuing the proposed revisions to its Acquisition Regulation until a thorough cost-benefit analysis is completed, and it can confirm in both quantitative and qualitative terms that the revisions are cost effective and will achieve the benefits envisioned by the Department. The absence of a cost-benefit analysis should be considered when identifying material internal control weaknesses as part of the yearend assurance memorandum on internal controls.

We discussed this report with officials from the Office of Procurement and Assistance Management on April 18, 1996. Following the meeting, the Department elected to transmit the notice of proposed rulemaking to the Office of Management and Budget without the fee policy revisions.

PART II

FINDING AND RECOMMENDATION

Management and Operating Contractor Available Fees

FINDING

It is the Department of Energy's policy that contractors bear an equitable share of contract cost risk and that they be compensated for assuming that risk. However, the Department, during Fiscal Year 1996, proposed changes to its Acquisition Regulation that may increase available management and operating contractor fees by as much as \$218 million per year without demonstrating (1) a commensurate increase in risk assumed by the contractors or (2) other quantitative or qualitative benefits that render the proposal in the best interest of the government. The revisions to the Acquisition Regulation were proposed without performing a cost-benefit analysis. Without such an analysis, the Department cannot ensure that the revisions to the Acquisition Regulation are cost effective and that they achieve the long-term contract reform goals of the Department.

RECOMMENDATION

We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management:

Postpone issuance of the proposed revisions to its Acquisition Regulation until a thorough cost-benefit analysis is completed, and it can confirm in both quantitative and qualitative terms that the revisions are cost effective and will achieve the benefits envisioned by the Department.

MANAGEMENT REACTION

In responding to the draft report on April 30, 1996, the Deputy Assistant Secretary for Procurement and Assistance Management stated that the Department's fee policy was evolving, and he set forth a series of objectives that would govern the development of this policy. The response indicated that the new proposal would not be issued until the draft fee policy objectives were met. Management comments did not specifically address whether a cost-benefit analysis would be performed. Detailed management and auditor comments are included in Part III, and verbatim management comments are included in Appendix I of this report.

DETAILS OF FINDING

CONTRACTOR COST RISK AND COMPENSATION REQUIREMENTS

The Department of Energy's Acquisition Regulation requires that contractors assume an equitable share of the contract cost risk and that they be compensated for the assumption of that risk. The Acquisition Regulation also requires contracting officials to make a determination of the degree of cost responsibility assumed by the contractor when profit/fee allowances are based on contractor assumption of risk. The Acquisition Regulation further states that the negotiating official, in developing a pre-negotiation fee objective, consider the type of contract to be negotiated and the anticipated contractor cost risk.

AVAILABLE FEE REVISIONS

In December 1995, the Office of Procurement and Assistance Management proposed changes to the method used to annually calculate and negotiate "for-profit" management and operating contractor available fees. The changes were drafted in response to the Department's 1994 Contract Reform Team's overall conclusion that contracting should "work better and cost less." According to Headquarters Procurement officials, the principal objectives of the proposed revisions are to establish requirements similar to those contained in the Federal Acquisition Regulation, use performance-based contracting methods, and add discipline to the fee negotiation process. The Department's objectives in taking this action were further clarified in an April 30, 1996, memorandum provided in response to an earlier draft of this report. The April 30 memorandum is included in this report at Appendix I.

The revisions proposed by Procurement and the Office of General Counsel would eliminate provisions of the Accountability Rule and restructure the Department's fee determination process by establishing contract performance areas within categories of work. The December 1995 proposal allowed management and operating contractor fees to be calculated on 16 rather than 4 fee bases. However, the Department subsequently reduced the number of fee bases contractors would be permitted to use to 12 by eliminating a contract performance area. The revisions would also retain the current fee schedules and the 100 percent increase in fees for assuming additional risk established by the Accountability Rule.

Increased Available Fees

The fee policy revision to the Acquisition Regulation could result in as much as a \$218 million increase in available contractor fees per year for 28 "for-profit" management and operating contractors. The \$218 million increase in available fees represents the maximum fee calculation for each contract under the proposed revised fee structure, which was based on our application of the proposed fee structure to Fiscal Year 1995

information used by the Department to calculate available contractor fees. Using Fiscal Year 1995 fee bases and applicable "for-profit" management and operating contractors award fee percentages, we estimated that available fees for the 28 contractors could approximate \$630 million per year under the proposal. The difference between our estimate of the impact of the new proposal and Fiscal Year 1995 available contractor fees (\$630 million and \$412 million, respectively) represents the potential increase in available fees. (see Appendix III).

Currently, management and operating contractor available fees are based on four categories of work: production/manufacturing, research & development, construction/construction management, and special equipment/subcontracting. The proposed revision will allow each contractor to increase the number of fee bases by allowing three performance areas to be subdivided by the four categories of work. Table 2 illustrates the further subdivision of the fee bases permitted by the proposed fee policy revision to the Acquisition Regulation.

Table 2

Number Of Possible Fee Bases

Categories of Work Performance Areas	Number of Possible Fee Bases			
	1. Production	2. R&D	3. Construction	4. Special Equipment
1. Basic Mission	X	X	X	X
2. Construction	X	X	X	X
3. Environmental	X	X	X	X

For cost-reimbursement contractors, the Department established standards for the maximum allowable fee for each fee base. These standards, in the form of "fee schedules," are structured to be regressive in nature--as the dollar amount of the contract cost base increases, the allowable fee percentage decreases. An example of an actual fee schedule is provided at Appendix II. As noted in the example, a \$25,000 base for research and development activities permits contractors to earn a maximum fee of 10 percent; while a \$25 million base permits contractors to earn a maximum fee of 5.27 percent. When large contractor efforts are divided into smaller bases, fees are calculated separately for each of the bases using the higher fee percentage. In such situations, the aggregated fees for the smaller bases exceed the single maximum contractor fee, which would have been available had the effort not been subdivided. Thus, although the overall work product may be the same, the contractor receives substantially higher fees in this scenario. This essentially reflects the effect of the fee proposal currently under consideration by the Department.

The effect of subdividing larger fee bases into smaller more numerous fee bases can be further illustrated by the following actual examples. For Fiscal Year 1995, the Oak

Ridge Operations Office permitted Martin Marietta Energy Systems (now Lockheed Martin Energy Systems) to separate total cost estimates into fee bases for each of its three business entities--Laboratory Business Unit, Weapons Business Unit, and Environmental Restoration and Waste Management Business Unit. Thus, Energy Systems' fee structure was calculated on 12 rather than the usual 4 bases. This action had a dramatic effect on the overall total available fee because the fee schedules used by the Department are regressive (i.e., fee percentages increase when the dollar amount of a fee base decreases). By segregating costs into additional fee bases, Martin Marietta Energy Systems' available fees, in Fiscal Year 1995, were \$29.5 million higher than they would have been if four fee bases were used to calculate available fees.

A similar effect was illustrated in a 1995 Office of Inspector General report concerning the Westinghouse Savannah River Company contract. According to the report, Westinghouse received a \$5.2 million fee for the first 6 months of their contract in Fiscal Year 1989 and received \$17.3 million for the 6-month period ending March 1994. This increased fee was due in part to the Department's Savannah River Operations Office allowing the contractor to increasingly subdivide its fee bases from two in Fiscal Year 1989 to eight smaller dollar value fee bases in Fiscal Year 1994. This subdivision allowed the contractor to apply larger fee percentages to the eight smaller fee bases.

The fee policy proposed by the Department which may, by application, substantially increase contractor fees represents a significant change in approach. In 1991, the Department increased the amount of available fee contractors could earn by 100 percent and introduced avoidable cost provisions under the Accountability Rule. The Department's current proposal retains the 100 percent increase for risk associated with the Accountability Rule, but eliminates the previously implemented avoidable cost provisions. Therefore, contractors under the current proposal may have the opportunity for greater available fees without a commensurate increase in risk.

Contractor Risk

The Contract Reform Team's recommended actions and Procurement's proposed revisions are designed to hold contractors more accountable for fines, penalties, third-party liabilities, and loss to Government property. These revisions (1) shift the burden of proof for the allowability of costs related to fines, penalties, etc. from the Government to the contractor and (2) eliminate the contractor's fee as the maximum liability ceiling. However, a Headquarters Procurement representative told us that, in his opinion, shifting the burden of proof or eliminating ceilings did not materially increase contractor risk. Also, the Department could not quantify the cost risk associated with the proposed changes because it did not specifically track items such as fines and penalties. Historically, these costs were paid as operating costs and were not separately identified.

COST-BENEFIT ANALYSIS

A cost-benefit analysis involves a determination of the costs needed to implement a change and the measurable monetary and other benefits envisioned as a result of the change. While a cost-benefit analysis of potential increases in fee is not specifically required by the Departmental Acquisition Regulation, prudent business practice dictates that any change, which increases cost, should be analyzed to determine if the benefits justify the cost. A cost-benefit analysis of increased available management and operating contractor fees should have contrasted the estimated increase in available contractor fees to the expected benefits that would result from the contractor's assumption of additional risk.

Although our analysis of the proposed fee structure shows that contractor available fees may increase substantially, discussions with management indicated that only limited work had been done to quantify the risk or the increase in available fees. In our judgment, prudent business practice dictates that a much broader study be conducted to determine if the benefits justify any increase in available fees. Further, Contract Reform Team and Procurement officials acknowledged that the Department did not have analytical data to demonstrate whether the revisions will be an effective means for making contractors more accountable and improving performance. They indicated that as a practical matter it could take up to 3 to 4 years to determine if the revisions achieved their objective. However, once the new fee policy is in effect and its terms have been incorporated into multi-year management and operating contracts, it may be extremely difficult, if not impossible, to substantially modify the terms of these contracts in the future even though the Department may not be benefiting from the proposed changes.

The Department needs to accumulate detailed information from Departmental field offices that shows how available contractor fees would be impacted by the revised fee structure and the extent to which Departmental costs for fines, penalties, third-party liabilities, and property loss and damage would be reduced prior to promulgation of the new rule. Such information would be one important factor in enabling the Department to assess whether the increase in available contractor fees is commensurate with contractor risk. In October 1995, Headquarters Procurement requested Departmental field offices to provide a calculation of available contractor fees under the proposed fee structure for each contractor by November 1995 in order to assess the impact of the revised structure on contractor fees. A Headquarters Procurement official told us that this information was requested as part of their ongoing effort to track and analyze contractor fees and not as part of the rulemaking effort. However, this data would be a beneficial starting point for initiating a cost-benefit analysis.

This is not the first time the Department increased fees without analyzing the cost and benefits of their proposed change. A similar situation occurred with the implementation of the Accountability Rule. The Office of Inspector General found that no cost-benefit analysis was performed prior to its implementation in 1991. We noted that a cost-benefit

analysis was initiated subsequent to our 1992 audit, however, it was never completed. Subsequent to the implementation of the Accountability Rule, the Department concluded that the Rule, despite its worthwhile objectives, was ineffective and inefficient. We believe that the shortcomings of the Accountability Rule might have become apparent if it had been subjected to a cost-benefit analysis prior to implementation.

REVISIONS MAY NOT BE COST EFFECTIVE

Without performing a cost-benefit analysis of the proposed changes to determine their impact on available contractor fees and cost risk, the Department cannot ensure that the rulemaking effort will be cost effective and achieve the benefits envisioned by the Department. Without an analysis of the costs and benefits of the proposal, the Department could pay additional fees that exceed the contractor's cost risk. Our analysis indicated that available fees may increase by as much as \$218 million. Therefore, the Department should postpone issuance of the proposed rulemaking until a cost-benefit analysis is completed.

An exit conference was held with the Office of Procurement and Assistance Management on April 18, 1996, to discuss the results of the audit. Following this meeting, the Department elected to transmit the notice of proposed rulemaking to the Office of Management and Budget without the fee policy revisions. The Department stated in the notice that its fee policy for profit making and nonprofit contractors will be promulgated as a separate proposal.

PART III

MANAGEMENT AND AUDITOR COMMENTS

On April 30, 1996, the Deputy Assistant Secretary for Procurement and Assistance Management provided revised comments on the audit report. In his response, he set forth a series of objectives that would be followed in developing the new policy. The response indicated that the new proposal would not be issued until the draft fee policy objectives were met. Management comments did not specifically address whether a cost-benefit analysis would be performed. A summary of management and auditor comments follow. Appendix I contains verbatim management comments on the report.

Recommendation

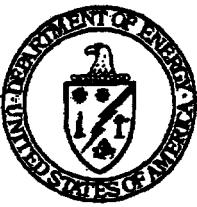
We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management postpone issuance of the proposed revisions to its Acquisition Regulation until a thorough cost-benefit analysis is completed, and it can confirm in both quantitative and qualitative terms that the revisions are cost effective and will achieve the benefits envisioned by the Department.

Management Comments. Management indicated that the evolving nature of the fee policy makes it difficult to provide meaningful comments on the report and stated that the report is based on an outdated version of the draft fee policy. Consequently, management's response focused on the objectives and goal of the evolving fee policy. As shown in management's verbatim comments in Appendix I, management listed the key objectives of the fee policy and indicated that the policy, as it finally evolves, is intended to provide a rational and workable approach to determining reasonable profits and fees under performance-based contracts. Management also indicated that the draft fee policy would not proceed to rulemaking until the Department is satisfied that the policy meets the Department's key objectives.

Auditor Comments. The audit report is based on a March 4, 1996, draft of the Department's fee policy. This version was the latest proposal provided to the auditors, and it was the subject of an extensive discussion with representatives of the Office of Procurement and Assistance Management on April 18, 1996. We recognize that the Department's fee proposal is in a draft stage and is subject to change. However, a review of earlier versions of this policy (August 24 and December 27, 1995) and followup discussions with Procurement officials indicated that the Department foresaw the need to increase fees commensurate with the perceived increase in contractor risk.

The decision not to forward the draft policy to the Office of Management and Budget and to perform a thorough assessment of the policy is laudable. In conducting this assessment, the most important point to note is that any proposal that potentially increases management and operating contractor fees should be subject to a comprehensive cost-benefit analysis. The performance of this analysis would permit the Department to

determine whether the proposal is consistent with the Department's stated fee policy objectives. A cost-benefit analysis would also assist the Department in making contracting "work better and cost less" and potentially prevent a recurrence of the type of problems that were associated with implementation of the Accountability Rule.

**Department of Energy**

Washington, DC 20585

APR 30 1996

MEMORANDUM FOR: **MANAGER, CAPITAL REGIONAL AUDIT OFFICE
OFFICE OF THE INSPECTOR GENERAL**

FROM: **RICHARD HOPF** *(Handwritten signature)*
**DEPUTY ASSISTANT SECRETARY FOR
PROCUREMENT AND ASSISTANCE MANAGEMENT**

SUBJECT: **DRAFT REPORT ON "DEPARTMENT OF ENERGY
MANAGEMENT AND OPERATING CONTRACTOR
AVAILABLE FEES"**

I appreciated the opportunity to meet with you on Thursday, April 18, 1996, regarding your final draft report entitled "Audit of Department of Energy (DOE) Management and Operating (M&O) Contractor Available Fees." The discussion was helpful in my gaining an understanding of your perspective. In addition, it was useful in communicating my perspectives on fee policy, including our objectives in revising the current policy.

As you are aware, the draft fee policy that served as a basis for your audit is not the current and final thinking on the issue. Since your review of that early version of the draft policy, we have further assessed the issues identified in your report, as well as comments and concerns raised by both Headquarters and field staff regarding the draft fee policy. We have been working closely with our stakeholders to ensure that the Department's fee policy, as it finally evolves, represents a rational and workable approach to determining reasonable profits and fees under performance-based management contracts. Because of the evolving nature of the fee policy, it is exceedingly difficult to meaningfully engage in a typical audit/response cycle where the basic policy is in a state of flux. Therefore, rather than respond to the criticisms and issues raised in your report regarding that outdated version of the draft policy, I would like to share with you the key objectives of our efforts to construct a fee policy. These objectives include providing:

- a fee structure that facilitates the application of performance-based management concepts to our M&O contracts and similar contracts, including flexibility in structuring incentives that motivate contractors to excellence and penalize them for failures;

- for the payment of fee based on results, not merely for costs incurred;
- reasonable fees commensurate with the performance, business, and cost risks that will be assumed by the contractor in performance of the contract;
- a fee structure that attracts the best business partners in the management and operation of the Department's facilities and sites;
- for the application of the policy to nonprofit and educational organizations;
- for consistency between future total available fee amounts and the range of fee amounts which have been available and earned in the past;
- for consistency in the amounts of profit and fee paid across the complex for similar types of work; and,
- appropriate checks and balances to ensure consistent and proper application of the fee policy.

In the meeting, you stated that the implementation of the fee policy which you had reviewed could result in an increase in future fees paid to our M&O contractors. It was suggested that the vagaries of the application of that early draft of the fee policy supported that observation. However, I believe that the final regulations will provide sufficient direction and the necessary checks and balances to limit local discretion in the award of fees that are inconsistent with the policy. We are none-the-less appreciative of your concerns and will keep in mind your perspective as we develop future iterations of the fee policy.

You also expressed concern that the draft policy would be released without a thorough assessment of whether the policy would meet the Department's objectives. Please be assured that we will not release the draft fee policy to rulemaking until we are satisfied that the draft fee policy meets these objectives. As that effort progresses, we look forward to sharing the evolving policy with you, and we will work with your staff to address your concerns and suggestions.

You suggested that a cost-benefit analysis be performed to determine the impact of the proposed changes to the current fee policy. In this regard, I would very much appreciate your ideas regarding how such a cost-benefit analysis could be designed, so as to meet our mutual needs. However, it must realistically identify and measure the

consequences of implementing the fee policy. It must be clear regarding what is to be measured, how it is measured, the bounds on the analysis and the success indices to be applied.

I believe we share the same objectives regarding an effective fee policy for the Department's M&O contracts, and I am very interested in working with your office to ensure that they are achieved.

APPENDIX II

**DEPARTMENTAL FEE SCHEDULE
FOR RESEARCH AND DEVELOPMENT EFFORTS**

Fee Base (dollars)	Fee (dollars)	Fee (percent) ¹
25,000	2,500	10.00
50,000	5,000	10.00
100,000	10,000	10.00
200,000	18,000	9.00
400,000	34,000	8.50
600,000	49,000	8.17
800,000	63,000	7.88
1,000,000	77,000	7.70
3,000,000	205,000	6.83
5,000,000	330,000	6.60
10,000,000	614,000	6.14
15,000,000	875,000	5.83
25,000,000	1,318,000	5.27
40,000,000	1,897,000	4.74
60,000,000	2,572,000	4.29
80,000,000	3,170,000	3.96
100,000,000	3,662,000	3.66
150,000,000	4,434,000	2.96
200,000,000	4,955,000	2.48
300,000,000	5,561,000	1.85
400,000,000	6,095,000	1.52
500,000,000	6,556,000	1.31
Over \$500 million	6,556,000	²

¹ The schedule also contains an incremental fee percent for dollar amounts that fall between those shown in the fee base column. The incremental fee percentages also decrease when the fee base increases.

² The incremental fee is 0.46 percent of the fee base amount over \$500 million.

Effect of the Proposed Change on Contractor Available Fees

DOE Office	Contractor	Total Budget	Actual 1995 Available Fee	Projected Fee Per Proposed Rule	Projected	Increase Due to Proposed Rule
					Fee Per Proposed Rule	
1 Oak Ridge Operations	Lockheed Martin Energy Systems	\$ 1,948,370,000	\$ 76,131,000	\$106,928,915	\$ 30,797,915	
2 Savannah River Operations	Westinghouse Savannah River Company	1,700,104,000	50,000,000	81,341,332	31,341,332	
3 Albuquerque Operations	Sandia Corporation	1,538,298,000	14,532,000	25,373,560	10,841,560	
4 Richland Operations	Westinghouse Hanford Company	1,381,657,000	41,000,000	66,374,367	25,374,367	
5 Rocky Flats Field	EG&G Rocky Flats Inc.	901,755,000	23,500,000	39,926,877	16,426,877	
6 Idaho Operations	Lockheed Idaho Technologies Company	808,949,000	42,153,011	76,313,768	34,160,757	
7 Richland Operations	Battelle Memorial Institute	582,500,000	12,300,000	19,127,720	6,827,720	
8 Albuquerque Operations	AlliedSignal Inc.	395,571,000	22,882,500	32,486,824	9,604,324	
9 Pittsburgh Naval Reactors	Westinghouse Electric Corporation	344,251,000	9,020,914	13,242,145	4,221,231	
10 Nevada Operations	Reynolds Electrical & Engineering Co., Inc.	323,334,000	14,530,100	19,440,718	4,910,618	
11 Albuquerque Operations	Mason & Hanger - Silas Mason Co., Inc.	304,250,000	16,590,000	26,094,845	9,504,845	
12 Schenectady Naval Reactors	Lockheed Martin Corporation - KAPL, Inc.	292,162,000	7,833,000	11,254,710	3,421,710	
13 Golden Field	Midwest Research Institute	220,793,000	7,580,000	12,679,897	5,099,897	
14 Headquarters Procurement	TRW Environmental Safety Systems, Inc.	209,943,000	9,234,400	15,047,598	5,813,198	
15 Nevada Operations	EG&G/Energy Measurements, Inc.	184,098,000	(1)	11,750,000	(1)	
16 Strategic Petroleum Reserve	DynMcDermott Petroleum Operations Co.	182,817,048	6,755,000	9,179,954	2,424,954	
17 Headquarters Procurement	Bechtel Petroleum Operations, Inc.	146,800,000	5,800,000	8,408,440	2,608,440	
18 Oak Ridge Operations	MK-Ferguson of Oak Ridge Company	142,733,000	4,849,700	5,993,552	1,143,852	
19 Ohio Field	EG&G Mound Applied Technologies, Inc.	133,835,000	11,740,000	15,220,385	3,480,385	
20 Ohio Field	West Valley Nuclear Services Co., Inc.	129,620,000	-	-	(2)	
21 Nevada Operations	Raytheon Services Nevada	122,773,868	-	-	(2)	
22 Albuquerque Operations	Lockheed Martin Specialty Components, Inc.	86,500,000	7,262,500	9,199,313	1,936,813	
23 Albuquerque Operations	Westinghouse Electric Corporation	73,800,000	-	-	(2)	
24 Savannah River Operations	Wackenhut Services, Inc.	67,470,364	4,120,000	5,397,347	1,277,347	
25 Idaho Operations	Lockheed Idaho Technologies Company	40,969,000	3,220,875	4,158,418	937,543	
26 Rocky Flats Field	Wackenhut Services, Inc.	38,483,500	2,529,772	3,295,867	766,095	
27 Pittsburgh Energy Tech. Ctr.	BDM-Oklahoma, Inc.	38,139,779	2,863,990	3,530,730	666,740	
28 Oakland Operations	Rockwell International Corporation	25,551,120	-	-	(2)	
29 Headquarters Procurement	Fluor Daniel (NPOSR), Inc.	20,235,000	1,440,000	1,826,118	386,118	
30 Richland Operations	Hanford Environmental Health Foundation	19,602,132	440,000	553,439	113,439	
31 Albuquerque Operations	Ross Aviation, Inc.	18,587,566	800,000	908,256	108,256	
32 Nevada Operations	Wackenhut Services, Inc.	18,500,000	1,365,000	1,734,083	369,083	
		<u>\$ 12,442,462,377</u>	<u>\$ 412,223,762</u>	<u>\$630,394,844</u>	<u>\$218,171,082</u>	

(1) Information Calendar Year 1994

(2) Information was not available to make comparison

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