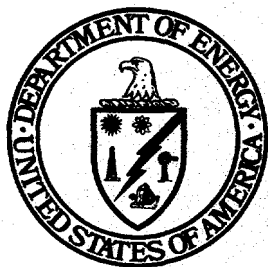


AUDIT REPORT

THE COST REDUCTION INCENTIVE PROGRAM AT THE SAVANNAH RIVER SITE

May 1998



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

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DEPARTMENT OF ENERGY

Washington, DC 20585

May 29, 1998

MEMORANDUM FOR THE MANAGER, SAVANNAH RIVER OPERATIONS OFFICE

FROM: Terry L. Brendlinger, Manager
Eastern Regional Audit Office
Office of Inspector General

A handwritten signature in cursive script, reading "Terry L. Brendlinger", is written over the typed name and title.

SUBJECT: INFORMATION: Audit Report on "The Cost Reduction Incentive Program at the Savannah River Site"

BACKGROUND

The Department of Energy (Department) established a Cost-Reduction Incentive Program (CRIP) at Westinghouse Savannah River Company (Westinghouse) in October 1992. The objective of the CRIP is to provide an incentive for Westinghouse and its employees to examine processes and techniques and make one-time improvements to reduce the cost of the contract and return "saved" funds to the direct control of the Department. In 1997, the Department performed a comprehensive review of Westinghouse's performance-based incentives and cost-reduction incentives, and concluded that most of the savings identified through the CRIP occurred through greater management focus on reducing costs, working smart, or the results of budget constraints, as opposed to innovative changes in work methods and processes. The Assessment Team recommended that the Savannah River Operations Office (Operations Office) reevaluate the effectiveness of the CRIP and consider either modifying the program to provide for payment only for innovative ideas, or cancel the program and utilize performance-based incentives to reward cost savings over some pre-established threshold. The objective of this audit was to determine whether the Operations Office took appropriate action in response to the Department's internal assessment of the CRIP.

RESULTS OF AUDIT

The Operations Office did not take appropriate action in response to the internal assessment. The Operations Office stated that Westinghouse did not agree to the modification or cancellation of the CRIP, and the Department could not unilaterally modify or cancel the program because it was incorporated into the contract. However, the Operations Office could have substantially reduced its CRIP payments to Westinghouse without amending the contract by (1) enforcing the contract terms that required Westinghouse to use best commercial practices and industry standards in contract performance, and (2) requiring Westinghouse to comply with its internal procedure which required that cost-reduction proposals be innovative. As a result of providing CRIP awards to Westinghouse for non-innovative proposals, the Department incurred at least \$1.7 million in unnecessary costs in FY 1997.

We recommend that the Manager, Savannah River Operations Office (1) require Westinghouse to comply with its internal procedure requiring that cost-reduction proposals be innovative and (2) discontinue the practice of providing incentive awards to Westinghouse for non-innovative proposals.

COST REDUCTION INCENTIVE PROGRAM AT THE SAVANNAH RIVE SITE

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Overview

INTRODUCTION AND OBJECTIVE

The Department established a CRIP at Westinghouse in October 1992. The objective of the CRIP is to provide an incentive for Westinghouse and its employees to examine processes and techniques and make one-time improvements to reduce the cost of the contract and return "saved" funds to the direct control of the Department. Under the CRIP, Westinghouse submits cost-reduction proposals to the Department for approval, and the Department shares the savings realized from approved proposals with Westinghouse and its employees. The Department awards Westinghouse up to 25 percent of the savings realized, and Westinghouse is required to share at least 10 percent of its award with the employees who develop the proposals.

In February 1994, the Department's Contract Reform Team issued a report entitled *Making Contracting Work Better and Cost Less*. The Contract Reform Team recommended, and the Secretary of Energy approved, 48 action items to improve contracting practices within the Department. Action Item Number 11 required the development of a Departmentwide incentive program for contractor cost-reduction and cost-avoidance programs. The action item required that contractors be allowed to share in any measurable near-term savings realized, and that contractors be expected to develop a system of cost-savings initiatives for its employees.

The Department issued guidelines for its cost-reduction/cost-incentive program in April 1995. The guidelines state that approved cost-reduction proposals must be initiated by the contractor and describe an innovative change to a design process or method which will result in cost savings to the Department without adversely impacting contract performance. The guidelines define innovative as a new process or method which demonstrates a deviation from a business-as-usual approach by striving for cost effectiveness beyond routine business practice.

The Office of Inspector General (OIG) issued Report DOE/IG-0411, *Report on Audit of the Contractor Incentive Programs at the Rocky Flats Environmental Technology Site*, in August 1997. The audit determined that the Rocky Flats Field Office approved cost-reduction proposals with reported savings of \$16 million which did not meet basic Departmental criteria—they were not innovative and generally did not return savings to the Department.

In addition, the OIG issued three reports in 1997 dealing with performance-based incentives¹ at Departmental sites. In March 1997, we issued Report DOE/IG-0401, *Inspection of the Performance Based Incentive Program at the Richland Operations Office*. The report showed that the Richland Operations Office paid incentive fees that were excessive when compared to the cost of labor and material used to perform the work, or for work that was (1) accomplished before the program was established, (2) not completed, or (3) easily achieved by the contractor. Also, in July 1997, we issued Report DOE/IG-0410, *Audit of Environmental Restoration at the Los Alamos National Laboratory*. The audit found that the performance criteria used to evaluate the cost effectiveness of remediating contaminated sites were not always reasonable, measurable, and complete. Additionally, in October 1997, we issued Report DOE/IG 0412, *Report on Audit of the Contractor Incentive Program at the Nevada Operations Office*. The audit determined that cost-reduction performance measures were vague and non-specific, and the Nevada Operations Office rewarded performance that could not be objectively evaluated.

As a result of the problems identified in OIG reports, the Secretary of Energy directed a comprehensive review of all performance-based management contracts. A review of Westinghouse's performance-based incentives and cost-reduction incentives was conducted as part of the Department's comprehensive review. The Assessment Team issued its *Final Report on the Combined Headquarters/Field Assessment of Incentives Used in Performance Based Management Contracts at the Savannah River Site* in September 1997. The report concluded that a majority of the savings identified for cost-reduction incentives occurred through greater management focus on reducing costs, working smart, or the result of budget constraints, as opposed to true innovation in work

¹ Performance-based incentives are incentive fees paid to a contractor where an identified element of the contractor's profit is tied to the achievement of specific technical performance objectives, delivery schedules, or cost control objectives. The Contract Reform Team report recommended the use of multiple fee arrangements within a single contract, such as the use of an incentive fee and an award fee provision and the development of cost-reduction incentive programs.

methods, processes, and material utilization. The Assessment Team recommended that the Operations Office reevaluate the effectiveness of the CRIP and consider either modifying the program to provide for payment only for innovative ideas, or cancel the program and utilize performance-based incentives to reward cost savings over some pre-established threshold.

The objective of this audit was to determine whether the Operations Office took appropriate action in response to the Department's internal assessment of the CRIP.

OBSERVATIONS AND CONCLUSIONS

The audit disclosed that the Operations Office did not take appropriate action in response to the Department's internal assessment. The Operations Office stated that Westinghouse did not agree to modify or cancel the CRIP, and the Department could not unilaterally modify or cancel the program because it was incorporated into the contract. However, the Operations Office could have substantially reduced its CRIP awards to Westinghouse, without revising the contract, by (1) enforcing contract terms that required Westinghouse to use best commercial practices and industry standards in contract performance, and (2) requiring Westinghouse to comply with its internal procedure which required that cost-reduction proposals be innovative. As a result of providing CRIP incentives to Westinghouse for non-innovative proposals, the Department incurred \$1.7 million in unnecessary costs in FY 1997.

The audit identified a material internal control weakness that management should consider when preparing its yearend assurance memorandum on internal controls.

Office of Inspector General
Office of Inspector General

RESPONSE TO INTERNAL ASSESSMENT

Operations Office Did Not Take Appropriate Action

The Operations Office did not take appropriate action in response to the Department's internal assessment of the Savannah River Site's CRIP. The Operations Office stated that it had several discussions with Westinghouse regarding the Assessment Team's recommendations; however, Westinghouse did not agree to the modification or cancellation of the CRIP. Also, the Operations Office stated that it could not unilaterally modify or cancel the CRIP because the program was incorporated into the contract.

Management stated that in order for Westinghouse to give up its CRIP awards, the Department would have to create a performance-based incentive category to offset the contractor's loss. However, this would result in performance-based incentives/award fees in excess of the contractual limit, and Departmental Headquarters had not agreed to increase the limit. Therefore, the Operations Office neither modified nor canceled the program.

Department Could Have Reduced Awards Without Modifying the Contract

We determined that the Department could have substantially reduced CRIP awards to Westinghouse without modifying the contract or canceling the program. The Department could have enforced the contract terms that required Westinghouse to use best commercial practices and industry standards in contract performance, without benefit of the CRIP. Also, the Department could have required Westinghouse to comply with Departmental guidelines and Westinghouse's internal procedure requiring that cost-reduction proposals be innovative.

The statement of work for the contract requires Westinghouse to use its expertise, best commercial practices, and industry standards in all matters pertaining to contract performance. It also requires Westinghouse to integrate the best-of-class capabilities of industry and academia into the work conducted at the Savannah River Site. Additionally, the contract requires Westinghouse to challenge the status-quo and existing paradigms in formulating and implementing safe, high-quality, timely, and cost-effective programs and operations. If the Operations Office limited its incentive awards to only those proposals that exceeded best commercial practices and industry standards, the Department could have substantially reduced its CRIP awards to Westinghouse.

Additionally, the Department could have required Westinghouse to follow its own internal procedure for submitting cost-reduction proposals to the Department. Westinghouse's procedure states that the program provides monetary incentives for employees to suggest *innovative* ideas that result in hard-dollar (near-term) savings. The procedure defines innovative as a change in existing practice that is not expected as a standard business practice. With respect to standard business practices, the procedure states that the Department expects Westinghouse to exceed minimum performance standards, strive to attain the highest standards as measured against best available practices, be aware of practices employed by other Departmental contractors and the private sector, and use those best practices or experiences as benchmarks to improve cost effectiveness. Despite its procedure requiring cost-reduction proposals to be innovative, Westinghouse submitted proposals that involved standard business practices already being used by other Departmental sites and private industry.

**Cost-Reduction Incentives
Did Not Produce
Innovative Practices and
Techniques**

The cost-reduction incentives paid to Westinghouse did not produce innovative practices and techniques at the Savannah River Site. During FY 1997, Westinghouse submitted 220 cost-reduction proposals for the Operations Office's approval. The Operations Office approved 35 proposals with \$16.3 million in estimated savings, for which Westinghouse was awarded \$2.4 million² in CRIP incentives. We reviewed the 7 largest awards to Westinghouse, which accounted for \$1.7 million, or about 70 percent of the total CRIP incentives awarded during the year. We found that none of the proposals identified innovative business practices or techniques. The proposals identified business practices and techniques that are commonly used by other management and operating contractors or by private industry. Four examples follow.

² Westinghouse received \$0.6 million during FY 1997 and will receive \$1.8 million upon validation of the actual savings achieved in FYs 1998 and 1999.

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- The Department awarded \$937,000 to Westinghouse for implementing a commercial design process into the *Conduct of Engineering and Technical Support Manual*. The cost-reduction proposal stated that the revised practices and processes were consistent with those found in industry and non-nuclear utilities. The process identified the minimum set of procedures required to execute program support and general service modifications commensurate with the best practices used by commercial architect/engineering firms for similar modifications.
 - The Department awarded \$164,000 to Westinghouse for reducing railroad transportation cost. Prior to the proposal, Westinghouse transported coal and other commodities to the site exclusively by rail. Westinghouse proposed that it could save the Department \$1.1 million by transporting coal and other commodities using a combination of rail and trucks.
 - The Department awarded Westinghouse \$158,000 for implementing productivity improvements in the Engineering and Construction Division Controller Department. The improvements included (1) reorganizing the department into three groups with clearly defined, non-overlapping tasks for each employee; (2) consolidating or eliminating monthly and weekly reports; and (3) reducing the number of meetings.
 - The Department awarded Westinghouse \$90,000 for eliminating unnecessary office supplies from its inventory. Westinghouse stated that the new process would identify inventory items that could be eliminated or replaced with less-expensive items performing the same function. Additionally, "nice to have items," which also have functional, mission-related purposes, would be controlled through management approval. Westinghouse estimated that the new process would eliminate purchases of \$300,000 in non-essential office supplies each year.

The proposals summarized above involve business practices and techniques that are commonly used by other management and operating contractors and private industry. For example, Lockheed Martin Energy Systems uses a combination of railroad and trucking services to economically transport coal to the Y-12 Plant in Oak Ridge, Tennessee.

Westinghouse's proposals appear to be typical of the types of actions taken by managers in the Government and private industry to avoid waste and inefficiency. Cash incentives should not be required to motivate Westinghouse to produce these types of actions.

Program Resulted in Unnecessary Costs

As a result of these conditions, the Department incurred at least \$1.7 million in unnecessary costs in FY 1997. The Department also incurred costs for Westinghouse and the Operations Office to process non-innovative CRIP proposals. However, neither Westinghouse nor the Department tracked the amount of time spent preparing, reviewing, and approving the proposals. Therefore, we could not determine administrative costs for the program.

RECOMMENDATIONS

We recommend that the Manager, Savannah River Operations Office:

1. Require Westinghouse to comply with its internal procedure requiring that CRIP proposals be innovative, and
2. Discontinue the practice of giving incentive awards to Westinghouse for non-innovative proposals.

MANAGEMENT REACTION

Management partially concurred with the finding and recommendations. Management concurred that the Operations Office had not taken aggressive action towards implementing the recommendations in the internal assessment report. However, management stated that the Operations Office and Westinghouse are currently evaluating the CRIP with the objective of minimizing the administrative costs and making it more consistent with Departmental policy. Management stated that the CRIP was initiated at the Savannah River Site in 1992 as a simple cost reduction program, and that innovation, as the term is used today, was not a requirement. The Operations Office is attempting to modify the program so that innovative ideas are rewarded under the CRIP and non-innovative yet laudable ideas are rewarded under the award fee portion of the contract. The target date for the modification is October 1, 1998. Management's entire response is in Appendix 2 of this report.

AUDITOR COMMENTS

Management's comments were not fully responsive to the audit recommendations. Management's comments suggest that the audit recommendations could not be implemented without first modifying the contract or obtaining Westinghouse's concurrence. However, Westinghouse's contract states that the Department's Contracting Officer may accept or reject, in whole or in part, any CRIP proposal submitted by Westinghouse. The acceptance or rejection criteria is nonspecific, and the contract terms do not require acceptance of any particular CRIP proposal. Thus, the Contracting Officer could reject any Westinghouse proposal considered to be non-innovative without violating the terms of the contract. For this reason, we do not agree that the Department must modify the contract before it can implement the audit recommendations. Nevertheless, if management is successful in achieving a timely contract modification which limits CRIP awards to innovative proposals, we would consider the Department's actions to be consistent with the intent of the audit recommendations.

Appendix 1

SCOPE

The audit was performed at the Savannah River Site in Aiken, South Carolina, from September 17, 1997, through February 4, 1998. The audit included a review of cost-reduction proposals submitted by Westinghouse and approved by the Operations Office in FY 1997.

METHODOLOGY

To accomplish the audit objective, we:

- Reviewed Departmental and Operations Office guidelines and internal assessments regarding CRIP management;
- Evaluated the terms of the Department's contract with Westinghouse regarding the statement of work and CRIP provisions;
- Reviewed Westinghouse internal procedures regarding development and submittal of cost-reduction proposals to the Operations Office;
- Evaluated seven cost-reduction proposals, with the highest dollar values approved in FY 1997, to determine whether the proposals involved innovative processes or techniques; and
- Determined the total amount of cost-reduction incentives awarded to Westinghouse and the cost incurred by the Operations Office and Westinghouse to administer and manage the CRIP in FY 1997.

The audit was conducted in accordance with generally accepted Government auditing standards for performance audits, and included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the objective of the audit. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. We did not rely on computer-generated data during this audit.

An exit conference was waived by the Savannah River Operations Office.

Appendix 2

United States Government

Department of Energy (DOE)

Savannah River Operations Office (SR)

memorandum

DATE: May 11, 1998

REPLY TO

ATTN OF: CMD (Reynolds/803-725-1680)

SUBJECT: Draft Report on "The Cost Reduction Incentive Program at the Savannah River Site"
(Your memo, dated 4/13/98)

To: Terry L. Brendlinger, Manager, Eastern Regional Audit Office, (IG-36), OR

The attachment to this memorandum addresses the recommendations contained in the subject draft report.

Some understanding of the background of this Cost Reduction Program (CRP) is necessary in order to understand SR's implementation. The CRP was initiated at SR in 1992 and was intended as a means to reduce the cost of contract operations. The program was designed and implemented as a simple cost reduction program. The concept was based upon a belief that budgeted funds would be expended unless there was an incentive to the contractor to reduce costs of operation. An integral part of the program was to obtain the involvement of the contractor employees who would see, on a day-to-day basis, the opportunities to save money. Accordingly, a provision in the program was a requirement for the contractor to share the savings with the employees. Innovation, as the term is utilized today, was not a contractual criteria under the program.

We agree the contractor did not strictly follow its own internal procedures which required innovation or initiative and suggestions which went beyond "good management practices." However, these procedures were more restrictive than the terms of the contract, are subject to change by the contractor without DOE approval, and were not the basis for DOE's payments. Overall we believe the program has been a tremendous success with over \$750M in savings resulting from the program, with only \$21M paid to the contractor. The potential for an additional \$46M in savings has yet to be validated for outyears. The key to the program's success has been the involvement of the entire workforce in identifying cost savings opportunities, whether they be driven by innovation, efficiencies, design changes, introduction of new best-practice based approaches or application of more traditional practices to the accomplishment of work.

Employees and management identify cost saving initiatives, along with the proposed amount of the savings. These savings are returned to DOE through a formal change control process and the initiative is implemented. Only then is the proposal considered, by the DOE, for an incentive award. The contractor has returned 10 percent of the incentive payment to the employee(s) who initiated and implemented the savings ideas.

In summary, I concur SR did not take aggressive action towards implementing the recommendations made in the Department's 1997 internal assessment report on SR's Program. While there have been ongoing discussions at the staff level regarding the program with the contractor, we have not reached resolution on the issue. I concur it is time for the program to be revised and we have already commenced senior management level discussions with the contractor towards this end. We are looking towards a program where, for example, innovation is rewarded under the CRP and non-innovative yet laudable ideas are addressed under the award fee portion of the contract.

The draft report indicates your office believes a material internal control weakness exists due to payments being made for non-innovative proposals. We cannot agree with this assessment as innovation has not been a standard in the contract for payment; and accordingly, all payments made to the contractor have been consistent with the existing terms of the contract. As noted above, however, this is an area we have identified for improvement.

I appreciate the opportunity to provide input and comments to assist the OIG in its validation and final report efforts. If you or your staff have any questions, contact Alfred Garrett at 803-725-7790, for audit matters or concerns regarding comments to the findings and recommendations in the draft report.

/s/

Greg Rudy
Acting Manager

FED:TER

TD-98-0044

Attachment:
Comments on Draft Report on "The CRP at SRS"

cc w/att:
HR-5
FM-1

Attachment: Memorandum, Rudy to Brendlinger, Draft Report on "The Cost Reduction Incentive Program at the Savannah River Site," dated May 11, 1998.

**COMMENTS ON DRAFT REPORT ON "THE COST REDUCTION
INCENTIVE PROGRAM AT THE SAVANNAH RIVER SITE**

RECOMMENDATION

1. The Manager, Savannah River Operations Office require Westinghouse Savannah River Company (WSRC) to comply with its internal procedure requiring that Cost Reduction Incentive Program (CRP) proposals be innovative.

SR RESPONSE:

Partially Concur. The DOE contract with WSRC (DE-AC09-96SR18500, Clause H.37, Cost Reduction Proposal) does not require that proposals be innovative. Furthermore, because the referenced procedure is an internal WSRC procedure, it could be changed by WSRC to mirror the contract language.

However, DOE and WSRC are evaluating the program with the objective of minimizing the administrative costs and making it more consistent with the new DOE guidance contained in Acquisition Letter 97-09. Although the new program has not been finalized, we believe it may contain a combination of the Award Fee process and the CRP. The CRP could be limited to truly innovative actions and initiatives and the Award Fee portion address non-innovative initiatives. This structure will retain the beneficial aspects of management and employee involvement and initiative in identifying all types of potential cost reductions and efficiencies. Modification to the CRP clause will require negotiations between DOE and WSRC. We anticipate a modification to the contract will be effected by October 1, 1998.

RECOMMENDATION

2. The Manager, Savannah River Operations Office discontinue the practice of giving incentive awards to WSRC for non-innovative proposals.

SR RESPONSE:

Partially concur. As stated above, the DOE contract with WSRC (DE-AC09-96SR18500, Clause H.37, Cost Reduction Proposal) does not require that proposals be innovative, and DOE cannot unilaterally impose an innovative requirement. Also as stated above, DOE and WSRC are evaluating the program with the objective of streamlining the process and making it more consistent with the new DOE guidance contained in Acquisition Letter 97-09.

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