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Audit of Department of Energy Support Service Contracting

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U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL

AUDIT OF
DEPARTMENT OF ENERGY
SUPPORT SERVICE CONTRACTING

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Report Number: CR-B-95-06
Date of Issue: June 30, 1995

Capital Regional Audit Office
Germantown, Maryland 20874

MASTER

AUDIT OF DEPARTMENT OF ENERGY
SUPPORT SERVICE CONTRACTING

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

AUDIT OF DEPARTMENT OF ENERGY
SUPPORT SERVICE CONTRACTING

Audit Report Number: CR-B-95-06

SUMMARY

The Department of Energy (Department) awards support service contracts when it needs to acquire special knowledge and skills not available within the Department or when they are available in the private sector at a lesser cost. Annual expenditures for support service contracts have increased from \$88 million in 1980 to \$674 million in Fiscal Year 1994. The Department's 313 active support service contracts cover a wide variety of services that help the Department accomplish its mission. They include grounds maintenance, security, electrical and plumbing, transportation, and management support services.

The purpose of this audit was to review the Department's acquisition and use of support service contractors and subcontractors. The audit objectives were to determine if the Department (1) paid fees to both support service contractors and subcontractors for services exclusively performed by subcontractors, (2) used support service contractors to perform inherent government functions, and (3) rolled over unearned award fees to subsequent evaluation periods and had adequate management controls to ensure that contractor performance would be evaluated.

The Department did not always obtain support services in the most economical and effective manner. The Department negotiated and paid four of six support service contractors an estimated \$5.1 million in fees for services exclusively provided by subcontractors because the Department did not have a policy which addressed the inclusion, at the pre-award phase, of subcontract labor in the support service contractors' fee determinations. Furthermore, while we found no instances where support service contractors performed inherent government functions, we did note that the Department maintained minimal administration over major portions of contracted-for services on three of six support service contracts. This occurred because contractors subcontracted extensively for support services. Consequently, the Department may have decreased their ability to control cost growth on these three contracts. As discussed in Part IV, the Department's process was sufficient in five of six cases to evaluate support service contractor performance. However, one of six cost-plus-award-fee contractors received award fees that exceeded its performance ratings by \$89,000 because one

Departmental office elected to rollover unearned portions of fees from prior evaluation periods and make them available in the next evaluation period.

To resolve these issues, we recommend that the Deputy Assistant Secretary for Procurement and Assistance Management (1) develop and implement support service pre-award procedures starting with the request for proposals that ensure the support service contractor's fee is based only on the direct labor hours they expend and (2) pursue opportunities to reduce support service contractors' subcontracting to a level where the Department, not the support service contractor, is administering a substantial portion of support services.

Department management did not concur with the finding and recommendations noting that the recommendations are inappropriate and lack supporting rationale.

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PART I

APPROACH AND OVERVIEW

INTRODUCTION

The Department awards support service contracts when it needs to acquire special knowledge and skills not available within the Department or when they are available in the private sector at a lesser cost. Annual expenditures for support service contracts have increased from \$88 million in 1980 to \$674 million in Fiscal Year 1994.

The purpose of this audit was to review the Department's acquisition and use of support service contractors and subcontractors. The objectives of this audit were to determine if the Department (1) paid fees to both support service contractors and subcontractors for services exclusively performed by subcontractors, (2) used support service contractors to perform inherent Government functions, and (3) rolled over unearned award fees to subsequent evaluation periods and had adequate management controls to ensure that contractor performance would be evaluated.

SCOPE AND METHODOLOGY

The audit was performed from September 13, 1993, through July 28, 1994, at the Department's Chicago Operations Office; Headquarters Procurement Operations Office; Pittsburgh and Morgantown Energy Technology Centers; and Yucca Mountain Project Office. We also obtained information on two support service contracts from Albuquerque Operations Office and Western Area Power Administration officials. We used September 16, 1993, Procurement and Assistance Data System information to select a judgmental sample of support service contracts for review at these locations. As of September 16, 1993, the system listed 313 active support service contracts totaling \$2.4 billion. We evaluated nine support service contracts (listed in Table 1) valued at \$769 million.

Service contracts A through C are cost-plus-fixed-fee contracts and contracts D through I are cost-plus-award-fee contracts. The primary difference between the cost-plus contract documents is the method used to determine the fee. A cost-plus-fixed-fee contract provides for payment to the contractor of a negotiated fee that is fixed at the beginning of the contract. The fee does not vary with actual cost but may be adjusted as a result of changes in the scope of work performed under the contract. In contrast, a cost-plus-award-fee contract provides for a fee consisting of (1) a base amount (which may be zero) fixed at inception of the contract and (2) an award amount based upon a judgmental evaluation by the Government sufficient to provide motivation for excellence in contract performance.

TABLE 1

SERVICE CONTRACTS REVIEWED

<u>Departmental Office</u>	<u>Service Contracts</u>	<u>Contract Type</u>	<u>Departmental Contract Number</u>
Headquarters	A	CPFF	AC01-93EW10279
Chicago	B	CPFF	AC02-90CH10415
Morgantown	C	CPFF	AC21-90MC26328
Headquarters	D	CPAF	AC01-88MA33222
Pittsburgh	E	CPAF	AC22-89PC88400
Nevada*	F	CPAF	AC08-87NV10576
Headquarters	G	CPAF	AC01-92MA21100
Albuquerque	H	CPAF	AC04-91AL58678
West. Area Power	I	CPAF	AC65-89WA04360

CPFF = Cost-plus-fixed-fee

CPAF = Cost-plus-award-fee

* Contract administered by Yucca Mountain Project Office

We reviewed six of the nine contracts (A through F) to determine whether the Department (1) negotiated and paid fees to its support service contractors for services exclusively provided by subcontractors, (2) used support service contractors to perform inherent Government functions, and (3) maintained control over contracted-for support services. The other three contracts (G through I) were not addressed under objectives one and two because of their relatively small dollar value. For contracts A through F, we reviewed pre-award documentation and identified subcontractor hours included in the support service contractors' fee calculation. We multiplied the percentage of subcontractor hours provided on each contract by the total fees paid to the service contractor to determine the amount of fees the Department paid to six support service contractors for work performed by subcontractors. We analyzed contractual arrangements between support service contractors and subcontractors and task assignments issued to each to determine if the support service contractors performed inherent Government functions and whether the Department administered contracted-for services. Service contractor and Departmental officials were also interviewed to determine the service contractor's role on those tasks that were primarily performed by subcontractors.

Furthermore, we reviewed six cost-plus-award-fee contracts (D through I) to determine if adequate management controls existed to evaluate contractor performance and if contractor award fees exceeded its performance ratings. We examined award fee evaluation processes, procedures, plans, and determination reports. We also reviewed contractor invoices and award fee determination reports to determine if Departmental offices rolled over unearned service contractor award fees to subsequent

evaluation periods. If unearned award fees were rolled over, we analyzed service contractor award fee payments to determine if they exceeded their performance ratings.

We examined applicable Federal laws and Federal and Departmental regulations, procedures, and practices as well as Department and contractor records and documents. We also interviewed Departmental officials responsible for administering these contracts, contractor personnel, and Office of Management and Budget officials to obtain additional information and discussed selected aspects of contract award and administration.

The audit was made 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 objectives of the audit. We utilized computer-processed data in a major Departmental system to identify the universe of support service contractors and did not fully examine the reliability of the computer generated data. 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 discussed this report with members of the Deputy Assistant Secretary for Procurement and Assistance Management's staff on March 30, 1995.

BACKGROUND

The Department's support service contractors provide a wide variety of services that help the Department accomplish its mission. They include grounds maintenance, security, electrical and plumbing, transportation, and various administrative; technical; and management support services. Departmental Headquarters Offices administered 153 of the total 313 active support service contracts. The other 160 were administered by other Departmental offices. The majority of the support service contracts (216) were cost-plus-fixed-fee, 7 were cost-plus-award-fee, and the remaining 90 were other types such as fixed-price and labor-hour contracts.

Support service contracts often require the delivery of an authorized level-of-effort (direct productive labor hours) that are controlled through the issuance of task assignments--i.e., written plans normally prepared by the program office requiring the service. Task assignments generally contain a description of the work needed, the estimated labor hours and cost, and required deliverables. Service contractor profits are based on direct productive labor hours provided under the contract.

The Contract Reform Team in its February 1994 report, "Making Contracting Work Better and Cost Less," recommended a series of actions that could result in fundamental changes in the Department's contracting practices and contract administration techniques. The report included several concerns with the

Department's support service contracting practices. These concerns included whether (1) use of cost-reimbursement contracts is the most cost effective way to acquire contractor services, (2) service contractors are performing governmental functions, and (3) service contracts are well managed. They also noted that the Department's technical and management support service contracts are generally cost-plus-fixed-fee with work initiated through issuance of task assignments. While this approach provides flexibility to meet unplanned program needs, the report noted that costs frequently exceed original contract estimates primarily because of poorly defined program requirements; overly broad statements of work; and underestimated contract hours. The report further noted that the Department's use of cost-reimbursement type support service contracts with poorly defined work requirements shifts the performance and cost risks to the Department.

The Reform Team also reported that well defined support service contracts often may be the most cost-effective means of procuring expertise. They noted that instead of awarding or extending cost-reimbursement contracts, the Department should (1) determine whether discrete tasks or functions can be performed and separately competed or subcontracted on a fixed-price basis; (2) develop objective, policy-based performance measures and incentives when a cost-reimbursement contract is appropriate for some or all of the work; (3) use the best contracting approach that addresses required work, policy-driven requirements, and incentives; and (4) actively pursue and solicit competition on new contracts.

OBSERVATIONS AND CONCLUSIONS

The Department did not always obtain support services in the most economical and effective manner. The absence of a Departmental policy that addresses the inclusion of subcontractor labor in support service contractor fee determinations during the contract pre-award phase resulted in the Department paying \$5.1 million in fees to four of six support service contractors for services exclusively provided by subcontractors. Two Departmental offices took actions during the pre-award phase to limit support service contractor fees on two of six support service contracts. One office negotiated a service contract that required the support service contractor to share its fees with several subcontractors. The other office proposed and negotiated a service contractor fee that was based on the direct labor hours the support service contractor provided exclusive of subcontractor hours. These two offices considered these practices to be economical. Furthermore, in three of six support service contracts, the Department maintained minimal administration over major portions of contracted-for support services because three Departmental offices permitted extensive subcontracting for specialized support service skills. These three support service contractors subcontracted from 34 to 56

percent of the work effort. As a result, Departmental administration of these contracts was diminished which may have contributed to contract cost growth.

Our analysis of six cost-plus-award-fee contracts found that only one of the six contractors received award fees that exceeded its performance ratings. The Pittsburgh Energy Technology Center's service contractor received award fees that exceeded the contractors' performance evaluation score in 5 of 10 evaluation periods. During these five periods, the contractor received over 99 percent of the available award fee despite the fact that its performance score ranged from 90.60 percent to 97.38 percent. The Center paid over \$89,000 in award fees that exceeded the contractors performance because it elected to rollover unearned fees and make them available in subsequent evaluation periods as an incentive to improve the contractors performance. However, our analysis of the performance ratings showed that the contractors performance only improved marginally in most periods and, in fact, declined over three consecutive periods.

The need to limit support service contractor fees during the pre-award phase to only direct labor hours they expend and ensure effective administration of service contracts should be considered by the Department in preparing its yearend assurance memorandum on internal controls.

PART II

FINDING AND RECOMMENDATIONS

Support Service Contract Arrangements

FINDING

Acquisition regulations require that Federal agencies obtain support services in the most economical and effective manner. On management and operating contracts, acquisition regulations require the Department to exclude estimated subcontract costs from the fee base under certain conditions. In addition, Federal agencies are required to exercise effective contract administration to ensure that the Government maintains control over its service contracts. The Department did not always obtain support services in the most economical and effective manner. The Department (1) negotiated contracts that required it to pay fees to both support service contractors and subcontractors for services exclusively provided by subcontractors and (2) maintained minimal administration over major portions of contracted-for services on three of six support service contracts. This occurred because the Department lacked a policy for addressing the inclusion of subcontractor labor in the service contractors' fee determinations during the contract pre-award phase and permitted extensive subcontracting by support service contractors. Because of these contractual fee arrangements and extensive subcontracting, the Department paid an estimated \$5.1 million in fees to four of six support service contractors for work exclusively provided by subcontractors and may have decreased their ability to control cost growth on three of six support service contracts.

RECOMMENDATIONS

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

1. Develop and implement support service pre-award procedures starting with the request for proposals that ensure the support service contractor's fee is based only on the direct labor hours they expend.
2. Pursue opportunities to reduce support service contractors' subcontracting to a level where the Department, not the support service contractor, is administering a substantial portion of support services.

MANAGEMENT REACTION

Management did not concur with the finding and recommendations and noted that they strongly disagree with the

report. Management stated that they believe the report's recommendations are inappropriate and lack supporting rationale. Detailed management and auditor comments appear in Part III of this report.

DETAILS OF FINDING

ACQUISITION AND CONTRACT ADMINISTRATION REQUIREMENTS

The Federal Acquisition Regulation requires that the Department obtain services in the most economical and effective manner. This regulation requires a determination of the resources needed to provide the contracted services and the use of prudent business judgment in carrying out procurement actions. Departmental Acquisition Regulations require the Department to exclude estimated subcontract costs from a management and operating contractors' fee base when subcontractor costs are of such magnitude or nature that they distort the technical and management effort actually required of the management and operating contractor. However, this is not a requirement for support service contractors.

Office of Management and Budget Policy Letter 92-1 requires that Federal agencies exercise effective oversight of any contract awarded to ensure that the contract is under the control of Government officials. The Policy Letter cites several factors that should be considered in deciding if Government officials have lost or might lose control over contract administration. These factors include the degree to which agencies have effective management policies and procedures that enable meaningful oversight of contractor performance, the resources available for such oversight, the agency's oversight practices, the duration of the contract, and the complexity of the tasks to be performed.

SUPPORT SERVICE PRACTICES

The Department did not always obtain support services in the most economical and effective manner. Department contracting officials' pre-award practices permitted support service contractors (A,B,D,F) to base their fees on subcontractor as well as their own costs and labor hours. We also noted that three service contractors (A,E,B), rather than the Department, administered 56, 55 and 34 percent, respectively, of the effort expended on these contracts.

Fee Determinations

Department contracting officials negotiated contracts that resulted in fee payments to both support service contractors and subcontractors for services exclusively provided by subcontractors. As shown in Table 2 this occurred on four of six contracts.

TABLE 2

SERVICE CONTRACT FEES PAID

<u>Labor Hours (in 000's)</u>				<u>Fees Paid (in Millions)</u>	
<u>Service Contract</u>	<u>Contractor Hours</u>	<u>Subs. Hours</u>	<u>Total Hours</u>	<u>Contractor Based on Total Hrs.</u>	<u>Subcontractor</u>
A	186	236	422	\$ 1.8	\$.8
B	311	157	468	1.8	.7
C	1,866	(a)	1,866	3.7	(a)
D	5,126	1,519	6,645	6.0	2.5
E	1,000	1,245	2,245	4.0	(b)
F	2,114	343	2,457 (c)	15.0	1.5

(a) Subcontractor hours were excluded from service contractor fee determination during the pre-award phase.

(b) Subcontractors share in fees paid to service contractor as stipulated in the contract.

(c) Includes only option period direct labor through March 2, 1994.

Unlike management and operating contractors, the Department allowed support service contractors to negotiate and base their fees on services exclusively provided by their subcontractors. This negotiating practice frequently resulted in excessive negotiated fees for support service contractors. As shown in Table 3, the Department negotiated support service contractor fees that ranged from 5 percent to 21.6 percent of the service contractors' estimated costs. Additional fees of 4.6 to 16.4 percent were paid to subcontractors for their work.

TABLE 3

SERVICE CONTRACTOR AND SUBCONTRACTOR
FEES AS A PERCENTAGE OF COST

<u>Service Contract</u>	<u>Contractor Costs (in 000's)</u>		<u>Total Fees Negotiated (in 000's)</u>	<u>Contractor Fee Percent</u>	<u>Subcontractor Fee Percent</u>
A	\$10,051		\$2,173	21.6	4.9 to 8.1
B (a)	19,497		2,226	11.4	6.6 to 16.4
C	80,428	(b)	4,826	6.0	(c)
D	116,357		8,223	7.1	4.6 to 8.0
E	62,293	(d)	3,115	5.0	(d)
F	426,806	(b)	42,564	10.0	8.9 to 9.3

- (a) Includes original and Modification 111 of the contract.
- (b) Includes both service contractor and subcontractor costs because costs for each were not available.
- (c) Fee information not available because subcontracts were generally fixed price.
- (d) Includes subcontractor costs and fees because subcontractors shared in total negotiated fees.

Appendix B shows the actual costs and fees claimed by the six support service contractors and their major subcontractors. The following examples illustrate where support service contractors relied extensively on subcontractors to complete major portions of contract work assignments and included subcontractor labor hours in their fee determination.

In January 1993, the Departmental Headquarters Procurement Operations Office awarded a \$27.7 million contract to support service contractor A for the contract base period. This included \$10 million in support service contractor costs, \$15.5 million in subcontractor costs, and \$2.2 million in support service contractor fees. Support service contractor A was required to provide 513,000 direct labor hours during a 3-year period for the Department's Environmental Restoration and Waste Management Program. The 513,000 hours authorized under the contract included both support service and subcontract labor hours and, along with the total estimated contract costs, formed the basis for the negotiated \$2.2 million fee. Contract A's support services included engineering and technical analysis, quality assurance, planning, training, and outreach activities. To complement its in-house expertise, the support service contractor acquired additional broad-based and specialized skills

in such areas as quality management systems; training; and environmental restoration and waste management activities from five subcontractors.

As of February 1994, support service contractor A claimed 422,000 labor hours for work performed on 32 tasks. Five subcontractors provided over 236,000 of these hours, or 56 percent, and the support service contractor provided the other 186,000 hours. In accordance with negotiated fee arrangements, the Department paid \$1.8 million in fees to this support service contractor. The contractor's fee was based on his and the subcontractors' costs and labor hours. Another \$800,000 in fees were paid to subcontractors. In effect, an estimated \$1 million of the \$1.8 million the support service contractor received in fees was based on subcontractor costs and direct labor hours.

Other examples of fee payments to service contractors for work exclusively performed by a subcontractor were clearly evident at the task level. For example, a subcontractor on support service contract B provided 38,923 of 38,989 labor hours (99.8 percent) needed for one task. The Department paid a total of \$297,000 in fees for this task: \$167,000 was paid to the service contractor for 66 hours it provided and the 38,923 hours direct labor hours provided by the subcontractor. The remaining \$130,000 was paid to the subcontractor. On another task, a subcontractor provided 12,555 of 12,954 hours or 97 percent of the effort. The Department paid the service contractor \$55,000 in fees for 399 direct labor hours it provided and the 12,555 hours provided by the subcontractor. An additional fee of \$74,000 was paid to the subcontractor for this task.

Administration of Support Services Contracts

The Department maintained minimal administration over major portions of contracted-for support services on three of six contracts. The Department's Contract Reform Team also recognized that the Department was not adequately in control of its contractors and, consequently, contractors were not sufficiently accountable to the Department. Our finding supports the Reform Team's conclusion on three of six service contracts we examined. As shown in Table 4, support service contractors A, E, and B subcontracted out 56, 55 and 34 percent, respectively, of their support service contract with the Department. As a result, the Department was unable to directly administer major portions of the services it contracted-for to accomplish its mission and may have decreased its ability to control cost growth.

TABLE 4

DIRECT LABOR HOURS CHARGED BY CONTRACT
(in 000's)

<u>Service Contract</u>	<u>Total Hours</u>	<u>Contractor Hours</u>	<u>Subcontractor Hours</u>	<u>Percent of Subcontract Effort</u>
A	422	186	236	56
E	2,245	1,000	1,245	55
B	468	311	157	34
D	6,645	5,126	1,519	23
F	2,457	2,114	343	14
C	1,866	1,866	*	*

* Subcontractor direct labor hours not available.

The Department did not have "privity of contract" with subcontractors under the contract terms and, therefore, the Department relied on its support service contractors to administer subcontractor work. "Privity of contract" means that there is a legally recognized connection between parties to a contract and, therefore, legally enforceable rights exist between the parties. As shown in Appendix A, service contractor A's subcontractors provided from 55 percent to 100 percent of the direct labor on 19 tasks, which included various engineering and technical analysis support; specialized studies; quality assurance; planning; and education and training activities.

The following two examples illustrate that support service contractor A, not the Department, was administering major portions of the subcontractor's work. A subcontractor with specialized training expertise provided over 30,000 of the 33,000 hours needed to conduct training courses for Department employees. On another task involving technical assistance activities, graphics and audio/visual services, monitoring trade publications, and developing an information center, three subcontractors provided 49,000 of the 59,400 hours or 82 percent of the hours expended on this task. The scope of work the service contractor included in the two subcontracted tasks was essentially identical to the scope of work contained in the Department's task assignments issued to the service contractor. According to the service contractor representative, one of the contractor's functions was to administer the subcontractor's work. The service contractor representative told us that subcontractor invoices were reviewed to ensure that claimed costs were reasonable and allowable and that the subcontractors performed the work in accordance with the task assignments. We also discussed the contractors role on the 19 tasks that involved mostly subcontractor labor with the responsible Departmental personnel. We were informed that the contractor's direct labor effort on these tasks primarily involved administering the subcontractor's work.

DEPARTMENTAL POLICY

Paying fees to service contractors and subcontractors for services provided exclusively by the subcontractor and minimally administering major portions of contracted-for support services occurred because neither the Department's procurement policy nor Federal Acquisition Regulations address these issues. References from the Office of Management and Budget only indicate that agencies should procure services in an economical manner and maintain control over services provided by support service contractors. As a result, the Department permitted each procurement office to independently negotiate support service contractor fee arrangements and the extent to which service contractors subcontracted for services.

Subcontractor Labor Hours

Procurement officials with Departmental Headquarters, Chicago Operations Office, and the Yucca Mountain Project Office negotiated the inclusion of subcontractor direct labor hours in four of the six service contractors' fee calculations. They informed us that this is a common practice that occurs on most contracts and explained that the Department uses the weighted profit guidelines criteria contained in Federal and Departmental Acquisition Regulations to establish a profit/fee objective prior to award. The guidelines allowed contractors to earn a profit for subcontracted items to compensate them for managing subcontractor activities.

However, the Pittsburgh and Morgantown Energy Technology Centers (Pittsburgh and Morgantown) negotiated support service contracts that limited support service contractor fees. Pittsburgh's contract stipulated that the support service contractor and subcontractors would share fees from an award fee pool. In accordance with the teaming agreement between the service contractor and its subcontractors, the award fee was to be shared among the contractor and subcontractors according to the costs each incurred. The contractor stated in the teaming agreement that Pittsburgh "benefits in this approach since there is no 'pyramiding' of fee; i.e., we do not add fee on fee between prime and TEAM subcontractors." A Pittsburgh contracting official told us that there is no Departmental policy that prohibits contractors from including subcontractor labor in its fee determinations. However, he advised us that Pittsburgh's policy is to inform potential contractors prior to negotiations that they must share fees with their subcontractors. He stated that this policy is an economical and efficient way to do business.

Morgantown negotiated a specified number of direct labor hours to be provided under support service contract C during the base and option years of the contract. Morgantown used the Department's weighted profit guidelines criteria to establish a profit/fee objective prior to contract award. In accordance with the guidelines, the support service contractor was permitted to

earn a fee for managing subcontractor activities. However, the support service contractor's fee was based upon the direct labor hours the service contractor provided and not upon labor hours or cost incurred by subcontractors. A Morgantown contracting official told us that he does not believe the contractor should receive fees on subcontracted labor noting that including subcontract labor in support service contractor fee determinations is costly and an uneconomical practice.

Extensive Subcontracting

Support service contractors, not the Department, administered major portions of services the Department needed to accomplish its mission because some Departmental offices permitted extensive subcontracting for specialized support service skills. According to Department contract officials, the Department did not have "privity of contract" with subcontractors and, therefore, relied on its support service contractors to administer subcontractor work. Although Headquarters, Pittsburgh Energy Technology Center, and Chicago Operations Office were aware at the time of award that its service contractors would use subcontractor personnel extensively to meet the broad work required under the contract statement of work, they awarded these task order/work segment contracts to ensure that all services could be obtained quickly as program needs were identified.

A contracting official advised us that the Chicago Operations Office awarded a smaller support service contract based on support service needs identified at that time. However, new requirements such as those resulting from the Department's environmental restoration program and tiger team assessments necessitated significant increases in support services. In March 1993, Departmental Headquarters approved Chicago's request to increase the cost by \$20 million and the level of effort by 266,000 direct labor hours. In its request to Headquarters, Chicago stated that this increase was needed to "accommodate the increasing diversity of expertise needed to fully support current missions assigned to [the Chicago Operations Office], as well as new missions and expanding responsibilities for current missions, some of which stem from new and changing guidance and requirements."

Although these three Departmental offices contracted for support services, it was the support service contractor, not the Department, who administered major portions of the work. For instance, in its request to Headquarters for authorization to procure technical expertise through a service contract, the Chicago Operations Office stated that "no direct Government supervision and/or direction beyond that given in the task order will be required or given to the contractor to complete the assigned tasks. Performance will be at the contractor's discretion with the requirement that the final documents be delivered upon final completion."

IMPACT OF PROCUREMENT PRACTICES

By allowing four support service contractors to collect fees for services provided exclusively by subcontractors and maintaining minimal administration over major portions of contracted-for support services on three of six contracts, the Department may be contributing to increases in contract costs. We estimated that \$5.1 million in fees paid to four support service contractors could have been avoided if during the pre-award phase, the Department prohibited subcontractor labor hours from support service contractor fee calculations. As shown in Table 5, a significant portion of fees paid to four of six support service contractors were based on labor hours provided by subcontractors.

TABLE 5

FEE PAYMENTS BY CONTRACT
(in millions)

<u>Service Contract</u>	<u>Total</u>	<u>Service Contractor Fees</u>		<u>Subcontractor Fees</u>
		<u>Based on Contractor Hours</u>	<u>Based on Subcontract Hours</u>	
A	\$1.8	\$0.8	\$1.0	\$0.8
B	1.8	1.2	0.6	0.7
D	6.0	4.6	1.4	2.5
F	<u>15.0</u>	<u>12.9</u>	<u>2.1</u>	<u>1.5</u>
Totals	<u>\$24.6</u>	<u>\$19.5</u>	<u>\$5.1</u>	<u>\$5.5*</u>

* Includes fees only for major subcontractors.

In addition, the Department's ability to effectively administer its support service contracts was diminished, and this may have contributed to contract cost growth. Departmental offices relied on support service contractors to acquire the necessary labor skills from subcontractors and ensure that the subcontractors' work on many task assignments were within cost limitations, within the scope of work, and were performed in a timely manner. This diminished control was also recognized by the Department's Contract Reform Team and in the Secretary of Energy's May 26, 1993, testimony on Departmental contract administration before the House Committee on Energy and Commerce. The Reform Team reported that Departmental program officials often rely on support service contractors to perform many daily functions with limited oversight of contractor performance. In her testimony, the Secretary noted that some Departmental activities that should be performed by Federal staff are being carried out by contractors. The Secretary also stated that the Department's heavy reliance on contractors with relatively small Federal staff raises serious concerns about how effectively the

Department can manage its missions and whether Department personnel have the expertise necessary to do their jobs. Furthermore, Office of Management and Budget Policy Letter 92-1 highlights the problem of lack of contract oversight as a loss of Government control and requires Federal agencies to be aware of their existing contract oversight responsibilities.

One example where diminished Department administration may be partly the cause for contract cost growth is a Headquarter's support service contract which authorized \$27.7 million and 513,000 direct labor hours over the 3-year base period. The contractor spent \$25.4 million and used 422,000 hours, or 82 percent, in the first 14 months. A portion of the hours directly provided by the service contractor were used to administer the subcontractor's work. According to Department contract representatives, this contractor will likely expend the authorized direct labor hours before the contract period expires. Consequently, the Department planned to solicit and award another contract to purchase more direct labor hours to satisfy its environmental restoration and waste management support service requirements for the remaining contract period.

In another example, the Chicago Operations Office's \$15.2 million support service contract for 239,475 direct labor hours increased to 651,000 authorized hours at an estimated cost of \$44 million over the 5-year contract period. Its subcontractors were initially expected to provide 90,675 hours at an estimated cost of \$6.4 million. However, by March 1994 subcontractors expended 157,000 hours and subcontractor costs rose to over \$11 million. This increase in the level-of-effort was needed to obtain a broader diversity of skills than originally planned to meet current as well as new and expanding missions assigned to the Chicago Operations Office. As of March 1994, the contractor spent over \$31 million and expended 468,000 direct labor hours.

PART III

MANAGEMENT AND AUDITOR COMMENTS

In responding to our initial draft version of this report, the Office of Procurement and Assistance Management did not concur with the report finding and recommendations noting that the recommendations are inappropriate and lack supporting rationale. A summary of management and auditor comments follow.

Recommendation 1.

The Deputy Assistant Secretary for Procurement and Assistance Management develop and implement support service pre-award procedures starting with the request for proposals that ensure the support service contractors's fee is based only on the direct labor hours they expend.

Management Comments. Management did not concur with the recommendation. Management stated that the Department of Energy Acquisition Regulation Subpart 915.9 (Profit) provides adequate coverage of fee considerations regarding subcontractor services, which are included in the Department's fee policy. Generally, the weighted guidelines method is used to calculate fee. The intent is to remunerate contractors for financial and other risks they assume, resources they use, and organization, performance, and management capabilities they employ.

Management stated that 915.970-2(d) of the Department's Acquisition Regulations specify a fee range of 1 to 4 percent for subcontracted items verses a fee range of 4 to 14 percent for services not subcontracted. Since the fee is based on many factors, almost all of which are weighted more heavily than subcontracts, our calculations in Tables 2 and 5 of the initial draft report are probably not accurate because they assume a uniform weight that was applied to all factors. In addition, management noted that 915.970-8(b)(2)(i) directs the contracting officer to consider the managerial and technical effort necessary for the prime contractor(s) to select subcontractors and administer subcontracts.

Management also noted that a fee is negotiated after consideration of a number factors including subcontract efforts. Thus, it would be counterproductive to arbitrarily limit or exclude one factor without giving consideration to the overall effort to be performed under a contract. One possible consequence of this recommendation would be that it is highly likely that contractors would perform more work themselves, which would certainly lead to higher fee payments (assuming the use of weighted guidelines) and also to higher overall labor costs.

Auditor Comments. We do not share management's view that the report recommendations are inappropriate and lack supporting rationale. In our analysis of the six service contracts, we considered the methods used to establish the support service contractors' fee, including the use of weighted guidelines. The weighted guidelines profit/fee objective criteria does not prevent excessive fee payments. In fact, this criteria was used by the Department to establish a Departmental profit/fee objective for four of six support service contracts. These four included the Pittsburgh and Morgantown contracts which limited fee payments, and two of the four contracts (B and D) where the Department paid substantial fees for support services. The four contracts in question were not negotiated in an economical manner. The Department negotiated fees for the four support service contractors which included subcontractor labor hours in their actual fee determinations. This resulted in substantial fees on several contracts. For example, the Department negotiated fees on support service contracts A and B of 21.6 and 11.4 percent of service contractor costs excluding subcontractor effort. Additional fees of 4.6 percent to 16.4 percent were paid to subcontractors performing work for service contractors. In effect, the Department's negotiating practice resulted in the Department paying fees to four support service contractors for work provided exclusively by subcontractors.

We agree that support service contractors should be compensated for managing subcontractor activities as set forth in the weighted guidelines. However, it is uneconomical to negotiate support service contractor fees using the weighted guideline factors or any other method if adequate controls do not exist to ensure that support service contractor fees are based solely on the direct labor hours they expend. The practices followed by Morgantown and Pittsburgh to procure support services were economical and provided adequate controls to prevent service contractors from earning fees on subcontracted labor. The Department should implement Morgantown's and Pittsburgh's support services contracting practices Departmentwide because they represent best business practices. This is consistent with the views expressed by the Contract Reform Team in its February 1994 report that noted the Department should use the best contracting approach that addresses the required work.

Morgantown established a fee objective for subcontracted items for support service contractor C in its weighted guidelines analysis. However, Morgantown required in its request for proposals that the support service contractor's negotiated fee be based solely on the direct labor hours they expend, including their efforts in managing subcontractor activities, but not for direct labor expended by subcontractors. Consequently, the support service contractor was paid fees based on the direct labor they expended and not for the direct labor hours incurred by subcontractors.

Pittsburgh used the weighted guidelines to establish a profit/fee objective for support service contractor E.

Pittsburgh negotiated the support service contractor's fee based on total direct labor hours, including subcontractor hours, but did not assign a weight for subcontracted items. In addition, Pittsburgh stipulated in the contract that any award fee earned shall be paid to the support service contractor and distributed among its subcontractors. This approach ensured that the Department did not pay a fee to both the support service contractor and subcontractors for the same direct labor hours expended.

Management stated that the calculations in Tables 2 and 5 probably are not accurate. Our estimates were accurate because they were based on contractual requirements for determining support service contractor fees that stipulated that support service contractor fees would be based on its and the subcontractors' direct labor hours expended. Using this approach, our estimates were calculated by multiplying the percentage of direct labor hours expended by subcontractors by the cumulative fees claimed on the support service contractor's invoice.

Additionally, our recommendation would not result in support service contractors doing significantly more work themselves. Consequently, our recommendation would not lead to higher fee payments (assuming use of weighted guidelines) and higher overall labor costs for several reasons. First, the weighted guidelines already provide a financial incentive for service contractors to use in-house rather than subcontracted labor by allowing them to earn more fee; i.e., higher fee percentages are assigned to in-house labor. Second, weighted guidelines are not used in all cases. As noted previously, weighted guidelines were completed on four of six contracts, but only two of the four contracts in question. Third, assuming that support service contractors used more in-house labor, any additional fees paid to service contractors would likely be offset through significant reductions in subcontractor fees and overhead charged by service contractors on subcontractor costs. Finally, support service contractors often may not have the in-house expertise to complete the work forcing them to rely heavily on subcontracted work. For example, contractors A and B relied extensively on subcontractors to complete many of the contract tasks because they did not have sufficient in-house expertise to complete those tasks.

Recommendation 2.

The Deputy Assistant Secretary for Procurement and Assistance Management pursue opportunities to reduce support service contractors' subcontracting to a level where the Department, not the support service contractor, is administering a substantial portion of support services.

Management Comments. Management did not concur with the recommendation. Management commented that the initial draft report implies that subcontracting to any significant extent indicates a lack of control and did not believe a certain level of subcontracting indicates that the Department has abdicated its contract management responsibility. In some cases, subcontracting may be the most economical and effective means to obtain the right services at the lowest possible cost. Management noted that the examples given in the report appear to illustrate an increase in the Department's requirements, not a lack of control over the prime contractor.

Auditor Comments. Acquisition Letter 92-3 indicates that in the absence of a direct contractual relationship with the subcontractor, the Department's legal basis for administering subcontract work is through the support service contractor. While the Department is directly responsible for support service contractor performance and may not have relinquished its contract responsibilities in this regard and the fact that the Department does not have "privity of contract" with subcontractors, forces the Department to rely on its support service contractors to administer subcontracted work and ensure that subcontractors comply with contractual and task assignment requirements.

Furthermore, the examples provided on pages 15 through 17 of the report noted that there were increases in the Department's requirements that contributed to cost growth on support service contracts A and B. However, additional overhead charges and fees associated with extensive subcontracting may also be a contributing factor to contract cost growth. While we do not dispute that subcontracting in some cases may be the most economical method to procure support services, the issue raised in this report is whether the Department is able to effectively administer contract work that involves extensive subcontracting. To ensure that the Department effectively administers major portions of contracted-for support services, we believe the Department should pursue opportunities to reduce the level of subcontracting on service contracts that require substantial subcontractor effort. This can be accomplished by contracting directly with the subcontractor who is providing the support service.

PART IV

OTHER MATTERS

Award Fees Paid to Support Service Contractors

The Department of Energy Acquisition Regulations require the Department to evaluate award fee contractors and determine their award fee at the end of specified evaluation periods. The award fee is the amount of money potentially available to the contractor for performance above minimally acceptable levels. The regulation states that payment of an award fee shall generally reflect a contractors performance during specified contract evaluation periods. However, the regulations also allow fee determination officials at their discretion to accumulate unearned fees and make those fees available for award in subsequent evaluation periods.

We reviewed six cost-plus-award-fee contracts. In each case, the contractor's performance was assessed and rated for award fee purposes at periodic intervals according to performance evaluation plans. These plans required the Department to evaluate the contractor's performance and prepare a performance evaluation report for each evaluation period that would serve as the basis for the award fee determination official's decision on the amount of fee awarded to each contractor.

Our review disclosed that a Pittsburgh Energy Technology Center (Pittsburgh) contractor received award fees that exceeded its performance ratings. This occurred because Pittsburgh elected to rollover unearned portions of fees from prior evaluation periods and make them available in the next evaluation period. As a result, Pittsburgh unnecessarily paid the contractor over \$89,000 in award fees. A contract official told us that Pittsburgh elected to rollover the unearned fees on this contract because it provided the contractor with a financial incentive to improve performance in deficient areas. Other Departmental offices did not rollover unearned fees to subsequent evaluation periods on their cost-plus-award-fee contracts. Departmental officials at these locations told us that they did not rollover unearned fees because they felt that the contractor should only receive the portion of the original designated award fee that it earned.

As shown in Table 6, Pittsburgh's support service contractor received over 99 percent of the maximum available award fee in 5 of the 10 evaluation periods even though the contractor's performance ratings were lower than 99 percent in all 5 periods and declined over periods 4 through 6. For all 10 periods combined, the contractor received 97.72 percent of the maximum award fee available even though the contractor's performance ranged from 90.60 percent to 97.38 percent during the 10 evaluation periods. For example in Evaluation Period 1, the contractor earned \$368,033 of the \$406,218 maximum available fee

based on a 90.60 percent performance rating. Pittsburgh elected to rollover the unearned portion of \$38,185 to Period 2. The contractor was paid 95.32 percent (Period 2's evaluation score) of the unearned fee or \$36,397.

Although award fee rollover is permitted and could provide an incentive to improve contractor performance, the incentive was not effective in this case. Table 6 shows that the contractor made significant improvements in performance in only 1 of the 10 evaluation periods. Further, this practice resulted in the contractor being rewarded for declining performance over an 18-month period (covering Periods 4 through 6). As a result, we suggest that Pittsburgh adopt the practices of the other offices reviewed and discontinue the rollover of unearned award fees on its support service contract unless unusual circumstances warrant such a practice.

TABLE 6

AWARD FEES PAID BY EVALUATION PERIOD

<u>Period</u>	<u>Maximum Available</u>	<u>Total Paid</u>	<u>Percent Paid</u>	<u>Performance Rating</u>	<u>Rollover Portion</u>
1	\$406,218	\$404,430	99.56	90.60	\$36,397
2	406,218	387,207	95.32	95.32	0
3	426,786	425,948	99.81	95.62	17,856
4	426,786	407,666	95.52	95.52	0
5	426,786	425,855	99.79	95.46	18,446
6	426,786	406,300	95.20	95.20	0
7	316,417	316,074	99.90	96.24	11,555
8	563,030	546,815	97.12	97.12	0
9	322,827	319,614	99.01	97.38	5,245
10	<u>369,010</u>	<u>357,571</u>	<u>96.90</u>	<u>96.90</u>	<u>0</u>
Totals	<u>\$4,090,861</u>	<u>\$3,997,480</u>	<u>97.72</u>	<u>95.54</u>	<u>\$89,499</u>

PART V

APPENDIX A

SUPPORT SERVICE CONTRACT A
LABOR HOURS BY TASK

<u>Task</u>	<u>Contractor</u> <u>Hours</u>	<u>Subcontractor</u> <u>Hours</u>	<u>Percentage</u>
1	8,841	10,760	55
2	10,797	14,271	57
3	5,179	8,816	63
4	12,541	25,860	67
5	6	17	74
6	119	417	78
7	3,645	14,602	80
8	102	461	82
9	719	3,289	82
10	10,453	48,995	82
11	178	1,189	87
12	19	137	88
13	158	1,332	89
14	2,315	30,703	93
15	589	13,854	96
16	123	5,589	98
17	0	380	100
18	1	1,792	100
19	<u>0</u>	<u>1,220</u>	<u>100</u>
Totals	<u>55,785</u>	<u>183,684</u>	<u>77</u>

APPENDIX B

SUPPORT SERVICE CONTRACTOR AND SUBCONTRACTOR ACTUAL COSTS, FEES, AND LABOR HOURS (in 000's)

SERVICE CONTRACT	SUPPORT SERVICE CONTRACTORS				MAJOR SUBCONTRACTOR				a/
	COSTS	FEES	FEE PERCENT	LABOR HOURS	COSTS	FEES	FEE PERCENT	LABOR HOURS	
A	\$9,734	\$1,790	18.39%	186	\$10,785	\$756	7.01%	205	
B	18,366	1,866	10.16%	311	8,653	703	8.12%	127	
C	50,734	3,661	7.22%	1,866	22,918	b/	b/	b/	
D	148,966	5,955	4.00%	5,126	39,510	2,497	6.32%	1,441	
E	84,418	3,997	4.73%	1,000	c/	c/	c/	1,245	
F	228,336	23,184	d/ 10.15%	2,114	e/ 16,381	1,501	9.16%	261	

a/ - Labor hours are less than subcontractor hours shown in Tables 2 and 4 because they include only major subcontractors.

b/ - Subcontractor data not available.

c/ - Support service contractor shares fees with subcontractors.

d/ - Includes base and option period service contractor fees.

e/ - Includes only option period labor hours.

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