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ENERGY MANAGEMENT

**High Risk Area Requires
Fundamental Change**

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our views on contract management issues at the Department of Energy (DOE). Our testimony will draw primarily on our December 1992 report on DOE contract management.¹ DOE's contract management was the subject of one of 17 reports we issued in areas we believe are especially vulnerable to waste, fraud, and abuse throughout the federal government. I would like to commend you, Mr. Chairman, and the members of this Subcommittee for your continued support in helping to strengthen federal programs and contract management in particular.

As you know, we have appeared before this Subcommittee a number of times in the past few years to discuss persistent problems with civilian agencies' contracting practices. As recently as December 1992, we testified before your Subcommittee to highlight actions agencies could take to improve their oversight and management of contractors.

In recent testimony,² the Comptroller General pointed out that the state of management in the federal government is not good. Too many principles, structures, and processes that may have worked well years ago no longer allow the government to respond quickly and effectively to a rapidly changing world. This situation is exemplified in DOE's approach to managing contracts.

In summary, DOE's fundamental weaknesses in contract management have resulted in widespread mismanagement of federal property and funds. Our work has shown that DOE's lenient approach to contract management jeopardized the nation's multibillion-dollar investment in the nuclear weapons complex and national laboratory network.

At the core of DOE's problems is a contracting philosophy dating back to the Manhattan Project of World War II, when the federal government sought to obtain private industry's participation in dangerous and uncertain activities by giving contractors wide latitude in operating the government's weapons research and production facilities. Under the veil of national security, contractors operated largely without oversight or financial risk.

¹High-Risk Series: Department of Energy Contract Management (GAO/HR-93-9, Dec. 1992).

²Major Issues Facing a New Congress and a New Administration (GAO/T-OCG-93-1, Jan. 8, 1993).

Operating under this "philosophy of least interference," DOE and its predecessor agencies never developed adequate controls or supporting management systems to provide information for effective oversight. Over time, DOE's ability to oversee contractors eroded even further, leaving the Department in a weaker position to exercise oversight. As the condition of the weapons complex deteriorated and environmental problems began to surface, weaknesses in DOE's ability to oversee contractors came into sharp focus.

Today, DOE is trying to overcome this legacy of inadequate oversight and, to its credit, recognizes that its contract management philosophy has placed at risk the government's tremendous annual investment in contractors' services. In response, it calls for increased oversight made by GAO and others, DOE has made improving its contracting management practices a departmental priority. DOE has begun to implement new contracting rules and has taken steps to instill a new organizational culture that acknowledges management shortcomings. We applaud these efforts. But these new initiatives also raise new concerns about fundamental weaknesses in management information necessary to support changes. As a result, implementing change in DOE is not an easy task. It is an obligation that will require more focused attention on fundamental issues plaguing DOE's progress. Changing a contract management approach that led to so many problems will take time and a significant commitment on the part of DOE's leadership.

Our testimony today will begin with background information on management and operating contractors and then provide an overview of the dimensions of DOE's contracting problems and the obstacles to efficient contract management, address DOE's contract management initiatives, and, finally, assess the action needed to strengthen contract management.

BACKGROUND

During World War II, the Manhattan Engineer District of the U.S. Army Corps of Engineers--a predecessor to DOE--was responsible for developing and producing the first atomic bomb. More commonly known as the Manhattan Project, the enterprise was based on contractual arrangements among the War Department, industry, and academic organizations and created an unprecedented approach to contract management in response to the exigencies of war.

After the war, the newly created Atomic Energy Commission decided that special incentives were needed to retain the participation of its management and operating contractors. Under a "philosophy of least interference," the Commission gave its contractors virtual independence in managing and operating the sprawling 12-state network of weapons facilities. External

oversight of the contractors' activities was limited by national security concerns. The Commission's lack of involvement in operating the facilities was reflected in contract clauses that relieved the contractors of virtually all financial risk and exempted them from most federal and state environmental laws. DOE carried over this approach to contract management intact.

Today, DOE is the only cabinet-level office that contracts out its major missions. Providing employment to about 140,000 contractor and 20,000 federal personnel (with 5,000 field employees directly overseeing contractors), DOE is also the largest civilian contracting agency in the federal government. In fiscal year 1992, about \$15.6 billion of DOE's \$20 billion procurement budget went to management and operating contractors who design, test, develop, and produce the nation's nuclear arsenal; manage the country's national laboratories; and conduct basic research in science and energy.

To manage and operate its facilities, DOE has entered into 52 fully cost-reimbursable contracts with 35 contractors. These include multinational firms and academic organizations, such as Westinghouse, General Electric, AT&T, and the University of California. The University of California and AT&T have operated some of DOE's facilities continuously since 1943 and 1949, respectively.

DOE's predecessors chose cost-reimbursable contracts because of the difficulties of estimating production and research work loads in advance. DOE has continued this approach as its principal relationship with contractors. DOE uses primarily two types of cost-reimbursable contracts: the cost-plus-award-fee and the cost-plus-management fee. The majority of DOE's contracts--28 out of 52--are held by profit-making firms and are cost-plus-award-fee contracts. A cost-plus-award-fee contract compensates a firm for costs incurred, provides a "base fee" for operating the facility, and provides an additional fee (the award fee) on the basis of DOE's evaluation of the company's performance. In fiscal year 1991, contractors earned award fees ranging from \$673,000 to \$18 million. Most of the remaining 24 contracts are with nonprofit organizations and are cost-plus-management-fee agreements that, in addition to reimbursing all costs, provide a supplemental management fee agreed upon during contract negotiations.

DIMENSIONS OF THE PROBLEM

Much of DOE's vulnerability to waste, fraud, abuse, and mismanagement stems from long-standing inadequacies in the Department's oversight of contractors' operations and activities. DOE's management approach has led to negligible control and limited contractor responsibility.

For example, DOE's ineffective contract management has resulted in the following incidents:

- Missing secret documents. The management and operating contractor at Lawrence Livermore National Laboratory could not account for 10,000 of 600,000 secret documents on nuclear weapons and laser technology. DOE's reviews of the contractor's controls were inadequate to identify this breach in security.
- Tripled subcontract costs. DOE's failure to oversee a subcontractor's quality control procedures and fabrication methods on containers used to transport nuclear waste cost taxpayers millions of dollars. DOE remained uninvolved while the subcontractor designed, tested, and produced the containers. Ultimately, DOE paid the prime contractor about \$14 million for 15 containers that met design criteria--or about the same amount that the prime contractor had originally agreed to pay the subcontractor for 52 containers. This tripling of unit costs could have been avoided if DOE had monitored the subcontractor's activities from the start.
- Funding of construction projects without required congressional authorization. In 1991, DOE's Inspector General (IG) reported that the operating contractors at DOE's Savannah River production facility improperly charged a construction account (1) \$13 million to fund a warehouse complex, directly circumventing congressional funding authorization; (2) \$33 million to purchase unauthorized capital equipment; and (3) \$13 million to cover a shortfall in operating funds. These practices enabled the facility to avoid reporting potential funding problems. At the time of the IG's audit, a Savannah River plant contractor was conducting a complete inventory of the capital equipment acquired through these improper procedures. Contractor officials estimated that as much as 25 percent of this equipment might be missing.
- Reimbursement of contractors for thefts by employees. Some contract clauses could require DOE to reimburse contractors for all costs--even those DOE considers unreasonable--unless the Department could demonstrate that the costs had been incurred through the willful misconduct or bad faith of corporate management. Consequently, a contract clause required DOE to reimburse a contractor for \$420,000 in money and materials that a contractor's employee had stolen. Such payments reflect an irresponsible use of government funds.

These examples demonstrate the systemic nature of DOE's contract management problems. We will now examine some of the

basic weaknesses that have contributed to this situation.

OBSTACLES TO EFFICIENT CONTRACT MANAGEMENT

DOE's weak oversight of its contractors remains one of the Department's fundamental problems and significantly affects the ability to control costs. Yet DOE lacks the tools and resources to effectively oversee its contractors. For example, DOE's current information systems do not provide the kinds of data the Department needs to effectively manage contracts. Furthermore, DOE's oversight of the award and management fees process, under which contractors receive millions of dollars, is weak and lacking in guidelines. Finally, DOE has historically accepted nonstandard contract clauses, limiting the Department's control over contractors' activities. Better contract management becomes particularly urgent as DOE moves to correct significant environmental, safety, and health problems at nuclear plants. This work is expected to cost at least \$160 billion and will, in large part, be performed by contractors.

DOE Lacks Essential Decision-Making Information

Lack of management information is a fundamental weakness in DOE's contracting practices. DOE spends about \$1.6 billion annually to provide its managers and staff with information to help them accomplish DOE's mission. Yet DOE's managers still do not have management and financial information essential for effective contract management. For example, DOE's financial systems were designed to meet program managers' needs when producing weapons was more important than providing oversight. Now that DOE is attempting to strengthen oversight, these systems cannot reliably produce the information needed to gauge either the status or the costs of its contractors' activities.

DOE also lacks adequate systems to budget for certain types of financial commitments to contractors, called "uncosted obligations." These are obligations that DOE has made to contractors for goods and services that have not yet been provided and for which no costs have been incurred. Although DOE ended fiscal year 1991 with approximately \$9.7 billion in uncosted obligations, it had not, as we testified in March 1992,³ established a system for ensuring that these obligations were analyzed during its budget preparation. Without adequate information on uncosted obligations and systematic reviews of its financial commitments, DOE cannot guarantee that its budget requests represent the minimum amount needed for annual operations.

³Energy Management: Systematic Analysis of DOE's Uncosted Obligations Is Needed (GAO/T-RCED-92-41, Mar. 24, 1992).

DOE's Oversight of the Award Fee Process Is Weak

Another weakness in DOE's contract management is that DOE cannot always support the millions of dollars in award or management fees that it pays to contractors. Award fees are a primary tool for changing contractor behavior. Yet DOE does not provide objective criteria for the award or management fees it pays contractors, leaving open the possibility of abuse. Thus, contractors are sometimes rewarded for questionable performance. For example, in 1989 we pointed out problems in DOE's award fee process and recommended that DOE restructure the process to reduce the level of discretion exercised in making a final award determination. The problems we identified still exist. In March 1992,⁴ we reported that a fee of nearly \$2 million was awarded to the Rocky Flats management and operating contractor even though a DOE review board, in its initial rating of the contractor's performance, had recommended no award at all on the basis of established evaluation criteria. The review board raised 30 significant deficiencies, chief of which was the contractor's poor performance on environmental, safety, and health issues. However, a subsequent management review discounted the review board's recommendation and significantly increased the score to award a fee of \$1.7 million.

Management fees paid to nonprofit organizations reflect similar problems. According to its IG, DOE lacks written criteria for establishing management fees. The IG report noted that DOE and the University of California negotiated a management fee of \$12 million for the University to operate three weapons laboratories.⁵ This fee was to be increased automatically each year by \$250,000 for fiscal years 1987 through 1992. Although DOE did not provide detailed justifications for these increases, current DOE contracts indicate that \$8 million of the management fee is in lieu of reimbursing the university for indirect costs. The university is required to spend "a significant portion" of the remaining fee (which was about \$4.75 million in fiscal year 1991) on "complementary and beneficial activities." DOE was unable to identify these "activities," yet it paid the \$4.75 million fee. Because DOE has no guidelines for these fees, it is virtually impossible to evaluate whether they are reasonable.

⁴Nuclear Health and Safety: Increased Rating Results in Award Fee to Rocky Flats Contractor (GAO/RCED-92-162, Mar. 24, 1992).

⁵General Management Inspection of the San Francisco Operations Office (DOE/IG-0290, Sept. 20, 1990).

Many Contracts Contain Nonstandard Clauses

Compounding DOE's problems in contract management is the continued use of contract provisions that limit the Department's control. Nearly 70 percent of DOE's management and operating contracts do not contain standard clauses commonly used by other federal agencies to protect the government's interests. Thus, from the outset DOE is contractually precluded from exercising much of the authority it normally would have to control contractors' activities. DOE's extensive use of nonstandard contract clauses has restricted the agency's ability to control costs. This fundamental weakness dates back to the use by DOE's predecessor agencies of special incentives they believed were necessary to attract and retain contractors. Since then, DOE's contractors have been reluctant to negotiate contracts with more stringent clauses.

Consequently, DOE's contracts with the University of California for operating three national laboratories did not include the standard procurement clause that would require the contractor to obtain DOE's approval of vehicle leases. Thus, the Lawrence Livermore Laboratory was able to lease 58 vehicles from the university at commercial rates without obtaining DOE's approval. Under the university's rates, DOE paid about \$600,000 more for the vehicles than it would have paid under government rates. When DOE directed the laboratory to terminate some commercial leases to reduce its fleet size, the laboratory did not comply, citing a contract clause requiring that DOE and the university "mutually" agree on property management issues. As a result, the contract terms prevented DOE from correcting this waste of funds.

Improved Contract Management Is Critical for Environmental Cleanup

DOE's fundamental contracting weaknesses have contributed to significant environmental, safety, and health problems at the Department's nuclear weapons plants. Because contractors will have a significant role in correcting these problems, improvements in DOE's contract management will be critical. As DOE has admitted, its contractors have released radioactive contaminants at many, if not all, of its weapons production sites. In addition, years of neglect have made the complex obsolete and unsafe.

Resolving safety issues at DOE facilities continues to be a significant problem for DOE. Safety concerns led to DOE's closing much of the complex and are an important reason why many key facilities remain closed. On the environmental side, DOE's efforts to clean up the legacy of weapons production have been hampered by technological, compliance, and management problems that have led, in turn, to missed milestones and escalating

budgets. In the quest for weapons supremacy, DOE and its contractors placed an overriding emphasis on weapons production and relegated environmental, safety, and health issues to a minor role.

Over the years, contractors' concerns with meeting production quotas and DOE's inattention to oversight compounded DOE's environmental problems. Today, it is estimated that it will cost as much as \$160 billion to clean up the nuclear weapons complex and restore it to a safe condition. Given that contractors will be receiving much of this money, correcting DOE's contract management problems remains urgent.

DOE'S CONTRACT MANAGEMENT INITIATIVES

DOE acknowledges its contract management problems, having identified contract management as a material weakness in its three most recent Federal Managers' Financial Integrity Act reports to the President on internal control weaknesses. DOE is changing its contracting practices to address these concerns and is also attempting to change its "culture" from one that emphasizes weapons production at all costs to one that is sensitive to environmental, safety, and health issues and accountability.

Changes Address Issues of Accountability and Oversight

With new contract terms and conditions, DOE hopes to make its contracting relationships more consistent with the government's interests. For example, DOE is incorporating a new accountability rule into its contracts with profit-making organizations. Under this rule, DOE will (1) hold contractors liable for costs that could have been avoided by proper contract performance and (2) increase contractors' potential award fees to offset the increase in their financial risk.

DOE is also attempting to delete as many nonstandard contract clauses as possible. In fact, the Department recently concluded negotiations with the University of California, and some contract clauses requiring "mutual" agreement on property management issues have been eliminated. Finally, DOE is introducing "task order contracting," a practice that will require DOE to specifically authorize each task before money can be obligated or work can begin.

To increase contractors' compliance with environmental, safety, and health standards, DOE has instituted a requirement that at least 51 percent of a contractor's award fee must be based on these important performance measures. Furthermore, DOE will deny the entire award fee if performance in any of these areas is unacceptable.

DOE has also proposed a new contracting approach for cleaning up contamination at the nation's nuclear weapons sites. This new approach would transfer cleanup responsibilities at each DOE facility from an existing management and operating contractor to an environmental restoration management contractor. Goals include improving contractors' performance, lowering costs, achieving more timely restoration, and increasing accountability. DOE has recently begun a pilot test of this approach at the Fernald, Ohio, site and is in the process of awarding another contract for the Hanford, Washington, site.

DOE has also increased its field staff. In fiscal year 1992, DOE added about 400 additional employees to its field offices, which brings the staff level to nearly 5,000. DOE believes these changes will help address weaknesses in its contract oversight.

Cultural Change Reinforces Reforms

One of DOE's most important changes is to instill a new culture within the agency. This change in culture acknowledges the systemic nature of DOE's contract management problems and institutes reforms in oversight and contractor liability. The new culture is an attempt to embrace the development of (1) compatibility between DOE's mission to produce nuclear weapons and its mission to clean up the environment--intended to replace almost 50 years of production at environmental expense, (2) a workplace culture that demands excellence and personal accountability--intended to replace DOE's ambiguous lines of authority, and (3) an atmosphere that welcomes openness and constructive criticism--intended to replace DOE's practice of making decisions under extreme secrecy.

The importance of a change in culture is paramount. Even if DOE staff are provided with a range of improvements in contracting practices, nothing will improve if the staff do not apply these practices properly.

Initiatives Raise New Challenges

We believe that DOE's efforts to address these contract management problems are significant positive actions. However, the systemic nature of these weaknesses--insufficient oversight, lack of information essential for management, nonstandard contracts, and questionable fees--requires a major commitment not only from DOE but also from its contractors. The initiatives will take years to implement. Meanwhile, several problems that must be solved before improved accountability and performance can be achieved are not being fully addressed.

DOE's new rule to make contractors more accountable, for example, requires that DOE (1) incorporate accountability provisions into all cost-plus-award-fee contracts, (2) develop

operational procedures to identify all avoidable costs, and (3) train staff to implement the rule in a timely manner. Until DOE completes all of these actions, however, the management and operating contractors may receive increased award fees without incurring a commensurate increase in risk. Furthermore, because contractors can actually increase their earnings without performing better, DOE's diligence in oversight is especially important. This situation occurs because, in return for increasing contractors' liability, DOE also substantially increased the contractors' fee pool (base fee plus award fee). Consequently, a contractor may now receive lower DOE ratings and yet actually receive higher earnings because of the larger amounts now available for distribution.

Although DOE now requires that 51 percent of a contractor's award fee must be based on performance on environmental, safety, and health issues, the fee determination process is still largely subjective--as we found at Rocky Flats. DOE needs to show and document clearly the relationship between a contractor's performance and the amount of the award fee. The more DOE reduces the level of discretion in the award fee ratings, the more DOE must ensure that contractors are compensated objectively.

Improving oversight through task order contracting will require increased resources for administering contracts and estimating costs. Although DOE is increasing its staff, it is still not known whether DOE will have sufficient resources for these responsibilities. Field units are still reporting to headquarters that they cannot meet their work load with existing staff, including the demands for increased financial oversight. Both GAO and DOE IG reports have drawn attention to the need for better trained staff to oversee contractors and to provide sound technical oversight, particularly in the newer mission area of environmental cleanup.

In addition, neither DOE nor its contractors have developed adequate cost-estimating systems. Furthermore, DOE has not yet developed its own cost estimates for task orders and will therefore need to rely on estimates developed by contractors to negotiate cost, schedule, and performance milestones.

The new approach to environmental restoration management contracting carries over many problems from current management and operating contracts. For example, DOE has stated that under the new approach, site labor costs will not change. That is primarily because environmental restoration contractors will be required to hire as many of the existing management and operating contractors' staff as they can effectively employ, at their present salary and benefit levels.

Moreover, the new approach does not specify how responsibility will be divided between DOE and the new contractors or how it will be shared with the existing management and operating contractors. Overseeing the environmental restoration contractors will also require more and better-trained staff. Thus far, DOE has largely ignored training because the focus has been on contractor selection.

CONCLUSIONS

DOE's contract management philosophy has put at risk billions of dollars in yearly contractors' services. Spurred by strong congressional oversight and recommendations from GAO, DOE's IG, and others, DOE has begun to make contract management reforms. The initiatives are steps in the right direction.

These reforms are directed at giving contractors more incentive to act responsibly while simultaneously increasing oversight of contractors' activities. Nevertheless, actions taken to date will take years to implement and must be implemented correctly in the spirit of change in culture sought by management.

With the new administration, DOE has an opportunity to build on the momentum from recent changes in contract management. The new administration needs to continue requiring increased contractor accountability. Also, improved information and financial management systems and better-trained technical staff will be necessary to ensure that accountability.

Finally, changes of this magnitude will take long-term commitment and sustained leadership to realize. DOE's problems will not be corrected overnight, and wholesale changes will require concerted effort from DOE's managers, employees, and contractors, as well as continued congressional oversight.

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Mr. Chairman, this concludes our prepared remarks. We will be pleased to respond to any questions from the Subcommittee at this time.

RELATED GAO PRODUCTS

Major Issues Facing a New Congress and a New Administration (GAO/T-OCG-93-1, Jan. 8, 1993).

Government Management--Report on 17 High Risk Areas (GAO/T-OCG-93-2, Jan. 8, 1993).

High-Risk Series: Department of Energy Contract Management (GAO/HR-93-9, Dec. 1992).

Federal Contracting: Cost-Effective Contract Management Requires Sustained Commitment (GAO/T-RCED-93-2, Dec. 3, 1992).

Department of Energy: Better Information Resources Management Needed to Accomplish Mission (GAO/IMTEC-92-53, Sept. 29, 1992).

DOE Management: Impediments to Environmental Restoration Management Contracting (GAO/RCED-92-244, Aug. 14, 1992).

Federal Research: Implementation of the Super Collider's Cost and Schedule Control System (GAO/RCED-92-242, July 21, 1992).

Nuclear Health and Safety: More Can Be Done to Better Control Environmental Restoration Costs (GAO/RCED-92-71, Apr. 20, 1992).

Energy Management: Vulnerability of DOE's Contracting to Waste, Fraud, Abuse, and Mismanagement (GAO/RCED-92-101, Apr. 10, 1992).

Federal Research: Concerns About the Superconducting Super Collider (GAO/T-RCED-92-48, Apr. 9, 1992).

Nuclear Health and Safety: Increased Rating Results in Award Fee to Rocky Flats Contractor (GAO/RCED-92-162, Mar. 24, 1992).

Energy Management: Systematic Analysis of DOE's Uncosted Obligations Is Needed (GAO/T-RCED-92-41, Mar. 24, 1992).

Nuclear Weapons Complex: Major Safety, Environmental, and Reconfiguration Issues Facing DOE (GAO/T-RCED-92-31, Feb. 25, 1992).

Nuclear Waste: Weak DOE Contract Management Invited TRUPACT-II Setbacks (GAO/RCED-92-26, Jan. 14, 1992).

Energy Management: DOE Has an Opportunity to Improve Its University of California Contracts (GAO/RCED-92-75, Dec. 26, 1991).

Energy Management: Tightening Fee Process and Contractor

Accountability Will Challenge DOE (GAO/RCED-92-9, Oct. 30, 1991).

Energy Management: Contract Audit Problems Create the Potential for Fraud, Waste, and Abuse (GAO/RCED-92-41, Oct. 11, 1991).

Energy Management: DOE Actions to Improve Oversight of Contractors' Subcontracting Practices (GAO/RCED-92-28, Oct. 7, 1991).

DOE Management: Improvements Needed in Oversight of Procurement and Property Management Practices at the Lawrence Livermore National Laboratory (GAO/T-RCED-91-88, Aug. 20, 1991).

DOE Management: DOE Needs to Improve Oversight of Subcontracting Practices of Management and Operating Contractors (GAO/T-RCED-91-79, Aug. 1, 1991).

DOE Management: Management Problems at the Three DOE Laboratories Operated by the University of California (GAO/T-RCED-91-86, July 31, 1991).

Nuclear Security: Property Control Problems at DOE's Livermore Laboratory Continue (GAO/RCED-91-141, May 16, 1991)

Nuclear Security: Accountability for Livermore's Secret Classified Documents Is Inadequate (GAO/RCED-91-65, Feb. 8, 1991).

Nuclear Security: DOE Oversight of Livermore's Property Management System Is Inadequate (GAO/RCED-90-122, Apr. 18, 1990).

Hazardous Waste: Contractors Should Be Accountable for Environmental Performance (GAO/RCED-90-23, Oct. 30, 1989).

Nuclear Health and Safety: DOE's Award Fees at Rocky Flats Do Not Adequately Reflect ES&H Problems (GAO/RCED-90-47, Oct. 23, 1989).

Energy Management: DOE Should Improve Its Controls Over Work for Other Federal Agencies (GAO/RCED-89-21, Feb. 9, 1989).

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