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Resources, Community, and
Economic Development Division

B-278476

November 24, 1997

The Honorable Ron Wyden
United States Senate

Subject: Department of Energy: Subcontracting Practices

Dear Senator Wyden:

This report responds to several questions you had regarding subcontract oversight practices used by the Department of Energy (DOE). DOE accomplishes much of its work by contracting with private companies, and these companies in turn often subcontract many of the tasks to other companies. Your questions stem from a subcontract for cleaning up a radioactive waste dump called Pit 9 at DOE's Idaho Falls site, which we previously reported was a failure.[1] The project was behind schedule and over budget and could not be completed either within the established time frame or the original subcontract price. DOE and the contractors blamed each other for the problems. The ultimate cost to DOE for the project is still unclear because DOE and the contractors have not reached agreement on how to proceed with the project.

As a result of these problems, you raised concerns about DOE's subcontract oversight practices in general, as well as how these practices were reflected in the Pit 9 project. The Pit 9 project involves two companies, or "corporate affiliates," that are part of Lockheed Martin. One company, Lockheed Martin Idaho Technologies Company, has a direct (prime) contract with DOE to manage and operate the entire Idaho Falls site. The other company, Lockheed Martin Advanced Environmental

[1]Nuclear Waste: Department of Energy's Project to Clean Up Pit 9 at Idaho Falls Is Experiencing Problems (GAO/RCED-97-180, July 28, 1997); Nuclear Waste: Department of Energy's Pit 9 Cleanup Project Is Experiencing Problems (GAO/T-RCED-97-221, July 28, 1997).

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Systems, has a subcontract with Lockheed Martin Idaho Technologies Company to clean up the wastes in Pit 9. In its role as management and operating contractor for the Idaho Falls site, Lockheed Martin Idaho Technologies Company is responsible for administering the subcontract with Lockheed Martin Advanced Environmental Systems. As agreed with your office, this report discusses whether DOE has policies or contract requirements that (1) limit subcontracting between corporate affiliates or limit the amount a subcontractor can charge for profit when it contracts with a corporate affiliate and (2) ensure that contractors and subcontractors make payments they owe to suppliers or other companies supporting their work.

In summary, we found the following:

In certain instances federal and DOE procurement regulations place limits on subcontracting between a DOE contractor and its corporate affiliates. The nature of DOE's controls over these transactions between corporate affiliates depends on the type of contract that exists between DOE and the prime contractor. If DOE has a cost-reimbursement contract with the prime contractor under which the contractor generally is paid for all costs incurred, the regulations generally (1) require that DOE have approval authority over transactions between corporate affiliates and (2) prohibit amounts for profit that can be charged on such transactions if the contractor and subcontractor have the same corporate affiliation. However, if DOE has a fixed-price contract with the prime contractor under which the contractor is paid a fixed amount regardless of the contractor's costs for doing the work, the regulations do not call for imposing such controls on subcontracts. Controls are not applied under fixed-price contracts because, unlike under cost-reimbursement arrangements, the overall costs to the government are not affected. In the case of the Pit 9 project, even though the prime contract was a cost-reimbursement contract, DOE allowed the subcontractor to include an amount for profit. DOE did so because at the time the Pit 9 subcontractor was initially selected, the management and operating contract for the Idaho Falls site was held by EG&G Idaho, a company that was not a corporate affiliate of Lockheed Martin Advanced Environmental Systems.

While DOE expects its contractors to conduct business in a responsible manner, it generally lacks the authority to require contractors or their subcontractors to make payments to suppliers or other companies supporting the work. An exception exists for certain federal construction

project contracts, for which federal law requires, among other things, that the contractor post a payment bond to better ensure that suppliers receive payments owed to them. In the case of the Pit 9 project, DOE determined that the project was not a federal construction project because a private company would own and operate the facilities. Therefore, DOE did not require a payment bond. A supplier subsequently complained about not being paid by Lockheed Martin Advanced Environmental Systems for proposed design work on an analytical laboratory. DOE examined the complaint, in keeping with its general practice of looking into allegations that contractors are not performing responsibly, and determined that the complaint was not valid because no contractual arrangement existed between the two companies.

BACKGROUND

Cleaning up facilities that over the past 50 years have produced the nation's supply of nuclear materials for weapons is an enormous and complex task. This effort is being performed primarily by contractors that manage and operate many of DOE's sites, generally under cost-reimbursement contracts. Under such a contracting arrangement, these "M&O contractors" are paid for all costs they incur to the extent that the costs are allowable under the contract. However, primarily in an attempt to reduce its cleanup costs, in certain instances DOE has used fixed-price contracts to purchase specific waste cleanup services. These fixed-price contracts are generally managed either by the M&O contractors or by DOE directly. The Pit 9 project at the Idaho Falls site is one of such contracts intended to clean up DOE's radioactive wastes. Pit 9 is an inactive disposal site about 1 acre in size. In the 1960s, DOE used it to dispose of radiologically contaminated and hazardous wastes, most of which were packaged in barrels and boxes and covered with soil. The Pit 9 project is being implemented through a contract between Lockheed Martin Idaho Technologies Company, the M&O contractor, and Lockheed Martin Advanced Environmental Systems, a subcontractor.

The Federal Acquisition Regulation (FAR) contains overall procurement and contracting requirements for federal executive agencies. DOE has also issued supplemental requirements in the Department of Energy Acquisition Regulation (DEAR). The DEAR includes detailed controls over M&O contractors and their subcontracting and procurement practices. DOE's contracting officers are responsible for ensuring that M&O contractors conform to the relevant regulations.

DOE'S CONTROLS OVER CONTRACTS WITH CORPORATE AFFILIATES VARY WITH THE TYPE OF CONTRACT

The type of contract between DOE and its prime contractor determines the extent of DOE's controls over the contractor's procurements, including transactions between corporate affiliates. Controls are stronger when the prime contract is a cost-reimbursement contract because under such a contract costs potentially can be added and passed through to the government. As a result, DOE looks more closely at the costs incurred and generally prohibits the addition of an amount for profit in a subcontract with a corporate affiliate. In the case of the Pit 9 subcontract, even though the M&O contract was a cost-reimbursement contract, DOE allowed the subcontract to include a profit because it determined that the initial selection of the subcontract firm was not a transaction between corporate affiliates.

DOE Oversees Contracts Between Affiliates When the Prime Contract is a Cost-Reimbursement Contract

When the prime contract between DOE and a company is on a cost-reimbursement basis, as is the case with most M&O contracts, DOE has detailed procedures to follow in overseeing the contractor's procurements. Because M&O contractors usually obtain needed goods and services through subcontracting, DOE must ensure that the M&O's procurement system meets the standards established by the DEAR. To do so, the DOE contracting officer (1) requires the M&O contractor to maintain written descriptions of its procurement system and submit those descriptions for review and approval, (2) ensures that periodic appraisals of the contractor's procurement system are performed, and (3) sets threshold levels by types of transactions and reviews and approves individual purchasing actions that exceed those threshold levels. For example, at the Idaho Falls site, the DOE contracting officer must review and approve the M&O contractor's procurement of individual transactions for $2 million or more.

These requirements do not preclude contractors from entering into subcontracts with affiliated companies. However, DOE monitors these transactions to ensure that the government is getting a good value. Regardless of whether the subcontract is cost-reimbursement or fixed-price, such subcontracted transactions generally require review and approval by the DOE contracting officer. In addition, the subcontract with the affiliate would generally not be allowed to include an amount for

profit unless a similar amount was subtracted from the M&O contractor's profit (normally referred to as the "fee" for a cost-reimbursement contract).

DOE Does Not Oversee Contracts Between Affiliates When the Prime Contract Is a Fixed-Price Contract

When a prime contract is awarded on a fixed-price basis, with the prime contractor being paid a specified amount that is not subject to adjustment on the basis of the contractor's actual costs, DOE is generally unconcerned about subcontracts with affiliates. Since DOE would be paying a fixed price regardless of the costs the contractor incurred, subcontracting with a corporate affiliate would not adversely affect DOE's overall costs. Therefore, the stronger controls DOE places on cost-reimbursement prime contracts are not needed under fixed-price prime contracts.

Profit on Pit 9 Subcontract Was Allowed Because of Special Circumstances

The M&O contractor at the Idaho Falls site–Lockheed Martin Idaho Technologies Company–has a cost-reimbursement prime contract with DOE. The Pit 9 subcontract is a fixed-price subcontract between Lockheed Martin Idaho Technologies Company and Lockheed Martin Advanced Environmental Systems, a subcontractor. Since the M&O contract is a cost-reimbursement prime contract, DOE would generally prohibit the subcontractor from including an amount for profit in the subcontract because it is between corporate affiliates. However, the Pit 9 subcontract was a special case in which DOE allowed a profit to be included.

The exception for the Pit 9 subcontract occurred because when Lockheed Martin Advanced Environmental Systems was initially selected for the subcontract, no corporate affiliation existed between it and the initial M&O contractor. The procurement for the Pit 9 subcontract was conducted by the previous M&O contractor at the Idaho Falls site–EG&G Idaho. EG&G Idaho evaluated the proposals and selected the Lockheed Martin company to perform the Pit 9 subcontract. During this same period, DOE recompeted the M&O contract at the site. After Lockheed Martin Advanced Environmental Systems was selected for the Pit 9 project but before the final price was negotiated for the fixed-price subcontract, Lockheed Martin Idaho Technologies Company won the M&O

contract for the Idaho Falls site. This M&O contract was awarded on a cost-reimbursement basis. Because the contracting relationship for the Pit 9 project would now involve two affiliated companies, DOE decided to assume responsibility for the final Pit 9 subcontract negotiations. According to DOE officials, DOE also decided that because Lockheed Martin Advanced Environmental Systems had been selected by EG&G Idaho and not by Lockheed Martin Idaho Technologies Company, an amount for profit was allowable. DOE approved a profit as part of the subcontract price, without requiring the new M&O contractor to reduce its profit (called a "fee" for a cost-reimbursement contract) by an equivalent amount. If the subcontract had been ruled a transaction between corporate affiliates, the DEAR would have required a reduction in the M&O contractor's payment to offset the profit going to the corporate affiliate.

Although DOE allowed a profit to be included in the Pit 9 subcontract, it also took steps to further oversee the corporate relationship created in the middle of the subcontracting process. Although DOE conducted the price negotiations for the subcontract, the Lockheed Martin M&O contractor signed the subcontract with Lockheed Martin Advanced Environmental Systems and was responsible for administering the subcontract. DOE was concerned about the potential conflict of interest associated with one corporate affiliate overseeing a subcontract with another. To address this concern, DOE required the Lockheed Martin M&O contractor to prepare an organizational conflict of interest plan, which included the establishment of a program oversight board with members from DOE, Lockheed Martin Idaho Technologies Company, and an impartial third party to monitor the dealings between the two Lockheed Martin companies.

DOE GENERALLY CANNOT REQUIRE CONTRACTORS OR SUBCONTRACTORS TO PAY SUPPLIERS OR COMPANIES PROVIDING SERVICES

DOE generally lacks the authority to ensure that suppliers or companies that do work for contractors or subcontractors receive payment for their services. An exception exists for federal construction projects, which include a requirement under the Miller Act (40 U.S.C. 270a et seq.) that contractors provide the government with a payment bond to ensure that suppliers of labor and materials will receive payment for their efforts. For other than construction contracts, the Miller Act does not apply. However, DOE officials said that, as a general practice, they look into any

allegations that DOE's contractors are not acting responsibly in carrying out work at DOE's sites.

The Miller Act requires that for federal construction contracts–contracts "for the construction, alteration, or repair of any public building or public work of the United States" exceeding $100,000–the contractor must post a performance bond that protects the government in case the contractor fails to complete its contract and a separate payment bond that protects suppliers of labor and materials against nonpayment by the contractor. Suppliers and subcontractors that do not receive payment from the contractor for their work or materials may file a claim against the payment bond to collect the amounts owed.

While the Miller Act and implementing regulations require bonds for federal construction contracts, the FAR specifies that generally agencies shall not require either performance or payment bonds for other than construction contracts. DOE does not generally require payment bonds on other types of contracts; rather, it relies on its contractors to act responsibly and pay their suppliers. DOE also encourages its M&O contractors to establish an ombudsman or a similar program to handle the questions or concerns of their subcontractors and suppliers. Nevertheless, DOE officials at the Idaho Falls site and in headquarters stated that, even without direct authority, they look into complaints against DOE's contractors and work informally to resolve problems.

In the case of the Pit 9 project, DOE determined that the Miller Act did not apply and therefore a payment bond was not required. The project was structured so that Lockheed Martin Advanced Environmental Systems was to finance, design, build, own, and operate the Pit 9 facilities with DOE paying for the remediation of the Pit 9 wastes on a unit-price basis. According to DOE officials, DOE decided that the Miller Act did not apply because (1) DOE was purchasing the performance of a service rather than the construction of a facility, and (2) the completed facilities would be owned by the private contractor and would not be considered public buildings.

During the Pit 9 project, one company complained that it had not been paid by Lockheed Martin Advanced Environmental Systems for proposed design work on an analytical laboratory. DOE reviewed the complaint to determine if it was legitimate. DOE concluded that the complaint was not legitimate because no subcontract existed between Lockheed Martin

Advanced Environmental Systems and the company registering the complaint.

AGENCY COMMENTS

We provided a draft of our report to DOE for its review and comment. In its written comments (see enc. I), DOE said that, generally, the report was a balanced and accurate description of DOE's oversight of subcontracts between corporate affiliates. However, DOE (1) disagreed that the Pit 9 subcontract was a transaction between corporate affiliates and (2) suggested that we provide more information on DOE's regulatory framework for affiliate transactions.

DOE said our report should state that the Pit 9 subcontract award was not a transaction between corporate affiliates. According to DOE's Deputy Assistant Secretary for Procurement and Assistance Management, because EG&G Idaho selected Lockheed Martin Advanced Environmental Systems for the Pit 9 subcontract and because EG&G Idaho had no affiliate relationship with Lockheed Martin Advanced Environmental Systems, the subcontract award was not an affiliate transaction. While we agree that the initial selection of Lockheed Martin Advanced Environmental Systems as the Pit 9 subcontractor did not involve two affiliated companies, the resulting subcontract, which defined the subcontract's requirements and price, was a subcontract between two corporate affiliates, now called Lockheed Martin Idaho Technologies Company and Lockheed Martin Advanced Environmental Systems. Therefore, in our view, the Pit 9 subcontract was a transaction between corporate affiliates.

Regarding the discussion of DOE's regulatory framework, DOE suggested that we include in our report a more detailed explanation of DOE's regulatory controls over affiliate transactions by M&O contractors. We believe, however, that the report adequately explains these controls without being overly technical and thus we did not add more detail.

DOE also suggested several clarifications, which we incorporated where appropriate.

SCOPE AND METHODOLOGY

We conducted our review at DOE headquarters, DOE's Idaho Operations Office in Idaho Falls, and the offices of its M&O contractor and the

subcontractor for Pit 9. To respond to your questions, we reviewed the FAR, DEAR, and the Miller Act and other documentation provided by DOE and the contractors, including the M&O contract and the Pit 9 subcontract at the Idaho Falls site. In addition, we interviewed contracting officials with DOE's Idaho Operations Office, the M&O contractor, and the subcontractor. To obtain DOE's overall view on these questions, we interviewed DOE's Deputy Assistant Secretary for Procurement and Assistance Management and the Deputy Assistant General Counsel for Procurement.

Our work was performed from September through October 1997 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Secretary of Energy. We will also make copies available to other interested parties upon request.

Please call me at (202) 512-8021 if you or your staff have any questions. Major contributors to this report include William R. Swick, Carole J. Blackwell, Susan W. Irwin, Stanley G. Stenersen, and Charles A. Sylvis.

Sincerely yours,

Gary L. Jones
Acting Associate Director
Energy, Resources, and
Science Issues

ENCLOSURE I

Department of Energy
Washington, DC 20585

November 19, 1997

Ms. Gary L. Jones
Acting Associate Director
Energy, Resources, and Science Issues
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Jones:

We have reviewed your draft report entitled DOE's Subcontracting Practices (GAO/RCED-98-30R, Code 141102) and, generally, we find the report to be a balanced and accurate description of subcontracting oversight by the Department with respect to affiliate transactions. We would like to offer the following paragraphs for your consideration as a more complete and detailed explanation of the regulatory framework which the Department applies to affiliate transactions.

The Federal Acquisition Regulation (FAR), which is generally applicable to Federal executive agencies, deals with the subject of contractor affiliate transactions only in the context of contracting agency review of contractor purchasing systems The FAR directs agencies, in their review of a cost-reimbursement contractor's purchasing system, to give "special attention" to, among other things, the contractor's transactions with its affiliates.

Although the FAR provides little guidance on this matter, the Department of Energy Acquisition Regulation (DEAR), which contains requirements specific to DOE contractors, provides considerably more detailed guidance and controls on affiliate transactions for its management and operating (M&O) contractors. DOE regulations provide for significant limitations on how M&O contractors may purchase from affiliates. For example, the DEAR calls for the provision at cost by an affiliate where the affiliate receives a non-competitive award for technical services consisting of a special expertise of the affiliate In all other situations involving the provisions of supplies or services, it requires that the transaction be conducted in such a manner as to ensure an arms-length relationship between the contracting parties It also requires advance notification to the Contracting Officer prior to making purchases from contractor-affiliated sources over a value established by the Head of the Contracting Activity There are even more restrictions associated with M&O subcontracts with affiliates for the performance of core contract work itself. Such subcontracts require DOE authorization and usually involve an adjustment of the contractor's fee. DOE approval normally would require either that the affiliate perform such work without fee or profit, or that the M&O's fee be adjusted downward.

ENCLOSURE I

In addition to these general comments, we respectfully offer the specific comments on the attachment for your consideration for purposes of clarity.

If you have any additional questions regarding this matter, please contact me at 202-586-8613.

Sincerely,

Richard H. Hopf
Deputy Assistant Secretary for
Procurement and Assistance Management

Attachment:
Comments on Draft Report B-278476

ENCLOSURE I

COMMENTS ON DRAFT REPORT B-278476

Now on p. 5. 1. On page 7, we recommend changing the first four words in the fifth line of the first paragraph to read, ". . . a fee or profit . . . ." rather than, ". . . a fee for profit . . . ."

Now on p. 5. 2. On page 7, we recommend changing the last sentence of the first paragraph to read. "However, in the case of the Pit 9 subcontract, the subcontract award was not, in fact, an affiliate transaction."

3. On page 7, we recommend replacing the first two sentences of the second paragraph with the following three sentences:

Now on p. 5. "When Lockheed Martin Advanced Environmental Systems was competitively selected for the subcontract, no corporate affiliation existed between it and the then M&O contractor. The competitive procurement for the Pit 9 subcontract was conducted by the previous M&O contractor at the Idaho Falls site-EG&G Idaho. EG&G Idaho had no affiliate relationship with Lockheed Martin Advanced Environmental Systems."

Now on p. 6. 4. On page 7, we recommend changing the eighth and ninth sentences, beginning on the 14th line of the second paragraph, to read as follows:

"According to DOE officials, DOE also decided that because Lockheed Martin Advanced Environmental Systems had been selected by EG&G Idaho and not by Lockheed Martin Idaho Technologies Company, a subcontract fee was permissible. DOE approved a fee as part of the subcontract price, without requiring the new M&O contractor to reduce its fee by an equivalent amount."

Now on p. 6. 5. On page 8, we recommend changing the terms ". . . fee for profit . . . ." on the second and third lines at the top of the page, to read, ". . . fee . . . ."

On page 8, we recommend revising the last sentence of the first full paragraph, and adding a new last sentence to the paragraph to read as follows:

Now on p. 6. "To address this concern, DOE required the Lockheed Martin M&O contractor to prepare an organizational conflict of interest plan, which included the establishment of a program oversight board with members from DOE, Lockheed Martin Idaho Technologies Company, and an impartial third party to monitor the dealings between the two Lockheed Martin companies. DOE reports that the organizational conflict of interest plan has worked well, and that the affiliate relationship has not affected the Lockheed Martin M&O contractor in its aggressive administration of the subcontract."

(141102)

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