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Report to the Secretary of Energy

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DEPARTMENT OF ENERGY

Challenges to Implementing Contract Reform

GAO

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Resources, Community, and
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The Honorable Hazel R. O'Leary
The Secretary of Energy

Dear Madam Secretary:

This letter summarizes our views on your Contract Reform Team's report entitled Making Contracting Work Better and Cost Less, February 1994.[1] The Reform Team's effort stemmed from your pledge in early 1993 to evaluate and fundamentally reform the Department of Energy's (DOE) contracting practices.

As you know, we participated in several Reform Team meetings, supplied background information for Team staff, and presented our views at the DOE meetings on contract reform. We also briefed you and your senior managers on a variety of DOE's contracting issues as well as on the overall management challenges facing the Department. We appreciate the opportunity to work with you and your staff on these important issues. Our objective in this letter is to present several issues that your staff may want to consider as they develop a strategy for implementing contract reform.

Results in Brief

The Reform Team acknowledges that "weaknesses in DOE's outdated contracting practices are significant and systemic." The Team's recommendations—over 45 in total—are a bold step forward for DOE, address many of the concerns previously raised in our reports, include an ambitious timetable for implementation, and require action by many different parts of the organization.

As DOE moves forward with its contracting changes, a number of issues confront management as it develops an implementing strategy:

- DOE staff should be prepared to implement the Team's initiatives with stronger contract administration and oversight skills, supported by reliable management and financial information systems. Weaknesses in these areas have long plagued DOE's contracting activities and have hampered past contracting reform efforts.

[1] Pursuant to the Feb. 17, 1994, notice in the Federal Register requesting comments on the Contract Reform Team's recommendations.

- The recommendation to hold nonprofit contractors to the same level of accountability as profit-making firms highlights the importance of having a skilled workforce and strong systems to properly administer new contracting rules.
- DOE's desire to grant contractors greater freedom to change the skill mix of their workforces to meet new mission requirements underscores the importance of DOE's having an overall plan for restructuring the entire contractor workforce.
- The recommendations to negotiate performance-based contracts places a high premium on developing fee and profit policies that are consistent with results-oriented performance measures.
- Requiring audited financial statements from DOE's contractors (under review by the Chief Financial Officer) could lessen the need for the Team's other recommendations on voucher accounting and contract audits.

Finally, a key to achieving contracting change will be establishing a strong institutional entity with the oversight responsibility for holding DOE managers accountable for implementing the Reform Team's recommendations.

Background

DOE's contractors manage the nation's nuclear weapons production complex and conduct basic research and development in science and energy for the Department. In fiscal year 1993, the cost of these activities totaled about $19 billion. Newer missions now require DOE's contractors to manage the largest environmental cleanup effort in the nation's history and redirect the expansive national laboratory network into centers of excellence for commercial technology and economic competitiveness.

Employing nearly 150,000 contractor employees, DOE is the largest civilian contracting agency in the federal government. It has 52 management and operating (M&O) contracts with many private corporations and nonprofit institutions. The key feature of DOE's M&O contracting is that all costs to contractors are generally reimbursed by DOE. Historically, DOE has provided little oversight over its contractors' activities and the resulting costs to DOE. DOE has about 20,000 employees, 5,200 of whom are located in field offices directly responsible for overseeing contractors.

The urgency and uncertainties associated with building the world's first atomic bombs led to special arrangements that allowed DOE's predecessors to rely extensively on the contractors' expertise to manage and operate a vast network of weapons facilities. Contractors have worked under these arrangements for nearly 50 years and have made extraordinary contributions to the nation's nuclear enterprise. However, changing national priorities, recent world events, the environmental degradation of the DOE's weapons complex, and the demand for greater accountability by DOE and its contractors call into question the continuance of these special arrangements.

Contracting Reforms Are a Major Step Forward

DOE intends to make significant changes in its 50-year-old contracting practices. Over 45 specific "action items" are advanced, along with other recommendations for changing how DOE conducts it business through the private sector. An aggressive time schedule for completing actions is also presented. Many recommendations start immediately and cover a wide range of contracting practices.

The Reform Team accurately characterizes DOE's basic contracting weaknesses and boldly calls for fundamental change, a position consistent with our views articulated in numerous reports to DOE and the Congress (see the end of this report for a list of related GAO reports and testimonies).

The Team's basic premise is that DOE's contracting suffers from an overreliance on cost contracts, a lack of well-defined performance criteria and measures, and weaknesses in oversight. To correct these conditions, the Team established broad goals calling for

- more flexibility in contracting,
- wider use of incentives for contractors, and
- a willingness to experiment.

These changes, along with many other measures suggested, should provide DOE with a stronger basis for selecting and evaluating those contractor behaviors that are consistent with mission needs.

Preparing DOE for Change

The Reform Team recognizes that changing DOE's contracting practices poses "an enormous challenge." We certainly agree and believe that fundamental change is a long-term process. As DOE develops its strategy to implement contract change, we believe closer attention to several issues can help prepare DOE for contracting reform.

Improving DOE's Oversight Skills and Capabilities

The Reform Team's report focuses heavily on improving DOE's contracting vehicles—a substantial need—but gives less attention to developing ways to improve contract administration and oversight. We believe that under any new contracting strategy, DOE's challenge is to manage its contractors more effectively than it has in the past. Although the Reform Team acknowledges the needs in these areas, few of its recommendations aim to improve workforce skills and systems, and many actions are scheduled before workforce and systems corrections are in place. For example, a recommendation to improve financial management is a critical action slated for implementation late in the cycle.

Poor contract administration and oversight skills are major reasons why DOE has had difficulty in its past contracting practices. Applying new practices will require significant training and perhaps higher staff levels in some locations—needs acknowledged by the Reform Team. Our examination of DOE's implementation of past contracting reforms illustrates the need for having a technically skilled and trained workforce with supporting systems to administer reforms before major changes in contracting practices are attempted. Both the accountability rule and task order contracting—two of DOE's previous contracting initiatives—encountered many difficulties because field staff were not trained to administer these programs.[2] As a result, DOE staff were forced to rely on the contractors for information and systems support. DOE staff could not independently evaluate the contractors' costs or other activities. Ultimately, under the accountability rule, contractors received higher fees without a commensurate increase in risk.

Furthermore, the field office managers reported being overwhelmed by the demands of new initiatives. Field managers still report that they are understaffed in many areas, and other reviews and observations—including those by the Reform Team—frequently document and recognize the need to upgrade staff skills.

The use of performance-based standards also underscores the need for a more skilled workforce. Designing and administering new sets of performance standards under a new contract form could be quite complex, particularly at diversified facilities where research and production activities all exist under a single contractor. In addition, the Team's Rocky Flats model is a complex arrangement that places a high premium on the skills of DOE's local staff. The model was designed to

[2]The accountability rule holds contractors liable for expenditures not allowed by regulation or those that could have been avoided by proper contract performance. Task order contracting requires DOE to describe tasks to be performed by the contractor in substantially more detail than under previous arrangements and requires specific DOE authorization before work can begin or moneys can be obligated.

blend a variety of fixed-price and cost-reimbursable contracts under potentially many different contractors; some of the contracts are to be administered by DOE staff and others by a new form of management contractor.

To the extent that DOE's contractors negotiate higher potential fees to compensate for increased levels of accountability, a danger exists that under DOE's new contracting environment, contractors could receive higher profits without a corresponding increase in risk or performance. Strengthening DOE's contract administration and oversight skills as among the highest—and earliest—priorities would help ensure that new contracting practices achieve their intended objectives.

Changing the Contractor Workforce

Historically, only a handful of senior managers are replaced when new contractors arrive to manage and operate DOE's facilities—as few as a dozen out of 14,000 employees in one changeover. The contractors are required by DOE's policy to retain the existing workforce, except for a small number of "key" officials. In other words, the contractor workforce is more or less permanent. The Reform Team argues that workforce retention policies restrict a new contractor's ability to change the skill mix to meet changing mission requirements.

The Reform Team's desire to revise DOE's policy requiring a contractor to retain the previous contractor's workforce could be a significant change in DOE's practice. This is a complex issue involving many considerations, such as union agreements, retraining, and cost effectiveness.[3] How DOE prepares to allow its contractors more freedom to change their workforces will be closely watched by stakeholder groups, including the Congress, states, and regulators.

Having in place a plan that is based on an analysis of the contractors' skill needs, consistent with DOE's changing missions, would be important to the success of new policies.

Providing More Contract Financial Incentives

The Reform Team recommends using performance-based measures for evaluating the contractors' activities on a more objective and results-oriented basis. The Team also recommends developing incentives to reward superior and penalize inferior performance. Setting an objective

[3]For example, under section 3161 of the National Defense Authorization Act for Fiscal Year 1993, the Secretary of Energy must develop a plan for restructuring the workforce for a defense nuclear facility, whenever a change in workforce is deemed necessary.

to reduce the disincentives in the current contractors' profit structure would help DOE achieve its new goals.

For example, historically, DOE has relied extensively on the cost-plus-award-fee contract by which a for-profit contractor earns a "base" fee for operating a DOE facility. The contractor need only perform at the level of "satisfactory" to earn its base fee. In addition, the contractor can earn an additional or "award" fee based on DOE's evaluation of the contractor's performance. DOE uses award fees to influence contractors' behavior, for example, in environmental, safety and health issues. Recently, in a rare occurrence, two DOE contractors were denied award fees because of poor performance.

In some contracts, the award fee earned is smaller than the base fee, and DOE allows unearned award fees to carry over to the next rating period, thereby creating a second chance for the contractor. Consequently, a contractor could receive little or no award fee for poor performance in one period but then, in the next period, receive an award fee, plus all or part of its previously unearned fee even if performance declines. DOE's carryover provision could limit contractors' incentive because contractors may be afforded an opportunity to earn fees that previous performance did not merit. This provision could also raise the assumption that little incentive exists to strive for the award fee, thereby limiting the success of DOE's new performance-based measures.

Increasing the Accountability of Nonprofit Contractors

The Reform Team makes a recommendation to hold nonprofit contractors to the same controls on cost reimbursement as profit-making contractors. In general, DOE has not subjected nonprofits to the same level of cost controls as for-profit contractors. To compensate for the increased risk, the Reform Team intends to pay nonprofits a management fee, subject to certain limitations.

Holding nonprofits to a higher level of accountability underscores the need to be able to competently administer the new cost-control provisions. We have consistently reported on DOE's weaknesses in the administrative oversight of its national laboratories, and we fear that providing additional fees could lead to the same results that DOE experienced with the accountability rule as applied to for-profit contractors—higher fees without the increased risk. The burden of proof will be on DOE to ensure that only allowable costs are claimed and reimbursed.

Strengthening Financial Management

The Reform Team recommends a number of actions to improve financial management, such as "explore alternatives to the use of the Voucher Accounting for Net Expenditures Accrued" and "evaluate increasing Departmental capability for review and audit of contracts and contractors." In addition, the Team noted that DOE is considering the costs and benefits of requiring audited financial statements from contractors.

We believe that audited financial statements, if properly planned and conducted, could achieve the objectives of the Team's other financial improvement recommendations. Combining all three actions into a single audit strategy could be an efficient and effective implementing approach.

Finally, the Team recommends benchmarking various indirect-cost categories against the "best in class" of public and private businesses with the goal of reducing indirect costs. As these benchmarking techniques are developed, in order to achieve cost-reduction goals, it is important that DOE closely monitor progress to ensure that the artificial transfer of indirect costs to direct-cost categories does not occur.

Designating an Oversight Entity for Contracting Reform

The Team acknowledges the importance of contracting to DOE's mission and notes that effecting change of this magnitude will be "an enormous challenge." We agree. Reforming DOE's contracting practices will be an ongoing and long-term process. Meeting this challenge will also mean designing and implementing an effective strategy that sets realistic goals for executing actions, allows for gauging success, and then makes the necessary adjustments.

Perhaps the most important feature of an implementing strategy is holding responsible officials accountable for action. The Team intends to establish a committee of senior managers to oversee the reform's implementation. This committee will certainly serve an important leadership role. However, overseeing the progress of contracting reform will require an ongoing presence by a central source with the authority to oversee progress and make adjustments as necessary.

Conclusions

The Contract Reform Team has made many important recommendations to change the way DOE conducts its business through contractors. Its many recommendations, including using performance-based measures to evaluate contractors, providing more incentives to motivate behavior, and reducing strict reliance on cost contracts, are major steps for DOE. The challenge facing DOE's leadership will be developing a strategy for implementing these reforms so that real change takes place. Overcoming workforce and management information weaknesses—necessary prerequisites for change—is a major hurdle for DOE.

We are sending copies of this report to interested congressional committees and subcommittees and to the Director, Office of Management and Budget. We will also make copies available to others upon request.

If you or your staff have any questions about the information provided in this report, please contact me at (202) 512-3841. Other major contributors to this report are listed in appendix II.

Sincerely yours,

Victor S. Rezendes
Director, Energy and Science Issues

Objectives, Scope, and Methodology

The purpose of our review was to evaluate DOE's contracting reform efforts under way to improve contracting practices. This is one of a series of GAO reports that assess the Department's management and organizational performance.

We examined the Contract Reform Team's report and the documentation used to prepare the report. We also attended several meetings of the Contract Reform Team and discussed aspects of the Team's findings with several DOE officials.

We examined the progress that DOE had made on implementing four major initiatives that were the major contracting changes DOE made over the past several years: the accountability rule, task order contracting, incentive contracting, and environmental restoration management contracting. In reviewing these initiatives, we interviewed DOE headquarters and field officials, examined DOE's internal reports relevant to the implementation and success of these initiatives, and discussed their implementation with field managers. We performed our audit work at DOE headquarters in Washington, D.C., and at the following DOE field offices: Albuquerque, in Albuquerque, New Mexico; Nevada, in Las Vegas, Nevada; and the Rocky Flats Plant, near Denver, Colorado.

We also examined relevant criteria in the Federal Acquisition Regulation and the Department of Energy Acquisition Regulation to determine how the new contracting initiatives are consistent with these regulations.

Also, we interviewed contractors to obtain their perspective on the impact of DOE's new contract initiatives and the status of the implementation efforts.

We conducted our review from June 1993 through February 1994 in accordance with generally accepted government auditing standards.

Major Contributors to This Report

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Related GAO Products

Financial Management: Energy's Material Financial Management Weaknesses Require Corrective Action (GAO/AIMD-93-29, September 30, 1993).

Department of Energy: DOE Management Problems Require A Long-Term Commitment To Change (GAO/RCED-93-72, Aug. 31, 1993).

Energy Management: High Risk Area Requires Fundamental Change (GAO/T-RCED-93-7, Feb. 17, 1993).

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

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).

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

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

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