August 13, 1997

MEMORANDUM FOR THE SECRETARY

FROM: John C. Layton
Inspector General

SUBJECT: INFORMATION: Report on "Audit of the Contractor Incentive Programs at the Rocky Flats Environmental Technology Site"

BACKGROUND:

The Department of Energy (Department) is using performance-based contracts to solve problems associated with its traditional management and operating contracts. These performance-based contracts are to include cost reduction incentive programs to motivate contractors to reduce costs by employing innovative practices. Additionally, these contracts are to encourage and reward superior, results-oriented performance through a clearly defined performance measure incentive program. The purpose of this audit was to determine whether cost savings awards and performance fees paid by the Rocky Flats Field Office (Rocky Flats) were appropriate and justified.

DISCUSSION:

We found that contrary to the Department's guidance on cost reduction incentives, Rocky Flats approved three Kaiser Hill Company, LLC (Kaiser-Hill) cost reduction proposals that did not meet basic criteria. These proposals, with approved savings of about $16 million, were not innovative and generally did not return savings to the Department. The proposals were approved because Rocky Flats did not use the contract in conjunction with Departmental guidance as a basis for accepting or rejecting the proposals.

In addition, we found that the contract with Kaiser-Hill for the operation of the Rocky Flats Site contained performance measures which did not always include clearly defined criteria, were not structured to encourage and reward superior performance, and were often process-rather than results-oriented.

We recommended that the Deputy Assistant Secretary for Procurement and Assistance Management and the Manager, Rocky Flats Field Office take several corrective actions. Management concurred with four recommendations and partially concurred with the remaining two.

Attachment

cc: Deputy Secretary
Under Secretary

U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL

AUDIT OF THE CONTRACTOR INCENTIVE PROGRAMS

AT THE ROCKY FLATS ENVIRONMENTAL TECHNOLOGY SITE

Report Number: DOE/IG-0411 Western Regional Audit Office
Date of Issue: August 13, 1997 Albuquerque, New Mexico 87185

AUDIT OF THE CONTRACTOR INCENTIVE PROGRAMS
AT THE ROCKY FLATS ENVIRONMENTAL TECHNOLOGY SITE

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

AUDIT OF THE CONTRACTOR INCENTIVE PROGRAMS AT THE ROCKY FLATS ENVIRONMENTAL TECHNOLOGY SITE

Audit Report Number: DOE/IG-0411

SUMMARY

The Contract Reform Report entitled Making Contracting Work Better and Cost Less made several recommendations to improve contracting within the Department of Energy (Department). The report recommended that the Department motivate contractors to employ innovative business practices and techniques to reduce or avoid costs associated with contract performance. It also recommended that Department contracts contain performance measures that are clearly stated, structured to encourage and reward superior performance, and are results-oriented. The objective of this audit was to determine whether cost savings awards and performance fees paid by the Rocky Flats Field Office (Rocky Flats) were appropriate and justified. As part of the audit, we reviewed the cost reduction and performance measure incentive programs at the Rocky Flats Environmental Technology Site (Rocky Flats Site) to determine (1) whether Rocky Flats rewarded Kaiser-Hill Company, LLC (Kaiser-Hill) for cost reduction proposals that were innovative and resulted in savings that were returned to the Department's control, and (2) if performance measures rewarded performance expectations that were properly defined, within the contract period, and produced results.

Contrary to the Department's guidance on cost reduction incentives, Rocky Flats approved three Kaiser-Hill cost reduction proposals that did not meet basic criteria. These proposals, with approved savings of about $16 million, were not innovative and generally did not return savings to the Department. The proposals were approved because Rocky Flats did not use the contract in conjunction with Departmental guidance as a basis for accepting or rejecting the proposals. As a result, Rocky Flats awarded almost $5.6 million to Kaiser-Hill. Because Kaiser-Hill did not always return savings as stipulated in the Department's guidance, Rocky Flats used nearly $4.4 million of program funding to pay Kaiser-Hill.

In addition, our review of the contract with Kaiser-Hill for the operation of the Rocky Flats Site disclosed that it included performance measures which did not meet the Contract Reform Report's recommendation. Performance measures did not always

include clearly defined criteria, were not structured to encourage and reward superior performance, and were often process- rather than results-oriented. For meeting such performance measures, Rocky Flats paid about $6.9 million in incentive fees.

We recommended that the Deputy Assistant Secretary for Procurement and Assistance Management ensure that all Department of Energy contracts with cost reduction incentive programs include provisions that require cost reduction proposals to be innovative and result in the return of savings to the Department's control and to use the data developed in this audit as part of its Departmentwide review of the performance-based contracting incentive programs. The Deputy Assistant Secretary for Procurement and Assistance Management concurred with these recommendations.

We recommended that the Manager, Rocky Flats Field Office, direct the Contracting Officer to: (1) utilize Departmental cost reduction incentive program guidance; (2) establish performance measures that are clearly defined using objective data, structured to encourage and reward superior performance, and are results- rather than process-oriented; (3) take action to recover the amounts awarded for cost reduction proposals that were not innovative or did not return savings to the Department's control; and (4) review all incentive fees paid and seek recovery of fees for performance that occurred before the effective date of the contract or outside of the measurement period. The Manager, Rocky Flats Field Office concurred with the first two recommendations and partially concurred with the last two.

__________(Signed)___________
Office of Inspector General

PART I

APPROACH AND OVERVIEW

INTRODUCTION

The Department is using performance-based management contracts to solve problems associated with its traditional management and operating contracts. The performance-based management contracts are to include cost reduction incentive programs to motivate contractors to reduce costs by employing innovative practices. Additionally, these contracts are to encourage and reward superior, results-oriented performance through a clearly defined performance measure incentive program. The objective of this audit was to determine whether cost savings awards and performance fees paid by Rocky Flats were appropriate and justified. As part of the audit, we reviewed the cost reduction and performance measure incentive programs at the Rocky Flats Site to determine (1) whether Rocky Flats rewarded Kaiser-Hill for cost reduction proposals that were innovative and resulted in savings that were returned to the Department's control, and (2) if performance measures rewarded performance expectations that were properly defined, within the contract period, and produced results.

SCOPE AND METHODOLOGY

The audit was conducted at the Rocky Flats Site near Golden, Colorado, from September 1996 through May 1997. To accomplish the audit objective, we:

- o compared contractual provisions and Rocky Flats procedures to applicable Departmental guidance for cost reduction incentive programs and performance measures;
- o reviewed the six Fiscal Year 1995 and 1996 cost reduction proposals that Rocky Flats had reviewed and rendered a decision on as of November 6, 1996;
- o reviewed seven selected performance measures for Fiscal Year 1995 and eight performance measures for Fiscal Year 1996 that were among the measures with the highest fees; and,
- o interviewed Department and contractor officials.

The audit was conducted according to generally accepted Government auditing standards for performance audits, which included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objective. We limited our review of internal controls to those controls associated with reviewing cost reduction proposals and implementing performance measures. 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. The audit did not rely extensively on computer processed data. Therefore, we did not fully examine the reliability of the computerized data used.

We discussed the results of our review with officials in the Office of Procurement and Assistance Management and officials at Rocky Flats during the course of the audit and at an exit briefing with Rocky Flats on June 20, 1997.

BACKGROUND

For several decades the Rocky Flats Site operated as part of the nation's nuclear weapons production complex. In 1989, however, the Department shut down production at the Rocky Flats Site in order to improve the conduct of operations, the standards of performance, and the management structure. The Cold War ended while the plant was shut down and, in 1992, the process of transitioning from the production mission began. By the end of 1994, all production activities had ceased and the new mission was to clean up the Site, including preparing for decontamination and disposition of its facilities.

Concurrent with these changes, Contract Reform was moving through the Department. Historically, many of the Department's facilities, including the Rocky Flats Site, had been managed and operated for the Department under management and operating (M&O) contracts. The Department reimbursed the M&O contractors' costs and paid them a fee. In a February 1994 report, Making Contracting Work Better and Cost Less, the Department's Contract Reform Team advocated the use of performance-based contracts to solve problems inherent in the M&O process. One of the report's many recommendations was that the Department motivate its contractors to employ innovative business practices and techniques to reduce or avoid costs associated with contract performance. Another recommendation was for the Department to utilize performance-based contracts. The contracts were to have performance measures that were clearly stated and results-oriented so that contractors would know what was expected. Through an incentive fee process, the performance measures and an evaluation of contractor performance in relation to the measures were to be used to reward superior performance and discourage substandard performance.

On July 1, 1995, the M&O contract with EG&G Rocky Flats, Inc. (EG&G), ended and the Department's contract with Kaiser-Hill became effective. The Rocky Flats mission was to clean up, deactivate, and prepare for decontamination and disposition of the facilities that were once part of the Department's Nuclear Weapons Complex. Kaiser-Hill, as the integrating contractor at the Rocky Flats Site, was supposed to support the Site's federal staff in its contract management activities, including finding the appropriate mix of contractors to accomplish this mission. Kaiser-Hill assembled a team of primary companies to serve as subcontractors to tackle specific areas of operations. There were also a number of sub-tier contractors to the primary team members.

Cost Reduction Incentives

As recommended by the Contract Reform Team, the contract with Kaiser-Hill included an incentive program to reduce costs. Contract Clause H.6., Cost Reduction Proposals, encouraged Kaiser-Hill to develop and submit proposals to the Contracting Officer for review. If the Contracting Officer approved the proposal, Kaiser-Hill could receive 35 percent of the estimated savings, with half of the "award," or 17.5 percent, going to the Kaiser-Hill employees who were eligible to participate in the Employee Incentive Compensation Plan.

As of November 6, 1996, Kaiser-Hill submitted 20 cost reduction proposals with claimed savings of nearly $33.3 million. As of January 27, 1997, indications were that Kaiser-Hill planned to submit an additional 51 proposals with an estimated claimed savings of as much as $77 million.

Performance Measures

The contract also established performance measures to give the contractor the opportunity to earn incentive fees commensurate with the achievement of measurable optimum contract performance. Performance measures were written on a fiscal year basis. Because Kaiser-Hill's contract was effective July 1, 1995, performance measures were written for the fourth quarter of Fiscal Year 1995. Another set of performance measures was written for Fiscal Year 1996. A minor amount of Kaiser-Hill's potential fee was tied to acceptable performance, while the majority of available fee was tied to superior performance. Kaiser-Hill and its primary subcontractors earned about $6.5 million of $8.8 million in available incentive fees for the fourth quarter of Fiscal Year 1995. For Fiscal Year 1996, Kaiser-Hill and its primary subcontractors earned $29.2 million of $39.1 million in available fees. Kaiser-Hill employees were to receive 20 percent of the performance fees earned by Kaiser-Hill.

OBSERVATIONS AND CONCLUSIONS

On March 19, 1997, the Secretary of Energy announced an initiative to review the use of performance-based incentives in contracts for the management of Department of Energy sites and facilities. The purpose of the review, the results of which are to be available by mid-August 1997, is "to ensure that incentives identified in the Department's contracts are rational, appropriately constructed, tied to reasonable fee incentives, and properly administered." Pending completion of the review and in response to this report, the Deputy Assistant Secretary for Procurement and Assistance Management directed the following actions:

- o Operations Offices shall establish a senior management team to perform an integrated review of all performance incentives prior to their being finalized.

- o Cost Reduction/Cost Savings incentives, in order to be considered for review, must meet the minimum conditions and principles set forth in guidance to be published by my office and as contained in the "Cost Reduction" clause of the draft fee policy.

- o Performance incentives, including Cost Reduction/Cost Savings incentives shall be subject to Headquarters' review and approval until lessons learned and remedial guidelines have been implemented.

- o As necessary, negotiations will be undertaken with the site contractors to either modify Cost Reduction/Cost Savings incentive provisions consistent with Departmental guidance or discontinue their application.

This audit report raises a number of concerns regarding the implementation and administration of both the contractor performance and cost savings incentive programs at the Rocky Flats Site. However, it was the view of Rocky Flats' management that contractor performance had improved as a result of instituting performance-based contracting. We support the use of performance-based contracting, where appropriate, and believe that implementation of the recommendations in this report will further improve contractor performance.

PART II

COST REDUCTION INCENTIVES

According to Departmental guidance, cost reduction incentive programs should reward contractors for innovative cost reduction proposals that reference appropriate baselines and return savings to the Department's control. However, Rocky Flats approved three of Kaiser-Hill's proposals, valued at $16 million in estimated savings, that were not innovative and generally did not return hard dollar savings. For example, Rocky Flats approved a Kaiser-Hill work force reduction proposal that was mission and budget driven and planned by Rocky Flats and EG&G, the predecessor contractor. In addition, Kaiser-Hill did not return any of the estimated savings to the Department. Rocky Flats approved the proposals because it did not rely upon the terms of the contract with Kaiser Hill and available Departmental guidance as a basis for accepting or rejecting cost reduction proposals. As a result, Rocky Flats awarded almost $5.6 million to Kaiser-Hill for cost reduction incentives which we found to be questionable. To make these awards, Rocky Flats used nearly $4.4 million of program funding because Kaiser-Hill had not always returned hard dollar savings to the Department.

RECOMMENDATIONS

We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management ensure that Departmental contracts with cost reduction incentive programs include provisions that require the cost reduction proposals to be innovative and result in the return of hard dollar savings to the Department's control.

We recommend that the Manager, Rocky Flats Field Office, direct the Contracting Officer to:

Utilize the contract in conjunction with Departmental guidance as a basis for accepting or rejecting cost reduction proposals. Specifically, reject proposals that are not innovative or do not result in hard dollar savings that are returned to the Department's control.

Take action to recover the amounts paid to Kaiser-Hill for cost reduction proposals that were not innovative or did not return savings to the Department's control.

MANAGEMENT REACTION

The Deputy Assistant Secretary for Procurement and Assistance Management concurred with the recommendation. The Manager, Rocky Flats Field Office, concurred with the first recommendation and partially concurred with the second. Part IV of this report includes detailed management and auditor comments.

COST REDUCTION INCENTIVE PROGRAMS

As recommended in the Department's report on Contract Reform, the Department's contract with Kaiser-Hill includes an incentive to encourage Kaiser-Hill to reduce operating costs. Kaiser-Hill can benefit from this incentive by developing cost reduction proposals and submitting them to Rocky Flats for review. According to the Rocky Flats draft procedure for implementing the cost reduction proposal program, the review includes a technical and financial review. If the proposal is subsequently approved by the Contracting Officer, the contract allows Kaiser-Hill to receive a 35 percent share of the savings realized by the Department. If the proposal is rejected, the contract requires that the Department set forth the reasons in writing.

Although it allows the Department to accept or reject each cost reduction proposal, the contract does not contain specific guidance about how this is to be accomplished. Consequently, we looked at the Department's April 1995 guidance, Report on Contract Reform Action Item No. 11, Cost Reduction/Cost Avoidance Incentives, which was issued just months before the Kaiser-Hill contract became effective. The guidance considered the "lessons learned" from earlier cost reduction incentive programs. It also considered prior Office of Inspector General report findings (See Appendix A) that cost savings claimed by contractors were "soft" savings; that is, the savings were not tangible and could not be deobligated from the contracts or reallocated. In our earlier reports, we also expressed concerns about the Department's validation of claimed savings, the baselines used to support savings, and the lack of program guidance.

According to the April 1995 guidance, cost reduction programs should reward contractors for innovative practices that result in hard dollar savings being returned to the Department. The guidance defines innovative practices as new processes or methods that strive for cost effectiveness above and beyond routine business practices. Accordingly, proposals should not be considered innovative if they are based on changes in mission, forced budget reductions, or Department direction. The guidance defines hard dollar savings as "measurable, near term savings" that result from adopting new or modified work methods or techniques. To provide measurable savings, therefore, proposals should provide verifiable baselines and describe how new procedures will produce savings that can be returned to the Department. In order to qualify for sharing, savings must result in funding being returned to the direct control of the Department. Savings should be available for deobligation in the immediate fiscal year or become available for deobligation in the following fiscal year. Rocky Flats' draft procedure for implementing its cost reduction proposal program also referenced innovation and hard dollar savings as being components of successful cost reduction proposals.

COST REDUCTION PROPOSALS

At the time of our audit, Rocky Flats had reviewed and reached a decision on six cost reduction proposals submitted by Kaiser-Hill and valued, as revised, at $20.2 million. In three instances, Rocky Flats rejected proposals valued at $830,000 because they lacked innovation or did not demonstrate verifiable savings. In the other instances, Rocky Flats approved Kaiser-Hill's cost reduction proposals but at a reduced value of about $16 million. We concluded that Rocky Flats should have rejected all six proposals because they did not meet the criteria established in the Department's guidance.

Work Force Reductions

On September 29, 1995, Kaiser-Hill submitted a cost reduction proposal claiming estimated savings of about $20.7 million for advancing to July 1, 1995, a reduction in work force planned for November 1, 1995. The Contracting Officer initially rejected the proposal on the grounds that an existing performance measure already rewarded Kaiser-Hill for work force reductions. Kaiser-Hill submitted a revised proposal and asked that Rocky Flats reconsider its decision because the benefits were separate and distinct from the benefits of the performance measure. Specifically, Kaiser-Hill noted that the work force was being reduced prior to the September 30, 1995, date shown for meeting the performance measure. The revised proposal claimed savings of over $14.9 million for the period July 1 through September 30, 1995. Kaiser-Hill claimed that, through its efforts, the work force went from 5,832 employees to 4,617 employees, a reduction of 1,215 employees.

The Contracting Officer accepted the proposal based on a Rocky Flats technical review that recommended approval because Kaiser-Hill accelerated a Department-directed work force reduction. Because of a parallel financial review, however, the estimated savings were reduced from $14.9 million to about $12.3 million. The financial review also noted that the proposal could be rejected in its entirety because (1) Rocky Flats directed the reductions in anticipation of reduced budgets, (2) the reductions were accomplished by EG&G before the effective date of the contract with Kaiser-Hill, and (3) a transition contract, which covered the period May 1 through June 30, 1995, compensated Kaiser-Hill for participating in the work force reduction. Despite the findings expressed in the financial review, the Contracting Officer approved the proposal and awarded Kaiser-Hill a $4.3 million incentive bonus.

This audit disclosed that the substantive concerns raised during the financial review were supported by the April 1995 Departmental guidance. We concluded, as well, that Rocky Flats should have rejected Kaiser-Hill's proposal for lack of innovation and other reasons, based on the following:

o Rocky Flats anticipated that work force reductions would be part of the transition from a defense mission to an environmental cleanup mission. A July 1992, Rocky Flats Transition Plan provided to Congress showed that stopping weapon component production would reduce the work force to 4,500 in Fiscal Year 1995 from the 8,000 employees in Fiscal Year 1992.

o The reduction-in-force was driven by a declining budget. The Rocky Flats Site's total budget (new budget authority and carryover) dropped $121 million, from $912 million for Fiscal Year 1995 to $791 million for Fiscal Year 1996. According to the Rocky Flats Budget Officer, reductions of this magnitude inevitably result in staff reductions.

o Rocky Flats had planned the work force reductions several months before Kaiser-Hill was selected as the new, integrating contractor. In December 1994, Rocky Flats informed Headquarters that it intended to reduce the work force in Fiscal Year 1995 to better posture the new integrating contractor for the reduced Fiscal Year 1996 budget. Rocky Flats directed EG&G, the then current management and operating contractor for the Rocky Flats Site, to assess the impact of a reduced work force resulting from the decreased budget. This assessment was to assume that work force reductions would occur by July 1, 1995, at which time the employment level would be as low as 4,500 employees. In February 1995, Rocky Flats announced its intention to reduce the work force by as many as 1,700 employees by November 1995.

o EG&G, the predecessor contractor, actually separated the employees before the effective date of the contract with Kaiser-Hill and before Kaiser-Hill became responsible for the Rocky Flats Site. On June 28, 1995, about 934 employees were voluntarily separated from EG&G. That was also the last day at the Rocky Flats Site for about 281 employees involuntarily separated, even though those employees were paid through August 28, 1995.

o Kaiser-Hill did not return hard dollar savings to the Department. To have such savings, an established baseline of cost, schedule, and work scope would have to be compared with a new baseline. Since Kaiser-Hill did not establish a new baseline in the proposal, a comparison could not be made; consequently, savings could not be returned to the Department's control.

Furthermore, a transition contract provided for compensation to Kaiser-Hill for work force restructuring activities. Rocky Flats paid Kaiser-Hill a fixed price of about $9.9 million for transition activities specified in the statement of work. These activities included developing a work force restructuring plan, preparing for the transfer and hire of employees, conducting employee orientations, interviewing incumbent management and staff, and initiating procedures required by the reduction process, including the identification of the number of employees in affected classifications. For these reasons, Kaiser-Hill should not have been awarded nearly $4.3 million for the accelerated work force cost reduction proposal.

Rocky Flats agreed that the work force reductions were a Department initiative. Rocky Flats, however, stated that none of these Department plans or initiatives targeted significant work force reductions on July 1, 1995, and without Kaiser-Hill's initiative, the reductions would not have occurred until November 1, 1995. According to Rocky Flats, EG&G never planned to reduce the work force by July 1, 1995, and the effectiveness and timeliness of the reductions were due to Kaiser-Hill. The savings rewarded for this cost reduction proposal were due to the acceleration of the reductions from the previously planned date of November 1 to July 1, 1995. Only those savings for accelerated work force reductions were recognized and rewarded.

During our audit, we requested documentation to support Rocky Flats' assertion that Kaiser-Hill accelerated the planned reductions in the work force. Rocky Flats produced documentation that stated reductions would occur "by" November 1, 1995. From this, we concluded that the reductions could have occurred any time before that date. In fact, Rocky Flats had directed EG&G to prepare assessments on the basis of work force reductions occurring by July 1, 1995.

Rocky Flats also commented that the report implies that EG&G was responsible for the savings rather than Kaiser-Hill because EG&G had separated the employees and provided them with work force restructuring benefits. According to Rocky Flats, this line of reasoning ignores the fact that it was strictly because of Kaiser-Hill's decision to hire fewer workers that they were separated by EG&G. If not for Kaiser-Hill's decision to hire fewer workers than EG&G had on staff, there would have been no such separations and no savings for the period from July 1 to November 1, 1995.

We did not intend to imply that EG&G was responsible for the savings. Rather, it was a declining budget that drove the work force reductions. As previously stated, we did not find support to show that the separations would occur on November 1, 1995, or that Kaiser-Hill accelerated the reductions in work force. Further, the transition contract compensated Kaiser-Hill for its participation in the work force reductions.

Fringe Benefit Changes

On September 29, 1995, Kaiser-Hill submitted a cost reduction proposal that estimated savings of about $3.3 million for changes it made to EG&G's fringe benefit package. Specifically, Kaiser-Hill claimed savings of $1.6 million for shifting medical costs to employees, $1.2 million for reducing savings plan contributions, and $640,000 for consolidating paid leave provisions. The $3.6 million total savings was offset by about $290,000 of implementation costs for net savings of about $3.3 million. This proposal used the savings period of August 1, 1995 through July 31, 1997.1

The technical review recommended that the proposal be approved because the changes being made by Kaiser-Hill represented a major step in bringing benefits in line with private industry. The financial review recommended approval of the proposal, but recommended that the award be reduced because Kaiser-Hill did not return the portion of the $3.3 million savings related to Fiscal Year 1995. The Contracting Officer approved the proposal and Kaiser-Hill's $1.1 million share2 of the full $3.3 million savings contained in the proposal because it was determined that the contract did not require Kaiser-Hill to return savings. The preliminary results of a later financial review, made to validate the savings, noted that estimated savings were overstated by over $1 million. Rocky Flats is still in the process of validating the estimated savings claimed.

Applying the Departmental guidance, we found that Rocky Flats should have rejected the proposal because it was not innovative. According to a 1995 U.S. Chamber of Commerce study of benefit practices, Kaiser-Hill's proposed actions -- shifting of medical benefit costs to employees, reducing employer savings plan contributions, and consolidating paid leave by doing away with specific leave categories -- were all trends in private industry. Also, it was known that EG&G's medical benefits were greater than the benefits paid by private industry. This had been documented in a June 1994 Office of Inspector General report (See Appendix A). Finally, in Kaiser-Hill's best and final offer, before being awarded the integrating contract, it said that it would bring fringe benefits in line with private industry. Therefore, by taking the actions contained in its cost savings proposal, Kaiser-Hill was not going above and beyond routine business practice.

Also, the proposal did not result in Kaiser-Hill's returning hard dollar savings to the Department's control. That is, Kaiser-Hill did not make funding available for immediate deobligation or, alternatively, show how proposed savings would be reallocated to other work.

Rocky Flats disagreed with the audit conclusion that it should have rejected the cost reduction proposal for lack of innovation. Rocky Flats asserted that although reductions in employee benefits had been a noticeable trend in industry, the work force at the Rocky Flats Site and many other Department sites had been insulated from such trends. Thus, the reduction in employee benefits was a very significant departure from "business as usual."

Narrowly viewed, it might appear that Kaiser-Hill was being innovative in reducing fringe benefits. We noted, however, that the report on Contract Reform stated that cost reduction incentives should motivate contractors to employ innovative business practices and techniques to reduce or avoid costs associated with contract performance. From a broader view, one which factors in the June 1994 Office of Inspector General report that disclosed that contractor employee health benefit costs at Rocky Flats were unreasonable, Kaiser-Hill's actions were not innovative. Based on the position it has taken in this matter, it would appear that Rocky Flats would reward virtually any cost reduction claim, even though its contract with Kaiser-Hill requires that the contractor operate economically as a normal course of business. In order to operate economically, Kaiser-Hill should routinely examine its operations to identify ways to reduce the cost of doing business.

Elimination of a Support Services Contract

On December 22, 1995, Kaiser-Hill submitted a proposal that claimed savings of $1.2 million over two years for eliminating a computer support services contract. According to the proposal, Kaiser-Hill personnel became sufficiently skilled at database administration and technical support by September 30, 1995, and no longer needed the contract support. Accordingly, Kaiser-Hill chose not to renew the contract on October 1, 1995, and returned $612,000 through a baseline change proposal that was budgeted in Fiscal Year 1996.

The technical review recommended approval, in part, because the proposal was not considered to be a standard Rocky Flats Site practice. A preliminary financial review recommended disapproval of the proposal because of inaccuracies in the estimated savings claimed and because the claimed action was a Department requirement. The follow-up financial review reduced the estimated savings base, increased implementation costs, and reduced the term of shared savings. The Contracting Officer ultimately approved $448,840 of the $1.2 million savings claimed by Kaiser-Hill.

We found that the proposal should have been rejected because it was not innovative. Kaiser-Hill stated in its proposal that the need for the contract was based on higher than necessary system requirements and duplicated another contractor's work scope. By opting not to renew the contract, Kaiser-Hill was merely carrying out DOE Order 1360.1B, Acquisition and Management of Computing Resources, which required Department contractors to annually evaluate computer resource needs.

Rocky Flats stated that the cost reduction proposal was not merely the result of a standard Site practice. Kaiser-Hill had identified, developed and put in place the necessary skills to replace the subcontract. However, as stated previously, the contract requires that Kaiser-Hill operate economically as a normal course of business. Performing routine business practices, such as make or buy, lease versus purchase, or staffing analyses should not be rewarded even when they result in lower costs.

REASONS FOR APPROVAL

Rocky Flats approved the three proposals because it did not rely on the contract terms and Departmental guidance as a basis for accepting or rejecting the proposals. Contract Clause H.6., Cost Reduction Proposals, allowed the rejection of any proposal as long as Rocky Flats provided reasons for the rejection. In addition, the clause stated that such rejections could not be disputed. The clause also stipulated that if Rocky Flats could not negotiate acceptable terms, the proposal would be considered rejected. Despite having the contractual right to reject proposals, Rocky Flats did not apply the clause to the three proposals.

Although the contract clause did not include specific criteria for accepting or rejecting proposals, such criteria was contained in the Department's guidance on cost reduction incentives, as well as in Rocky Flats' own draft procedures for reviewing and approving cost reduction proposals. Both documents required proposals to be innovative and to result in the return of hard dollar savings to the Department. The guidance pointed out, for instance, that an innovative proposal was not one that resulted from a change in mission, a forced budget reduction, Department direction, or was a standard business practice. If Rocky Flats had applied the Department's guidance or its own draft procedures, we believe it would have rejected all of the proposals.

Rocky Flats defended its decisions to accept the three proposals by stating that the contract neither required that proposals be innovative or return dollars to the Department nor did it require Kaiser-Hill to submit proposals that followed Departmental or Rocky Flats guidance. According to Rocky Flats officials, therefore, there was no established basis for rejecting the proposals. We concluded, however, that the contract provided Rocky Flats appropriate latitude to reject cost reduction proposals that did not meet basic criteria. The Deputy Assistant Secretary, in responding to this report, agreed that the Contracting Officer has broad latitude to reject cost reduction proposals unless specific language to the contrary is in the contract. The Deputy Assistant Secretary further stated that he believed that the existing clause did not preclude Rocky Flats from applying the criteria contained in the 1995 guidance. Thus, the position taken by the Rocky Flats officials was, in our judgment, contrary to the concepts advocated in the Department's guidance on cost reduction incentives and was inconsistent with its own actions in those cases where cost reduction proposals had been rejected.

According to Rocky Flats, it would be inappropriate to apply the Departmental guidance because it was nonmandatory and it was issued after the contract with Kaiser-Hill was signed. In addition, Rocky Flats noted that, during contract negotiations, Kaiser-Hill reduced its proposed total incentive fees, while increasing its estimated cost savings under the cost reduction proposal program. However, it does not seem reasonable to disqualify the guidance because it was nonmandatory. The guidance was the best available at the time, and it embodied concepts contained in the Contract Reform Team Report. In fact, a Rocky Flats official was part of the team that produced the guidance. Further, there does not appear to be a logical relationship between its decision as to application of the guidance and any trade-off between total proposed incentive fees and cost reduction proposals.

Rocky Flats disagreed that its acceptance of cost reduction proposals was in any way "...contrary to its own actions in those instances where proposals were rejected." It contended that: (i) each of the reasons for rejecting the cost reduction proposals was supported by contract language and (ii) the Contract Reform guidance support for these decisions was inconsequential to the Contracting Officer's mandates under the contract.3

AWARDS PAID TO KAISER-HILL

By not relying on existing contract terms and available guidance, Rocky Flats awarded Kaiser-Hill almost $5.6 million for cost reduction proposals that should have been rejected. Rocky

Flats paid only $5 million of Kaiser-Hill's share in Fiscal Year 1996 because half of the fringe benefit proposal's estimated savings were attributable to future periods. The following table shows that Kaiser-Hill received nearly $4.4 million more than it returned to the Department as hard dollar savings.

TABLE 1
Awards Paid in Fiscal Year 1996

Description of Proposal	Approved Savings	Returned Savings Savings	Kaiser-Hill's Share (35%)	Share Paid in FY 1996
Work Force Reductions	$12,255,031	0	$4,289,261	$4,289,261
Fringe Benefit Changes	3,264,412	0	1,142,544	541,873
Elim. Support Services4	448,840	$612,000	157,095	157,095
Totals	$15,968,283	$612,000	$5,588,900	$4,988,229
Returned Savings				612,000
Award Paid w/Program Funds				$4,376,229

Because Kaiser-Hill did not always return hard dollar savings to the Department, Rocky Flats had to reduce program funding by nearly $4.4 million in order to pay Kaiser-Hill for its share of the cost savings awards in Fiscal Year 1996. For example, Rocky Flats reduced site landlord and field office funding for infrastructure costs associated with environmental management programs.

Rocky Flats was especially concerned about the audit conclusion that hard dollar savings were not returned to the Department. Rocky Flats stated that the report suggested that the Government did not receive any benefit as a result of the accelerated work force reduction and fringe benefit cost reductions. Rocky Flats said that the total savings for these two reductions -- approximately $15.5 million, based on preliminary estimates -- was a real savings, of which $4.8 million was paid to Kaiser-Hill in Fiscal Year 1996. The $10.7 million remainder was stated to have been reallocated to other work during the fourth quarter of Fiscal Year 1995, when Kaiser-Hill operated under the previous contractor's baseline, and in Fiscal Year 1996 when Kaiser-Hill reflected the savings in the new baseline it submitted. Rocky Flats stated that its review and acceptance of the new baseline for Fiscal Year 1996 indicated an acceptance of the proposed reallocation, which complied with the intent of the Departmental guidance to return savings to the Department's control. Rocky Flats further asserted that the April 1995 Departmental guidance did not address the actions to be taken when the entire baseline is in a period of transition. While it could have exercised more control over the disposition of the savings, Rocky Flats believed it would not have been cost effective for Kaiser-Hill to generate a new baseline incorporating out-of-date data (work force levels and labor costs prior to the work force reduction) into a baseline just so Rocky Flats could subsequently modify the work scope and revise the baseline. Rocky Flats also stated that the work force reduction savings could be readily calculated because the salaries and benefits of the individuals whose jobs were terminated were known and, therefore, there was a clear baseline for the personnel costs of each individual.

We agree that the amount of savings that should have occurred as a result of reducing the work force and changing fringe benefits could be readily calculated. However, without a paper trail, no one knows what additional work, if any, the Department received for the $10.7 million. The $10.7 million could have been spent without the Department getting any additional work performed.

The return of hard dollar savings allows the Department to maintain control over the integrity of the cost baseline. Without the return of savings from the cost reductions to the Department's control, there is no reduced overall cost and Kaiser-Hill is no longer accountable for performing other work within previously agreed upon budgets. Past Office of Inspector General reports (See Appendix A) have been critical of "soft dollar" savings and, accordingly, the Departmental guidance uses "hard dollar" savings.

We are concerned that other mission-related activities could suffer unless Rocky Flats requires Kaiser-Hill to return hard dollar savings. Kaiser-Hill, for example, had already submitted about $13 million of cost reduction proposals without indicating that it would return hard dollar savings to the Department. In addition, indications were that Kaiser-Hill planned to submit an additional 51 proposals with as much as $77 million in estimated savings. According to Kaiser-Hill's Cost Reduction Program Manager, only about $18 million of this amount may be returned to the Department. If these figures prove reasonably accurate, Rocky Flats could end up paying $31.5 million (35 percent of $90 million) but only receive savings of $18 million; thus, Rocky Flats may need to reduce program funding by $13.5 million to pay Kaiser-Hill its award.

EFFECT ON CONTRACT REFORM INITIATIVES

The Contract Reform Team effort provided the conceptual basis for the Department of Energy's transition toward performance-based contracts and programs to incentivize contractor efforts to reduce operating costs, such as the contract at the Rocky Flats Site. We are concerned that as new contracting methodologies are adopted throughout the Department, the issues discussed in this report could occur at other locations. Additional problems regarding contractor cost reduction proposals could undermine the Department's Contract Reform effort.

PART III

PERFORMANCE MEASURE INCENTIVES

The Contract Reform effort concluded that performance-based contracting should be the method of choice for obtaining contractual assistance in managing major Departmental facilities and operations. The Contract Reform Team recommended that such contracts contain performance measures that are clearly stated, structured to encourage and reward superior performance, and results-oriented. Our review of the contract with Kaiser-Hill for the operation of the Rocky Flats Site disclosed that it included performance measures which did not meet the Contract Reform Team's recommendation. The performance measures did not always include clearly defined criteria, were not structured to encourage and reward superior performance, and were often process- rather than results-oriented. For meeting such performance measures, Rocky Flats awarded about $6.9 million to Kaiser-Hill.5 Based on a "lessons learned" exercise, Rocky Flats indicated it was in the process of identifying and implementing improvements to its performance-based contracting practices.

RECOMMENDATIONS

We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management use the data developed during this audit at the Rocky Flats Site as part of its Departmentwide review of the performance-based contracting incentives program to clarify Departmental guidance on developing and executing performance measures.

We recommend that the Manager, Rocky Flats Field Office, direct the Contracting Officer to:

Establish performance measures that are clearly defined using objective data, structured to encourage and reward superior performance, and are results- rather than process-oriented.

Review all incentive fees paid and seek recovery of fees for performance that occurred before the effective date of the contract or outside of the measurement period.

MANAGEMENT REACTION

The Deputy Assistant Secretary for Procurement and Assistance Management concurred with the recommendation. The Manager, Rocky Flats Field Office, concurred with the first recommendation and partially concurred with the second. Part IV of this report includes detailed management and auditor comments.

DEFINING PERFORMANCE MEASURES

One of the underlying principles of Contract Reform is to reward and, thereby, encourage superior performance. To do this, performance measure expectations should be defined through the use of objective data. However, several Kaiser-Hill performance measures defined expectations without objective data to support the definition. This resulted in payment of incentive fees to the contractor that were questionable in relation to the level of work performed.

Kaiser-Hill was rewarded for performance which could not be adequately characterized. For example, the Kaiser-Hill contract included two performance measures for venting storage drums. These drums contained potentially explosive gases. The first measure defined superior performance as venting 1,182 drums during the three-month period ended September 1995. The second measure defined acceptable performance as venting 600 drums over the subsequent three-month period, which ended December 1995. By the end of the first three-month period, Kaiser-Hill had vented 1,204 drums and was awarded a superior performance fee of $339,774. By the end of the second three-month period, Kaiser-Hill had vented approximately 600 drums and was awarded an acceptable performance fee of $666,3536.

The audit disclosed that Rocky Flats did not have the objective data needed to support the definitions of superior or acceptable expectations for these performance measures. Although Rocky Flats officials indicated that the expectations were subjectively determined using factors such as funding, building availability, and drum movements, they could not provide formal analytical data to support the determination. Moreover, a Rocky Flats manager involved in monitoring the drum venting activity provided us with baseline data that showed that at least 20 drums could be vented per day, or approximately 1,200 drums in a three-month period. If correct, this information supported a definition of acceptable performance as venting approximately 1,200 drums in a three-month period. Using this standard, Kaiser-Hill's performance for the period ending September 1995 was no more than acceptable, while its performance for the period ending December 1995, in which only 600 drums were vented, was less than acceptable. Although the fees paid for the drum venting operations appeared to be in accordance with the terms of the contract, we concluded that the measures did not define performance levels in a way which supported the payment of incentive fees totaling about $1 million to Kaiser-Hill for venting drums.

Two performance measures for excessing property also lacked the objective data needed to define acceptable or superior levels of performance. The measures defined an acceptable level of performance as entering 4,790 line items of controlled and 2,080 line items of noncontrolled property into the Government's property system. The superior level was defined as 7,185 items of controlled property and 2,400 items of noncontrolled property. Rocky Flats had not developed the objective data needed to support these definitions. Officials stated that the levels were based on past performance and management judgment. However, various Rocky Flats managers acknowledged that the historical information was not all that good and that no specific numerical analysis supported performance level determinations for either controlled or noncontrolled property. Without such data, we questioned whether the performance measures could be relied upon. In fact, as the audit disclosed, Kaiser-Hill processed more than twice the number of data entries of controlled property and nearly four times the amount of noncontrolled property required by the measures. We concluded that the contractor's actual performance confirmed that the original performance levels, which were not supported by objective data, were not realistic. For this effort, Kaiser-Hill received a performance fee of $2.3 million.

Rocky Flats stated that the performance measures related to excess property recognized that the property system Kaiser-Hill inherited had long been identified as ineffective by the Office of Inspector General and the General Accounting Office. The measures also recognized that Kaiser-Hill's property management and disposal system was not fully approved and that the system required remedial action to bring it to the level where the Department could accept it. Rocky Flats stated that it recognized the difficulty of establishing appropriate interim milestones as incentives toward a successful system. Because the previous contractor's performance had been so lacking, Rocky Flats found it difficult to predict how quickly improvements could be made and difficult to establish appropriate performance measures. Rocky Flats agreed that, in retrospect, the performance measures used in Fiscal Year 1996 in this area could have been more challenging but that the performance measures had focused Kaiser-Hill's attention on correcting the problems in a seriously flawed property system.

The Kaiser-Hill contract contained a performance measure that addressed operational safety requirements. One expectation of this measure was to reduce safety violations by 10 percent from the prior quarter in each of six specified buildings. However, Rocky Flats did not obtain the baseline data needed to define this expectation. In one illustration of the need for quality baseline data, the audit disclosed that one of the six buildings had not had any safety violations in the prior quarter. Rocky Flats officials stated that they were unaware that the building had had no safety violations. Nonetheless, Kaiser-Hill received a performance fee of $60,920 for conformance with the safety expectation for this building.

Another expectation associated with the operational safety measure was designed to encourage Kaiser-Hill to self-identify safety violations. Under this performance measure, the contractor was not to receive a fee if Rocky Flats brought more than two safety violations to Kaiser-Hill's attention. The rationale for the measure was that Kaiser-Hill would not be demonstrating it was doing an effective job of identifying safety violations if the Department found more than two violations during the performance period. In fact, Rocky Flats management identified three safety violations which, according to the contract, should have nullified any associated incentive fee. Nonetheless, Rocky Flats paid Kaiser-Hill $584,240 for this measure. Rocky Flats admitted that the definition of "self-identification" may not have been as good as it could have been and that the documentation supporting the payment of the incentive fee was incomplete.

PERFORMANCE BEFORE THE EFFECTIVE DATE OF THE CONTRACT

Rocky Flats paid Kaiser-Hill for performance that occurred before the July 1, 1995, effective date of the contract. Kaiser-Hill was awarded $558,021 for a measure that required a significant reduction in the contractor work force at the Rocky Flats Site. For the most part, the reduction-in-force occurred on June 28, 1995, shortly before Kaiser-Hill became the integrating contractor at the Site. Similarly, Kaiser-Hill received an award of $317,098 for a measure which required a regulatory summit before the effective date of its operating contract with the Department. Kaiser-Hill, in documenting its incentive fee request, referenced a series of meetings that began in April 1995. This was nearly two months prior to the initiation of its prime contract.7

PERFORMANCE OUTSIDE THE MEASUREMENT PERIOD

Kaiser-Hill received performance incentive awards for activities that fell outside the measurement period. For example, the Kaiser-Hill contract included an environment-related performance measure for removing ground contaminants. One of the requirements of the performance measure was the delivery of an acceptable interim completion report by September 30, 1995. According to available documentation, however, Kaiser-Hill did not deliver an acceptable report to Rocky Flats until November 6, 1995. Nonetheless, Kaiser-Hill received an incentive fee of $257,851 for successful performance of this measure.

In comments provided just prior to issuance of this report, Rocky Flats stated that the delay in delivering the interim completion report was not due to failure in performance on the contractor's part. Instead the delay was due to Rocky Flats' decision to extend the completion date so as not to incur additional costs associated with meeting the original deadline of September 30, 1995. However, Rocky Flats did not provide any support for this position.

In another example, on June 26, 1996, Rocky Flats and Kaiser-Hill agreed to a performance measure to implement a process for preparing and approving a "Justification for Continued Operations." The performance period was to begin July 1, 1996. Kaiser-Hill actually implemented the "Justification for Continued Operations" process on January 23, 1996, about five months before the related performance measure was formulated and approved. This was inconsistent with the fundamental principles of performance-based contracting to: (1) set clearly defined expectations in advance of the contractor work effort, and (2) reward the contractor based on an objective evaluation of the work after completion. Kaiser-Hill received a $160,000 incentive fee for this measure.

Rocky Flats disagreed that performance occurred in January and stated that although precursor activities were begun in January, training was conducted at regular staff meetings during the performance period. Further, Rocky Flats stated that implementing the "Justification for Continued Operations" procedure was not as important as implementing the "Operational Safety Requirement/Technical Safety Requirements" procedure that also was part of the performance expectation. However, Rocky Flats was not able to produce documentation of the training that took place during the staff meetings. Additionally, documentation validating completion did not reference the training that occurred during the performance period. Finally, the performance criteria did not distinguish between the importance of the two procedures but made the fee payment contingent upon Kaiser-Hill implementing both procedures.

PROCESS-ORIENTED PERFORMANCE MEASURES

The Kaiser-Hill contract contained two performance measures which were process-oriented, not results-oriented. The first measure required that Kaiser-Hill conduct a "summit meeting" with cognizant federal and state regulatory agencies. The measure described an acceptable level of performance as one where the summit occurred by July 31, 1995, and superior level as one where the summit was held by July 1, 1995. Convening meetings with cognizant agencies appears to be a positive step in the effort to communicate with regulatory bodies. However, as a purely process-oriented performance measure, such meetings were given the status of being an end unto themselves. The ultimate goal was to restructure the regulatory approach to meeting environmental risk reduction objectives. Thus, a results-oriented measure to achieve regulatory restructuring would have stipulated the intended outcome of the meetings along with a method for evaluating the outcome. Such a results-oriented measure, for example, might have required a revised regulatory agreement that addressed specified objectives. Kaiser-Hill was paid a superior performance fee of $317,098 for a series of meetings that began in April 1995. Although this incentive fee may have been in compliance with the literal terms of the contract, we concluded that the performance-based contracting approach did not envision giving contractors an incentive fee for simply convening meetings.

The Kaiser-Hill contract also established a performance measure that required Kaiser-Hill to keep six buildings available in Fiscal Year 1996 to allow certain risk reduction activities to take place. Specifically, the space in those buildings dedicated to risk reduction activities had to be available 65 percent of the time for Kaiser-Hill to be eligible for the full incentive fee. By basing the incentive fee on "keeping buildings available," this performance measure focused on process rather than outcome. As part of a results-oriented measure, the Department should have focused its performance evaluation on ensuring that the contractor's actions resulted in the successful accomplishment of the risk reduction activities. In fact, the audit disclosed that individual risk reduction activities were themselves incentivized in the contract. Ultimately, Rocky Flats paid Kaiser-Hill $1.7 million, or 83 percent of the possible fee, for keeping five of the six buildings open. Yet, the measure did not require that the risk reduction activities, the desired outcome, be accomplished.

Rocky Flats agreed that these were process-oriented measures, but disagreed with the audits' assessment of their value to the Department. Rocky Flats stated that the efforts begun by Kaiser-Hill under the "regulatory summit" performance measure ultimately resulted in the implementation of the Rocky Flats Cleanup Agreement, which was widely recognized as a milestone accomplishment in restructuring and improving the Department's relationships with its regulators. Similarly, the "building availability" measure had provided major value to the Department, for it moved the percentage of time a facility was available for completing mission related work from the historic 20-30 percent range to the 80-90 percent range.

The Deputy Assistant Secretary for Procurement and Assistance Management stated that establishing results-oriented performance measures is a goal of performance-based contracting but that there will be limited instances where it may be important to associate fee with the accomplishment of critical process objectives. We agree that there could be circumstances that warrant rewarding process. It would be preferable, however, to reward results, rather than process, when both the results and the process are expected to occur in the same performance period. Thus, if risk reduction activities are the desired result and are incentivized for a performance period and building availability is a prerequisite for the risk reduction activities to occur, any financial incentive should be placed on accomplishing the risk reduction activities rather than on keeping the buildings available.

REASONS AWARDS WERE MADE

We attempted to determine why Rocky Flats awarded performance fees to Kaiser-Hill under the circumstances disclosed during this review. We concluded that the new challenges associated with performance-based contracting were a primary cause. Historically, most of the Department's contracting dollars were spent under the traditional management and operating contract concept. These contracts contained a general work scope and reimbursed essentially all of the contractor's costs. While some of these contracts paid an award fee based on performance, the amount of the fee was largely subjective. In contrast, performance-based contracts were to have clearly defined scopes of work, results-oriented criteria and measures, and incentives for contractors to meet and exceed the criteria. The conceptual change to performance-based contracts was significant, requiring a substantial amount of preparation time and additional experience. We observed that the ambitious implementation schedule for performance-based contracting at the Rocky Flats Site may not have been adequate to permit such action. Rocky Flats, in essence, had to implement performance-based contracting at the same time that it was learning the fundamentals of the process, including the development of meaningful measures.

Kaiser-Hill, rather than Rocky Flats, developed the Fiscal Year 1995 performance measures as part of its "best and final offer." The performance measures did not, in our judgment, define or describe with any specificity the work requirements, acceptance criteria, or completion documentation. In October 1995, Rocky Flats issued an internal procedure on the development of performance measures. This procedure established rating plans to address the shortcomings of the Fiscal Year 1995 performance measures. Rocky Flats and Kaiser-Hill retroactively applied the rating plans to the Fiscal Year 1995 performance measures but full use of the rating plans did not go into effect until Fiscal Year 1996. During Fiscal Year 1996, Rocky Flats also consolidated responsibility for performance measure development into one group, which conducted training for local program personnel on how to write measures.

INCENTIVE FEES PAID TO KAISER-HILL

The Department rewarded Kaiser-Hill for meeting performance measures that did not always include clearly defined criteria, were not structured to encourage and reward superior performance, and were often process- rather than results-oriented. In addition, the Department rewarded Kaiser-Hill for performance that occurred before the effective date of the contract or outside the performance period. The following table summarizes the incentive fees of about $6.9 million paid to Kaiser-Hill for meeting these measures.

TABLE 2
Incentive Fees Paid to Kaiser-Hill

Description of Performance Measure	Not Clearly Defined	Before Contract/ Outside Period	Process-Oriented	Incentive Fee
Vent 1,182 Residue Drums by	X			$339,774
Vent about 600 Residue Drums by 12/31/95	X			$666,353
Excess Property	X			$2,245,599
Operational Safety requirements	X			
Reduce Violations in				$60,920
Specified Buildings	X			$584,240
Self-identify Violations	X			
Justification for Continued Operations		X		$160,000
Reduce Contractor Work Force Force		X		$558,021
Conduct Regulatory Summit		X	X	$317,098
Remove Ground Contaminants		X		$257,851

Contaminants		
Keep Specified Buildings ,312 Available	X	$1,671,312
Total		$6,861,168

LESSONS LEARNED

In moving to performance-based contracting, the Department sought to attain its mission through superior contractor performance. Contractor accountability was to be improved by measuring and incentivizing contractor activity to provide better operating results for taxpayer-provided funds. While the audit disclosed certain concerns regarding the status of the implementation of performance-based contracting at the Rocky Flats Site, we noted that Rocky Flats has instituted a "lessons learned" process. It has identified improvements to be made to its performance-based contracting.

- o Performance measures are to be written so that they focus on fewer, yet critically important matters, that are closely aligned with the strategy regarding the future of the Rocky Flats Site.

- o Performance measures are to be structured so as to address results, not process.

- o Performance measures are to discourage the inefficient use of resources by requiring that the work be done within budget. Cost parameters were defined for a set of pilot performance measures in Fiscal Year 1997. Performance must be achieved within specific budgets or fee is reduced or eliminated.

- o "Gateway" performance measures are to be used that require one year's work to be done before incentives can be earned for the following year's work.

- o Step earning curves, where incentives are paid based on achievement of specified performance levels rather than on a "straight line" basis, are to be used.

- o Super Stretch performance measures, where potential fees are identified for activities not included within the established funding baseline, are to be used. In order to earn these fees, the contractor must first identify and reprogram resources by achieving efficiencies in funded work areas.

Such improvements would assist in the implementation of Contract Reform at the Rocky Flats Site.

PART IV

MANAGEMENT AND AUDITOR COMMENTS

The Deputy Assistant Secretary for Procurement and Assistance Management concurred with the recommendations. The Manager, Rocky Flats Field Office, concurred with two recommendations and partially concurred with two others. Both parties provided comments on specific matters contained in Parts II and III of the report; in general, those comments have been incorporated into their respective parts. Management memoranda, without the detailed attachments, are provided in Appendices B and C. A summary of the comments made with regard to the recommendations and our responses follow.

COST REDUCTION INCENTIVES

Recommendation to the Deputy Assistant Secretary for Procurement and Assistance Management

Recommendation. We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management ensure that Departmental contracts with cost reduction incentive programs include provisions that require the cost reduction proposals to be innovative and result in the return of hard dollar savings to the Department's control.

Management Comments. Concur. The Department's draft fee policy, which is in final review prior to publication as a Notice of Proposed Rulemaking, contains the requirement that any contract which contemplates a cost savings program must contain the "Cost Reduction" clause prescribed in the policy. The clause requires that cost savings incentives return any realized savings to the control of the Department. In addition, the clause requires that design, method, or process cost reduction incentives be innovative.

Auditor Comments. Making the draft fee policy a contract requirement is considered responsive to the recommendation.

Recommendation No. 1 to Rocky Flats

Recommendation. We recommend that the Manager, Rocky Flats Field Office, utilize the contract in conjunction with Departmental guidance as a basis for accepting or rejecting cost reduction proposals. Specifically, reject proposals that are not innovative or do not result in hard dollar savings that are returned to the Department's control.

Management Comments. Concur. Management stated that it recognized that there were problems associated with the existing cost reduction incentive program and that Kaiser-Hill had also voiced concerns about the program and expressed a desire to reconsider the provisions of clause H.6. As a result, Rocky Flats has engaged in discussions with the contractor to work toward resolution of mutual concerns. Assuming continuance of the cost reduction incentive program, Rocky Flats will initiate negotiations to incorporate Departmental policy and guidance prevailing at the time changes to the program are incorporated into the contract. According to the Deputy Assistant Secretary for Procurement and Assistance Management, this guidance will require the rejection of proposals that are not innovative or do not result in hard dollar savings that are returned to the Government. It is estimated that negotiations will be completed and a contract modification issued in December 1997.

Auditor Comments. Rocky Flats' planned actions are responsive to the recommendation.

Recommendation No. 2 to Rocky Flats

Recommendation. We recommend that the Manager, Rocky Flats Field Office, take action to recover the amounts paid to Kaiser-Hill for cost reduction proposals that were not innovative or did not return savings to the Department's control.

Management Comments. Partially concur. Rocky Flats stated that it would review the language of the Kaiser-Hill transition and integrating contracts to ensure that Kaiser-Hill had not received redundant compensation associated with the accelerated work force reduction. If, as a result of the additional review, it was determined that inappropriate compensation was paid to Kaiser-Hill, Rocky Flats would seek recovery of such amounts under Clause H.6., Cost Reduction Proposals, of the contract. Rocky Flats planned to complete the review in January 1998.

Rocky Flats also stated, however, that the recommendation appeared to suggest that the Contracting Officer has a contractual right to recover amounts paid to Kaiser-Hill for approved cost reduction proposals that were not innovative or did not return hard dollar savings to the Department's control. Since neither of these items was a prerequisite for approval of cost reduction proposals under contract Clause H.6., Cost Reduction Proposals, the Department's Office of General Counsel advised Rocky Flats that the Government would have no legal grounds for recovery after approval of a cost reduction proposal which met all other contract terms and conditions.

Rocky Flats also stated that it was in the process of validating the estimated cost savings related to the fringe benefit proposal and that it would seek recovery of any amounts determined to be inappropriately paid to the contractor. The validation was expected to be completed by January 1988.

Auditor Comments. Rocky Flats' planned actions to review for redundant compensation and validate savings are appropriate. However, it should be noted that $4.3 million, or 98 percent of the total award amount paid out of program funds to Kaiser-Hill in Fiscal Year 1996, was redundant compensation (that is, for work force reduction efforts compensated under the fixed-price transition contract). This is not, however, the only basis for recovery. Another is the fact that Kaiser-Hill should not have received a cost reduction award for work force reductions carried out by another contractor, EG&G. Further, a precedent exists for recovering awards. In an Office of Inspector General report involving the Performance Based Incentive Program at the Richland Operations Office (See Appendix A), we recommended recovery of fee that was not warranted. Management took the necessary action and the contractor agreed to a partial return of previously paid fee. In summary, there is a Department of Energy precedent for recovery of fee under these circumstances. Therefore, we believe the Department should pursue this approach aggressively.

PERFORMANCE MEASURE INCENTIVES

Recommendation to the Deputy Assistant Secretary for Procurement and Assistance Management

Recommendation. We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management use the data developed during this audit at the Rocky Flats Site as part of its Departmentwide review of the performance-based contracting incentives program to clarify Departmental guidance on developing and executing performance measures.

Management Comments. Concur. The information contained in this audit report and Office of Inspector General Report entitled "Inspection of the Performance Based Incentive Program at the

Richland Operations Office," will be used as part of the Departmentwide review of performance-based contracting currently being conducted be these offices.

Auditor Comments. The proposed actions are considered responsive to the recommendation.

Recommendation No. 1 to Rocky Flats

Recommendation. We recommend that the Manager, Rocky Flats Field Office, direct the Contracting Officer to establish performance measures that are clearly defined using objective data, structured to encourage and reward superior performance, and are results- rather than process-oriented.

Management Comments. Concur. Rocky Flats concurs with the establishment of clearly defined performance measures as a tool for focusing the attention of the contractor and Federal staff on the critical few measures that incentivize the contractor to concentrate on end results rather than interim process-oriented measures. Over time, Rocky Flats has endeavored to improve its processes to ensure that performance expectations are clearly understood by staff responsible for monitoring performance and the contractor as well. As with any process, there is generally room for improvement, and Rocky Flats has been open to suggestions resulting from the recent reviews of performance incentives directed by the Secretary, and internal processes designed to review lessons learned. Rocky Flats staff also have participated in meetings sponsored by the Office of Procurement and Assistance Management and the Fee Incentives and Analysis Team established by the Office of Environmental Management to establish guidelines for development of objective performance incentives. Finally, Rocky Flats agrees that performance incentives should primarily be objective and results-oriented (but not solely objective and results-oriented). In some limited circumstances, it may be appropriate to utilize performance measures to improve certain processes of a critical nature because in the long run it constitutes significant value to the government.

Auditor Comments. The proposed actions are considered responsive to the recommendation. While we agree that there could be circumstances that warrant rewarding process, it would seem reasonable to reward results, rather than process, when both the results and the process are expected to occur in the same performance period.

Recommendation No. 2 to Rocky Flats

Recommendation. We recommend that the Manager, Rocky Flats Field Office, direct the Contracting Officer to review all incentive fees paid and seek recovery of fees for performance that occurred before the effective date of the contract or outside of the measurement period.

Management Comments. Partially concur. Rocky Flats does not object to the recommendation to review all incentive fees paid. A thorough review of the Fiscal Year 1997 performance based incentives was conducted in June 1997 as part of the Secretarys Performance Based Incentive Review. In those cases in which it is determined that fees were inappropriately paid for performance completion outside of the measurement period, Rocky Flats will seek recovery or adjustments to fees paid. These actions will be completed in December 1997.

Rocky Flats noted, however, that the Federal Acquisition Regulation (FAR) does not prohibit a contractor from beginning performance prior to the contract effective date. This practice is acceptable, as reflected by the cost principles in FAR 31.205-32, which states that precontract costs are allowable to the extent that they would have been allowable if incurred after the date of the contract. For examples noted in the report, Kaiser-Hill proposed the performance incentives in the best and final offer submitted in March 1995. Performance against these incentives did not begin until after the contract award date of April 4, 1995. The fact that performance occurred prior to the effective date of July 1, 1995, was not prohibited. Rocky Flats noted that performance incentives must be established early enough in the process to influence performance.

Auditor Comments. Rocky Flats' planned actions to review all incentive fees paid and seek recovery of fees paid for work that was outside the measurement period are responsive to the recommendation. However, we disagree that the fees paid for performance before the effective date of the contract -- work force restructuring and regulatory summit meetings -- do not warrant further review. The integrating contract stipulated in Clause B.6.(c), Performance Based Incentive Fee, that the available incentive fee was for the period commencing on the effective date of the contract, July 1, 1995. Because these activities fell within the work scope of the transition contract, work performed prior to July 1, 1995, Kaiser Hill was compensated for this work under the transition contract. It would not, therefore, appear to be eligible for performance fees under the integrating contract.

PART V

APPENDICES

Summary of Related Office of Inspector General Reports

DOE/IG-0310, General Management Inspection of the Department of Energy's Nevada Field Office, May 1992.

Part of the report covered the Nevada Field Offices (Nevada) Productivity Incentive Fee Program. This incentive program was designed to motivate the contractor, through incentives, to identify initiatives that would result in an overall increase in the efficiency and effectiveness of its operation. The Office of Inspector General found that Nevada's Productivity Incentive Fee Program was operated without clear authorization and written documentation on how the program should work. Of particular concern was the lack of policy and guidance on how to verify contractor submitted cost savings and where the funds to pay the incentive fees should come from.

DOE/IG-0352, Inspection of the Cost Reduction Incentive Program at the Department of Energy's Idaho Operations Office, July 1994.

This inspection reviewed the economy and efficiency of Idaho Operation Offices (Idaho) Cost Reduction Incentive Program. The program was supposed to motivate and provide incentive to the contractors which would result in cost savings while increasing the efficiency and effectiveness of their operations. The report disclosed that: (1) Idaho officials did not fully validate approved cost savings because of difficulty with soft dollar savings; (2) hard dollar savings were not deobligated and returned to the Department; (3) a conflict of interest may have existed because contractors might defer work to future periods to show cost savings in the current period; (4) the program duplicated the fees that contractors earn through their existing fee provisions and value engineering programs; (5) the costs savings could be a result of over budgeting (uncosted balances); and (6) policies and procedures on cost reduction incentives were needed

DOE/IG-0401, Inspection of the Performance Based Incentive Program at the Richland Operations Office, March 1997.

This inspection reviewed the Richland Operations Office's (Richland) Performance Based Incentive Program. The report showed that Richland did not always make the best use of the incentive fees paid to the management and operating contractor. The inspection found examples of incentive fees paid that were (1) excessive when compared with the cost of labor and material to perform the work, (2) for work that was accomplished before Richland's program was established, (3) for work that was not completed, and (4) for work that was easily achieved by the contractor. There was also an instance where the contractor compromised quality and safety in order to earn an incentive fee. The report also contained a number of administrative weaknesses and observations.

DOE/IG-0350, Audit of Health Benefit Costs at the Department's Management and Operating Contractors, June 1994.

This audit reviewed the reasonableness of the Department's share of management and operating contractor benefit costs. According to the Department of Energy Acquisition Regulation, reasonableness was to be measured by comparing the contractor's benefit costs to the costs incurred by other firms and to costs incurred by the contractor's own private sector operations. The audit reported that the Department's share of contractor benefit costs was not reasonable based on either comparative measure. As a result, in Fiscal Year 1991 the Department paid $15.4 million in excess of industry norms for health benefit costs at the six contractors audited, which included the management and operating contractor at the Rocky Flats Site.

July 17, 1997

MEMORANDUM FOR	REGIONAL MANAGER WESTERN REGIONAL AUDIT OFFICE OFFICE OF INSPECTOR GENERAL
FROM:	RICHARD H. HOPF DEPUTY ASSISTANT SECRETARY FOR PROCUREMENT AND ASSISTANCE MANAGEMENT
SUBJECT:	DRAFT REPORT ON "AUDIT OF PERFORMANCE FEES

AND COST SAVINGS AWARDS AT ROCKY FLATS"

I appreciate the opportunity to review and comment on the official draft report on the "Audit of Performance Fees and Cost Savings Awards at Rocky Flats." The report will be helpful in developing an overall assessment of the Department of Energy's usage of performance-based contracting incentives.

Regarding the specific recommendations contained in the draft audit report which are addressed to me, I would concur as follows:

1. Recommendation: We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management ensure that Departmental contracts with cost reduction incentive programs include provisions that require the cost reduction proposals to be innovative and result in the return of hard dollar savings to the Department's control.

   Response: The Department's draft fee policy, which is in final review prior to publication as a Notice of Proposed Rulemaking (NOPR), contains the requirement that any contract which contemplates a cost savings program must contain the "Cost Reduction" clause prescribed in the policy. That clause requires that cost savings incentives must return any realized savings to the control of the Department. In addition, the clause requires that design, method, or process cost reduction incentives be innovative. The language contained in the draft clause refines the 1995 guidance on this subject and is, therefore, viewed as responsive to your recommendation. (Clause is attached.)

2. Recommendation: We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management use the data developed during this audit at the Rocky Flats Site as part of its Department-wide review of the performance-based contracting incentives program to clarify Departmental guidance on developing and executing performance measures.

   Response: I concur in the recommendation. The information contained in the draft audit report as well as that information contained in the audit report entitled "Inspection of the Performance-Based Incentive Program at the Richland Operations Office" will be used as part of the Department-wide review of performance-based contracting currently being conducted by these offices.

The review of the Department's performance-based incentives is scheduled to be completed in the near future. The review has identified some systemic problems and their causes. Many of these problems are the result of the rapid transition the Department undertook as part of Contract Reform to move from ill-defined performance objectives and subjective performance incentives to more specific results-oriented expectations and more objectively determined fees. As part of the initial site reviews, the review teams have provided feedback to the Operations Offices concerning areas of needed improvement to be applied in the development of the FY98 performance measures and incentives. Additional areas for improvement identified during the completion of the review will also be provided to the

Operations Offices.

Based on the information gathered and analysis to date, I have decided to direct the following actions pending the completion of the performance-based incentive review:

o Operations Offices shall establish a senior management team to perform an integrated review of all performance incentives prior to their being finalized.

o Cost Reduction/Cost Savings incentives, in order to be considered for review, must meet the minimum conditions and principles set forth in guidance to be published by my office and as contained in the "Cost Reduction" clause of the draft fee policy.

o Performance incentives, including Cost Reduction/Cost Savings incentives shall be subject to Headquarter's review and approval until lessons learned and remedial guidelines have been implemented.

o As necessary, negotiations will be undertaken with the site contractors to either modify Cost Reduction/Cost Savings incentive provisions consistent with Departmental guidelines or discontinue their application.

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I would like to make one general observation on the draft report. I understand that it is the purpose of these audit reports to be critical, and, in many cases, your observations help form the basis for initiatives to improve deficient practices or processes. However, this focus sometimes causes the reader to lose sight of the more positive affects of the Department's attempts to move off the status quo regarding management and operating contracts. Although implementation of performance-based contracting and the use of incentives can and will be improved, it appears to us that, overall, the contract at Rocky Flats has been quite successful. As compared to prior contractor performance, measurable achievements under the current contract reflect significant improvement.

With respect to the specific findings and comments contained in the draft report, we offer a number of comments/suggestions for review. They are also attached.

Attachment

NOTE: The attachment contained detailed valuable information which has been incorporated into the body of the text or in Part IV. Because of the volume of text in the various attachments, they have not been included in this report.

DOE F 1325.8

United States Government memorandum

Department of Energy
Rocky Flats Field Office

DATE: July 15, 1997

REPLY TO
ATTN OF: FCFO:GGD:08023

SUBJECT: Office of Inspector General Official Draft Report - Audit of Performance Fees and Cost Savings Awards at Rocky Flats

TO: Gregory H. Friedman, Deputy Inspector General for Audit Services, IG-30

Thank you for the opportunity to review and comment on the subject draft report, "Audit of Performance Fees and Cost Savings Awards at Rocky Flats." We appreciate your review of these programs at the Rocky Flats Environmental Technology Site (Site). We believe the information contained in the draft report, in conjunction with the comprehensive site reviews directed by the Secretary of all performance-based contracts, and the Site's own efforts for continuous improvement will be helpful in improving the incentive fee program and the cost reduction incentive program at Rocky Flats. Many of the issues identified in the draft report had already been identified by Rocky Flats Field Office (RFFO) through our own internal reviews prior to the audit.

The draft report contained recommendations for the Manager of the Rocky Flats Field Office as well as the Deputy Assistant Secretary for Procurement and Assistance Management. We have worked in close collaboration with the Deputy Assistant Secretary for Procurement and Assistance Management and representatives of the Office of Environmental Management in reviewing the Inspector General's draft report and its recommendations. This response deals with only those recommendations directed to the RFFO. The Deputy Assistant Secretary for Procurement and Assistance Management will submit a separate response on recommendations directed to him.

It is generally conceded that the Department faced major challenges in moving to expeditiously implement contract reform and introduce dramatic changes designed to modify contracting practices which had been in effect for decades. While recognizing the need for further improvement, RFFO believes strongly that performance-based contracting (with its focus on results) has been an important tool in accomplishing the Department's goal of accelerated cleanup. Our experience indicates that there have been improvements in performance as a result of instituting a performance-based integrating contract at Rocky Flats compared to accomplishments in previous years

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under a management and operating contract. One need only go back to FY 1995 and compare what we were able to accomplish then to what we accomplished in FY 1996 to see a significant difference which includes:

- o Substantially more work has been accomplished notwithstanding major reductions in staffing levels and a budget reduction of over $100 million per year;

- o Considerable improvement, as measured by objective criteria in safety performance; and

o Consistent and more predictable contractor performance.

Experience and insights gained by RFFO and DOE in administering this type of contract are expected to lead to continued improvements, greater productivity and additional increases in the "real work" related to expediting Site closure. Some of the enhancements and innovative measures taken by RFFO were recognized and cited in the draft report. These enhancements and other actions taken to improve overall performance include:

o A more collaborative approach to development of performance measures and incentives, involving appropriate RFFO site managers and Headquarters organizations, to ensure that performance incentives are concentrated on the "critical few" measures that will advance the ultimate goal of Site closure;

o Establishment of "gateways," requiring that the contractor perform all work in a performance area prior to earning fees for related performance incentives in a subsequent period;

o Initiatives to improve cost monitoring and control to ensure that work is performed within budgeted costs and established schedules;

o Development of formal validation procedures for ensuring that incentivized work is performed within established parameters and criteria prior to authorizing payment;

o Modifications to existing procedures for development of performance measures to reflect lessons learned and to ensure that performance incentives are in compliance with established Site guidelines; and

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o Improved lines of communication between all parties involved in the development, issuance, monitoring, and validation of performance measures.

Specific comments and responses to the draft report are attached. I especially want to highlight my concern with the draft report's assertion that Rocky Flats had to reduce program funding by nearly $4.4 million in fiscal year 1996 because Kaiser-Hill did not return "hard dollar" savings to the Department. The report suggests that the Government did not receive any benefit as result of the accelerated workforce reduction and fringe benefit cost reduction efforts.

I believe the available evidence supports the conclusion that the total savings for these two efforts (approximately $15.5 million based on preliminary estimates) were real savings, of which $4.8 million was paid to Kaiser-Hill in FY 1996. The remainder was allocated to other work during the fourth quarter of FY 1995, as Kaiser-Hill operated against the existing baseline established under the previous contractor, and in FY 1996, when Kaiser-Hill reflected the savings in the new baseline which they submitted. The RFFO's review and acceptance of the revised baseline indicated an acceptance of the proposed reallocation, which complies with the intent of the Departmental guidance for the return of savings to DOE control. While RFFO could have exerted greater efforts to more clearly identify and segregate the reallocation of savings, the savings were real and the Department received the benefit of reduced personnel costs which were applied to additional work in FY 1995, FY 1996 and FY 1997.

If you have any questions concerning this response, please contact me directly at (303) 966-2025 or Jerry Duffy at (303) 966-4264.

Jessie M. Roberson
Manager

Attachment:
RFFO Comments on Official Draft Report

NOTE: The attachment contained detailed valuable information which has been incorporated into the body of the text or in Part IV. Because of the volume of text in the various attachments, they have not been included in this report.

IG Report No.__DOE/IG-0411

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2. What additional information related to findings and recommendations could have been included in this report to assist management in implementing corrective actions?

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message more clear to the reader?

4. What additional actions could the Office of Inspector General have taken on the issues discussed in this report which would have been helpful?

Please include your name and telephone number so that we may contact you should we have any questions about your comments.

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If you wish to discuss this report or your comments with a staff member of the Office of Inspector General, please contact Wilma Slaughter at (202) 586-1924.

1 The Kaiser-Hill contract allows cost savings to be calculated over a two-year period. Departmental guidance limits cost saving calculations to one year.

2 In Fiscal Year 1996, Rocky Flats paid Kaiser-Hill over $541,873 of its $1.14 million share before final validation of the estimated savings. In contrast, Departmental guidance states that the contractor's share of any savings should not be paid until after the savings are validated and returned to the Department for disposition.

3 Subsequent to our fieldwork, Rocky Flats reversed its decision on one of the three cost reduction proposals initially rejected because Department direction was deemed insufficient grounds for a rejection.

4 Kaiser-Hill returned $612,000 through a baseline change proposal. However, Rocky Flats' financial review reduced this amount due to inaccuracies in estimated savings and implementation costs.

5 Performance measure incentive fees shown as being awarded to Kaiser-Hill include incentive fees that Kaiser-Hill awarded to its subcontractors and ultimately billed to the Department.

6 The fee for the Fiscal Year 1996 performance measure exceeded the fee for the Fiscal Year 1995 performance measure because Rocky Flats negotiated the fees using different fee pools and a different number of measures.

7 The meetings are also discussed in subsequent paragraphs under

"Process-Oriented Performance Measures."