



U.S. Department of Energy
Office of Inspector General
Office of Audit Services

Audit Report

Utility System Leases at the East Tennessee Technology Park



Department of Energy

Washington, DC 20585

June 25, 2003

MEMORANDUM FOR THE SECRETARY

FROM:

Greg Friedman
Gregory H. Friedman
Inspector General

SUBJECT:

INFORMATION: Audit Report on "Utility System Leases at the East Tennessee Technology Park"

BACKGROUND

In 1998, the Department of Energy's Oak Ridge Operations Office entered into a series of utility leases with the Community Reuse Organization of East Tennessee (CROET). Under the lease terms, CROET was to manage a variety of Government-owned utility systems – including steam, compressed air, nitrogen, water, and natural gas – at the Department's East Tennessee Technology Park (ETTP). By agreement, the Department leased its utility systems to CROET at no charge. In turn, CROET was to contract with a third party with utilities expertise to operate and maintain the utility systems for the Department.

Department officials believed that, using this approach, CROET could operate the systems, improve site infrastructure, and sell the utilities back to the Department, as well as to other ETTP tenants, at significant savings. The Department's agreement with CROET stated that the Department would realize annual savings of 15 percent in the first year, 20 percent in the second year, and 25 percent in the following years for the services provided, compared to the Department's benchmark budget. Further, the agreement stated that the Department would reinvest a portion of the savings in the rehabilitation of the systems and facilities. The objective of the audit was to determine whether the utility system leases at ETTP have been managed to improve site infrastructure and reduce costs to the Department.

RESULTS OF AUDIT

The audit disclosed that the Department's goals were not being achieved. Specifically, the utility leases:

- Were not structured so as to create incentives for reducing cost and improving operating efficiency. Specifically, they allowed the contractor to be reimbursed for various markups and budget overruns;



- Did not ensure that all funds the Department paid for infrastructure repairs and rehabilitation were used for that purpose rather than being deposited in an interest bearing bank account or otherwise used; and,
- Did not adequately protect the Government's interests with respect to price adjustments and accountability over certain personal property.

We further noted that the Department had not obtained competitive bids for management of the utility systems and infrastructure. As a result of these conditions, the Department now pays about the same as it did before the leases were agreed to, even though its utility usage has declined over the same period. Based on our review, we questioned \$6.9 million in lease costs, including costs for commodity markups, improperly used repair and rehabilitation funds, interest on unused funds and tenant bad debts.

The Office of Inspector General recognizes the important part that CROET plays in representing the interests of the East Tennessee region as the Department's role in the local economy changes. At the same time, it is incumbent on the Department, in our judgment, to ensure that the interests of all taxpayers are protected when entering into agreements with community reuse organizations. We discussed similar issues in our recent report on *Transfer of Excess Personal Property from the Nevada Test Site to the Community Reuse Organization* (DOE/IG-0589, March 2003).

MANAGEMENT REACTION

In written comments included as Appendix 3, the Manager, Oak Ridge Operations Office generally concurred with the recommendations. However, the Manager expressed concerns about the report's conclusions and characterizations, particularly in regard to our analysis of utility cost trends at ETTP. That analysis, management's concerns, and our responses are incorporated in the body of the report.

Attachment

cc: Deputy Secretary
Under Secretary for Energy, Science and Environment
Assistant Secretary for Environmental Management

UTILITY SYSTEM LEASES AT THE EAST TENNESSEE TECHNOLOGY PARK

TABLE OF CONTENTS

Utility Costs

Details of Finding.....	1
Recommendations	7
Comments	8

Appendices

1. Prior Audit Reports.....	9
2. Objective, Scope, and Methodology	11
3. Management Comments.....	13

UTILITY COSTS

Background

In the early 1990s, the Department of Energy (Department) began to transition some of its sites and facilities from missions in support of nuclear weapons production to environmental cleanup. At about the same time, legislation was enacted establishing regional community reuse organizations throughout the country. These organizations were established to assist local communities with the transition from economic dependence on the Federal government to reliance on private industry. The Community Reuse Organization of East Tennessee (CROET) was established for this purpose.

On March 20, 1998, the Department leased its major utility systems, with the exception of electricity, to CROET at no cost. Eight 10-year leases were signed which covered East Tennessee Technology Park's (ETTP) steam, compressed air, nitrogen, potable water generation and distribution systems; wastewater collection and treatment systems; storm drain collection system; natural gas distribution system; and, recirculating cooling water and fire protection water distribution system. On the same day, CROET entered into a fixed-price contract with a third-party contractor for the management, operation, maintenance, and rehabilitation of ETTP utility systems. The Department, on April 23 and June 26, 1998, signed two additional leases with CROET for roads and grounds maintenance.

The 10 leases originally included personal property with an acquisition cost of about \$2.5 million¹ to support utility systems and facilities. However, the Department modified the lease agreements in July 1998 and transferred title for \$1.9 million¹ of this property to CROET. Among the transfers were automobiles, utility vehicles, cranes, lawn maintenance equipment, and computer and audio/video equipment.

Leases with CROET

The audit disclosed that the utility leases were inefficient and costly to the Department because they:

- Were structured to create disincentives for reducing utility cost and improving operating efficiency;
- Did not ensure that all funds the Department paid for infrastructure repairs and rehabilitation were used for that purpose; and,

¹ Acquisition cost was used because fair market value had not been determined. Fair market value would likely have been considerably less than acquisition cost.

-
- Did not adequately protect the Government's interests with respect to price adjustments and the accountability for personal property.

Operating Efficiency

Although the Department anticipated that the lease arrangements would reduce utility costs, the agreements themselves required the Department to pay commodity markups that created disincentives for reducing cost and improving operating efficiency. Each year, a five-member utility committee establishes rates that will be charged to the Department for utility services. Included in these rates are the costs of commodities such as electricity, natural gas, and fuel oil used by the third-party contractor to provide the utility services, plus up to 18 percent in markups for profit and contributions to the Major Repairs and Rehabilitation Fund. If CROET exceeds its budget for commodities, the Department reimburses CROET the difference, along with the applicable markup. Thus, "profits" increase as consumption increases.

Also, with respect to electricity and natural gas, the third-party contractor acquired the commodities from the Department and consumed them to provide the ETP utility services. CROET subsequently charged the Department for the cost of the commodities plus the additional markup. Thus, the Department paid a markup of 18 percent for electricity and natural gas that it had provided.

Infrastructure Issues

As part of its monthly utility payments to CROET, the Department also pays into a Major Repairs and Rehabilitation Fund to make improvements to the existing utility and infrastructure facilities at ETP. Since 1998, the Department has invested \$4.9 million in the fund; however, only about \$411,000 has, thus far, been spent to improve existing utility and infrastructure facilities. As of August 31, 2002, CROET had accumulated most of the rest of the infrastructure funds – about \$3.2 million – in an investment account. Moreover, CROET had earned \$171,000 in interest revenue on the unspent balance. We noted that the lease agreements do not contain specific requirements as to how the funds are to be used, or whether unspent funds will be returned to the Department. Based on current rates, the Department could contribute an additional \$8 million to the fund over the remaining life of the leases without adequate assurance that needed infrastructure repairs and rehabilitation will occur.

In addition, some of the funds that were expended from the Major Repairs and Rehabilitation Fund were used for purposes other than improving existing utility and infrastructure facilities at ETTP. For example, CROET spent about \$505,000 to replace mowers, tractors, and vehicles transferred from the Department to CROET at the beginning of the lease. Further, CROET plans to spend an additional \$795,000 from the fund to replace mowers, tractors, and vehicles at ETTP in the next few years.

Protections

With respect to the administration of the leases, we found that adequate protections were not in place. For example, the Department paid for adjustments to monthly utility invoices without adequate support. Invoices from CROET consist of the monthly ETTP utility costs, adjusted for utility costs billed to CROET's tenants at the site. Several invoices included a billing adjustment that increased the Department's cost by as much as \$66,000. Most adjustments were described as "billing adjustments," and no support was provided to substantiate or validate the adjustment amount. The Department's environmental management contractor at ETTP approved the invoices for payment without validating the adjustments.

Further, the Department did not hold CROET accountable for all personal property items used in utility operations. According to the lease terms, any personal property item that was leased without a transfer of title to CROET in July 1998 would revert to the control and custody of the Department. However, we identified 24 items with an acquisition cost of \$620,000¹ that were not part of the title transfer, and the Department and CROET officials were, initially, unaware of the location and condition of the items. A subsequent inspection of the 24 items resulted in 12 items with an acquisition cost of \$169,000¹ that could not be located or verified. The items include utility equipment, vehicles, and lawnmowers.

Subsequent to our fieldwork, the Department informed us that 4 of the 12 missing items have been located, and that if CROET is unable to return the remaining 8 items, it will reimburse the Department for the replacement cost of the items.

¹ Acquisition cost was used because fair market value had not been determined. Fair market value would likely have been considerably less than acquisition cost.

Competition and Safeguards

The Department entered into the agreement with CROET without requiring CROET to obtain competitive bids from potential third-party utility service providers. The Federal Acquisition Regulation generally requires contracting officers to seek competition to secure the most advantageous contract for the Government and give all interested parties an opportunity to compete. Despite this requirement, the Department entered into sole-source negotiations with CROET and the third-party contractor in May 1997 for the management and operation of Government-owned utility systems at ETTP. In February 1998, CROET published an announcement of its intentions to enter into a service agreement with the third-party, and requested that other parties, if interested, submit a proposal. By this time, however, the Department, CROET, and the third-party had already entered into a formal agreement. Thus, the opportunity for other companies to compete was virtually non-existent.

Also, the Department did not include basic safeguards in the lease agreements to ensure fair and reasonable prices for utility services. The agreements state that the Department and CROET will establish a utility committee to manage CROET's contract with the third-party and set annual utility rates for the Department and commercial tenants at ETTP based on a benchmark budget. The utility committee is comprised of five voting members, including two from the Department.

The Department's members on the utility committee did not always act in the Department's best interest. For example, in September 2002, the utility committee approved the addition of "uncollectible accounts" and "CROET administration" fees into the price the Department pays for utilities, despite the previous objections of the Department's lease representative. The representative's position was that the Department could not legally fund tenants' bad debts², and CROET's administration fees were already included in the utility rates. In spite of the lease representative's position, a senior Department official offered a motion in favor of including the uncollectible and administrative fees in the rate increase. The motion passed unanimously and the Department has since paid for uncollectible tenant utilities and the additional amount for CROET administration fees.

² This position is supported by Federal Acquisition Regulation 31.703 and Office of Management and Budget Circular No. A-122 which state that bad debts, including losses (whether actual or estimated) arising from uncollectible accounts and other claims, related collections costs, and related legal costs, are unallowable.

Costs of Utilities

We found that utility costs were decreasing at the ETTP before the Department entered into the leasing agreements with CROET. The cost of major utilities decreased from about \$12 million in 1993 and 1994 to about \$9.4 million in 1995 and 1996, then dropped to \$6.9 million in 1997, the year before the leases began. Factors affecting costs at that time included improved management practices by the previous management and operating contractor, staffing reductions, and completion of capital improvements and repairs totaling about \$4.3 million in 1996. Since entering into the leases, the annual cost of major utilities increased from about \$8.3 million during the first year of the leases, to about \$8.6 million during the fourth year. We identified two primary contributors to the cost increases: CROET's commodity markups, which began during the second year of the leases, and CROET's administration fees, which were added during the fourth year.

Management disagreed with this analysis, stating that utility costs have been significantly reduced since 1993 and have stabilized at about \$8 million per year, or \$9 million per year when capital improvements are included. In management's view, the analysis failed to consider normal increases in labor and utility commodities costs, which are allowed under the lease agreements. Also, management believed that the analysis should have included \$9.5 million spent for capital improvements over the 5.5 years that preceded the lease. Management asserted that by using the lease agreements, the overall cost of utilities was reduced from an average of \$10.5 million before the lease to about \$8.6 million in the fourth year of the lease.

The Office of Inspector General recognizes that ETTP's utility costs were significantly reduced after 1993; however, the reductions were made by the previous management and operating contractor before the Department entered into the leases. Also, while rising labor and commodity rates may have contributed to cost increases, CROET agreed to reduce overall utility costs by at least 25 percent over 3 years. In this regard, benchmark budgets were not adjusted for labor and commodity cost increases. Further, expenditures for capital improvements were not included in our analysis of annual operating costs because that would have distorted the true cost of utility

operations. The Department made significant improvements in major utility systems before the leases which, presumably, resulted in more efficient utility operations for the third-party contractor.

Based on our analysis of costs incurred under the agreement, we concluded that the Department has paid significantly more than it needed to for utilities since the leases have been in effect. In total, we have questioned \$6.9 million, as illustrated in the schedule below.

Schedule of Questioned Costs	
Commodity Markups	\$1,623,787
Major Repairs and Rehabilitation Fund	4,505,121
Interest on Fund	171,023
Billing Adjustments	184,422
Tenant Bad Debt	138,778
CROET Administration Fees	277,924
TOTAL	<u>\$6,901,055</u>

Management indicated that it does not consider the cost of commodity markups, the Major Repair and Rehabilitation Fund, interest on the fund, and CROET administration fees to be questionable. To the contrary, these costs are considered reasonable and necessary. Also, management asserted that the Department would have incurred the cost of commodity markups regardless of whether CROET or a management and integration contractor provided utility services to ETPP.

Based on our audit, however, the Office of Inspector General concluded that CROET's billing practices for commodity markups, the Major Repairs and Rehabilitation Fund, and CROET administration fees could be considered a cost-plus-a-percentage-of-cost pricing arrangement, which is prohibited by Federal and Departmental acquisition regulations. Under this type of pricing arrangement, the contractor's profits increase in direct proportion to the amount of funds expended by the customer for contract performance. Thus, the contractor receives greater profits by incurring additional costs.

It is important to note that the vast majority of funds expended at the ETTP site are appropriated for the purpose of remediating the environmental impacts of the Department's historic missions at the Oak Ridge Reservation. To the extent that these funds are expended unnecessarily, the cleanup mission, that now includes an emphasis on accelerated closure of the ETTP, can be negatively affected. While the Office of Inspector General recognizes the role that CROET plays in representing the interests of East Tennessee as ETTP missions change, the Department should exercise care to ensure that cleanup funds are spent as effectively as possible to the benefit of all Federal taxpayers.

RECOMMENDATIONS

We recommend that the Manager, Oak Ridge Operations Office:

1. Perform a detailed analysis of the lease provisions questioned in this report and restructure the lease agreements as necessary to ensure that appropriate contracting and accounting controls are in place to protect the Department's interest;
2. Ensure that any future agreements for utility services are subject to full competition;
3. Make a determination as to the allowability of questioned costs in this report and recover funds as appropriate;
4. Cease automatic capital improvement payments to CROET and approve future capital improvements on a case-by-case basis, consistent with the ETTP Closure Plan;
5. Obtain an audit of monthly invoices paid by the environmental management contractor to CROET, and reimbursed by the Department, and ensure that only reasonable, allowable, and allocable costs are reimbursed by the Department; and,
6. Inventory Government-owned property leased by CROET and ensure all items are appropriately accounted for.

**MANAGEMENT
REACTION**

Management generally concurred with the audit finding and recommendations and agreed to take corrective action. However, management did not agree with the conclusion reached or the methodology used to compare utility costs incurred before and after the lease agreements at ETTP. Management clarified its written comments on June 3, 2003, stating that it plans to perform an independent analysis of the lease provisions questioned in this report and restructure the lease agreements as necessary to ensure that appropriate controls are in place to protect the Department's interests. Also, management plans to fully evaluate all costs questioned in this report and make a final determination as to their allowability. Management plans to complete these actions no later than September 30, 2003.

We have included management's formal reaction as Appendix 3. Additionally, management's comments on the validity of the audit analysis, along with our responses, have been incorporated into the text of this report.

AUDITOR COMMENTS

We consider management's reaction, as clarified in subsequent discussions, to be consistent with the intent of the audit recommendations.

Appendix 1

PRIOR AUDIT REPORTS

- *Transfer of Excess Personal Property from the Nevada Test Site to the Community Reuse Organization* (DOE/IG-0589, March 11, 2003). Property transfers by the Nevada Site Office (Site Office) to the local Community Reuse Organization (CRO) were not in the best interest of the taxpayers. Hundreds of pieces of equipment, including trucks, office machines, and trailers, were transferred to the CRO for \$1 per transfer. Lab equipment was transferred to the CRO that was needed at another Department site, ultimately causing the Department to spend \$2.5 million unnecessarily. Additionally, the Site Office sold a drill rig to the local CRO for \$50,000 that is now being offered for sale by an out-of-state equipment broker for \$3.9 million. The Office of Inspector General (OIG) found that, in most cases, the Site Office made little, if any, effort to determine the current market value of the property, nor did it ensure that the equipment would be used for purposes directly related to developing the economies of communities around the Nevada Test Site.
- *Oak Ridge Operations Office Management of Personal Property* (INS-L-02-01, January 3, 2002). Government-owned personal property had been released, and in some cases, title had been transferred, to private entities that were on-site Departmental lessees and sub lessees, without documented radiological control reviews being performed. These private entities were leasing Department-owned facilities at the East Tennessee Technology Park (ETTP). The Oak Ridge Operations Office (ORO) had relied on lease restrictions and other administrative and physical restraints to prevent the inadvertent off-site release of the property. The OIG concluded that there might be increased safety risks for both off-site contamination and for private workers who are "co-located" with property formerly utilized by the Department at ETTP, if such property is not screened for radiological contamination before being turned over to lessees.
- *Sale of Land at Oak Ridge* (DOE/IG-0502, May 7, 2001). The Department's sale of land in February 2001 to a private contractor was an inappropriate use of the special authorities granted under the Atomic Energy Act of 1954 (Act). The Act gives the Department authority to sell land in the performance of a programmatic function without regard to standard Federal practices. The Department invoked the authority of the Act because it has broadly interpreted what it defines as a programmatic function under the Act. Further, the Department sought to facilitate the sale to the "preferred" purchaser. As a result, there was no assurance that the land was sold at fair market value and in the best interests of the Government.
- *Audit of Sale of Land to an Oak Ridge Hospital* (ER-L-99-01, November 25, 1998). The audit determined that ORO sold 3.5 acres of land and 2 buildings to a local hospital using the authority of the Act instead of following standard Federal practices. The audit questioned whether the authority granted by the Act should be used to avoid standard Federal practices when disposing of excess land at the Oak Ridge Reservation (Oak Ridge), and whether it was in the Government's best interest for ORO to use proceeds from the sale of Federal property to augment appropriations rather than deposit cash in the U.S. Treasury.

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- *Audit of the U.S. Department of Energy's Identification and Disposal of Nonessential Land* (DOE/IG-0399, January 8, 1997). The audit determined that the Department retained significant amounts of land, including about 16,000 acres at Oak Ridge, which were not essential to current and foreseeable mission requirements. Rather than dispose of the nonessential land at Oak Ridge, the Department retained ownership until local entities expressed an interest in acquiring specific parcels. The Department sometimes declared the parcels to be excess and sold the parcels to local entities at the appraised value using the authority granted by the Act. The audit concluded that the Department should exercise greater care in disposing of Government-owned land. Specifically, all interested parties should be given the opportunity to acquire excess land holdings.
 - *Audit of Economic Development Grants and a Cooperative Agreement with East Tennessee Not-For-Profit Organizations* (ER-B-97-01, October 22, 1996). Funds awarded to the East Tennessee Economic Council (ETEC) were not used for their intended purposes. The Department considered certain types of costs to be allowable even though they were outside the grants' approved scopes of work, and Department reviews of ETEC's invoices did not reveal all items that should not have been billed or were billed in error. Also, the Department advanced more funds than needed by ETEC to establish a revolving loan fund and allowed ETEC to hold the interest earned on the advanced funds. This occurred because ORO officials responsible for awarding and administering the grants were not familiar with Federal rules on cash advances and interest earned on cash advances.

Appendix 2

OBJECTIVE

The objective of the audit was to determine whether the utility system leases at the East Tennessee Technology Park (ETTP) have been managed to improve site infrastructure and reduce costs to the Department of Energy (Department).

SCOPE

The audit was performed from September 2002 to March 2003 at the ETTP at the Oak Ridge Reservation in Oak Ridge, Tennessee. The scope of the audit included the Department's utility system leases at ETTP and associated cost data from March 1998 through February 2003.

METHODOLOGY

To accomplish the audit objective, we:

- Examined the terms and conditions established in the Memorandums of Understanding and Agreement among the Department, the Community Reuse Organization of East Tennessee (CROET) and the third-party contractor;
- Analyzed the lease agreements related to utility services at ETTP;
- Reviewed Federal laws and regulations and Departmental guidance concerning leases of equipment and facilities and contracts for utility services;
- Evaluated expenditures for utility services at ETTP;
- Reviewed CROET's use of the Major Repair and Rehabilitation Fund for reasonableness;
- Reviewed the Department's method of purchasing commodities from CROET and the third-party contractor to identify unnecessary costs;
- Evaluated the Department's leasing and transferring of property to CROET; and,
- Interviewed Department and contractor officials at Department Headquarters, Oak Ridge Operations Office, and ETTP.

The audit was conducted in accordance with generally accepted Government auditing standards for performance audits and included tests of internal controls and compliance with laws and regulations to

the extent necessary to satisfy the audit objective. 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. Because only a limited amount of computer-processed data was used during the audit, we did not conduct a reliability assessment of computer-processed data.

Finally, we assessed the Department's compliance with the Government Performance and Results Act of 1993. The Department established performance incentives with the environmental management contractor at ETPP to support Departmental reindustrialization efforts; however, it did not establish specific incentives for utilities. Additionally, we determined that the utility-related performance incentive that the Department placed in the CROET leases did not benefit the Department.

Management officials waived the exit conference.

Appendix 3

DOE F 1325.8
(3/02)

United States Government

Department of Energy

Oak Ridge Operations Office

memorandum

DATE: May 19, 2003

REPLY TO

ATTN OF: AU-60:Clark

SUBJECT: **OAK RIDGE OPERATIONS MANAGEMENT RESPONSE TO DRAFT AUDIT REPORT,
UTILITY SYSTEM LEASES AT THE EAST TENNESSEE TECHNOLOGY PARK**

TO: Frederick D. Doggett, Deputy Assistant Inspector General for Audit Services, Office of
Inspector General, IG-32, FORS

We have reviewed the subject draft report and appreciate the opportunity to provide comments prior to the report becoming final. However, we still have serious concerns about the factual accuracy, the methodology of the financial analysis, and the objectivity of the report and have provided the basis for our concerns in more detail as an attachment to this memorandum.

It is important to recognize that the purpose of the entire Reindustrialization effort was to move the East Tennessee Technology Park (ETTP) closer to a closure site by reducing the Management and Integration contractor role in operating utilities, a precedent that had already been successfully set by the Department of Energy (DOE) Water Plant transfer. These actions made the Department a customer rather than a provider of such services.

We either concur or propose a qualified concurrence with your recommendations and request that you give our suggested modifications to the recommendations serious consideration in order that we might proceed with actions that will enhance DOE's ability to accelerate cleanup of the ETTP site.



Gerald G. Boyd
Manager

Attachments

cc w/attachments:

J. A. Meredith, AU-61, ORO

J. S. Miller, FM-73, ORO

W. J. Biloski, BJC

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

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