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Audit Report

Management Controls over Alternative Financing for Office and Support Facilities at Y-12

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Washington, DC 20585

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MEMORANDUM FOR THE ASSOCIATE ADMINISTRATOR FOR MANAGEMENT AND ADMINISTRATION, NATIONAL NUCLEAR SECURITY ADMINISTRATION

FROM: George W. Collard
Assistant Inspector General
for Audit Operations
Office of Inspector General

SUBJECT: INFORMATION: Audit Report on "Management Controls over Alternative Financing for Office and Support Facilities at Y-12"

INTRODUCTION AND OBJECTIVE

As part of the Nuclear Weapons Complex, the Y-12 National Security Complex plays a critical role in maintaining the nation's nuclear stockpile. However, more than 70 percent of its infrastructure was constructed prior to 1950, is burdened with deferred maintenance, and has become difficult to maintain safely. Faced with limited resources and growing mission demands, the Department of Energy and many other Government agencies are turning to approaches other than full Government funding to finance capital assets. Agencies are using alternative methods such as partnerships involving the public and private sector and operating leases to speed construction and/or replace needed facilities. For example, the Oak Ridge National Laboratory has used alternative financing to obtain new facilities. In addition, a number of sites throughout the Department, including Y-12, are considering the use of such methods.

BWXT Y-12, LLC, the management and operating contractor for Y-12, has proposed using private sector financing to replace a number of aging facilities that house technical and administrative support personnel. Under the proposed action, two parcels of Federal land would be conveyed to a private entity that would employ a private developer to design and construct the buildings. Once the buildings are complete, the private entity will lease them to BWXT for 20 years for about $11.6 million per year, using year-to-year operating funds. As of December 2004, the Y-12 Site Office had requested that the Administrator of the National Nuclear Security Administration authorize transfer of the land. Because of the critical nature of Y-12 operations, we initiated this audit to determine whether BWXT's proposed alternative financing arrangement for new office and support facilities is in the best security and financial interest of the National Nuclear Security Administration.

CONCLUSIONS AND OBSERVATIONS

Our audit disclosed a number of challenges to the successful implementation of BWXT's proposal to acquire new office and support facilities at Y-12. We noted differences among the financial instruments supporting the alternative financing arrangement that need to be resolved in determining whether the lease can be funded on an annual basis with operating funds under the Office of Management and Budget's criteria for operating leases. Our review also disclosed that potential security issues posed by commercial office space being located in close proximity to secured areas may not have been adequately evaluated.

MANAGEMENT REACTION

Management generally concurred with the report and its contention that the National Nuclear Security Administration faces a number of challenges to the successful implementation of BWXT's proposal. Management stated that it has consulted with the Office of General Counsel and obtained their concurrence that the alternative financing arrangement as structured meets the requirements of an operating lease. However, management did not fully agree with our conclusion and recommendation regarding the need for additional security analysis. Management's comments and our response are discussed in the body of this report.

Attachment

cc: Administrator, National Nuclear Security Administration

MANAGEMENT CONTROLS OVER ALTERNATIVE FINANCING FOR OFFICE AND SUPPORT FACILITIES AT Y-12

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Finance and Security

While a variety of alternative financing arrangements are available, BWXT Y-12, LLC (BWXT) chose to structure its proposal as an operating lease. To protect against potential anti-deficiency problems and to prevent Federal organizations from binding the Government to agreements for which funds have not been appropriated, the Office of Management and Budget (OMB) requires that operating leases conform to a number of strict criteria. As determined by the Chief Financial Officer, management and operating contractors, because of their integrated nature, are considered to be subject to OMB requirements related to leasing arrangements.

Operating leases are attractive because initial appropriations are only required for the first year lease payment and any cancellation costs. To ensure that operating leases are not used as substitutes for purchases of capital assets, among other things, OMB requires that:

- Ownership of the asset remains with the lessor during the term of the lease and is not transferred to the Government at or shortly after the end of the lease period;
- The lease does not permit the Government to buy the asset for a nominal amount at the end of the lease term (bargain-price purchase option); and,
- A private-sector market exists for the asset.

In contrast, a lease that is structured so that it essentially amounts to a purchase of a capital asset – it cannot be cancelled and/or transfers ownership of the property to the lessee at the end of the lease term for a nominal amount – is considered a capital lease. Leases of this sort require that budget authority be available prior to committing the Government. Generally, organizations must have obtained funding sufficient to cover the sum of the lease payments over the life of the agreement. A capital lease, therefore, provides little advantage over line-item capital funding methods.

Lease Provisions

BWXT structured its alternative financing arrangement to accommodate the use of an operating lease because it believed that approach was the most cost effective and is preferable from a budget perspective. To comply with constraints imposed by OMB for operating leases, the proposed lease agreement provides that the facilities will remain with the private entity rather than being automatically surrendered to the National Nuclear Security Administration (NNSA) at the end of the lease term. Further, the lease clauses do not include the right to acquire the property through a bargain-price purchase option or at a specified price at the end of the lease term. Rather, the deed for the land indicates that NNSA may purchase the assets at a mutually agreed upon price, but only if the contractor maintains the lease for 25 consecutive years – 5 years beyond the specified lease term.

While BWXT structured its alternative financing agreement to satisfy the requirements of an operating lease, we noted that a buy-back provision contained in the loan agreement between the private entity loaning funds for the facilities and the borrowing organization may render the alternative financing proposal a capital lease under OMB's criteria. Although not included in the lease agreement, the related loan agreement for the project contains a provision that would permit the assets to be purchased by the management and operating contractor for Y-12 at a nominal value. This arrangement may conflict with the OMB Circular A-11 provision against bargain-price purchase options in operating leases. If the loan agreement provision were determined to make the alternative financing arrangement a capital lease, then the Department would have to comply with OMB's requirements for initial full funding to avoid anti-deficiency related problems.

Although the loan agreement provision raises a question whether the financing arrangement meets the criteria for an operating lease, we noted that OMB appears to be amenable to providing flexibilities in this area and recently granted permission for the General Services Administration (GSA) to participate in a pilot program. The GSA initiative involved the formation of a partnership between public and private sector entities. GSA plans to issue a 35-year ground lease of Federal land to a private developer who will construct the facilities and lease them back to GSA. At the end of the ground lease, the developer will abandon the assets in place and ownership will be transferred to GSA at no cost.

Security Concerns

The proposed lease agreement also may increase security risks by potentially allowing future public access near buildings that are located within a security boundary. BWXT plans to ask NNSA to deed and convey all interest in two parcels of Federal land to a private entity. Based on the terms of the lease agreement currently under review – no automatic reversion or guaranteed purchase option – NNSA could lose possession of the buildings and land and would have no control as to who could ultimately occupy the facilities. According to Y-12 Site Office Security personnel, if the facility should become privately owned and occupied, a situation will exist which could facilitate access near NNSA production operations and increase the risk that a potential adversary could engage in prohibited activities. Although the Department's Office of Engineering and Construction Management and the Office of General Counsel are performing independent reviews of the costs and legal aspects of the project, a formal evaluation of security issues has not been performed.

Alternative Financing Guidance

Alternative financing arrangements are a relatively new funding concept in the Department. As such, NNSA has not prepared comprehensive guidance that describes the policies and procedures that Federal and contractor organizations should follow when developing and reviewing these arrangements. NNSA has no precedent for these types of transactions; therefore, BWXT elected to structure the Y-12 arrangement based primarily on its short-term goal of obtaining capital facilities by using annual operating funds. As we observed during our review, however, NNSA's long-term needs and risks associated with such transactions also need to be considered.

Comprehensive project management guidance for alternative financing arrangements could, in our opinion, help ensure that challenges and concerns such as those enumerated in this report are reviewed, considered and resolved. At a minimum, a planning document should be required that addresses all aspects of the transaction, including the consequences and costs of the preferred method and viable alternatives. During our review we learned that Sandia National Laboratories (Sandia) had developed real estate guidance that could be used as a basis or model for crafting such guidance. In particular, the Sandia guidance requires the preparation of a preliminary real estate plan. This plan must contain a total of 15 elements, including property justification, security considerations, and financing options. In addition, input from all appropriate parties must be solicited and considered.

RECOMMENDATIONS

Each of the issues described in our report could significantly impact the Y-12 proposal, as well as other sites that are actively considering similar arrangements, and should be fully considered and resolved by management before the proposed transaction is finalized. Should NNSA conclude that there is a mission need and elect to move forward with the BWXT proposal, we recommend that the Associate Administrator for Management and Administration, National Nuclear Security Administration:

1. In conjunction with the Chief Financial Officer, General Counsel and program officials, review all relevant documentation to ensure that the proposed financing arrangement should be accounted for as an operating lease.

If based on the recommended review, the financing arrangement is considered to be a capital lease, we recommend that the Associate Administrator for Management and Administration, National Nuclear Security Administration:

2. Enter discussions with OMB to allow the transaction to be structured in such a way that full funding of asset acquisition would not be required, such as the method being pursued under the GSA pilot program.

We recommend that the Manager, Y-12 Site Office:

3. Perform a security analysis to address potential security risks should the assets become available for public or private sector use in the future.

Finally, we recommend that the Associate Administrator for Management and Administration, National Nuclear Security Administration:

4. Develop comprehensive guidance regarding the development of alternative financing arrangements to acquire capital assets.

MANAGEMENT REACTION

NNSA's Associate Administrator for Management and Administration agreed with the report and concurred with our recommendations. However, management also made a number of observations that indicated it did not fully agree with our conclusion and recommendation regarding the need for a security analysis.

Management agreed with our first recommendation and stated that it would review all relevant documents. Management also stated it had consulted with the Office of General Counsel and had obtained its concurrence that the loan agreement between the private entities does not affect the structure of the alternative financing arrangement as an operating lease because the Government is not a party to the loan agreement.

Although NNSA concurred with the second recommendation, it believed the proposed financing structure meets OMB's requirements for an operating lease. However, if the lease is subsequently determined to be capital, management plans to pursue various options to fund the facilities, one of which may be discussions with the appropriate Federal agencies regarding the GSA pilot program.

For the third recommendation, NNSA acknowledged that no formal security analysis had been performed. However, management reported that based on various discussions, present operations, and site redevelopment plans, it did not believe that a formal security analysis was required at this time. In addition, management believed that it would be unlikely for the facilities to become available for public or private sector use in the future.

Finally, management concurred with the fourth recommendation. Management indicated that it had been working with the Office of Engineering and Construction Management and General Counsel to develop capital asset alternative financing guidance.

AUDITOR COMMENTS

We consider management's comments to be responsive to our recommendations, except for the recommendation regarding the need for a formal security analysis. Although we acknowledge that discussions have been held with certain security organizations, our recommendation for a formal security analysis is necessary to ensure that a disciplined and documented approach has been followed in identifying and mitigating potential security vulnerabilities posed by the proximity of commercial office space to the Department's secured areas at the Y-12 site.

OBJECTIVE

The objective of the audit was to determine whether BWXT's proposed alternative financing arrangement for new office and support facilities is in the best security and financial interests of NNSA.

SCOPE

The audit was performed from October 2004 to January 2005, at the Y-12 National Security Complex in Oak Ridge, Tennessee. The audit included a review of BWXT's alternative financing proposal for new administrative and technical support facilities.

METHODOLOGY

To accomplish the audit objective, we:

- Reviewed BWXT's alternative financing business proposal including the proposed deed and lease terms;
- Reviewed the Department's current laws and regulations pertaining to conveying land and accounting for operating leases; and,
- Interviewed personnel from:

  Y-12 National Security Complex;
  Oak Ridge Operations Office;
  Albuquerque Service Center;
  Sandia National Laboratories;
  Office of Engineering Construction and Management;
  Office of Management and Budget;
  General Services Administration; and,
  Government Accountability Office.

The audit was performed in accordance with generally accepted Government auditing standards for performance audits and included tests for compliance with laws and regulations to the extent necessary to satisfy the audit objective. However, as mentioned previously, alternative financing is a relatively new concept within NNSA. Accordingly, the audit focused on BWXT's alternative financing proposal for new administrative and technical support facilities. 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. As part of our review, we also evaluated the Department's implementation of the *Government Performance and Results Act of 1993*. We found that NNSA had not established specific performance objectives related to BWXT's alternative financing proposal. We did not rely on computer-processed data to support our analyses.

We held an exit conference with Management on February 24, 2005.

RELATED AUDIT REPORTS

Office of Inspector General

- Audit of the *Disposition of the Department's Excess Facilities* (DOE/IG-0550, April 2002). The audit found that the performance of the Department's program to dispose of excess facilities was not fully satisfactory. Facility disposition activities were not prioritized to balance mission requirements, reduce risks, and minimize life-cycle costs.

- Audit of *Sale of Land at Oak Ridge* (DOE/IG-0502, May 2001). This audit found that the Department inappropriately conveyed land without adhering to standard Federal practices. 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 *Land Conveyance and Transfer at Los Alamos National Laboratory* (DOE/IG-0469, April 2000). The audit found that for the ten tracts of land identified for conveyance and transfer at Los Alamos, the Department validated the environmental restoration and remediation cost estimates but did not validate the cost estimates associated with landlord activities. As a result, the Department had no assurance that the proposed costs for landlord activities reflect the costs to convey and transfer the land at Los Alamos.

- Audit of the *U.S. Department of Energy's Identification and Disposal of Nonessential Land* (DOE/IG-0399, January 1997). 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. The Department sometimes declared parcels of nonessential land to be excess and sold the parcels to local entities at the appraised value using the authority granted by the Atomic Energy Act.

- Audit of *Sale of Land to an Oak Ridge Hospital* (ER-L-99-01, November 1998). This audit questioned whether it was in the Government's best interest for the Department to use proceeds from the sale of Federal property to augment appropriations.

Government Accountability Office (GAO)

- *Alternative Approaches to Finance Federal Capital - Budget Services* (GAO-03-1011, August 2003). The report identified 10 capital financing approaches that have been used by one or more of 13 Federal agencies. As GAO has reported in the past, from a Government-wide perspective, the costs associated with these financing approaches may be greater than with full, up-front budget authority.

- *Budget Scoring Affects Some Lease Terms but Full Extent Is Uncertain - Budget Scoring* (GAO-01-929, August 2001). The report states that the way in which budget-scoring rules were implemented affected the lease or lease project term of at least 13 Federal agency leases. According to General Services Administration (GSA) officials, budget-scoring rules are affecting an unknown number of leases. The budget-scoring rules have the effect of favoring leasing and one option for scorekeeping that could be considered would be to recognize that many operating leases are used for long-term needs and should be treated on the same basis as purchases or construction.

- *Space Acquisition Economic Analyses* (GAO/GGD-99-49R, March 1999). The report found that although construction was almost always estimated by GSA to be the least costly approach for meeting long-term space needs, it was not always the approach proposed. The major non-economic factor identified that affected the acquisition decision was the budget scorekeeping rules that require the budget authority for the entire cost of acquiring an asset by construction, lease-purchase, or capital lease to be recorded in the budget when the acquisition is approved.

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