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

Audit Report

Idaho National Engineering and Environmental Laboratory's Strategic Initiative Fund

DOE/IG-0601

May 2003

Department of Energy

Washington, DC 20585

May 27, 2003

MEMORANDUM FOR THE SECRETARY

FROM: Greg Friedman
Gregory H. Friedman
Inspector General

SUBJECT: INFORMATION: Audit Report on "Idaho National Engineering and Environmental Laboratory's Strategic Initiative Fund"

BACKGROUND

In Fiscal Year 2000, the Idaho National Engineering and Environmental Laboratory (INEEL) established a Strategic Initiative Fund to pursue mission development opportunities by marketing its research, development, and engineering expertise to potential customers both within and external to the Department of Energy. The fund is financed through an indirect cost allocation assessed on all INEEL direct-funded programs. Major programs subject to this allocation include Environmental Management; Nuclear Energy, Science and Technology; National Security; and, work for others. INEEL, which is operated by Bechtel BWXT Idaho, LLC (Bechtel), spent about $23.7 million on the fund between 2000 and 2002.

The objective of this audit was to determine whether INEEL's use and distribution of costs associated with the Strategic Initiative Fund were appropriate.

RESULTS OF AUDIT

We found that, in the absence of more specific guidance, Bechtel had used the Strategic Initiative Fund for questionable purposes. Specifically, the fund had been used to:

- Supplement the Laboratory Directed Research and Development (LDRD) Program;

- Pay for activities that should have been funded directly by program offices; and,

- Pay for activities, such as advertising and marketing, that did not directly support INEEL's primary missions.

Further, the audit disclosed that the major programs providing funding to the Strategic Initiative Fund did not receive benefits commensurate with their contributions. For example, in 2002, Environmental Management contributed 68 percent of total funding, but received only 17 percent of the benefits.

In contrast, INEEL's other major program areas, including Nuclear Energy, National Security, and Science, all received far greater benefit from the fund than the amount of their contributions. Regarding the use of Environmental Management funds, the audit findings were especially troubling given the Department's emphasis on maximizing the efficiency and effectiveness of its environmental remediation program. In our view, any diversion of funds for other indirect or essentially unrelated purposes undermines this objective. In our judgment, the $24 million spent through the INEEL Strategic Initiative Fund between 2000 and 2002 could have been used more effectively by the sponsoring program offices to meet mission requirements.

We recommended that the Acting Chief Financial Officer, in coordination with the Under Secretary for Energy, Science and Environment, develop and implement policies and procedures to prohibit the use of mission development activities to supplement LDRD funds. We also recommended that the Manager, Idaho Operations Office, take steps to clarify the terms of Bechtel's contract as it pertains to mission development activities.

The issues addressed in this report, as well as the related policy implications, may affect other major Department sites with similar business development activities. In particular, the cost allocation issue is likely to arise at the many Department of Energy sites with ongoing Environmental Management missions.

MANAGEMENT REACTION

The Acting Chief Financial Officer did not concur with the audit finding and recommendations. His response stated that the contracting officer had deemed the costs questioned in the report to be allowable. However, the response indicated that management agreed to review Strategic Initiative Fund uses to ensure the fund is used appropriately, and that LDRD funds are not being augmented. Based on results of the review, clarifying guidance will be issued to other offices. In addition, the Idaho Operations Office agreed to clarify the terms of the Bechtel contract pertaining to mission development activities. Management's written comments are included in their entirety as Appendix 3.

Management's review of the uses of the Strategic Initiative Fund is a positive step forward. However, the examples cited in this report suggest to us that a Department-wide policy is needed to define appropriate uses of mission development funds and to prohibit the use of advertising, marketing, and direct selling activities to attract new customers for local projects and programs.

Attachment

cc: Deputy Secretary
Under Secretary for Energy, Science and Environment
Assistant Secretary for Environmental Management
Director, Office of Nuclear Energy, Science and Technology
Director, Office of Management, Budget and Evaluation/Chief Financial Officer
Manager, Idaho Operations Office

IDAHO NATIONAL ENGINEERING AND ENVIRONMENTAL LABORATORY'S STRATEGIC INITIATIVE FUND

TABLE OF CONTENTS

Strategic Initiative Fund

We found that Bechtel BWXT Idaho, LLC (Bechtel) used the Strategic Initiative Fund to supplement the Laboratory Directed Research and Development (LDRD) Program; pay for activities that should have been direct funded; and, pay for questionable activities such as advertising, marketing, and direct selling, that did not directly benefit the site's predominant activity, environmental cleanup efforts. Also, the associated costs were not appropriately allocated to benefiting programs.

LDRD Augmentation

Department Order 413.2A, *Laboratory Directed Research and Development*, defines how LDRD funds are to be used and provides annual funding limitations. One requirement in the order is that non-LDRD funds should not be used to supplement LDRD initiatives. Bechtel, however, in an approach that appears inconsistent with this policy, specifically requires program offices to demonstrate how the Strategic Initiative Fund will be integrated with the program's LDRD activities. In this regard, we identified several instances in which the Strategic Initiative Fund was used to augment LDRD funds to accomplish the technical goals of specific LDRD projects. For example:

- Two INEEL employees traveled to St. Petersburg, Russia in April 2002 for work related to an ongoing LDRD project. The LDRD fund was charged $9,728 for the cost of one employee, and the Strategic Initiative Fund was charged $6,701 for the cost of the other employee. According to management, it is appropriate to allocate the costs of a trip if both LDRD and business development activities are pursued, as occurred in this case. While we agree this is appropriate, evidence reviewed indicated that the employee's activities were centered on technical considerations, such as projected waste streams and potential design configurations for a pilot system being constructed at the INEEL. Further, upon returning, the employees submitted identical trip reports detailing the technical aspects of the research and development work with no mention of mission development.

- The Subsurface Science Initiative budgeted $1 million of Strategic Initiative Funds in FY 2002 for "…sponsoring LDRD projects that meet the technical objectives of the initiative, and enhance INEEL's R&D infrastructure through the acquisition of research equipment, and the design and construction of research laboratories." The objectives of the Subsurface Science Initiative are to enhance the INEEL's scientific and engineering capabilities and to provide better options for cleanup, monitoring, and long-term stewardship of contaminated sites.

- An INEEL scientist traveled to Torres del Paine National Park in Chile during May 2001 to conduct pollutant and nutrient cycling research. The travel package stated "The primary objective of this trip was to collect a series of moss, forest litter, and soil samples at a long-term research site we established at the Park in 1984." The Strategic Initiative Fund was charged $4,848 and the LDRD fund was charged $159 for the trip. Again, management stated that both LDRD and business development opportunities were explored on this trip. While business development may have been pursued, we found that the principle purpose of the trip was technical research in nature. In fact, 7 of the 8 objectives of the trip were technical research oriented. The business development objective stated "plans will be discussed for developing and submitting proposals for external funding to continue the research…" The auditors concluded that since the large majority of the trip was to support the LDRD project, the LDRD project should have paid the large majority of the costs. However, as it happened, the Strategic Initiative Fund paid for 97 percent of the costs.

According to Bechtel management, LDRD and business development funds, while separate in purpose, are aligned to achieve specific laboratory strategic priorities. Management stated that certain LDRD projects and the Strategic Initiative Fund share the same goal, at a strategic level, and thus, use generic scope of work. Bechtel management further stated that the Strategic Initiative Fund does not augment LDRD; rather, it is used only for mission development activities. However, based on the documentation provided to us, we concluded that the Strategic Initiative Fund has been used, as the cited examples illustrate, to directly support activities that center on technical LDRD activities.

Direct Funding

The Federal Acquisition Regulation (FAR) requires that any cost that can be identified specifically with a final cost objective shall be directly charged to that objective. We identified instances, however, in which the Strategic Initiative Fund paid for activities that, based on the work performed, directly benefited a specific program or project. For example:

- INEEL paid $755,000 for "roadmapping" of a Nuclear Energy project from the Strategic Initiative Fund in FYs 2001 and 2002. In contrast, a similar roadmapping project INEEL performed for the Office of Environmental Management (EM) was paid directly from EM funds.

- In July and August 2002, an INEEL employee traveled to Beijing, China to attend a conference at Nuclear Energy's request, at a cost of $7,027. Rather than charging the employee's travel and labor costs directly to a Nuclear Energy−funded project, Bechtel charged the cost to the Strategic Initiative Fund.

Bechtel management stated that the goal of the roadmapping activities was to acquire direct funding for these activities. In order to acquire the funding, they had to demonstrate that INEEL had the technical capability to effectively perform the work. In addition, the trip was appropriate since there were mission development opportunities in establishing international relationships with Chinese scientists. However, in our view, these activities should have been directly funded by the benefiting program as required by the applicable acquisition regulation.

Marketing Activities

Additionally, Bechtel used the Strategic Initiative Fund to pay for certain marketing and advertising activities. Such activities, while allowable under the terms of the contract, do not directly contribute to the site's predominant activity, environmental cleanup. For example, the fund was used to prepare a "site tour CD" and a "technical capabilities CD" for marketing purposes. Presumably, the intent of these CDs was to familiarize potential customers with the INEEL's products, services, and service capabilities.

Bechtel management stated that using the Strategic Initiative Fund for marketing purposes is appropriate since Bechtel is required by its contract to enhance the capabilities of the INEEL. The Department, in responding to the official draft report, stated that the prohibition against such costs typically apply to advertising, marketing, and direct selling costs associated with the corporate entity (Bechtel), not those of the Departmental entity (INEEL). For example, with respect to advertising costs, such costs may be allowable where the primary purpose of the activity is to facilitate contract performance in support of the Department's mission. Further, management stated that the costs associated with the Strategic Initiative Fund were reasonable in amount and were not costs incurred to promote Bechtel's interest, but rather to promote INEEL.

We recognize that contractors are allowed to incur advertising, marketing, or direct selling costs in certain situations where the primary purpose of the activity is to support the Department's mission or where specifically required for contract performance. However, given the scale of environmental cleanup work ongoing at INEEL, we question whether using cleanup funds for these purposes is in the Department's best interest. In our judgment, additional Department policy on mission development costs is needed to help determine whether these costs are reasonable.

Allocation of Costs

We also questioned the method by which Bechtel allocated costs to program offices to operate the Strategic Initiative Fund. Specifically, the audit questions Bechtel's inclusion of the fund as part of the general and administrative (G&A) expense pool, which is funded through an indirect cost recovery process. According to Cost Accounting Standards, expenses included in the G&A pool should benefit multiple final cost objectives and be administratively impractical to assign the costs directly. Further, indirect allocation of the costs should result in roughly the same allocation as if the costs had been assigned directly to benefiting cost objectives.

However, our audit found that Strategic Initiative Fund costs were easily identifiable to the benefiting programs, and programs funding the Strategic Initiative Fund did not receive benefits in roughly the same proportion as their contributions. In Fiscal Year 2002, the Strategic Initiative Fund was spent on 13 separate initiatives or divisions. Examples of these initiatives include the Generation IV Nuclear Energy Systems Initiative and the Environmental Stewardship Initiative. Funds spent on these activities can easily be assigned to benefiting programs. Rather than assigning these costs to benefiting programs, however, the costs were distributed to all programs through the G&A account.

As a result, contributions of funds by programs to the G&A expense pool were not proportional to the benefits received. For example, in Fiscal Year 2002, EM contributed 68 percent of the cost but received only 17 percent of the benefits. Conversely, National Security programs contributed about 2 percent of the cost and received 29 percent of the benefits. A comparison of funds contributed and funds used to benefit each major sponsor in FY 2002 follows:

<u>Source and Use of the Strategic Initiative Fund in Fiscal Year 2002</u>

Program Sponsor	Source of Funds		Use of Funds	
EM	$6,165,500	68%	$1,505,000	17%
National Security	168,800	2%	2,590,000	29%
EE/RE/SC/FE	225,100	2%	1,814,500	20%
Nuclear Energy	879,200	10%	1,925,000	21%
Work for Others	1,265,600	14%	0	0%
Other	322,700	4%	1,192,400	13%
TOTAL	$9,026,900	100%	$9,026,900	100%

Based on the amount contributed and benefits received, as shown above, EM spent about $4.6 million to, in essence, subsidize mission development activities for other INEEL program offices. We found similar results for FY 2001.

Management stated that it was more appropriate to include the Strategic Initiative Fund with the G&A pool because it benefited the entire site. However, we take issue with this position. These costs, in accordance with applicable cost accounting standards, should be allocated at the lowest level where the cost/benefit relationship exists, in this case directly to the benefiting program.

Department Guidance

We also found that the Department did not have adequate policies and procedures to control mission development activities, and that Bechtel's contract was unclear as to the allowability of advertising, marketing, and direct selling expenses.

The lack of Department policy governing the establishment and use of mission development funds and activities was recognized in 2000, when Congress directed the Department to conduct a review of overhead expenditures at its sites, including INEEL. Among other things, the review highlighted $7.6 million of program/business development costs at INEEL as an area where spending guidance may be needed and where direct funding would improve accountability. Specifically, the review concluded that "…while costs appear to be allowable under current contract terms and agreements, additional guidance would be helpful so that [Department] staff can readily determine that the levels and types of spending for such activities are reasonable; and rather than have some activities funded through overhead, more accountability could be provided if they were funded through a [Department] direct program." Despite the conclusions reached in this review, the Department had not created policies and procedures that defined limits for mission development activities.

In the absence of Department policy, Bechtel established informal guidelines as to how the Strategic Initiative Fund should be used. Based on our review of these guidelines and our discussions with management, we concluded that Bechtel considers it appropriate to use the fund for any costs as long as it can demonstrate a potential business development opportunity. As noted in the examples we cited, however, Bechtel's approach does not always ensure that the use of the fund is consistent with sound business practices.

Questioned Costs

In our opinion, the $24 million spent on the Strategic Initiative Fund between FY 2000 and FY 2002 could have been used more effectively by the sponsoring program offices to meet mission requirements. Also, some or all of the $24 million spent on fund activities appear questionable according to contract terms and the FAR. Finally, it appears that INEEL exceeded its LDRD administrative limit of $23.5 million for FY 2001 and $21 million in FY 2002 by augmenting its LDRD funds with expenditures charged to the Strategic Initiative Fund.

RECOMMENDATIONS

We recommend that the Acting Chief Financial Officer, in coordination with the Under Secretary for Energy, Science and Environment:

1. Perform a review of Bechtel's use of its Strategic Initiative Fund to determine (a) whether LDRD ceilings have been exceeded; and, (b) whether other Department contractors are employing similar overhead allocations; and,

2. Develop and implement policies and procedures for mission development activities prohibiting the use of mission development funds or other indirect cost pools to supplement existing LDRD funds.

In addition, we recommend that the Manager, Idaho Operations Office, clarify the terms of the Bechtel contract that address costs commonly used in mission development, such as advertising, marketing, and selling costs.

MANAGEMENT REACTION

The Acting Chief Financial Officer generally did not concur with the audit finding and recommendations, stating that the audit's supporting arguments were inconclusive. In response to recommendation 1(a), management's response stated that the contracting officer deemed the costs questioned in the report allowable. With regard to recommendation 2, management stated that any new prohibitions would be duplicative of policies that already exist. However, management did agree with recommendation 1(b) to review the Strategic Initiative Fund's uses to ensure the fund is used appropriately and LDRD funds are not being augmented. Based on results of the review, clarifying guidance will be issued to other offices. In addition, the Idaho Operations Office agreed to clarify the terms of the Bechtel contract pertaining to mission development activities. We have included management's written comments in their entirety as Appendix 3.

AUDITOR COMMENTS

In our view, a final determination of the appropriateness of Strategic Initiative Fund expenditures should not be made until the Department completes a thorough, independent review of fund uses. Further, the examples cited in this report suggest that a Department-wide policy is needed to define appropriate uses of mission development funds and to prohibit the use of advertising, marketing, and direct selling activities to attract new customers for local projects and programs.

PRIOR REPORTS

- *Research and Development at Lawrence Livermore National Laboratory,* (DOE/IG-0511, July 2001). The audit concluded that the Laboratory performed Research and Development (R&D) that was not authorized by the Department. For Fiscal Years (FY) 1998 through 2000, the audit identified 194 projects that involved R&D for which there was no contractual authority to do the work. Laboratory management circumvented the work authorization process by funding the R&D through overhead accounts. The audit recommended that the Laboratory discontinue unauthorized R&D, establish procedures to prevent overhead accounts from being used to fund unauthorized R&D, submit a description of all technical activities to be funded from overhead accounts, and reimburse the Department for the cost of unauthorized R&D.

- *Better Performance Reporting Could Aid Oversight of Laboratory-Directed R&D Program,* (GAO-01-927, September 2001). Since FY 1992, the Department's multi-program national laboratories have spent over $2 billion on LDRD projects. All LDRD projects reviewed at the five laboratories met the Department's guidelines for selection. In addition, each of the five laboratories had created the internal controls necessary to reasonably ensure compliance with the Department's guidelines. The audit recommended improved performance information reporting for the LDRD program.

- *Management of Laboratory Directed Research and Development at the National Renewable Energy Laboratory,* (WR-B-99-05, July 12, 1999). The National Renewable Energy Laboratory (NREL) funded 21 unqualified projects as LDRD and spent about $2.5 million on projects that did not meet the requirements of the Department's LDRD Program. In addition, NREL did not properly account for some LDRD costs, and some projects incurred questionable housing allowance costs.

- *Management of the Laboratory Directed Research and Development Program at the Lawrence Livermore National Laboratory*, (CR-B-98-02, November 14, 1997). Actions taken in FYs 1996 and 1997 by the Department and Lawrence Livermore National Laboratory increased the level of discretionary research work conducted at Livermore by an equivalent of $19 million. This increased level of discretionary research was primarily obtained by: removing G&A allocations from LDRD projects; using performance fee revenues and licensing and royalty income for discretionary research; and assessing a 6 percent LDRD surcharge on intra-Departmental requisition orders from other Department laboratories.

OBJECTIVE

The objective of this audit was to determine whether the Idaho National Engineering and Environmental Laboratory's (INEEL) use of and distribution of costs associated with the Strategic Initiative Fund were appropriate.

SCOPE

The audit was performed from October 21, 2002, to January 31, 2003, at the Idaho Operations Office and Bechtel BWXT Idaho, LLC (Bechtel) in Idaho Falls, Idaho. The audit scope was limited to the activities of the Strategic Initiative Fund from Fiscal Years 2000 through 2002.

METHODOLOGY

To accomplish the audit objective, we:

- Interviewed Idaho Operations Office and Bechtel personnel responsible for the Strategic Initiative Fund and the Laboratory Directed Research and Development (LDRD) Program;

- Reviewed foreign travel paid from the Strategic Initiative Fund and the LDRD Fund for Fiscal Years 2001 and 2002;

- Obtained and reviewed planning documents for the Strategic Initiative Fund;

- Researched Federal and Departmental regulations related to LDRD and mission development activities;

- Reviewed findings from prior audit reports regarding LDRD and mission development activities; and,

- Assessed internal controls and performance measures established under the Government Performance and Results Act of 1993.

The audit was performed 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. Specifically, we tested controls with respect to allocating Strategic Initiative Fund costs at the INEEL. 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. We relied on the contractor's automated cost accounting system to accomplish our audit objective and conducted tests to ensure reliability of the data.

We held an exit conference with the Team Leader, Accounting and Contract Finance Team, Office of Financial Policy and the Director, Financial Services Division, Idaho Operations Office on May 1, 2003.

Department of Energy
Washington, DC 20585

APR 17 2003

MEMORANDUM FOR DEPUTY ASSISTANT INSPECTOR GENERAL
FOR AUDIT SERVICES
OFFICE OF INSPECTOR GENERAL

FROM: James T. Campbell
JAMES T. CAMPBELL, ACTING DIRECTOR
OFFICE OF MANAGEMENT, BUDGET AND
EVALUATION/ACTING CHIEF FINANCIAL OFFICER

SUBJECT: Response to Draft Report on "Idaho National Engineering and Environmental Laboratory's Strategic Initiative Fund"

We have reviewed the subject report and provide the following comments:

General. While the report makes allegations of augmentation, payment of unallowable costs, and inappropriate allocation practices, its supporting arguments are rather inconclusive. For example, the report states that certain costs "appear questionable" and "could potentially be unallowable." Equally inconclusive is the statement in the report that laboratory directed research and development (LDRD) ceilings "may have been exceeded." These uncertainties are further enhanced by the recommendations that the Chief Financial Officer perform a review to determine the allowability of costs incurred and whether the LDRD ceilings have been exceeded.

Reference: Page 3, Potentially Unallowable Activities. The narrative recognizes that certain types of advertising, marketing, and direct selling costs are generally unallowable under Government contracts and then proceeds to provide a number of examples identified under the audit. The prohibition against such costs under the applicable cost principle typically apply to advertising, marketing, and direct selling costs associated with the specific company, that is Bechtel as a corporation, and not as the DOE entity of INEEL. In support of this view, the regulations generally provide that such costs are unallowable to the extent that the terms and conditions of the contract do not provide for their allowability. For example, with respect to advertising costs, such costs may be allowable where primary purpose of the activity is to facilitate contract performance in support of the DOE mission (see Clause I.25, paragraph (e)(1)). The allowability of selling costs is to be determined on the reasonable benefit to the agency program (see Clause I.25, paragraph (e)(22)). It seems clear, in any case, that the costs associated with the SIF were not costs incurred to promote Bechtel's parochial interests, but rather to promote DOE INEEL. Accordingly, we believe the accuracy of the report would be improved if these issues were addressed in more detail.

With regard to specific comments relating to the recommendations in the report, they are as follows:

Recommendation 1. Perform a review of Bechtel's use of the SIF to determine (a) allowability of costs incurred and whether LDRD ceilings have been exceeded; and (b) whether other Department contractors are employing similar overhead allocations.

Response:

Partial Concurrence. The contracting officer with oversight responsibility for the Bechtel contract has indicated that the costs questioned by the auditors are allowable. We have reviewed the applicable contract provisions and find no basis for a Headquarters review of the contracting officer's determination.

With regard to performing a review to determine whether LDRD ceilings have been exceeded, it appears, from the concerns raised in the report and the rebuttal from the Idaho Operations Office, that the line of distinction between the uses of these funds needs to be clearly drawn. We will work with the Idaho Operations Office to ensure that LDRD funds are not being augmented and that an appropriate use of the SIF is clearly identified.

With regard to Idaho's allocation practice related to the SIF, the main issue is whether the SIF should be included in the general and administrative (G&A) cost pool. The report suggests that it should be excluded while Idaho suggests that its purpose is for the benefit of the entire site. We will review this issue. If it is determined that it is appropriate to include the SIF in the G&A cost pool, it is understood that actual G&A rate charges incurred during the year of execution are likely to reveal that one program may have received a benefit higher or less than the contribution made. This is likely whether the cost element is the SIF or costs incurred by the legal office. The Cost Accounting Standards (CAS) recognize this reality by requiring that the G&A cost pool, in the aggregate, not at the cost element level, reflect a causal/beneficial relationship. Also, CAS allows costs that are not G&A expenses and are insignificant in amount to be included in the G&A cost pool. Idaho's annual SIF activity amounts to about one percent of Bechtel's budget.

Recommendation 1b. Perform a review of Bechtel's use of its Strategic Initiative Fund to determine whether other Department contractors are employing similar overhead allocations.

Response:

Agree in principle. Based on results of the review at Idaho, clarifying guidance will be issued to other offices.

Recommendation 2. Develop and implement policies and procedures for mission development activities prohibiting the use of mission development funds or other indirect cost pools to supplement existing LDRD funds.

Response:

Partial Concurrence. DOE Order 413.2A, Laboratory Directed Research and Development, already prohibits the augmentation of LDRD funds. Any issuance of new prohibitions would be merely a duplication of policy already in existence. As previously indicated, we will review the SIF to determine the best way to ensure that a distinction between the two funds can be clearly identified. Any new policies developed from this effort will reinforce the aforementioned prohibition and be applicable to all DOE facilities conducting SIF or similar-type activities and apply prospectively to the contractors involved.

Recommendation 3. Require the Idaho Operations Office to clarify the terms of the Bechtel contract that address costs commonly used in mission development, such as advertising, marketing, and selling costs.

Response:

Concur. The Idaho Operations Office has agreed with making clarity improvements to the contract. Therefore, this recommendation should be directed to the Idaho Operations Office.

With regard to the above actions to be taken, corrective action plans will be developed upon receipt of the final report. Should your staff have any questions regarding this memorandum, please have them contact Robert Myers, Team Leader, Accounting and Contract Finance Team, Office of Financial Policy, at (202) 586-8609.

IG Report No.: DOE/IG-0601

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