

DOE/IG-0427

AUDIT
REPORT

THE
U.S. DEPARTMENT OF ENERGY'S
PRIME CONTRACTOR FEES ON
SUBCONTRACTOR COSTS



SEPTEMBER 1998

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

September 11, 1998

MEMORANDUM FOR THE SECRETARY

FROM: Gregory H. Friedman
Acting Inspector General

SUBJECT: INFORMATION: Audit Report on "The U.S. Department of Energy's
Prime Contractor Fees on Subcontractor Costs"

BACKGROUND

In Fiscal Year 1996, the Department's prime contractors awarded \$5.3 billion in subcontracts. The purpose of this audit was to determine if the Department adjusted the fee bases of prime contractors to reflect the actual effort necessary to manage the technical and administrative activities of their subcontractors.

RESULTS OF AUDIT

The Department included a majority of subcontractor costs in the fee bases of many for-profit contractors even though subcontractor efforts did not require significant oversight or management by the prime contractor. In effect, both prime contractors and their subcontractors received fees for the same effort. The Department had not developed specific policies and procedures to define subcontractor costs that should be excluded from prime contractor fee bases. For 12 prime contractors audited, fees in a one-year period increased by an estimated \$34 million because fee bases were not adjusted. We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management (1) issue specific guidance to the Department's procurement offices identifying the types of and extent to which subcontractor costs may be included in prime contractor fee bases and (2) review, as part of a Procurement and Assistance Management quality assurance mechanism, subcontractor costs analyses performed to ensure fee policy is implemented.

MANAGEMENT REACTION

Management did not take exception to the audit finding and recommendations, but stated that the Department should not remove all or even the majority of subcontractor costs from the prime contractors' fee bases. Management suggested that the new Departmental fee policy which limits subcontracted costs to be included in prime contractors' fee bases to 80 percent was appropriate. We concluded that while the 80 percent ceiling may be a positive first step, more aggressive policies are needed. The report includes greater detail on the position expressed by management and on the Office of Inspector General's response.

Attachment

cc: Deputy Secretary
Under Secretary

The U.S. Department of Energy's Prime Contractor Fees On Subcontractor Costs

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Overview

INTRODUCTION AND OBJECTIVE

The U.S. Department of Energy (DOE) uses prime contractors to manage and operate its major facilities. These prime contractors obtain assistance from subcontractors to achieve the Department's objectives and missions. In Fiscal Year 1996, these prime contractors awarded \$5.3 billion in subcontracts.

In 1994, a Contract Reform Team recommended changes in contracting practices. One objective of contract reform--obtain quality performance at the least cost--was applicable to the subcontracting practices of the Department's prime contractors. This cost reduction objective resulted in policy changes that have been incorporated into the Department's Acquisition Regulations. Under the Acquisition Regulations, prime contractors are expected to subcontract work when it is cost effective and/or more efficient to do so.

The Regulations allow payment of a fee to DOE for-profit prime contractors based on factors such as the difficulty of work and level of required skills. In order to determine a prime contractor's fee, an evaluation of the contractor's total budget is to be made. Specific cost items that may distort technical and management effort actually required of the contractor are to be excluded from the total budget to arrive at a fee base. Available fee is then determined by applying the fee base to schedules specified in the Acquisition Regulations.

Subcontractor costs are among the items that should be excluded from the fee base to the extent that such costs distort a prime contractor's technical and management effort. The determination of subcontractor costs excluded from a prime contractor's fee base is made by individual procurement offices within the Department. The Office of Inspector General has issued prior reports on subcontractor costs. For example, one report found that the Department had significantly increased subcontractor costs included in a prime contractor's fee base, resulting in the Department paying two full fees for the same work. These reports are summarized in Appendix 2.

The objective of this audit was to determine if the Department adjusts the fee base of prime contractors in accordance with the technical and management effort actually required of the contractor.

CONCLUSIONS AND OBSERVATIONS

The Department did not adjust the fee bases of prime contractors to reflect actual managerial and technical effort associated with the oversight of

Adjustment of Fee Bases

Effort Distorted By Inclusion Of Subcontractor Costs

In Fiscal Year 1996, the Department included a majority of subcontractor costs in the fee base of its for-profit contractors. A detailed analysis of 12 prime contracts indicated that 8 included 100 percent of subcontractor costs in the fee base. Another contract included 90 percent of the subcontract costs. In total, 36 percent (or \$1.4 billion) of the prime contractors' fee bases were comprised of subcontractor costs. The following table illustrates the subcontractor costs that were included in the fee bases of the 12 contracts.

SUBCONTRACTOR COSTS INCLUDED IN FEE BASES

<u>Number of Contracts Reviewed</u>	<u>Percent of Subcontractor Costs in Fee Bases</u>	<u>Fee Base</u>	<u>Total Subcontractor Costs</u>
8	100	\$2,297,313,337	\$1,113,624,277
1	90	198,927,010	155,056,500
1	59	1,201,829,000	83,065,000
<u>2</u>	<u>0</u>	<u>72,297,276</u>	<u>0</u>
<u>12</u>		<u>\$3,770,366,623</u>	<u>\$1,351,745,777</u>

Discussions with field personnel indicated that there were four additional DOE prime contracts in which 100 percent of subcontractor costs were included in the fee bases. However, since procurement officials were not able to provide data on specific subcontract costs included in the fee bases for these four contracts, they were not included as part of our analysis.

The following examples illustrate the extent to which individual prime contractor fee bases were enhanced by the inclusion of subcontractor costs:

-
- Lockheed Idaho Technologies Company (LITCO) is responsible for managing and operating the Idaho National Engineering Laboratory. LITCO's fee base for Fiscal Year 1996 was \$638 million. Subcontractor costs of \$240 million were included in LITCO's fee base.
 - Allied Signal Inc. Kansas City Division (Allied) is responsible for the management, operation, maintenance, and support of the Department's Kansas City Plant. Allied's fee base for Fiscal Year 1996 totaled \$317 million. Ninety million dollars in subcontractor costs were included in Allied's fee base.

In some cases, the subcontractor efforts did not require significant oversight or management by the prime contractor. The use of fixed-price contracts and special restrictions placed on the prime contractor limited the involvement of the prime contractor in the management of the subcontract activities.

For example, in 1994, the Department's Contract Reform Team recommended the use of fixed-price contracts for routine, repetitive services. The report emphasized that fixed-price contracts place full performance risk on the contractor and that they typically do not entail the level of administrative oversight related to cost-reimbursement contracting. Federal Acquisition Regulation, Subpart 16.202-1, describes a fixed-price contract as one that "imposes a minimum administrative burden upon the contracting parties." According to a 1997 DOE self-assessment, fixed-price contracting was being used with increased frequency. In fact, one prime contractor included in the audit utilized fixed-price arrangements for 98 percent of its subcontracts. Despite the decreased burden of managing fixed-price contracts, the Department included 100 percent of subcontractor costs in many prime contractors' fee bases.

In another case, restrictions were placed on the prime contractor's ability to manage subcontract activity. Sandia Corporation performed work under the TRW Environmental Safety Systems, Inc. (TRW) contract. However, our analysis led us to conclude that TRW had only a limited role in directing the work of the subcontractor. The audit disclosed that: (1) the Sandia Technical Program Officer was responsible for the oversight and integration of all Sandia program activities, including developing how Sandia work is to be done and developing performance measures; (2) TRW could not alter or impose any scientific

interpretation or analysis of data collected, analyzed, or otherwise interpreted by Sandia--if TRW disagreed, it could state its position to DOE under a separate document; and (3) records identified as protected by Sandia were not available to TRW. Further, Sandia had the authority to communicate directly with the Department. Based on these facts, it appeared that TRW's effort to administer the subcontract was minimal. Consequently, \$9 million in Fiscal Year 1996 costs for the Sandia work should have been excluded from TRW's fee base.

Subcontractor Costs Can Distort The Prime Contractors' Effort

DOE Acquisition Regulation (DEAR) 970.1509-6(b) states that a prime contractor's fee base should exclude any part of the estimated cost or price of subcontracts and other major procurements that are of such magnitude or nature as to distort the technical and management effort actually required of the contractor.

The DEAR defines a prime contractor's fee base as "an estimate of necessary allowable costs to which a fee factor has been applied to determine the maximum fee allowance." It further identifies specific cost items, such as subcontracts, that may distort the prime contractor's effort and should be excluded from estimated costs in the calculation of available fees. The practical effect of this provision suggests that prime contractor fee calculations be based on costs associated with the prime contractor's actual effort, not on costs associated with another entity.

Need For Specific Policy And Procedures

Most subcontractor costs were included in prime contractor fee bases because the Department had not developed specific policies and procedures. The Department had not provided contracting officials with definitive criteria to determine which subcontract costs should be included or excluded. Specifically, policies and procedures were not in place to analyze the propriety of prime contractor fees, and the DEAR did not define or explain "such magnitude or nature as to distort the technical and management effort actually required of the contractor."

We found varying interpretations of the existing DEAR provisions. For example, some contracting officials did not consider subcontractor costs when negotiating a contractor's fee base. In contrast, others were of the opinion that subcontractor costs are an integral part of prime contractor operations and should generally be included in the fee base. Another official stated his reason for including subcontracting costs is that the Department did not want the exclusion of subcontracting costs to become a disincentive to the cost effective operation of the site.

Documentation and support for the decisions made in some cases was insufficient. For example, one procurement official stated that 10 percent of the prime's subcontractor costs were excluded because it was past practice. Other officials were not able to identify subcontractor costs included or excluded from the prime contractor fee bases. One contracting official stated that he could not provide subcontractor cost amounts for Fiscal Year 1996 because the information was never obtained by the Department. The information, according to this official, would have to be provided by the previous contractor. In another situation, the Departmental pre-negotiation package that identified subcontractor exclusions was prepared by the contractor.

The Department has made some efforts to address this situation. At the completion of the fieldwork phase of this audit, these efforts had just been initiated. In April 1998, a proposed fee policy was drafted. It stated that up to 80 percent of subcontractor costs might be included in a contractor's fee calculation "if the contracting officer determines that there are unique circumstances involving extraordinary management effort required to manage subcontract activities." Although this provision does not correct situations where excessive subcontractor costs are included in prime contractor fee bases, it provides an upper limit of 80 percent of costs and implies that an evaluation of contractor management effort is required.

A Headquarters Procurement official agreed that the Department should not be including 100 percent of subcontractor costs in prime contractor fee bases. This official added that DOE field offices could misinterpret the upper limit of 80 percent as a minimum. This misinterpretation could result in automatically allowing 80 percent of subcontractor costs in prime contractor fee bases. He added that 80 percent is a guide, and a prime contractor fee base should only include that portion of subcontractor costs that reflect the prime's effort in managing subcontracts. He stated that his office intends to review subcontractor costs included in prime contractor fee bases because the Department needs to develop a prudent business approach to subcontracting.

Fees On Work Performed By Subcontractors

By including subcontractor costs in prime contractor fee bases, the Department is, in essence, paying two fees for the same effort. Subcontracting efforts are included in the prime contractor's fee base, plus each prime contractor pays its subcontractors a fee for the actual work performed. For example, TRW paid Sandia an estimated

\$131,000 fee on \$8.8 million of work in Fiscal Year 1996. TRW earned about \$188,000 in fee for the same work. In addition, prime contractors are reimbursed for the costs associated with the administration and oversight of subcontractors.

The 12 prime contractors included in this review received an estimated \$34 million in fees for subcontractor costs during a one-year period. In the LITCO example illustrated on Page 4, including subcontractor costs in the fee base resulted in an earned fee of \$20.3 million in Fiscal Year 1996. Excluding subcontractor costs from the fee calculation would have resulted in an earned fee of \$12.4 million--a reduction of 39 percent. In the Allied example, the inclusion of subcontractor costs in the fee base resulted in an earned fee of \$19.3 million. Excluding the costs would have resulted in a fee earned of \$15.8 million--a reduction of 18 percent.

RECOMMENDATIONS

We recommend that the Deputy Assistant Secretary for Procurement and Assistance Management:

1. Issue specific guidance to the Department's procurement offices identifying the types of and extent to which subcontractor costs may be included in prime contractor fee bases.
2. Review, as part of a Procurement and Assistance Management quality assurance mechanism, subcontractor cost analyses performed to ensure fee policy is implemented.

MANAGEMENT REACTION

By memorandum dated July 17, 1998, the Office of Contract and Resource Management commented on a draft of this report. A summary of management's comments follows. Appendix 3 contains management's verbatim comments.

Management did not support the conclusion that all or even a majority of subcontractor costs should be removed from a prime contractor's fee base, or that the inclusion of such costs contributes to fee growth. Management stated that DOE Acquisition Regulation 970 is a subjective measure. The composition of the fee base "...will depend upon many variables including any required involvement by the prime contractor in performing the work, providing value added to the subcontracted work,

or managing and integrating numerous subcontracts." Additionally, it will depend on the type of subcontract, complexity of effort, and prime contractor's fee risk.

Management proposed a revision to the fee policy (DEAR 970) in April 1998. In developing this new policy, management recognized that there might not be adequate adjustments to prime contractor fee bases. The revision stipulates that a prime contractor's fee base shall include no more than 80 percent of subcontracted costs based on the contracting officer's discretion and on an assessment of the distortion of subcontractor costs. Management intends to subject its revised fee policy guidance "to the same review process as is currently in place for the review of management and operating contract fee negotiations."

**AUDITOR
COMMENTS**

The Office of Inspector General did not conclude that all or even a majority of subcontractor costs should be removed from a prime contractor's fee base. Subcontract costs included in a prime contractor's fee base should relate directly to the prime contractor's effort and contribution to the successful accomplishment of the subcontract. Our review of prime contract negotiations revealed that analyses generally are not conducted to determine which subcontractor costs should be included in prime contractor fee bases. In addition, including all or most subcontractor costs in the prime contractor fee bases has been costly, especially in light of the fact that the prime contractors are already reimbursed by the Department for their subcontractor management efforts.

Management's proposed fee policy would provide an upper limit. In our judgment, however, it will not correct situations where excessive subcontractor costs are included in prime contractor fee bases. Management stated that contracting officers must make an assessment of the distortion of subcontractor costs. However, the proposed policy does not require, or provide guidance on, such an assessment. Specific guidance is needed to assist contracting officers in determining the type and extent to which subcontract costs should be included in prime contractor fee bases. Further, a quality assurance mechanism is needed to ensure that the fee policy is implemented.

Appendix 1

SCOPE

The audit was performed between March 1997 and March 1998 and focused on Fiscal Year 1996 data to determine if the Department adjusts the fee bases of prime contractors in accordance with the technical and management effort actually required of the contractor.

Site visits were made to (1) Allied Signal - Kansas City Plant in Kansas City, Missouri; (2) TRW, Inc. in Las Vegas, Nevada, and Vienna, Virginia; (3) Sandia National Laboratories in Albuquerque, New Mexico; and (4) Headquarters Procurement.

METHODOLOGY

To accomplish the audit objective, we obtained and reviewed applicable laws and regulations pertaining to earned fees on subcontracting efforts and related reports issued by the Office of Inspector General. Additionally, discussions were held with Departmental officials who provided information regarding subcontracting practices and costs and the inclusion of subcontractor costs in prime contractor fee bases.

The analysis of fees paid to prime contractors on subcontractor costs was performed by obtaining fee base categories and subcontractor costs in each category (production, research and development, etc.) from negotiation documentation. Fee earned was then equally weighted among each fee category and the earned fee on subcontractor costs was estimated.

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. We did not rely on computer-processed data to accomplish our audit objective.

Management waived an exit conference on this audit effort.

PRIOR OFFICE OF INSPECTOR GENERAL REPORTS

Prior OIG reviews related to subcontractor fee issues are:

- *Inspection of Westinghouse Savannah River Company Fees for Managing and Operating the Savannah River Site*, Report Number DOE/IG-0377, dated August 1995. This inspection found that the Department had significantly increased the percentage of subcontractor costs in Westinghouse's fee bases from FY 1989 to FY 1993, which resulted in the Department paying two full fees for the same work. The OIG recommended that the Deputy Assistant Secretary for Procurement and Assistance Management establish a standard for weighting the dollar value of subcontracts in fee bases, along with a requirement for justification and approval when the standard is exceeded.
- *Audit of Department of Energy Support Service Contracting*, Report Number CR-B-95-06 dated June 1995. This audit found that the absence of a Departmental policy addressing the inclusion of subcontractor labor in support service contractor fee determinations resulted in the Department paying \$5.1 million in fees to four support service contractors for services exclusively provided by subcontractors.

Appendix 3

Department of Energy
Washington, DC 20585

July 17, 1998

MEMORANDUM FOR: WILLIAM S. MAHARAY, ACTING MANAGER
CAPITAL REGIONAL AUDIT OFFICE
OFFICE INSPECTOR GENERAL

FROM: STEPHEN J. MICHELSEN, DIRECTOR
OFFICE OF CONTRACT AND RESOURCE MANAGEMENT
OFFICE OF PROCUREMENT AND ASSISTANCE
MANAGEMENT

SUBJECT: RESPONSE TO DRAFT REPORT ON "AUDIT OF THE U.S.
DEPARTMENT OF ENERGY'S PRIME CONTRACTOR FEES
EARNED ON SUBCONTRACTOR COSTS"

The U. S. Department of Energy (DOE) appreciates the opportunity to review and comment on the Inspector General's (IG) draft report on "Audit of the U.S. Department of Energy's Prime Contractor Fees Earned on Subcontractor Costs." The stated objective of the audit was to determine if the Department adjusts the fee base of prime contractors in accordance with the technical and management effort actually required by the contractor as required by the DEAR. The conclusion of the audit is that the Department did not adjust the fee bases of the prime contractors to reflect actual managerial and technical effort associated with the oversight of subcontractors. The report recommends that the Deputy Assistant Secretary for Procurement and Assistance Management (1) issue specific guidance to the Department's procurement offices identifying the types of and extent to which subcontractor costs may be included in M&O contractor fee bases and (2) as part of a Procurement and Assistance Management quality assurance mechanism, review subcontractor costs analyses performed to ensure implementation of the guidance.

Generally, this office does not take exception with the audit's findings nor the recommendations. However, we disagree with the conclusion that it is or should be the policy of the Department to remove all or even the majority of subcontractor costs from the prime contractor's fee base when calculating the prime contractor's fee amount and that the inclusion of subcontract costs in the prime contractor's fee base is unreasonable and contributes to fee growth in the Department. The DEAR states that only those costs which reflect a distortion in the management effort or resources contributed by the prime contractor should be deducted from the fee base. This is a subjective measure

and will depend upon many variables including any required involvement by the prime contractor in performing the work, providing value added to the subcontracted work, or managing and integrating numerous subcontracts. It will also depend on the type of subcontract, the complexity of the effort to be performed and the risk to the prime's fee if the work is not performed well. For instance, the use of many fixed price subcontracts which must be integrated at the prime level may warrant inclusion of all the costs in the prime's fee base. The rationale is that even though any one of the subcontractors may be held accountable for its specific effort, if that effort is performed poorly to the point that it impacts the others, then the prime contractor is accountable.

Both FAR 15 and DEAR 915 weighted guidelines provisions recognize the inclusion of all costs associated with subcontracts as a legitimate basis for determining the prime contractor's fee. The issue in subcontracting is not how much fee is available, but if the work is being performed more efficiently (cost and fee) than if the prime contractor had performed it. It is noted that both policies, in recognition that the prime contractor may not provide the same level of management and resources to effort which is subcontracted, allow or provide that the amount of fee associated with subcontractor costs be less than if the prime contractor were doing the effort itself. The policy, set forth in the DEAR as it applies to M&O contracts, attempted to make provision for a similar adjustment in an environment which was not conducive to different fee ranges for different categories of cost. As noted in the audit, appropriate adjustments may not always have been taken. However, the impact of not taking these adjustments is not the fee amount associated with 100% of the subcontracted costs (as is implied by the audit when it points out that including subcontract costs in the 12 prime contracts reviewed resulted in an increase of \$34,000,000 in fee), but some, probably small, portion of it.

The Department has recognized that there may not be adequate adjustments to the prime contractor's fee bases reflecting a distortion in the technical and management effort actually required of the prime contractor. In the revision to the fee policy (currently published as a NOPR) as it applies to the Department's management and operating contracts, a stipulation has been made that the prime contractor's fee base shall include no more than 80% of subcontracted costs. The amount of costs of subcontracted effort to be included in the prime contractor's fee base up to that percent is at the discretion of the contracting officer based again on an assessment of the distortion in the technical and management effort actually required of the prime contractor. The impact of this adjustment to subcontract costs included in the fee base approximates the impact of similar adjustments effected by the weighted guidelines method (where lower fee ranges are applied to subcontracts).

With the change to the fee policy as it pertains to management and operating contracts, compliance with the change will be subject to the same review process as is currently in place for the review of management and operating contract fee negotiations.

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