



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

Audit Report

Management Controls over Performance Fees in the Idaho National Laboratory Contract

OAS-M-06-07

August 2006



Department of Energy
Washington, DC 20585

August 24, 2006

MEMORANDUM FOR THE ASSISTANT SECRETARY FOR NUCLEAR ENERGY

FROM:

George W. Collard
George W. Collard
Assistant Inspector General
For Performance Audits

SUBJECT:

INFORMATION: Audit Report on "Management Controls over Performance Fees in the Idaho National Laboratory Contract"

BACKGROUND

On February 1, 2005, Battelle Energy Alliance, LLC (Battelle) assumed responsibility for managing and operating the Idaho National Laboratory for the Department of Energy (Department) under a new 10-year contract. The mission of the Idaho National Laboratory is to enhance the Nation's energy security by becoming the preeminent, internationally-recognized nuclear energy research, development, and demonstration laboratory. To help realize this mission, the Department utilized a cost-plus-performance fee contract with Battelle. For the life of the contract, Battelle can earn \$179 million from fees with \$11.1 million available in Fiscal Year (FY) 2005 and \$18.7 million available per year through FY 2014.

A cost-plus-performance fee contract is designed to reward contractors based on their performance. In order to be effective, performance measures and fees should be reasonable in amount, correspond to expectations, and be established prior to the period to be measured. The Department has fairly clear guidance on how the metrics should be established. Because of the importance of achieving the Department's nuclear energy missions, we initiated this audit to determine whether the Department effectively used performance measures and fees to appropriately reward contractor performance at the Idaho National Laboratory.

RESULTS OF AUDIT

The Department did not always effectively use performance measures and fees to appropriately reward contractor performance. Specifically, the Department allocated approximately \$1.3 million in FY 2005 in fees that:

- Were disproportionately high for the work performed; and,
- Were implemented well after the performance period began.

Similarly, the FY 2006 performance measures and fees provide Battelle with the opportunity to earn approximately \$1.2 million in fees that are not commensurate with the work performed. For example, in FY 2006, the contractor can earn almost \$1 million for acquiring a minimum of \$400,000 in new work for the Laboratory.



Performance measures and fees were not always effectively used to appropriately reward contractor performance because the Department's Office of Nuclear Energy and the Idaho Operations Office did not fully communicate their respective expectations. Furthermore, in establishing fees, management did not balance achieving programmatic priorities against the level of difficulty associated with performing the work. As a result, we identified \$2.5 million in performance fees either paid to, or available to, the contractor during FYs 2005 and 2006 that were questionable. Our report makes specific recommendations to improve this process in the future.

During the audit, we also noted that the Department established many performance-based measures that were not outcome-oriented, particularly in FY 2005. Management acknowledged the need to make future measures outcome-oriented; accordingly, we did not make recommendations at this time. Details are presented in Appendix 2.

MANAGEMENT REACTION

Management generally concurred with the report. Management also provided clarifying comments, which are discussed in this report. Where appropriate, we modified our report to address management's concerns. We also included management's comments as Appendix 4.

Attachment

cc: Deputy Secretary
Under Secretary of Energy
Under Secretary for Science
Chief of Staff
Manager, Idaho Operations Office

REPORT ON MANAGEMENT CONTROLS OVER PERFORMANCE FEES IN THE IDAHO NATIONAL LABORATORY CONTRACT

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PERFORMANCE FEES IN THE IDAHO NATIONAL LABORATORY CONTRACT

Performance Measures and Fees

The Department of Energy (Department) did not always effectively use performance measures and fees to appropriately reward contractor performance. Specifically, the Department allocated approximately \$1.1 million for 3 of the 27 performance measures and fees for Fiscal Year (FY) 2005, which were disproportionately high for the work performed. Four of the 49 measures and fees established for FY 2006 provided the contractor the opportunity to earn \$1 million under similar circumstances. Also, some of the performance measures worth \$460,000, were implemented well after the performance period began.

Disproportionate Fees

Performance measures should be designed to ensure that the fee provided is commensurate with the work accomplished by the contractor. However, in some cases, the performance measures allowed Battelle to earn disproportionately high levels of fee. For example:

- Battelle's available fee was \$600,000 to complete certain steps necessary to establish a new Center for Advanced Energy Studies. The requirements to complete the measure included selecting a director; providing a project plan/development proposal to the Department; identifying a funding mechanism for a planned new facility; and documenting a Governing Management Structure (similar to a program charter). However, we noted that the work necessary to earn this fee required only \$220,000 of labor costs. Thus, the contractor's fee was almost three times the total cost or level of effort needed to accomplish the measure.
- Battelle's available fee was \$250,000 to decrease the total recordable case rate for on-the-job injuries by five percent. In order to achieve this level of performance, Battelle had to realize only two fewer "recordable" cases. Typical injuries at the Laboratory that result in recordable cases are from being struck by an object, overexertion, slips/trips, etc.
- Battelle also had \$250,000 in fee available for reducing the Day Away, Restricted, or Transferred (DART) rate by five percent. DART cases are recordable injury cases that result in work restrictions,

job transfers or time off due to injury. To achieve the fee, the contractor had to reduce the number of DART cases by one case.

Similarly, for FY 2006, four measures had disproportionately high levels of fee for acquiring newly funded projects. In total, Battelle can earn a "sales commission" of almost \$1 million for only acquiring a minimum of \$400,000 in new funding. For example Battelle can earn a fee of:

- \$499,000 for acquiring a newly funded project of at least \$100,000 worth of work in the Utility Sector program to reduce grid vulnerability;
- \$185,000 for acquiring a project of at least \$100,000 in Material Protection, Control and Accountability Training Program activities;
- \$185,000 for bringing in at least \$100,000 of work from an international client for a process control security assessment; and,
- \$93,500 for bringing in at least \$100,000 of work for compressed or liquefied natural gas technology.

Performance Plan Delays

The Performance Evaluation Measurement Plans (Plan), which outline the performance measures for each period, were not established in a timely manner. The Department signed the FY 2005 Plan on March 31, 2005, – two months after the start of the contract period. Also, the FY 2006 Plan was not signed until February 22, 2006, almost five months after the performance period began. The delay in establishing performance measures and fees was not consistent with the Department's objective to use performance measures and fees to clearly define performance expectations for the contractor before the commencement of the performance period. For example:

- In FY 2005, the transition of Argonne National Laboratory-West to the Idaho National Laboratory included a performance measure to complete training on business systems, transfer residual property, and transfer residual funding balance worth approximately \$180,000, that Battelle completed on March 28, 2005, or three days before the Plan was approved.

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- In January 2006, Battelle completed work for a \$280,000 performance measure to deliver a power system to the National Aeronautics and Space Administration for the New Horizons spacecraft. The Plan outlining the scope of work and fee was not approved until February 2006.

Development of Performance Measures

These deficiencies occurred because the Office of Nuclear Energy (Nuclear Energy) and the Idaho Operations Office (Idaho) did not effectively communicate their respective expectations.

Furthermore, in establishing fees, management did not balance achieving programmatic priorities against the level of difficulty associated with performing the work.

The Plans were delayed due to poor communication of expectations between Nuclear Energy and Idaho. For instance, we noted that the measures were developed from the bottom-up rather than top-down. Initially, the Plans were drafted by Battelle who identified and proposed both long-term and annual performance measures. Idaho reviewed and revised the measures, in consultation with the contractor, until it was satisfied with the presentation of the measures. Subsequently, the Plan was transmitted to Headquarters for review and approval. However, Headquarters was not satisfied with the Plan, thereby requiring extensive revisions over the course of several months to be in-line with its expectations. Had the expectations been clearly established by Headquarters and communicated to Idaho early in the process, the measures could have been established in a more timely manner. In discussing these concerns with Department officials, there was broad agreement that this area needs to be improved. Accordingly, management stated that they are taking steps to correct these problems to ensure timely measures in the future.

In discussing our concerns with disproportionate measures with Department officials, they acknowledged that there was insufficient documentation and analysis to fully demonstrate the rationale for these decisions. Specifically, for the disproportionate fees, we noted that management focused primarily on the Department's strategic priorities without appropriately balancing these priorities against the ease with which the contractor could earn the fee. This is in contrast to Departmental guidance, which requires that the amount of available fee should be in relation to the level of difficulty of the task or the risk associated with the task.

**Achieving the
Goals of
Performance Fees**

As a result of not always effectively using performance measures and fees to appropriately reward contractor performance, the Department allocated \$2.5 million in performance fees to the contractor during FYs 2005 and 2006 that were questionable. By not following its established guidelines, the Department has less assurance that its performance fees are improving performance in the most practical and effective manner. Since the contract offers an additional \$168 million of potential fees during the next nine years, it is imperative that the Department quickly address the problems outlined in this report.

RECOMMENDATIONS

We recommend that the Assistant Secretary for Nuclear Energy:

1. Establish performance expectations early in the planning process and convey the expectations to Idaho for inclusion in the Performance Evaluation Measurement Plan;
2. Ensure that the Performance Evaluation Measurement Plan is established prior to the period of commencement; and,
3. Establish fees in reasonable proportion to the amount of work to be performed.

**MANAGEMENT
REACTION AND
AUDITOR
COMMENTS**

The Assistant Secretary for Nuclear Energy generally concurred with the report. Management agreed with recommendations 1 and 2 to ensure that the Performance Evaluation Measurement Plan is in place before the start of the fiscal year. Management accepted recommendation 3, but noted that it may be impossible to consistently allocate fee based primarily on the dollar value of the work scope. Management made additional comments that we considered in preparing the final report.

Management's comments were responsive to our recommendations.

Regarding management's observations that it may not always be possible to allocate fee based primarily on the dollar value of the work, we observed that management's criteria for performance measures require that the incentive be commensurate with the level of difficulty of the work or the risk involved. We believe that the dollar value of the work scope is one measure of the difficulty of work and risk to the contractor. Furthermore, in some cases, the

incentive fee available to the contractor exceeded the benefit to the Department. As previously discussed, in FY 2006, the contractor can earn nearly \$1 million for acquiring \$400,000 in funding for new projects.

Management's comments are included as Appendix 4.

Appendix 1

OBJECTIVE

The objective of the audit was to determine whether the Department effectively used performance measures and fees to appropriately reward contractor performance at the Idaho National Laboratory.

SCOPE

The audit was performed from June 2005 to May 2006 at the Idaho Operations Office and Battelle Energy Alliance, LLC in Idaho Falls, Idaho. The audit covered the Idaho National Laboratory contract fees for Fiscal Years 2005 and 2006.

METHODOLOGY

To accomplish the audit objective, we:

- Obtained and reviewed the management and operating contract for the Idaho National Laboratory;
- Interviewed key personnel at the Idaho Operations Office and Battelle Energy Alliance, LLC.;
- Researched Federal and Departmental regulations;
- Reviewed findings from prior audit reports regarding performance fees and incentives; 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 the Department's effective use of performance measures and fees at the Idaho National Laboratory. 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. Also, we considered the establishment of performance measures in accordance with the Government Performance and Results Act of 1993 as they related to the audit objective. Finally, we did not rely on automated data processing equipment to accomplish our audit objective.

We held an exit conference with the Deputy Manager of the Idaho Operations Office on August 2, 2006.

OTHER MATTERS

Results-Oriented Performance Measures

According to Departmental procurement policy, contractor fees should be attached to performance-based results or outcomes, rather than for the processes performed by the contractor. In addition to Departmental policy, the Battelle Energy Alliance, LLC (Battelle) contract states that the Performance Evaluation Measurement Plan shall tie fee to outcomes. Contrary to the Departmental policy and the Battelle contract, the majority of performance measures and related fee were tied to process-oriented activities, such as planning documents, rather than outcomes. In fact, 16 of 26 performance measures for FY 2005 were process-oriented.

Department officials acknowledged the need to make future measures outcome-oriented. In FY 2005, the performance measures focused on consolidation of activities and planning for the future. With the transition and consolidation to a new contract, strategic planning was necessary to set the direction of the Idaho National Laboratory. It was anticipated that the plans would provide the basis for more tangible end results and that future measures would be more definitive and contain less planning documents.

However, the nuclear energy research program at the Idaho National Laboratory has been ongoing for many years and continues to move forward. Accordingly, outcome-oriented performance measures should be achievable regardless of the contractor. Although the Department improved its development of measures, six of 49 performance measures were process-oriented in the FY 2006 Performance Evaluation Measurement Plan.

RELATED AUDIT REPORTS

- *Use of Performance Based Incentives by the Office of Civilian Radioactive Waste Management* (DOE/IG-0702, September 2005). The Office of Civilian Radioactive Waste Management (OCRWM) did not administer the performance-based incentives to improve the contractor's performance. Specifically, OCRWM paid incentive fees even though additional time was needed by the contractor to complete quality work, work scope was decreased due to poor contractor performance, delivered products were not acceptable to OCRWM, and incentivized work was eliminated. Additionally, OCRWM paid a super stretch incentive fee for additional work scope even though the original work scope was not completed. OCRWM could not administer the contract to improve performance because clearly defined standards to evaluate performance had not been established.
- *Use of Performance-Based Incentives at Selected Departmental Sites* (DOE/IG-0510, July 2001). In February 1994, a contract reform team encouraged the use of performance-based incentives to link fee earned with performance results. The auditors found that the Department of Energy had not been utilizing performance-based incentives in a manner that would improve contractor performance. Problems were identified with 12 of the 19 incentives reviewed, field offices were not evaluating past incentives to negotiate recurring incentives, and there was not a formal review and approval process in place.
- *Performance Incentives at the Idaho National Engineering and Environmental Laboratory* (WR-B-00-05, April 2000). Auditors found that the performance-based incentives at the Idaho National Engineering and Environmental Laboratory had not been successful at improving performance and reducing costs. In some cases, where performance improved, the contractor was compensated twice, or the fee was disproportionately high. The auditors found problems with the way that management structured and validated incentives, resulting in \$11.3 million in questioned incentive fees paid to the contractor.

United States Government

Department of Energy

Memorandum

DATE: June 26, 2006

REPLY TO

ATTN OF: NE-40

SUBJECT: Management Comments on the Draft Report on "Audit of Performance Fees in the Idaho National Laboratory Contract"

TO: George W. Collard, Assistant Inspector General for Performance Audits, Office of the Inspector General (IG)

Thank you for providing the Office of Nuclear Energy (NE) with the opportunity to review your draft audit report that was transmitted by the IG memorandum dated June 6, 2006.

NE agrees without exception to findings 1 and 2. For the past two years, the Idaho National Laboratory (INL) Performance Evaluation Measurement Plan (PEMP) has not been completed by the due date. This is unacceptable, and we will assure that in the future, the INL PEMP is in place before the start of the fiscal year. Recommendation 3 is based upon a subjective evaluation of what level of award fee is "reasonable" for a given work scope. We accept the recommendation but note that it may be impossible to ever consistently meet the expectations of the IG regarding fee allocations based primarily on the specific dollar value of work scope associated with individual PEMP objectives.

We do not agree with finding 4. Planning, readiness, and execution of a program are distinctly different work scopes. In the examples cited, planning and readiness were necessary but not sufficient steps in achieving the desired outcomes that were implementation of integrated safety management and delivery of a radioisotope power system. Please reconsider this finding or provide additional explanation of your basis for concluding these steps are essentially the same scope of work.

If you have any questions on this matter, please contact Marvis Aleem, Audit Liaison, on 202-586-0382.



Dennis R. Spurgeon, Assistant Secretary
for Nuclear Energy

Attachment

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