

DOE/IG-0460

AUDIT REPORT

THE DEPARTMENT'S MANAGEMENT AND OPERATING CONTRACTOR MAKE- OR-BUY PROGRAM



FEBRUARY 2000

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

February 17, 2000

MEMORANDUM FOR THE SECRETARY

FROM: Gregory H. Friedman (Signed)
Inspector General

SUBJECT: INFORMATION: Audit Report on "The Department's Management and Operating Contractor Make-or-Buy Program"

BACKGROUND

In 1994, the Department of Energy's (Department) Contract Reform Team concluded that savings could accrue to the government if certain operating functions not essential to the Department's core mission were performed by outside contractors. Over the next several years, the Department initiated actions that required management and operating (M&O) contractors to identify, categorize, and evaluate all of their functions and prepare make-or-buy plans to obtain supplies and services on a least-cost basis subject to program specific make-or-buy criteria. The objective of this audit was to determine whether the Department's M&O contractors (1) identified those functions for which make-or-buy opportunities existed and (2) performed cost-benefit analyses.

RESULTS OF AUDIT

Only one of four contractors reviewed (Westinghouse Savannah River Company) had included all operating functions in its make-or-buy planning efforts. The other three contractors (Lockheed Martin, University of California, and University of Chicago) had either not included all functions in their make-or-buy plans or had not scheduled cost-benefit analyses for many outsourcing candidates. This occurred because Program Offices did not provide M&O contractors with guidance to assist in the identification process and procurement officials did not monitor contractor implementation of the program adequately. As a result, cost saving opportunities were missed.

We estimated that the Department could save up to \$5.3 million if cost-benefit analyses are conducted. Additional cost savings are likely if the three contractors reviewed the functions that they had excluded from the make-or-buy process, which were valued at \$1.3 billion. While we focused our review on four specific M&O contractors, we were able to determine that other Department of Energy M&O contractors had not included all operating functions in their make-or-buy process. Thus, substantial additional savings are possible if the make-or-buy concept is fully adopted at all Departmental sites.

We recommended that the Director, Contract Reform and Privatization Project Office, in conjunction with Headquarters program managers and the Office of Procurement and Assistance Management develop program specific guidance for evaluating contractor functions and monitor field implementation of contractor make-or-buy efforts.

MANAGEMENT REACTION

The Director of the Contract Reform and Privatization Project Office generally agreed with and proposed corrective actions for the recommendations. The Director disagreed with the OIG's estimate of savings available to the Department.

Attachment

cc: Deputy Secretary
Under Secretary

The Department's Management And Operating Contractor Make-Or-Buy Program

TABLE OF CONTENTS

Overview

Introduction And Objective 1

Conclusions And Observations..... 1

Opportunities For Outsourcing

Details Of Finding 3

Recommendations And Comments..... 9

Appendices

1. Scope And Methodology 11

2. Related Reports..... 12

3. Procurement And Assistance Management Guidance..... 13

Overview

INTRODUCTION AND OBJECTIVE

In 1994, the Department of Energy's (Department) Contract Reform Team concluded that savings could accrue to the Government if certain operating functions not essential to the Department's core mission were performed by outside contractors. Over the next several years, the Department developed an approach that required management and operating (M&O) contractors to identify, categorize, and evaluate operating functions and prepare make-or-buy plans to obtain supplies and services on a least-cost basis subject to program specific make-or-buy criteria. Such plans were to set forth each contractor's major functions categorized as "make" (performed by the contractor in-house), "buy" (outsourced), or "make-or-buy." The latter categorization required a cost-benefit analysis before a final determination could be made.

The objective of our audit was to determine whether the Department's M&O contractors (1) identified those functions for which make-or-buy opportunities existed and (2) performed cost-benefit analyses.

CONCLUSIONS AND OBSERVATIONS

Only one of four M&O contractors reviewed (Westinghouse Savannah River Company) had included all operating functions in its make-or-buy planning efforts. The other three contractors (Lockheed Martin, University of California, and University of Chicago) had either not included all functions in their make-or-buy planning efforts or had not scheduled cost-benefit analyses for many outsourcing candidates. Although the Department had taken actions to strengthen its make-or-buy program, about \$1.3 billion in operating functions were not included during the make-or-buy identification process at these three M&O contractors. Furthermore, of the 89 functions that were identified for potential outsourcing, 28, valued at approximately \$53 million, were not scheduled for a detailed cost-benefit analysis. This occurred because Headquarters Program Offices did not provide M&O contractors with guidance to assist in the identification process and procurement officials did not monitor contractor implementation of the program. As a result, outsourcing opportunities were missed.

We estimated that the Department could save up to \$5.3 million if the make-or-buy process is applied to the 28 excluded functions. Additional opportunities for savings may be available if the three contractors evaluated all operating functions in their make-or-buy programs. Developing viable make-or-buy programs at all other M&O contractors could also result in additional savings to the Department.

The conclusion of this report parallels that of a recently issued Office of Inspector General report on outsourcing opportunities at Los Alamos National Laboratory (WR-B-00-03). The report and this audit, indicate a more proactive approach for managing the Department's make-or-buy program is needed. Management should consider issues discussed in this audit report when preparing its yearend assurance memorandum on internal controls.

(Signed)

Office of Inspector General

Opportunities For Outsourcing

Identification Process And Cost-Benefit Analysis Not Implemented

Only one of the four M&O contractors reviewed, Westinghouse Savannah River Company (Savannah River Site), had included all operating functions in their make-or-buy planning efforts to determine if outsourcing opportunities existed. The three other contractors, Lockheed Martin (Sandia National Laboratories), University of California (Lawrence Livermore National Laboratory), and University of Chicago (Argonne National Laboratory) had excluded about \$1.3 billion in operating functions in the make-or-buy identification process. Furthermore, 28 of the 89 functions identified by 2 of the contractors (Sandia and Argonne) for potential outsourcing were not scheduled for cost-benefit analysis. The value of the 28 excluded functions was approximately \$53 million.

Identification Process

Table 1 shows the make-or-buy universe for the year each contractor plan was developed and the estimated value of functions that were either included or not included in the contractors make-or-buy identification process.

TABLE 1 – CONTRACTOR MAKE-OR-BUY
IDENTIFICATION PROCESS
(in millions)

<u>Site</u>	<u>Make-or-Buy Universe</u>	<u>Value of Functions</u>	
		<u>Included</u>	<u>Not Included¹</u>
Savannah River	\$1,081	\$1,081	\$ 0
Lawrence Livermore	1,233 ²	97	1,136
Sandia	1,646		1,536
110			
Argonne	<u>139³</u>	<u>72</u>	<u>67</u>
TOTAL	<u>\$4,099</u>	<u>\$2,786</u>	<u>\$1,313</u>

¹ This value may include functions that are less than the \$1 million threshold required to be used by the Department's M&O contractors in their identification process.

² Lawrence Livermore did not compile a potential make-or-buy universe. The \$1,233 million represents total expenditures of the Laboratory.

³ Argonne's contract did not require all functions to be included in their make-or-buy program.

Only the Savannah River Site identified and assessed all activities. The Savannah River Site identified and assessed 250 program and support functions valued at about \$1.1 billion during its identification process. Using a structured approach, all functions were categorized as either core or non-core operations. A Savannah River Operations Office official stated that the primary impetus for the contractor's aggressive participation in the program was to cut its costs in order to meet budget reductions.

In contrast, Lawrence Livermore National Laboratory, with total expenditures of approximately \$1.2 billion, did not include all functions in the competitive make-or-buy process. Instead, the contractor judgmentally selected three functions in each of the first 2 years of the contract. Overall, Livermore identified just 15 functions with a total value of approximately \$97 million, even though Livermore's Plant Engineering Department independently conducted its own evaluation and identified 48 functions. A Livermore official disclosed that the largest six of these functions were valued at over \$22 million. Only three functions with a valuation of \$8.9 million were subsequently selected by Livermore to be included in its overall make-or-buy program. Other functions not included by management in the make-or-buy process were: medical services, payroll, and computer services.

Livermore officials explained that a more aggressive approach to identify outsourcing opportunities would have upset employees. We were also advised that the contracting officer had waived identification of all program functions except Environmental Management functions, as required by the contract, because Headquarters program guidance had not been received.

Sandia National Laboratories identified all required program and support functions valued at about \$1.5 billion annually but excluded estimated operating costs of about \$110 million at Sandia in California. Sandia officials advised that many of the non-core functions at this location were already outsourced, and the exclusion of the California laboratory functions from the make-or-buy plan was due to a communication problem between the two laboratories.

Argonne National Laboratory judgmentally identified 22 support functions valued at approximately \$72 million. It excluded \$67 million in support functions such as telecommunications, mail services, health screening, and library information services. This limited selection process was, however, in accordance with the specific requirements of Argonne's contract. Beginning

in Fiscal Year 2000, new contract terms will require Argonne to consider all functions in the make-or-buy process. Total value of the functions is estimated to be \$506 million.

During the course of the audit, we contacted other M&O contractors to determine if all operating functions had been identified in their make-or-buy process. Several of these contractors reported that they had not fully identified their make-or-buy universe.

Cost-Benefit Analyses

The contractors' decision to "make" or "buy" non-essential items should be based on a detailed cost-benefit analysis. The four contractors reviewed had identified 89 candidate functions for outsourcing valued at \$192 million. However, 28 of these functions, valued at \$53 million, were excluded from any further evaluation. Table 2 identifies the number and value of outsourcing candidates not scheduled for cost-benefit analysis.

TABLE 2 – OUTSOURCING CANDIDATES NOT SCHEDULED FOR COST-BENEFIT ANALYSIS

	<u>Candidates</u>		<u>Candidates Not Scheduled</u>	
	<u>Number</u>	<u>Dollar Value</u>	<u>Number</u>	<u>Dollar Value</u>
		<u>(millions)</u>		<u>(millions)</u>
Savannah River	18	\$ 51	0	\$ 0
Lawrence Livermore	6	15	0	0
Argonne	22	72	9	36
Sandia	<u>43</u>	<u>54</u>	<u>19</u>	<u>17</u>
TOTAL	<u>89</u>	<u>\$192</u>	<u>28</u>	<u>\$53</u>

Savannah River and Livermore scheduled for analysis all "make-or-buy" functions identified. These functions included activities such as invoice processing and payment, fire department, fire systems maintenance and testing, facilities administration and planning, grounds maintenance, custodial services, and travel reservation and ticketing services. Savannah River and Livermore analyses indicated that such services could be outsourced and not affect the critical capabilities of the contractor.

In contrast, Argonne National Laboratory's contract required only 12 functions to be evaluated for outsourcing during the 5-year span of the contract. While the laboratory conducted and submitted 13 evaluations to the Department during the contract period, 22 functions had been identified for potential outsourcing and cost savings. Nine functions, valued at \$36 million annually, were identified for potential outsourcing but not scheduled for analysis. Examples of these functions include: computer operations and systems maintenance, medical services, telephone services, utilities supply, and fire department.

For Fiscal Years 1999 through 2001, Sandia has scheduled 24 of 43 outsourcing candidates for cost-benefit analysis. The remaining 19 functions, several outsourced by the other contractors included in our review, were excluded from any further analysis. Sandia officials explained that they planned to evaluate the selected functions over a 3-year period. However, analyzing all of the potential candidates would require additional staff, which could not be justified. The value of the functions not selected for review was estimated at \$17 million.

Elements Of A Successful Make-Or-Buy Program

A Department Contract Reform Team concluded that the Department and its M&O contractors should make more rational decisions concerning whether a contractor project or program should "make" or "buy" services. The team recommended that detailed make-or-buy plans be prepared that clearly set forth the areas and actions that each contractor proposed to take in operating government-owned facilities on a least-cost basis. Plans were also to be based on program specific guidance and subjected to contracting officer approval.

In June 1997, the Department formalized requirements for contractor make-or-buy programs by amending the Department of Energy Acquisition Regulation. This regulation required M&O contractors in preparing their make-or-buy plans to identify, categorize, and evaluate all of their functions over a dollar threshold.⁴ It also required contracting officers to evaluate, approve, and monitor contractors' plans. Furthermore, the Department's make-or-buy program and prudent business practices require that all identified outsourcing opportunities be evaluated to determine whether they should be performed by the contractor in-house (make) or outsourced (buy).

⁴ All functions estimated to cost less than one percent of the contractors' estimated total operating cost or \$1 million need not be included in the contractors' make-or-buy plan.

Once identified, each operating function is considered a feasible candidate for outsourcing if it is economical to do so.

Additionally, contracts for three of the four contractors – Westinghouse Savannah River Company, Lockheed Martin, and University of California – required all functions to be categorized for make-or-buy determinations. On the other hand, the University of Chicago was only to review landlord or support functions from a make-or-buy perspective.

Need For Guidance And Monitoring

The Department's M&O contractors were not fully successful in implementing their make-or-buy processes because Headquarters Program Offices did not provide contractors with specific guidance. In addition, procurement officials did not monitor contractor implementation of the program. As a consequence, outsourcing opportunities and savings were missed.

Program Guidance

Program specific make-or-buy guidance permits the contractor to consider factors other than least cost. Such factors reflect special needs or critical items of the Department. Departmental policy stated that the key to successful establishment of a make-or-buy plan is the development of program specific make-or-buy guidance, commonly referred to as criteria, and asserted that the contractor cannot prepare an acceptable plan without such criteria.

The Department did not provide the program specific criteria needed to produce contractor make-or-buy plans. Essentially, program officials indicated that they either did not understand their responsibility for issuing such guidance or thought that Department field offices were responsible for developing criteria.

The lack of program specific criteria hampered the completion of contractor make-or-buy plans. The contracting officer for the Lawrence Livermore National Laboratory contract limited the contractor's make-or-buy plan to only support and Environmental Management functions because the program specific make-or-buy criteria had not been developed. Additionally, Sandia National Laboratory had to develop its own program specific guidance in order to implement its make-or-buy plan.

Monitoring

Departmental procedures require field procurement officials to evaluate proposed make-or-buy plans following receipt from the contractor. After approval of the plan, field office responsibilities include assuring that contractor performance is in accordance with the plan and appropriate cost-benefit analyses are conducted. These monitoring responsibilities, however, were not carried out by the Department's field procurement officials.

Field office officials advised us that only limited attention had been given to monitoring contractor make-or-buy plans. Procurement officials at one field office stated that oversight of contractor activity had been limited to approval of the methodology contained in the contractor make-or-buy plan and evaluations of individual "make" or "buy" decisions were not made. Procurement officials at two other field offices could not validate "make" or "buy" decisions of contractors for which they had responsibility because neither contractor provided sufficient data on such decisions. Furthermore, one contractor advised that it never intended to provide the Department with the results from its formal make-or-buy analyses.

A Headquarters procurement official indicated that make-or-buy problems were due to incorrect assumptions made by Headquarters and field procurement officials. This official explained that previous attempts at instituting contract reform requirements created considerable discussion between field and Headquarters procurement officials. However, make-or-buy guidance created very little discussion. As a result, Headquarters assumed that the field agreed and was monitoring contractor efforts, and, conversely, the field assumed that no followup by Headquarters implied a low priority for the make-or-buy program. Consequently, the successful implementation of the make-or-buy program was hampered.

Under the requirements of the Government Performance and Results Act of 1993, managers are required to establish goals and performance measures for program activities. In keeping with this requirement, the Department's 1998 Strategic Plan stresses the importance of having reporting systems that provide useful information needed to manage operations including progress of organizational goals and objectives and forms the basis for performance measurement. Accordingly, accurate and timely data for make-or-buy activities is needed to measure the success of the Department's make-or-buy program. However, in implementing the Contract Reform Team's recommendations, the Department did not establish site-specific performance goals and measures for implementing the make-or-buy program.

**Make-Or-Buy
Opportunities Not
Maximized**

Our review of the Department and contractors' implementation efforts indicated that in most circumstances the Department had not maximized the benefits and savings that could be generated from an effective make-or-buy program. Where such effort was given, significant savings were realized. For example, Savannah River Site avoided \$116 million in construction costs by outsourcing the processing of contaminated laundry and by partnering with local municipalities in the development of a new sanitary landfill.

Based on our analysis of four sites reviewed, we estimated that the Department could save up to \$5.3 million by performing detailed cost-benefit analyses on the 28 outsourcing candidates not scheduled for further analysis. Additional savings may be possible through the inclusion of \$1.3 billion of operating functions into three contractors' make-or-buy programs. Further, savings may be possible by directing other contractors to include all functions in their make-or-buy programs.

RECOMMENDATIONS

We recommend that the Director, Contract Reform and Privatization Project Office, in conjunction with the Lead Program Secretarial Offices and the Office of Procurement and Assistance Management:

1. Establish site-specific performance goals, objectives, and milestones for implementing a make-or-buy program;
2. Develop program specific criteria for core functions; and
3. Ensure that field offices monitor contractor implementation of make-or-buy programs by:
 - a. reviewing plans for completeness, core or non-core determinations, and schedules of cost-benefit analyses;
 - b. conducting a thorough review of the cost-benefit analysis prior to approval of any make-or-buy decision;
 - c. determining that all "buy" decisions are implemented; and
 - d. documenting realized savings for make-or-buy decisions.

**MANAGEMENT
REACTION**

The Director of the Contract Reform and Privatization Project Office generally agreed with our recommendations and proposed corrective actions. The Director disagreed, however, with the OIG's estimate of savings available to the Department.

Regarding our recommendation to ensure that field offices document realized savings (3.d), the Department concurred in principle, but did not provide the method by which the savings would be collected or reported. As to our \$5.3 million estimate of available savings, the Director asserted that our calculation was based on an extremely limited sample of make-or-buy plans that included "low-hanging fruit."

**AUDITOR
COMMENTS**

The Department should more specifically address, in its action plan, a methodology for documenting savings. Since cost reduction is the conceptual basis for the make-or-buy program, such a methodology is necessary if the Department is to be in a position to evaluate the success of this program.

The OIG's estimate of available savings was based on realized demonstrated savings applied to the 28 outsourcing candidates included in our examination. This was an approach that resulted in a conservative estimate.

Appendix 1

SCOPE

The audit was performed August through October 1998 and January through October 1999 at the Department of Energy Headquarters; Argonne, Lawrence Livermore and Sandia National Laboratories; and the Savannah River Site. We also worked with various other Departmental sites to obtain contractor data in order to achieve the audit objective.

METHODOLOGY

To accomplish the audit objective, we:

- reviewed Federal and Departmental regulations and guidance relating to the make-or-buy program;
- held discussions with program officials to determine if program specific make-or-buy criteria had been developed;
- held discussions with Departmental and contractor officials to determine the implementation status of the make-or-buy program;
- reviewed and analyzed contractors' non-essential functions to determine whether they would be evaluated during the term of the contract;
- held discussions and collected data from appropriate Departmental contracting officers to determine the status of contractors' make-or-buy programs and whether they met the requirements of the make-or-buy policy; and
- developed estimated make-or-buy savings at the two sites.

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. 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 did not rely on computer-processed data. An exit conference was held with appropriate Headquarters officials on January 28, 2000.

RELATED OFFICE OF INSPECTOR GENERAL REPORTS

- *Audit of Outsourcing Opportunities at the Los Alamos National Laboratory* (WR-B-00-03, January 2000). Los Alamos had not identified all support services with outsourcing potential.
- *Audit of the Radioactive Liquid Waste Treatment Facility Operations at the Los Alamos National Laboratory* (WR-B-98-01, November 1997). Treatment costs were significantly higher when compared to similar costs incurred by the private sector because Los Alamos did not perform a complete analysis of privatization or prepare a make-or-buy plan for its treatment operations.
- *Audit of Effectiveness and Efficiency of the Rocky Flats Analytical Services Program*, (CR-B-95-01, November 1994). The M&O contractor at Rocky Flats did not evaluate alternatives to contractor provided analytical services. Instead, in-house laboratories were used to provide analytical services when less expensive and more efficient services were available from subcontract laboratories.
- *Audit of Central Shops Fabrication at the Savannah River Site* (ER-B-92-03, February 1992). Information necessary for management to effectively operate and manage the Central Shops fabrication was not available and there was no assurance as to the reasonableness of costs because Westinghouse Savannah River Company rarely prepared engineering estimates and did not perform make-or-buy analyses.

Appendix 3




Department of Energy

Washington, DC 20585

DEC 6 1999

MEMORANDUM TO **HEADS OF CONTRACTING ACTIVITIES**

FROM: **RICHARD H. HOPF, DIRECTOR** 
OFFICE OF PROCUREMENT AND ASSISTANCE
MANAGEMENT

SUBJECT: **CONTRACTOR MAKE OR BUY PLAN**
IMPLEMENTATION

This memorandum provides guidance and direction relating to field office administration of management and operating contractor make-or-buy plans, as prescribed by Department of Energy (DOE) Acquisition Regulation (DEAR) 970.1507.

Contractor make-or-buy plan requirements and the attendant administration responsibilities represent relatively new undertakings for the Department. Accordingly, it is important that we critically assess our progress from time to time so that we can make timely course corrections and ensure that appropriate levels of management attention are brought to bear on areas where improvements are needed. In this regard, this Office issued a November 3, 1999 report on the effectiveness of contract administration activities associated with management and operating contractor make-or-buy plan requirements. The report assessed whether the basic make-or-buy submission and approval requirements required by the Department of Energy's acquisition regulation had been met and analyzed the effectiveness of both the DOE's and the contractor's administration of the contract requirements. A copy of the report is attached for your information.

Our assessment indicated that the basic requirements for the submission of the contractor make-or-buy plans and contracting officer approval are being met. However, substantive issues relating to the quality and timeliness of DOE review and approval process and post-approval administration requirements were identified. With respect to field office administration responsibilities, the assessment noted that there is a lack of full understanding of the underlying principles of the DEAR make-or-buy policy and its attendant administration requirements. In addition, roles and responsibilities related to key activities oftentimes were not established or were unclear. This situation was exacerbated by a general lack of written local procedures.

Accordingly, as the Head of the Contracting Activity, you should ensure that local procedures are established for the administration of contractor make-or-buy plans. The local procedures should be consistent with DEAR 970.1507 and 970.5204-76 requirements and the Headquarters Acquisition Guide. Your local procedures should include, among other things: (1) the identification of roles and responsibilities for make-or-buy plan administration; and (2) mechanisms for determining whether the contractor has included the full scope of activities in its



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make-or-buy plan and assessing contractor compliance with its approved make-or-buy plan. To the extent that local procedures have already been established, you should review such procedures to ensure that they address key issues and concerns raised in the Headquarters assessment report.

The assessment also indicated that the requirement of Section 970.1507-2(a) for the establishment of program specific make-or-buy criteria by DOE program offices was not being accomplished. As a result, contractors were not always considering appropriate mission or program factors in their make-or-buy analyses. The lack of specifically assigned responsibility and accountability within the regulation for the development of the program specific make-or-buy criteria was a significant contributor to the situation.

A regulatory amendment to Section 970.1507-2(a) of the DEAR has been prepared to assign the Head of the Contracting Activity with the responsibility for ensuring that program specific make-or-buy criteria are developed and provided to the contractor for use in its make-or-buy plan analyses. The Head of the Contracting Activity, as the senior contracting official with direct responsibility for managing the contract, is in the best position to ensure that the program specific make-or-buy criteria are developed, provided to the contractor, and appropriately considered in make-or-buy activities.

We recognize that the Head of the Contracting Activity must rely on program, technical, and business specialists within the agency for the actual development of the program specific make-or-buy criteria so that the criteria appropriately reflect program considerations applicable to the contractor's make-or-buy decisions. The regulation also is being amended to add language to Section 970.1507-2(a) to recognize the collaboration needed to develop effective program specific make-or-buy criteria. A redline/strikeout copy of the proposed regulatory text is attached hereto for your information and to assist you in developing local procedures that reflect the regulatory changes.

We are in the process of establishing action plans to implement all of the remaining actions recommended in the report. The nature of the actions will likely necessitate future involvement by you or your staff. In this regard, it would be helpful if you provided us with a point of contact within your organization for purposes of ensuring that the direction herein has been accomplished and coordinating future communications, information exchanges, and actions.

You should be aware that the DOE Inspector General recently completed its own review of contractor make-or-buy plans. Depending on the recommendations of that report, additional actions on your part may be required.

Should you or your staff have questions regarding this memorandum, the accompanying report, or need assistance in implementing the direction, please contact Ed Simpson of my staff at 202-586-3168 or, via email, at edward.simpson@pr.doe.gov.

Attachments

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