DOE/IG-0432

AUDIT REPORT

THE U.S. DEPARTMENT OF ENERGY'S EFFORTS TO INCREASE THE FINANCIAL RESPONSIBILITY OF ITS MAJOR FOR-PROFIT OPERATING CONTRACTORS

NOVEMBER 1998

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

DEPARTMENT OF ENERGY
Washington, DC 20585

November 20, 1998

MEMORANDUM FOR THE SECRETARY

FROM: Gregory H. Friedman
Inspector General

SUBJECT: INFORMATION: Audit Report on "The U.S. Department of Energy's Efforts to Increase The Financial Responsibility Of Its Major For-Profit Operating Contractors"

BACKGROUND

In 1994, the Departmental contract reform team recommended that the Department's major for-profit operating contractors assume greater financial responsibility. In response, the Department developed model contract provisions to increase contractor financial responsibility and accountability. The objective of the audit was to determine if the Government is protected from liabilities such as fines, penalties, third-party claims, and damage to or loss of Government property incurred by contractors who manage and operate Department facilities and sites.

RESULTS OF AUDIT

The Government was not adequately protected against contractor created liabilities on 16 of its 20 major for-profit operating contracts awarded by the Department of Energy. This occurred because (1) the Department had not incorporated contract reform liability provisions into many of its major operating contracts and (2) Departmental officials had not recognized the implications of adding contract reform liability provisions without obtaining a performance guarantee with indemnification provisions from parent companies of its major operating contractors. As a result, the Department may be liable for any monetary awards resulting from liabilities such as fines, penalties, third-party claims, and damage to or loss of Government property. We recommend that the Director for Procurement and Assistance Management negotiate changes in major for-profit operating contracts to include contract reform liability provisions and ensure that performance guarantees with indemnification provisions are executed with subsidiary contractors' parent or corporate business entities. We also recommend that the Deputy Assistant Secretary issue regulatory rulemaking that requires indemnification provisions be included in performance guarantees signed by the parent or corporate business entity of subsidiary contractors.

MANAGEMENT REACTION

Management generally concurred with the finding and recommendations. The Office of Procurement and Assistance Policy indicated in its response that the mechanisms necessary to effect the new requirements were in place; however, the implementation is not complete.

cc: Acting Deputy Secretary
Under Secretary

The U.S. Department of Energy's Efforts To Increase The Financial Responsibility Of Its Major For-Profit Operating Contractors

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Overview

INTRODUCTION AND OBJECTIVE

Historically, the Department reimbursed its management and operating contractors for virtually all costs incurred in the performance of their contracts including fines and penalties, third-party claims, and Government property damage or loss. The only contractor costs not reimbursed by the Department were those resulting from willful misconduct or lack of good faith by the contractor's top level management, costs found to be unreasonable, and unallowable costs as specified in the contract.

The first significant Departmental attempt to revise this practice occurred in July 1991 with the issuance of the Accountability Rule. This rule made for-profit management and operating contractors liable for "avoidable costs" attributed to the negligence of contractor or subcontractor employees. The Accountability Rule also placed the burden of proof of the unallowability of certain costs on the Government. Under the Accountability Rule, the contracting officer was required to make a determination as to whether certain costs could be considered avoidable before they could be classified as unallowable. However, the Office of Inspector General, in its report DOE/IG-0339, *Audit of Implementation of the Accountability Rule*, dated January 1994, concluded that on five contracts, the Department increased contractor fees by $22.8 million and spent $2.5 million in administrative costs without any appreciable improvements in contractor performance.

In June 1993, the Secretary of Energy formed a contract reform team "to evaluate the contracting practices of the Department of Energy and to formulate specific proposals for improving those practices." The results of its review were published in February 1994. The reform team, as a part of its review of the Department's financial accountability systems, reached the same conclusion as the Office of Inspector General and found that the Accountability Rule had little measurable impact on contractor accountability and performance.

The contract reform team report called for changes in DOE contracting practices. Recommendations relating to contractor liability and accountability included (1) amending the Department's Acquisition Regulations to eliminate its avoidable-cost provisions under the Accountability Rule; (2) developing substantive standards similar to those in the Federal Acquisition Regulation; and (3) establishing a rebuttable presumption of unallowability for fines and penalties, third-party liability, and Government property damage or loss. (These types of costs would be classified as unallowable unless the contractor could prove otherwise.) The recommendations provided the basis for the Department's Final Rulemaking, which was published on June 27, 1997. The Final Rulemaking called for the removal of the liability ceiling for the Department's for-profit operating contractors. Previously, under the Accountability Rule liability for these contractors was capped at the amount of fee earned under the contract in any given period. The Department recognized that the consequence of increasing the contractor's perceived risk would be a general increase in fees to compensate contractors.

The objective of the audit was to determine if the Government is protected from liabilities such as fines, penalties, third-party claims, and damage to or loss of Government property incurred by contractors that manage and operate Department facilities and sites.

CONCLUSIONS AND OBSERVATIONS

The Department has not been fully successful in protecting the Government from liabilities. At the time of our audit, the Department had not taken the necessary steps to fully protect Government interests in 16 of 20 major for-profit operating contracts. In many cases, liability provisions had not been added to the contracts. In other cases, the Department had not incorporated indemnification provisions in performance guarantees that protected the Government against liabilities caused by independent subsidiaries that were created exclusively to manage and operate DOE's major facilities. However, the Department has increased fees, in part, to compensate its major contractors for assuming this perceived risk.

To protect the Government's interests, the Department needs to negotiate changes in its major for-profit operating contracts that do not contain contract reform liability provisions and negotiate indemnification provisions with parent or corporate entities of its subsidiary contractors. These amendments should incorporate the liability provisions recommended by the contract reform team and the recently issued model performance guarantee, which included indemnification provisions proposed by the Department. In addition, the Department should issue a regulatory rulemaking that requires indemnification provisions be included in performance guarantees signed by the parent or corporate business entity of subsidiary contractors.

In our opinion, the matters discussed in this report should be considered by management when preparing its yearend assurance memorandum on internal controls.

/S/
Office of Inspector General

Government Not Protected From Contractor Liabilities

The Government was not adequately protected from contractor created liabilities in 16 of its 20 major for-profit operating contracts awarded by the Department of Energy. These provisions were designed to hold the contractor accountable for fines, penalties, third-party claims, and Government property damage or loss. The provisions also removed contractor liability ceilings. In addition, the Department did not have indemnification provisions as part of a performance guarantee to protect the Government against liabilities created by the subsidiary companies that manage and operate its major facilities. Table 1 identifies the number of contracts where liability and/or indemnification provisions were missing as of April 1998.

TABLE 1

Missing Provisions	Number of Contracts
Liability	7
Indemnification	6
Liability and Indemnification	3
TOTAL	16

Appendix 2 provides a detailed list of contracts in which essential provisions covering liability and indemnification had not been incorporated.

While the Government was not protected against contractor created liabilities, the Department significantly increased the fees for 9 of these contractors. For Fiscal Years 1994 through 1997, the overall fees earned by the 16 contractors[1] increased from $167 million to $204 million, or 23 percent. During this same period, the contractors' overall obligational authority (i.e., the annual Departmental budget authority for which the contractor is responsible) decreased by over 10 percent. In short, an inverse relationship existed in which there was an increase in earned fees while actual expenditures at the respective Departmental sites decreased. In response to the draft report, the Office of Procurement and Assistance Policy indicated that increased fees could be due to other factors such as evolving fee policies and performance-based contracting concepts.

[1]Includes fees for 15 contractors. One contractor only earned fees in FY 1997; therefore, there was no basis for determining an increase for the 3-year period.

In the remaining four major for-profit operating contracts, the Government's interests were protected from contractor created liability. Unlike the contracts discussed previously, these contracts included all contract reform liability provisions, eliminated the ceiling on contractor liability, and, where necessary, included a performance guarantee with indemnification provisions signed by the parent company. The four contracts are shown below in Table 2.

TABLE 2

Contractor	Facility
Westinghouse Electric Corp.	Waste Isolation Pilot Plant
Allied Signal, Inc.	Kansas City Plant
Mason & Hanger Corporation	Pantex Plant
West Valley Nuclear Services	West Valley Demonstration Project

Contract Reform Liability Provisions

The Department had not incorporated contract reform liability provisions and eliminated the liability ceiling in 10 of its major for-profit operating contracts. According to field procurement officials, four of these contracts continued to operate under the Accountability Rule, while another five operated under liability provisions where the Government primarily paid all allowable, allocable, and reasonable costs incurred by its contractors. The one remaining contract incorporated the contract reform liability provisions but did not eliminate the ceiling on contractor liability.

Opportunities to incorporate liability provisions in the contracts existed prior to the June 1997 Final Rulemaking and soon after the issuance of the contract reform report. For example, model contract reform provisions that shifted financial responsibility to the contractors were available to the Department in 1994 and appeared in a major operating contract in January 1995. In addition, 6 of the 10 contracts incorporated other basic elements of contract reform such as performance-based fee or environment, safety and health provisions.

In September 1997, the Department issued Acquisition Letter No. 97-07 directing its field procurement personnel to incorporate the liability provisions in all for-profit operating contracts by the next contract modification, but no later than September 30, 1998. Procurement policy officials noted that it is unusual for such a directive to call for application to existing contracts. Officials responsible for 9 of the 10 contracts stated, at the time of our audit, that they were negotiating with contractors in an attempt to meet the Department's deadline. The one remaining contract had incorporated the liability provisions but continued to include a liability cap.

The following examples represent contracts that were modified after the initiation of the contract reform effort but still did not include all liability provisions:

- The Fernald Environmental Management Project Contract effective September 1, 1992, was modified July 13, 1994, to include the contract reform provisions for performance-based fee contracting but did not include the financial accountability provisions for fines, penalties, third-party liability and damage to or loss of Government property. This contract also continued the practice of capping liability at the amount of fee earned under the contract for a given fee period.

- In the Department's contract to operate the Strategic Petroleum Reserve in New Orleans, the project office required the contractor to purchase a $10 million liability insurance policy to protect the Government from any liability created by the contractor. This requirement was based on the concern that it would be difficult to hold the parent company financially liable for problems created by a company. The project office, while incorporating the contract reform liability provisions, limited the contractor's liability for third-party claims and damage to or loss of property under the contract to the amount of the insurance policy.

In response to the draft report, the Office of Procurement and Assistance Policy indicated that substantial progress has been made and continues to be made to incorporate the liability provisions of contract reform. According to a procurement official, the liability provisions should be in all applicable for-profit contracts by the end of Fiscal Year 1999. As of October 15, 1998, we were able to verify that the liability provisions had been incorporated in only two of these contracts and that the character of another contract had been changed leaving seven contracts without the liability provisions.

Indemnification Provisions

Thirteen of the major for-profit operating contractors that manage and operate the Department's major facilities, are subsidiary entities of major contractors. These subsidiaries have little or no corporate capital or financial resources, and they are essentially independent of the parent company. The Department did not negotiate indemnification provisions in a performance guarantee signed by the parent company of its subsidiary for nine of these contracts. Three of these contracts neither contained the indemnification nor liability provisions. The remaining six of these contracts contained new liability provisions but did not have an accompanying performance guarantee with indemnification provisions signed by the parent company. As a result, while potential liabilities for the six contractors may have increased, the financial structure of these subsidiary relationships provided little assurance that the companies would have the resources to pay a major liability claim. Further, there was no assurance, absent the requisite contract clauses, that the contractors' "corporate veil" could be pierced by the Department to hold the respective parent company responsible for such claims.

In response to our draft report, the Office of Procurement and Assistance Policy stated that performance guarantees exist for three of the nine subsidiary entities. We agree that these three contracts have guarantees. These guarantees assure the prompt and faithful performance of each of the provisions and conditions of the contract. However, we concluded that these guarantees do not contain the indemnification provisions necessary to protect the Government from contractor created liabilities.

To their credit, several field procurement activities have incorporated indemnification provisions into a standard performance guarantee to protect the Government against subsidiary liabilities. The Chief Counsel for the Nevada Field Office stated that the origin of the performance guarantee, which included indemnification provisions, dated back to the early to mid-1980s. A local Departmental procurement activity realized, during the contract negotiations for operation of the Mound Plant in Ohio, that having a subsidiary company with little or no assets managing and operating the facility may leave the Government responsible for potential liabilities.
The following examples represent instances where indemnification

provisions had not been incorporated in a performance guarantee at the time the contract was awarded:

- The contract to manage and operate the Savannah River site negotiated on August 6, 1996, was not supported by a performance guarantee. Subsequently, in early 1998, a performance guarantee was signed, but it did not contain specific indemnification provisions that would hold the parent corporation (CBS Corporation) responsible for losses or expenses that the Government may sustain as a result of the Savannah River company's activities.

- The contracts to manage and operate Oak Ridge National Laboratory and the Y-12 and K-25 sites included performance guarantees, which did not include indemnification provisions. At the Oak Ridge Operations Office, an official in the Office of Chief Counsel stated that there was a need for indemnification provisions to protect the Government from liabilities of subsidiary contractors. The official stated that the performance guarantees used in the Oak Ridge contracts only represented a parent guarantee of their subsidiary company's performance and did not indemnify the Government against liabilities created by their subsidiary. This official further stated that the Department needed to standardize its performance guarantee and include indemnification provisions to protect the Government's interest. The official believed that the contract reform Final Rulemaking in June 1997 should have included a policy statement on performance guarantees and indemnification provisions.

Prudent Business Practice Dictates That Government Interests Be Protected

In 1994, the contract reform team recommended and the Department developed model contract provisions to increase contractor financial responsibility and accountability in the area of fines, penalties, third-party liabilities, Government property damage or loss, and removal of the liability ceiling for the Department's major for-profit operating contractors. The Department believed that increased contractor financial responsibility would force its contractors to focus on providing quality products and services and shift the risk of loss, arising out of contractor management deficiencies, to the party who could prevent the loss--the contractor. In this context, prudent business practice dictates that the Department protect the Government's interests by taking steps to (1) incorporate these new provisions into its major contracts and (2) secure indemnification provisions in a performance guarantee with the parents of subsidiary companies when the subsidiary does not possess the financial capability to meet potential liabilities assumed under the contract.

Model contract liability provisions that shifted financial responsibility to the contractors were available to the Department in 1994 and began appearing in for-profit operating contracts in 1995. However, in only 4 of the 20 contracts included our review did procurement officials take all of the necessary actions to limit Government exposure to contractor incurred liabilities. A procurement policy official stated that the delay in requiring the incorporation of liability provisions in these contracts occurred because of the time required to translate the contract reform report recommendations into actual contract terms and provisions.

Implementation Needs To Be Completed

Departmental officials also had not recognized the implications of adding contract reform liability provisions to the contracts without obtaining a performance guarantee with indemnification provisions from parent companies. The need was not recognized until mid-1997 when procurement policy drafted an Acquisition Letter on performance guarantees, which included model indemnification provisions. A procurement policy official stated that no one recognized that the inclusion of contract reform liability provisions would create the need to protect the Government's interest by including a performance guarantee with indemnification provisions when it contracted with subsidiary contractors that lacked financial resources.

On May 27, 1998, the Department issued an Acquisition Letter on Performance Guarantees. In our opinion, this Acquisition Letter included the technical provisions needed to protect the Government's interest against liabilities created by the subsidiary companies that manage and operate its major facilities. See Appendix 3 for Acquisition Letter 98-05, which contains a model performance guarantee with indemnification provisions. The Department's Office of Procurement and Assistance Policy agreed that an Acquisition Letter, followed by a change in Departmental procurement regulations, was needed to protect the Government's interests. Procurement policy officials estimated that the Rulemaking could be finalized by April 1999. However, correcting this situation will ultimately require the Department to negotiate these guarantees with the parent companies of all of its major for-profit operating contractors.

The Department faces unique challenges in attempting to implement contract reform principles in contracts where the contractor is a subsidiary formed solely for the purposes of performing a specific

Potential Government Liabilities Continue To Exist

management and operating contract. Under the contract provisions that implement contract reform, there is to be no limitation on the liability that a contractor may be subjected to where such liability is "caused by contractor managerial personnel's (1) willful misconduct, (2) lack of good faith, or (3) failure to exercise prudent business judgment, which means failure to act in the same manner as a prudent person in the conduct of competitive business."

As a result, a DOE contractor, specifically one that is a subsidiary of a major entity, could incur a large liability that it does not have the resources to sustain. In such cases, given the emphasis of the contract reform effort on holding contractors accountable, the reasonable expectation is that the parent entity would assume such liabilities. However, in the absence of an effective form of performance guarantee with indemnification provisions, the parent may not be legally liable for those obligations. Though the Department may not be directly liable for those obligations (unless it deemed itself liable), it may have to pay third-party costs that are the contractual responsibility of the operating contractors.

As of April 30, 1998, 230 claims valued at $332 million had been filed against 11 of the 16 contractors where DOE, in our opinion, has not adequately protected the Government's interests. These third-party claims include whistleblower, workers' compensation, discrimination, and tort cases. While it is not possible to state with certainty the final dollar outcome of these lawsuits, we believe that the Department should utilize contract reform provisions and indemnification provisions in performance guarantees to help reduce future potential Government liability and financial exposure.

For example, a 1996 third-party lawsuit for damages in excess of $15 million is pending against a DOE subsidiary contractor. The liability provisions of the Department's contract with the contractor are in accordance with the Accountability Rule. Under these provisions, the contractor liability for third-party claims is limited to avoidable costs up to the amount of fee earned during the fee period when the event occurred. In this case, a judgment against the contractor at or near the $15 million claim amount would be greater than the annual fee earned by the contractor. If, as a result, the contractor becomes bankrupt and the parent is not bound, the Department could be confronted with paying some portion of the unpaid balance.

We recommend that the Director for Procurement and Assistance Management:

RECOMMENDATIONS

1. Negotiate changes to its major for-profit operating contracts to include contract reform liability provisions and negotiate indemnification provisions in a performance guarantee with the parent or corporate entity of subsidiary contractors.

2. Issue regulatory rulemaking that requires indemnification provisions be included in performance guarantees signed by the parent or corporate business entity of subsidiary contractors.

MANAGEMENT REACTION

Management generally concurred with the findings and recommendations. The Office of Procurement and Assistance Policy indicated that the mechanisms necessary to effect the new requirements were in place; however, the implementation is not complete.

AUDITOR COMMENTS

We believe management's actions are responsive to our recommendations.

APPENDIX 1

SCOPE

The audit fieldwork was performed from October 1997 through May 1998 at four of the Department's contractors--Westinghouse Savannah River Company, West Valley Nuclear Services, Lockheed Martin Energy Research, and Lockheed Martin Energy Systems. In addition, fieldwork was performed at Departmental Headquarters and the Savannah River and Oak Ridge Operations Offices. We also worked with various other DOE sites throughout the audit to obtain contractor data in order to achieve the audit objective.

METHODOLOGY

To accomplish the audit objective, we:

- Reviewed Federal and Departmental Regulations, Departmental Orders, contract terms, and local operating policies and procedures;

- Reviewed fees earned and other incentives to determine if fees increased for subsidiary company contractors;

- Held discussions and collected data from appropriate contractor officials to determine if the subsidiary contractors have assets or insurance protecting them against potential liabilities;

- Interviewed appropriate Department and contractor officials to determine if subsidiary company contractors' risk and liability increased since contract reform;

- Determined through discussions and documentation if the contract reform provisions relating to fines, penalties, third-party liability, and damage to or loss of Government property have been incorporated into each of the Department's for-profit operating contracts; and

- Held discussions with General Counsel at Headquarters and selected operations offices to determine if the Government is protected from liabilities as a result of indemnification provisions in the performance guarantees and if the Department considered issuing policy or procedures related to indemnification of the Government.

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 conduct a reliability assessment of computer-processed data because only a very limited amount of such data was used during the audit. Management waived an exit conference on this audit effort.

APPENDIX 2

STANDARD LIABILITY AND INDEMNIFICATION PROVISIONS
BY INDIVIDUAL CONTRACTOR
AS OF APRIL 1988
(check indicates missing provisions)

	For-Profit Operating Contractors[1]	FY97 Obligational Authority (in millions)	Liability Provisions	Indemnification Provisions	Liability and Indemnification Provisions	Total
1	Westinghouse Savannah River Co.	$1,465.7		✓		✓
2	Sandia Corporation	1,318.4	✓			✓
3	Fluor Daniel Hanford Company	1,142.5		✓		✓
4	Lockheed Martin Energy Systems	927.5		✓		✓
5	Lockheed Idaho Tech. Co. - INEL	531.3	✓			✓
6	Lockheed Martin Energy Research	499.7		✓		✓
7	AlliedSignal, Inc.	341.1				
8	Mason & Hanger Corporation	303.7				
9	TRW Environmental Safety Sys.	286.8		✓		✓
10	Westinghouse Electric Corp. – BAPL	276.3	✓			✓
11	KAPL, Inc.	269.2			✓	✓
12	Fluor Daniel Fernald	254.4			✓	✓
13	Bechtel Nevada Corporation	241.2		✓		✓
14	DynMcDermott Petroleum Ops. Co.	198.1			✓	✓
15	West Valley Nuclear Services	111.7				
16	Westinghouse Electric Corp. – WIPP	93.3				
17	Wackenhut-Savannah River	50.5	✓			✓
18	Lockheed Idaho Tech. Co. – SMC	33.3	✓			✓
19	Boeing North America	18.8	✓			✓
20	Wackenhut - Nev. Test Site & L.V.	15.6	✓			✓
	TOTALS		7	6	3	16

[1] Four for-profit operating contractors were not included in this analysis.

- Kaiser-Hill Company has a Contractor Controlled Insurance Program (CCIP) that appears to protect the Government against contractor created liabilities.
- Bechtel Petroleum Operations Contract was terminated in February 1998 because of the sale of the Naval Petroleum Reserve in California to Occidental Petroleum.
- BDM-Oklahoma contract will be privatized in November 1998.
- Fluor Daniel Services Contract was terminated in March 1998 and converted into a support service contract.

Department of Energy
Acquisition Regulation

No. 98-05**R**
Date 05/27/98

ACQUISITION LETTER

AUTHORITY

This Acquisition Letter is issued by the Procurement Executive pursuant to a delegation from the Secretary and under the authority of the Federal Acquisition Regulation (FAR), Section 1.301(a)(2).
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CONTENTS

CITATION	**TITLE**
FAR Subpart 9.104, 9.105	Determinations and documentation
DEAR Subpart 970.09	Management controls

Subject: Guarantee of Performance

I. **Purpose**. The purpose of this Acquisition Letter (AL) is to provide contracting officers with guidance in making a determination of responsibility on the assets of another corporate entity where the prospective contractor is newly organized or otherwise lacks financial resources.

This revision of AL 98-05 corrects typographical errors contained in the model Performance Guarantee Agreement distributed as part of that AL. The corrections have been made in bold type in the model attached to this revision. The date of issuance has not been changed.

II. **Background**. The Department of Energy contracts with entities that have been created by an already existing corporate entity or entities solely for the purpose of performing a specific contract. This occurs with the award of most management and operating contracts. This situation can occur in the award of contracts that are not management and operating contracts where the prospective awardee is created for performance of the instant contract, for example, where a joint venture or similar legally binding corporate partnership is created in other types of contracts. The Government's interests must be protected if the financial and other resources of a potential awardee necessary to establish financial responsibility are owned or controlled by a parent corporate entity or other entity.

III. **Guidance**. Prior to award of any contract, the contracting officer must make a responsibility determination, including consideration of whether the new entity will have sufficient financial and other resources available to it to carry out performance of the prospective contract, including any liabilities it could incur to the Department under the terms of the contract.

If the prospective contractor has been created solely to perform a DOE contract, it will likely have little or no financial resources available. In order to consider the financial or other resources of the parent corporate entity(ies) or other guarantors, each of those entities should be specifically bound by a performance guarantee. A performance guarantee will contractually bind the guarantor(s) to fulfill all obligations of the newly created corporate entity if necessary to the successful completion of performance of the contract. Of course, the parent corporate entity or other guarantor itself must be found to have sufficient resources in order to satisfy its guarantee.

Attachment 1 is a model solicitation provision intended for inclusion in solicitations of management and operating contracts in which the Department of Energy has required that the performing entity be a corporation organized for and dedicated to the performance of that management and operating contract.

Attachment 2 is a model performance guarantee agreement. Each performance guarantee agreement should be drafted to assure that it is enforceable in the forum where an enforcement action would be brought should the subsidiary corporate entity fail to perform, and should the parent refuse to fulfill its guarantee. The performance guarantee agreement should then be included as an appendix to the contract.

IV. **Effective Date**. This Acquisition Letter is effective on the date of issuance.

V. **Expiration Date**. This Acquisition Letter will remain in effect until rescinded or superseded. A rulemaking is being initiated to include the essence of this Acquisition Letter into the DEAR.

Model Solicitation Provision

AL 98-05 Guarantee of Performance.

The successful proposer is required by other provisions of this solicitation to organize a dedicated corporate entity to carry out the work under the contract to be awarded as a result of this solicitation. The successful proposer will be required, as part of the determination of responsibility of the newly organized, dedicated corporate entity and as a condition of the award of the contract to that entity, to execute a guarantee of that entity's performance. That guarantee of performance must be satisfactory in all respects to the Department of Energy.

PERFORMANCE GUARANTEE AGREEMENT

For value received, and in consideration of, and in order to induce the United States (the Government), to enter into Contract DE-____ __________ for the ______________________ (Contract dated, ________ by and between the Government and _______________ (Contractor), the undersigned, _________ _______________ (Guarantor), a corporation incorporated in the State of ___________ with its principal place of business at ____________________________ hereby unconditionally guarantees to the Government (a) the full and prompt payment and performance of all obligations, accrued and executory, which Contractor presently or hereafter may have to the Government under the Contract, and (b) the full and prompt payment and performance by Contractor of all other obligations and liabilities of Contractor to the Government, fixed or contingent, due or to become due, direct or indirect, now existing or hereafter and howsoever arising or incurred under the Contract, and Guarantor further agrees to indemnify the Government against any losses the Government may sustain and expenses it may incur as a result of the enforcement or attempted enforcement by the Government of any of its rights and remedies under the Contract, in the event of a default by Contractor thereunder, and/or as a result of the enforcement or attempted enforcement by the Government of any of its rights against Guarantor hereunder.

Guarantor has read and consents to the signing of the Contract. Guarantor further agrees that Contractor shall have the full right, without any notice to or consent from Guarantor, to make any and all modifications or amendments to the Contract without affecting, impairing, or discharging, in whole or in part, the liability of Guarantor hereunder.

Guarantor hereby expressly waives all defenses which might constitute a legal or equitable discharge of a surety or guarantor, and agrees that this Performance Guarantee Agreement shall be valid and unconditionally binding upon Guarantor regardless of (i) the reorganization, merger, or consolidation of Contractor into or with another entity, corporate or otherwise, or the liquidation or dissolution of Contractor, or the sale or other disposition of all or substantially all of the capital stock, business or assets of Contractor to any other person or party, or (ii) the institution of any bankruptcy, reorganization, insolvency, debt agreement, or receivership proceedings by or against Contractor, or adjudication of Contractor as a bankrupt, or (iii) the assertion by the Government against Contractor of any of the Government's rights and remedies provided for under the Contract, including any modifications or amendments thereto, or under any other document(s) or instrument(s) executed by Contractor, or existing in the Government's favor in law, equity, or bankruptcy.

Guarantor further agrees that its liability under this Performance Guarantee Agreement shall be continuing, absolute, primary, and direct, and that the Government shall not be required to pursue any right or remedy it may have against Contractor or other Guarantors under the Contract, or any modifications or amendments thereto, or any other document(s) or instrument(s) executed **by** Contractor, or otherwise. Guarantor affirms that the Government shall not be required to first commence any action or obtain any judgment against Contractor before enforcing this **Performance Guarantee Agreement against Guarantor, and that Guarantor will, upon demand, pay the** Government any amount, the payment of which is guaranteed hereunder and the payment of which by Contractor is in default under the Contract or under any other document(s) or instrument(s) executed by Contractor as aforesaid, and that Guarantor will, upon demand, perform all other obligations of Contractor, the performance of which by Contractor is guaranteed hereunder.

Guarantor agrees to assure that it shall cause this Performance Guarantee Agreement to be unconditionally binding upon any successor(s) to its interests regardless of (i) the reorganization, merger, or consolidation of Guarantor into or with another entity, corporate or otherwise, or the liquidation or dissolution of Guarantor, or the sale or other disposition of all or substantially all of the capital stock, business, or assets of Guarantor to any other person or party, or (ii) the institution of any bankruptcy, reorganization, insolvency, debt agreement, or receivership proceedings by or against Guarantor, or adjudication of Guarantor as a bankrupt.

Guarantor further warrants and represents to the Government that the execution and delivery of this Performance Guarantee Agreement is not in contravention of Guarantor's Articles of Organization, Charter, by-laws, and applicable law; that the execution and delivery of this Performance Guarantee Agreement, and the performance thereof, has been duly authorized by the Guarantor's Board of Directors, Trustees, or any other management board which is required to participate in such decisions; and that the execution, delivery, and performance of this Performance Guarantee Agreement will not result in a breach of, or constitute a default under, any loan agreement, indenture, or contract to which Guarantor is a party or by or under which it is bound.

No express or implied provision, warranty, representation or term of this Performance Guarantee Agreement is intended, or is to be construed, to confer upon any third person(s) any rights or remedies whatsoever, except as expressly provided in this Performance Guarantee Agreement.

In witness thereof, Guarantor has caused this Performance Guarantee Agreement to **be** executed by its duly authorized officer, and its corporate seal to be affixed hereto on ________________

NAME OF CORPORATION

NAME AND POSITION OF OFFICIAL
EXECUTING PERFORMANCE
GUARANTEE AGREEMENT ON BEHALF OF
GUARANTOR

ATTESTATION INCLUDING APPLICATION
OF SEAL BY AN OFFICIAL OF
GUARANTOR AUTHORIZED TO AFFIX
CORPORATE SEAL

Audit of Department of Energy Management and Operating Contractor Available Fees
DOE/IG-0390, May 8, 1996

The Department, during Fiscal Year 1996, proposed changes to its Acquisition Regulation that could have increased available management and operating contractor fees by as much as $218 million per year without demonstrating (1) a commensurate increase in risk assumed by the contractors or (2) other quantitative or qualitative benefits that render the proposal in the best interest of the Government. The revisions to the Acquisition Regulation were proposed without performing a cost-benefit analysis. Without such an analysis, the Department could not ensure that the revisions to the Acquisition Regulation are cost effective and that they achieve the long-term contract reform goals of the Department.

Audit of Implementation of the Accountability Rule
DOE/IG-0339, January 21, 1994

The Department had no conclusive evidence that the Accountability Rule was achieving its objectives. Although the Department had increased fees paid to the contractors by $22.8 million for five contracts and had funded $2.5 million in annual expenses to administer the Accountability Rule for six contracts, it had not received any measurable benefits in return for this investment. No significant improvements were evident in contractor performance, and the extent of changes in contractor liability was minimal. Also, unresolved factors that impeded the accomplishment of program objectives were (1) shortcomings in implementing guidance and direction, (2) lack of baseline or benchmark data, (3) the use of contract provisions that had not significantly increased or altered the contractors' liabilities, (4) a fee structure that did not maximize the incentives for contractors to improve performance, (5) negotiation of contract deviations that significantly reduced the liability of a management and operating contractor, and (6) failure of the Department to augment the staff of its operations offices.

Contract Reform Is Progressing, but Full Implementation Will Take Years
General Accounting Office, GAO/RCED-97-18, December 10, 1996

DOE has completed action on 47 of the 48 contract reform recommendations, but 9 of the completed actions did not meet the requirements of the contract reform team. DOE explained that while actions may not have strictly adhered to the requirements of the reform team, nevertheless, the actions achieved their intended goals. DOE also missed its deadlines for completing the required new policies, guidance, and plans that serve as the framework for contract reform by an average of 11 months. The missed deadlines have added to the time needed to implement contract reform.

Challenges to Implementing Contract Reform
General Accounting Office, GAO/RCED-94-150, March 21, 1994

- As DOE moves forward with its contracting changes, a number of issues confront management as it develops an implementing strategy:

- DOE staff should be prepared to implement the Team's initiatives with stronger contract administration and oversight skills, supported by reliable management and financial information systems. Weaknesses in these areas have long plagued DOE's contracting activities and have hampered past contracting reform efforts.
- The recommendation to hold nonprofit contractors to the same level of accountability as profit-making firms highlights the importance of having a skilled workforce and strong systems to properly administer new contracting rules.
- DOE's desire to grant contractors greater freedom to change the skill mix of their workforces to meet new mission requirements underscores the importance of DOE's having an overall plan for restructuring the entire contractor workforce.
- The recommendations to negotiate performance-based contracts places a high premium on developing fee and profit policies that are consistent with results-oriented performance measures.
- Requiring audited financial statements from DOE's contractors (under review by the Chief Financial Officer) could lessen the need for the Team's other recommendations on voucher accounting and contract audits.
- Finally, a key to achieving contracting change will be establishing a strong institutional entity with the oversight responsibility for holding DOE managers accountable for implementing the reform team's recommendations.

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