DOE/IG-0503

AUDIT REPORT

INCENTIVE FEES FOR BECHTEL JACOBS COMPANY LLC

MAY 2001

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

DEPARTMENT OF ENERGY
Washington, DC 20585

May 7, 2001

MEMORANDUM FOR THE SECRETARY

FROM: Gregory H. Friedman (Signed)
Inspector General

SUBJECT: INFORMATION: Audit Report on "Incentive Fees for Bechtel Jacobs Company LLC"

BACKGROUND

In December 1997, the Oak Ridge Operations Office (Operations Office) awarded a $2.5 billion performance-based management and integration contract to Bechtel Jacobs Company LLC (Bechtel Jacobs) for environmental remediation activities in Oak Ridge, Tennessee; Paducah, Kentucky; and Portsmouth, Ohio. The contractor was also responsible for uranium enrichment functions at Paducah and Portsmouth. Under this arrangement, the contractor is to receive incentive fees for accomplishing performance objectives negotiated before the start of the performance period, in this case prior to the beginning of each fiscal year. The performance objectives describe what the contractor is to accomplish and when the task is to be completed.

At the end of each fiscal year, based on an evaluation of actual performance in relation to prescribed objectives, the contractor is compensated for its work by receiving an incentive fee from the Department. For Fiscal Years 1999 and 2000, Bechtel Jacobs received incentive fees totaling $34.7 million.

The objective of this audit was to determine whether the Operations Office required Bechtel Jacobs to meet performance objectives that were established before the start of the performance period.

RESULTS OF AUDIT

Despite the terms of the contract, we found that the Operations Office had not established all of the contractor performance objectives prior to the start of the performance period nor had it required the contractor to meet all of the performance objectives that, in fact, had been established. Specifically, the Operations Office:

- did not incentivize performance objectives in Fiscal Year 1998;
- did not finalize performance objectives before the start of Fiscal Years 1999 and 2000; and,
- modified performance objectives to reduce expectations during each year.

We found that the Operations Office did not follow Departmental procedures for developing incentive fees. Further, plans were not developed for making compensating adjustments to fees to reflect performance objectives which were lowered during the period. The contractor received incentive fees of $6.2 million for Fiscal Years 1999 and 2000 performance, even though the initial performance expectations directly tied to the fees were not met.

MANAGEMENT REACTION

Management concurred with the finding and recommendations and stated that it will revise its current Performance Evaluation Plan to include provisions to address our recommendations. The revised Performance Evaluation Plan should be completed by May 30, 2001. Although management agreed to implement our recommendations, it contended that: (i) the contractor had earned its incentive fees; and (ii) changes to the initial expectations were made through a formal change control process. Management stated that the performance expectations were changed because of regulator delays, a lack of funding for the incentivized work, Department directed scope changes, lack of performance by other Department contractors, and changed conditions.

We recognize that there are circumstances, including some which are beyond the control of the Department and/or the contractor, that justify changes to contractor performance objectives. However, a pattern of frequent changes in successive periods, as we found at Oak Ridge, suggests that the fundamental character of the contract instrument has, in effect, been modified–instead of compensating the contractor for performance, the Department is rewarding a level of effort. This, in our view, undermines the goal of promoting excellence in contractor performance by incentivizing the fee process. In addition to the work reported here, the Office of Inspector General is currently examining various aspects of performance-based contracting practices at other Departmental sites.

Attachment

cc: Director of Procurement and Assistance Management

INCENTIVE FEES FOR BECHTEL JACOBS COMPANY LLC

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OVERVIEW

INTRODUCTION AND OBJECTIVE

In February 1994, the Department of Energy's (Department) Contract Reform Team issued its report entitled *Making Contracting Work Better and Cost Less*. One of the report's recommendations was that the Department should use an incentive fee approach in which the contractor's "profit" is tied to the achievement of specific cost, schedule, or technical objectives. This contracting approach is referred to as performance-based contracting.

In December 1997, the Oak Ridge Operations Office (Operations Office) awarded a $2.5 billion performance-based management and integration contract to Bechtel Jacobs Company LLC (Bechtel Jacobs) for environmental remediation activities at Department sites in Oak Ridge, Tennessee; Paducah, Kentucky; and Portsmouth, Ohio. A primary objective was to accelerate cleanup activities and maximize cost effectiveness. In addition to the environmental management work, Bechtel Jacobs is also responsible for the enrichment facility programs at Paducah and Portsmouth.

The contract states that the Operations Office will pay incentive fees to Bechtel Jacobs for accomplishing performance objectives negotiated before the start of each fiscal year (FY). Each incentive fee is based on a performance objective that describes what the contractor is to accomplish and when the task must be completed in order to qualify for payment of the fee. At the end of each year, the Operations Office pays Bechtel Jacobs the fee associated with performance objectives accomplished during the year. The Operations Office awarded $18.5 million and $16.2 million in incentive fees for work performed during FYs 1999 and 2000, respectively.

The objective of this audit was to determine whether the Operations Office required Bechtel Jacobs to meet performance objectives that were established before the start of the fiscal year.

CONCLUSIONS AND OBSERVATIONS

The Operations Office did not require Bechtel Jacobs to meet performance objectives that were established before the start of the fiscal year. Specifically, the Operations Office did not incentivize performance objectives in FY 1998, did not finalize performance objectives before the start of FYs 1999 and 2000, and modified performance objectives to reduce expectations during each year. This occurred because the Operations Office did not follow procedures for developing incentive fees and did not develop plans for reducing fees when performance expectations were lowered. As a result, the

Operations Office paid Bechtel Jacobs $6.2 million in fees for initial objectives that were not achieved.

The Office of Inspector General (OIG) and the General Accounting Office (GAO) have issued several reports related to performance-based contracts. The OIG determined that contractors were paid fees for work accomplished before incentives were established, for work that was easily accomplished, and for performance that was process-oriented rather than results-oriented. The GAO reported that the Department did not evaluate the impact of performance-based contracting on its laboratory contractors and, as a result, did not know if this new form of contracting was achieving the intended objectives of reducing costs and improving performance. (See Appendix 2 for a list of OIG and GAO reports.)

In March 2001, the OIG issued DOE/IG-0498, *Audit of Bechtel Jacobs Company LLC's Management and Integration Contract at Oak Ridge*. This audit reported that Bechtel Jacobs did not use competitive, fixed-price subcontracts or reduce staffing, through workforce transitioning, to the extent proposed. The audit also disclosed that the Oak Ridge Operations Office had not incorporated these requirements in the Bechtel Jacobs contract, limiting the Department's ability to hold the contractor accountable for achieving these goals. Bechtel Jacobs, in an attempt to explain the disconnect between its original proposal and actual performance, stated that managing and integrating the work was more difficult than anticipated. The report concluded, however, that the Department could have saved an additional $44.1 million in FY 2000 had Bechtel Jacobs met the initial terms of its proposal.

In addition to prior audits, the OIG has two ongoing audits dealing with similar issues. The audit of "Performance-Based Contracting Practices in the Department" is being conducted to determine if the Department's use of performance-based contracts has resulted in improved contractor performance. The audit of "Available Fees for the Department's Management and Integrating Contractors" is being performed to determine whether management and integrating contractors' fees were commensurate with their risks and responsibilities.

This audit identified issues that management should consider when preparing its yearend assurance memorandum on internal controls.

Signed
Office of Inspector General

Operations Office Did Not Require Bechtel Jacobs to Meet Performance Objectives

The Operations Office did not require Bechtel Jacobs to meet performance objectives that were established before the start of the fiscal year. Specifically, the Operations Office did not incentivize performance objectives in FY 1998, did not finalize performance objectives before the start of FYs 1999 and 2000, and modified performance objectives to reduce expectations during each year.

Performance Objectives Were not Incentivized in FY 1998

The Operations Office did not incentivize performance objectives in FY 1998. The contract originally included 25 performance objectives for which incentive fees were to be negotiated for April through September 1998. However, on August 26, 1998, the Operations Office removed all of the performance objectives and agreed to pay Bechtel Jacobs $9 million in fixed fee for the performance period. The performance objectives were removed because of difficulties related to contractor transition and difficulties with meeting the Department's requirement to establish costs for each performance objective.

The Operations Office agreed to pay the fixed fee even though Bechtel Jacobs did not complete 6 of the 25 performance objectives originally established for the period. Five of the incomplete objectives were related to project management and execution, including two that were reincentivized by the Operations Office in FY 2000. For example:

- Bechtel Jacobs was to complete scrap removal and preparation for disposal of Paducah Drum Mountain materials by September 30, 1998. Bechtel Jacobs finally completed this task in September 2000 and was paid $852,000 in incentive fees after completion.

- Bechtel Jacobs was to remove the sludge from a tank at Oak Ridge National Laboratory by September 30, 1998. Bechtel Jacobs completed this task in March 2000 and was paid $925,000 in incentive fees after completion.

Performance Objectives Were Not Finalized Before FY 1999 and FY 2000

The Operations Office did not finalize the majority of performance objectives before the start of FYs 1999 and 2000. In fact, only 11 of the 160 FY 1999 and FY 2000 performance objectives were finalized before the start of the fiscal year. The Operations Office did not finalize 5 performance objectives, worth a total of about $335,000 in fee, until September 2000. Further, as of November 15, 2000, the Operations Office had finalized only four FY 2001 performance objectives.

Performance Objectives Were Modified to Reduce Performance Expectations

The Operations Office reduced performance expectations for 56 of the 160 FY 1999 and FY 2000 performance objectives during the performance period. The following are examples of modified performance objectives.

- The Operations Office reduced the performance expectation for construction of a remediation facility at Paducah, Kentucky by 50 percent. The Operations Office originally agreed to pay $150,000 for completing construction of the facility by September 20, 1999. After the project was delayed about 2 months due to Department licensing issues, the Operations Office reduced the performance expectation in May 1999 so that Bechtel Jacobs could receive the full fee for completing only half the construction by September 30, 1999.

- In August 1999, the Operations Office reduced the performance expectation for waste disposal and repackaging at Portsmouth, Ohio by about 34 percent. The Operations Office agreed to pay Bechtel Jacobs $220,000 in fee if it disposed of or repackaged 1,183 containers of waste at Portsmouth by September 30, 1999. The Operations Office later reduced funding for the project and reduced performance expectations to require disposal of 783 containers, but it did not lower the fee associated with the task. As a result, the Operations Office paid Bechtel Jacobs the entire fee for disposing of only 66 percent of the containers in FY 1999. Furthermore, the Operations Office paid Bechtel Jacobs an additional $170,000 in incentive fees for disposing of the remaining 400 containers in FY 2000.

- The Operations Office significantly reduced the performance expectation for removing a uranium deposit from a facility at the Oak Ridge National Laboratory in FY 1999 and again in FY 2000. The Operations Office agreed to pay $546,000 in fee if Bechtel Jacobs completed the removal action by January 25, 1999. Afterward, Bechtel Jacobs discovered different conditions than expected. As a result, the Operations Office reduced the expectation to require only the design of removal equipment and the beginning of preparations for removal by August 31, 1999. The Operations Office paid Bechtel Jacobs the entire fee for completing the design and beginning preparations for removal on schedule. Then, in November 1999, the Operations Office agreed to pay $350,000 in additional fee if Bechtel Jacobs completed the entire removal action before October 2000. However, on September 27, 2000, the Operations Office lowered the performance expectation to having the removal equipment ready for installation. As a result, Bechtel Jacobs earned $896,000 in incentive fees without removing any of the waste. The performance expectations were reduced because the Department created additional work requirements and the contractor's work plans were inadequate. Further, the Operations Office plans to pay Bechtel Jacobs about $71,000 in fees for this removal action in FY 2001.

- The Operations Office eliminated a performance expectation for treating waste sediment, and added the associated fee to other performance objectives in FY 2000. The Operations Office agreed to pay Bechtel Jacobs $265,500 in fee if it began treating waste sediment by September 30, 2000. However, the treatment was deferred to FY 2001 after significantly more sediment was discovered during the site survey and the proposed treatment process did not appear to be working. Instead of deferring the incentive fee for the treatment of the sediment, the Operations Office increased available fees for backfilling the sediment and building the treatment plant by the fee originally assigned to the treatment.

Expectations Should Be Established Before Performance and Should Not Be Reduced

The Department's contract with Bechtel Jacobs states that incentive fees shall be paid to Bechtel Jacobs for the accomplishment of negotiated performance objectives, that the Operations Office and Bechtel Jacobs will negotiate performance objectives before the beginning of the fiscal year, and that the Operations Office will prepare an annual performance evaluation plan. The Operations Office's *Performance Evaluation Plan* for the Bechtel Jacobs contract details the processes for developing, managing, and evaluating incentive fees. The plan states that performance objectives shall be established annually before the performance period, and shall be results-oriented. Performance objectives consist of three variables: cost, schedule, and scope of work. The initial estimates for these variables become the project requirements. Increasing the cost or time allowed to complete a project, or decreasing the scope of work to be done is considered a reduction in project requirements.

Operations Office Did Not Follow Procedures or Develop Plans

The Operations Office did not follow procedures for developing and managing incentive fees and did not develop plans for reducing fees when performance expectations were lowered. The Operations Office did not incentivize performance objectives in FY 1998 because of difficulties related to Bechtel Jacobs' transition and difficulties with establishing costs for each performance objective. Operations Office managers stated that a major problem with negotiating incentive fees in FYs 1999 and 2000 was the changing scope and funding requirements. The performance expectations for negotiated performance objectives were reduced without a reduction in the incentive fee because the Operations Office did not develop plans for reallocating incentive fees. In the absence of a plan, the Operations Office assumed that the incentive fees were tied to the work that could be accomplished during the fiscal year, instead of the original performance objective. Although the Operations Office did not follow its own procedures, we determined that the performance objectives were established in accordance with the Government Performance and Results Act of 1993.

Operations Office Paid Fees When Expectations Were Not Met

The Operations Office paid Bechtel Jacobs $6.2 million in fees for FYs 1999 and 2000 performance, even though the initial performance expectations directly tied to these fees were not met. Bechtel Jacobs would not have received $6.2 million in fee had the Department held it accountable for achieving the agreed-to performance objectives, instead of reducing performance expectations. We determined the amount of overpayments by adding the fees associated with performance objectives for which the Department's expectations were reduced during FYs 1999 and 2000. We could not determine how much of the $9 million fixed fee paid for FY 1998 was unnecessary because the Operations Office never established the amount of fee available for specific performance objectives.

About $15.3 million of the fees paid to Bechtel Jacobs in FYs 1998, 1999, and 2000 were for work with no associated performance objectives or reduced expectations. This takes on added significance when future fees are considered, since Bechtel Jacobs could earn up to $149 million in additional incentive fees over the remaining base and option years of the contract.

RECOMMENDATIONS

We recommend that the Manager, Oak Ridge Operations Office implement the *Performance Evaluation Plan,* and:

1. Finalize performance objectives before the beginning of each performance period;

2. Ensure that incentive fees are not increased after the start of the period without requiring increased performance;

3. Ensure that incentive fees are decreased or not paid when performance requirements are decreased or not met; and,

4. Develop plans for reallocating incentives fees when performance requirements change.

MANAGEMENT REACTION

Management concurred with the finding and recommendations and stated that they were revising the Performance Evaluation Plan to include provisions that address the recommendations. The projected completion date is May 30, 2001. Management stated that the changes to performance expectations were made through a formal change control process. Management also stated that the performance expectations were changed because of regulator delays, a lack of funding for the incentivized work, Department directed scope changes, lack of performance by other Department contractors, and changed conditions.

AUDITOR COMMENTS

Management's planned actions are considered to be responsive. We acknowledge that there were numerous reasons for reducing performance expectations. However, our report contains numerous examples of the Department paying full incentive fees for Bechtel Jacobs accomplishing less work than planned. The Operations Office did not follow the Department's procedures for developing incentive fees, and did not develop plans for renegotiating or reassigning fees when performance expectations were lowered. The Operations Office should have deferred payment of incentive fees until the agreed-to tasks were completed or reassigned the fees to other high-priority projects.

Appendix 1

SCOPE

The audit was performed from June 15, 2000, to January 19, 2001, at the Oak Ridge Reservation in Oak Ridge, Tennessee; the Paducah Gaseous Diffusion Plant, in Paducah, Kentucky, and the Portsmouth Gaseous Diffusion Plant, in Portsmouth, Ohio. The audit included a review of Bechtel Jacobs' performance-based incentives in FYs 1998 through 2000.

METHODOLOGY

To accomplish the audit objective, we:

- Reviewed Departmental requirements for performance-based contracting;
- Reviewed the Operations Office's contractual and internal requirements for incentive fees;
- Reviewed FY 1999 and 2000 PBIs and related performance agreements between the Operations Office and Bechtel Jacobs;
- Assessed Bechtel Jacobs' cost collection system related to incentive fees;
- Reviewed the Operations Office's project cost variance techniques for evaluating and applying performance measures;
- Held discussions with Operations Office and Bechtel Jacobs personnel regarding the development and implementation of incentive fees; and,
- Determined that performance measures were established in accordance with 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. Accordingly, the assessment included reviews of the Department's contract with Bechtel Jacobs and guidance for the development of incentive fees. 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 to achieve our audit objective.

We held an exit conference with the Acting Chief Financial Officer, Oak Ridge Operations Office on April 23, 2001.

Related Office of Inspector General and General Accounting Office Reviews

This review concerned the Department's contract reform in the area of performance incentives. Prior Office of Inspector General and General Accounting Office reviews related to this area include those listed below.

Performance Incentives at the Idaho National Engineering and Environmental Laboratory, (WR-B-00-05, April 2000). Performance incentives at the INEEL had not been fully successful in improving performance and reducing costs and these problems resulted in the auditors questioning about $11.3 million in incentive fees paid to Lockheed Martin Idaho Technologies Company.

*National Laboratories: DOE Needs to Assess the Impact of Using Performance-Based Contract*s, (GAO/RCED-99-141, May 1999). The Department had not evaluated the impact of performance-based contracting on its laboratory contractors and, as a result, did not know if this new form of contracting was achieving the intended objectives of reducing costs and improving performance.

*The Fiscal Year 1996 Performance Based Incentive Program at the Savannah River Operations Offic*e, (INS-O-98-03, May 1998). The Savannah River Operations Office had incentives that were not clearly stated and paid excessive fees.

*Audit of the Contractor Incentive Program at the Nevada Operations Offic*e, (DOE/IG-0412, October 1997). The Nevada Operations Office performance incentives were vague, could not be objectively validated, and were implemented after the performance period had been completed.

*Audit of the Contractor Incentive Programs at the Rocky Flats Environmental Technology Sit*e, (DOE/IG-0411, August 1997). The Department's performance incentives at the Rocky Flats Environmental Technology Site did not always include clearly defined criteria, were not structured to encourage and reward superior performance, and were often process-oriented rather than results-oriented.

*Inspection of the Performance Based Incentive Program at the Richland Operations Offic*e, (DOE/IG-0401, March 1997). The Richland Operations Office paid excessive incentive fees; paid fees for work that was accomplished prior to the establishment of the incentive program; paid fees for work that was not completed, paid fee for work that was easily achieved by the contractor; and paid fee in an instance where quality and safety were compromised by the contractor in order to achieve an incentive fee.

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