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B-216375

APRIL 12, 1985

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The Honorable Mike Synar
Chairman, Subcommittee on Environment,
Energy, and Natural Resources
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

Subject: Selected Management Activities at the Naval Petroleum Reserve, California (RCED-85-7)

Your January 20, 1984, letter asked us to review certain aspects of the operations of the Department of Energy's (DOE) Naval Petroleum Reserve, California (NPRC). Specifically, we focused on the process used in establishing the fee for the contractor to operate NPRC in fiscal year 1984, the adequacy of NPRC's audit coverage, and justification for the proposed construction of additional NPRC office space.

We found that the contractor's fee was not established in accordance with DOE's regulations. We also found that independent audit coverage at NPRC in the last several years has been too limited to assure that major aspects of operations are adequately evaluated. In addition, we noted that NPRC's plans for acquisition of new office space did not fully take into consideration leasing as an alternative.

OBJECTIVES, SCOPE, AND METHODOLOGY

In examining the process followed in establishing the contractor's fee, we reviewed records of the fiscal year 1984 negotiations and compared this with DOE's fee-setting criteria. Also, we interviewed the prime contractor and DOE officials responsible for establishing, and later awarding, the fee and monitoring the contract.

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In our review of the NPRC audit function, we examined internal and external audit reports and their findings and the resultant actions taken. We interviewed internal and external auditors and evaluated their auditing procedures and independence based on published GAO standards. We also made a limited evaluation of internal controls in effect for functions such as overtime payments, reconciliation of letters-of-credit, and accounting for miscellaneous receipts.

In our review of planned additional office space, we examined the building proposal and contacted knowledgeable people in real estate to determine space availability.

Our review was performed at DOE and contractor offices at the NPRC near Bakersfield, California, and included work at Department of Energy offices in Washington, D.C.; Germantown, Maryland; and at the offices of Chevron, U.S.A., which owns part of the NPRC. We interviewed DOE procurement, NPRC, and Office of Naval Petroleum and Oil Shale Reserves (ONPOSR) officials and reviewed records, including pertinent contracts, regulations, and procedures dealing with NPRC.

We performed our review from February to September 1984 in accordance with generally accepted government auditing standards.

BACKGROUND

NPRC is the second largest oil field in the United States, with current production of 132,000 barrels a day, generating net revenues of over $1 billion annually. DOE has had the responsibility for operating the field since 1977, when it was transferred from the Navy by the Department of Energy Organization Act.

NPRC is owned jointly by the government and Standard Oil of California (Chevron) and operates as a single entity under a unit plan contract executed in 1944. Chevron owns approximately 20 percent of the land within NPRC and, as co-owner, has a seat on the operating committee, contributes to operating costs, and is entitled to a participating percentage of production. The government, however, retains control over the time and rate of development and production.

The day-to-day operation at NPRC is performed by the prime contractor, Williams Brothers Engineering Company (WBEC), under the direction of the operating committee. The contract is let for 5-year periods on a "cost plus award fee" basis. Under this contractual arrangement, the contractor is reimbursed for costs incurred and awarded an annual fee either partially or totally based on each year's performance. The current contract is in its fifth year and will end September 30, 1985.

At the time of our review, DOE estimated the contract costs for fiscal year 1984 at $170 million plus a potential award fee of nearly $6 million. DOE later cut back on NPRC operations, reducing final contract costs by $50 million and settling the fiscal year 1984 contract with a fee of $3.5 million, the highest that WBEC has received under its 5-year contract.

CONTRACTOR'S FEE NOT ESTABLISHED IN ACCORD WITH DOE PROCEDURES

DOE could not provide documentation, or an explanation showing that, in negotiating the contractor's potential award fee of nearly $6 million, it had followed procedures set forth in its regulations. Although we did not examine the fee-setting procedures used in previous years, fiscal year 1984 stands out because the potential award fee negotiated was almost double that set in previous years. We believe that, in future negotiations, the contractor's role needs to be assessed against DOE's fee-setting procedures and the results of the assessment documented.[1]

According to DOE regulations effective at the time of the 1984 negotiations, the contractor's potential fee was to be derived by placing a value on each of 11 factors, basically covering such things as the contractor's risk, responsibility, investment, etc. This amount was then to be compared with and subject to a maximum allowable amount, calculated from tables in DOE's procurement regulation. The lesser of the two amounts was then to be designated as the fixed fee. DOE, however, encourages the use of award fee contracts over fixed fee contracts because of the incentive for good performance offered by an award fee arrangement. In an award fee contract, the contractor agrees to accept one half or less of the fixed fee as a base fee, to be augmented by an award fee equal to 100 to 200 percent of the fixed fee. The award fee is awarded based strictly on contractor performance. The less a contractor relies on a base fee and the more its fee is related to performance, the higher the potential total fee.

In the 3 years prior to fiscal year 1984, a total potential fee of about $3 million was established using a base fee of 50 percent of the fixed fee and an award fee equal to 100 percent of the fixed fee. In 1984, however, the contractor accepted a base fee of zero, and thus qualified for an award fee of up to 200 percent of the fixed fee. This resulted in the contractor receiving a much higher fee for its services than in any of the previous years.

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[1]We have reported on similar problems with this type of DOE contract, DOE Should Strengthen Its Controls Over Award Fees to Contractors, GAO/RCED-84-39, Nov. 22, 1983.

In establishing the fixed fee for the fiscal year 1984 contract, we found no indication that the first step in the process--that is, consideration of the 11 factors--was performed. Documentation showed only a negotiation of what costs to use in calculating the maximum allowable amount. In this regard, the 1984 estimated contract cost of $170 million was reduced to $130 million for directed procurements and purchases of capital equipment and then applied to the tables in DOE regulations resulting in a maximum allowable fixed fee of $2.965 million. This amount, however, was not compared with or adjusted by an amount determined based on consideration of the 11 factors. Thus, the $2.965 million maximum allowable amount was the base used for establishing the total potential fee.

In looking at two of what appeared to be the more important of the 11 factors--financial risk and difficulty of work--a maximum fee would not appear warranted, as discussed below.

Financial risk to the contractor

The extent of the contractor's financial independence is limited. Although subject to regular budget and project approvals, the contractor must also request approval for individual purchase requisitions. With some recently adopted exceptions, all purchase requisitions exceeding $2,500, as well as the purchase of all "sensitive items," such as calculators, office equipment, stop watches, and batteries, must also be approved. According to the contractor, these expenditure thresholds, in effect since 1944, have resulted in DOE and operating committee approval of more than 98 percent of all dollars associated with contractor purchase requisitions. In addition, all costs incurred by the contractor are reimbursed unless specifically disallowed. Further, we noted that the use of a letter-of-credit[2] makes funds available to the contractor at the time costs are incurred.

DOE's purchase approval process reduces WBEC's financial risks and, we believe, makes a maximum award fee for this factor unwarranted. The DOE contracting officer agreed with us that there is no financial risk to the contractor at NPRC.

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[2]A letter from a banker authorizing and guaranteeing withdrawal up to a certain sum. WBEC draws money as needed.

Relative difficulty of the work

Although the contractor does complex work, technical advice and experience are available from Chevron and DOE personnel. In addition, the contractor has limited responsibility for the administrative and day-to-day technical management of field operations, with much of the decisionmaking responsibility having been retained by DOE and Chevron. For example, while WBEC is responsible for drilling, DOE retains responsibility for drilling engineering. This split in management responsibility requires the government to be more active in everyday matters than a contract monitoring role would require. According to members of the operating committee and the DOE Director of Engineering, a prime contractor would normally be responsible for the drilling engineering and any qualified engineer--government or private--could perform this function because detailed engineering specifications are developed and their implementation is overseen by the operating committee.

In addition, we noted that WBEC had to seek operating committee approval for many routine, if not minor, actions, including such things as (1) how and where to vary gas injection on a day-to-day basis to reach monthly pool target injection rates, (2) disposal of a junk vehicle, and (3) extension of a subcontract for janitorial services.

The DOE contracting officer agreed with us that the operation of NPRC would not be classified as difficult.

Recommendation

We recommend that prior to awarding the next contract to operate NPRC--an action which could take place very shortly--the Secretary of Energy verify and document the consistency of the fee-setting process with relevant DOE criteria.

AUDIT EFFECTIVENESS AT NPRC COULD BE ENHANCED

Although NPRC has been the subject of numerous audits by a number of audit organizations, we found that the scope of independent audit coverage has been too limited. NPRC's own internal review activity is organizationally placed so that it does not meet GAO's standards for independence. In addition, DOE's Inspector General (IG), who is independent, has not covered key aspects of NPRC operations.

Independent audit coverage has been limited

An internal audit organization should be independent of the officials directly responsible for the operations it reviews. To provide an adequate degree of independence, internal audit should be responsible to the highest practical organizational level, preferably to the agency head or to a principal official reporting directly to the agency head. GAO's Standards for Audit of Governmental Organizations, Programs, Activities, and Functions states that:

> "In all matters relating to the audit work, the audit organization and the individual auditors, whether government or public, must be free from personal or external impairments to independence, must be organizationally independent, and shall maintain an independent attitude and appearance."

Both the contractor and DOE have audit staffs located at NPRC and they have conducted numerous audits. While their work is valuable to local management, they do not meet GAO's standard of independence. At the time of our review, DOE's local audit staff reported to NPRC's Contracts and Financial Management Division, which had line responsibility for many of the functions being audited. In addition, its audits tended to be narrow in scope, covering such things as vendor discounts, sales/use taxes, vehicle mileage, overtime meals, petty cash, bank statement reconciliations, subcontractor activities, and payroll.

The only audit function that met GAO's standard of independence from NPRC management is that of the IG, but its coverage was also limited. For example, the IG had performed audits of warehousing and contract costs and, at the time of our review, was auditing certain aspects of revenues. We were advised, however, that no other work was planned for fiscal year 1984. The Chief of the IG's Western Division, responsible for reviewing NPRC activities, agreed that more coverage was needed, but said that they were limited by other audit responsibilities and available staff.

Need for audit coverage

At the time of our review, several major areas such as the development drilling program and payroll, with annual budgets of $80 million and $29 million, respectively, or property, currently valued at over $900 million, had never been audited by any group outside of NPRC.

Following are examples of payroll and other problems we identified that might have been corrected or brought to management attention given more audit coverage.

—During the period February 1983 through March 1984, the contractor provided temporary employees for DOE use with costs amounting to $57,000, even though the contract does not permit the hiring of temporary employees to be used in DOE positions. When, in March 1984, we questioned the use of temporary help, NPRC discontinued this practice.

--Reimbursements from vendors, amounting to $1.1 million, were received by the contractor during fiscal years 1981 through 1983, but not credited to the contract. This resulted in an overstatement of the contract amount and a proportioned potential overpayment in the fee to the contractor. We brought this matter to the attention of the Director, ONPOSR, and the IG.

When our review was completed, we were advised by the Director, ONPOSR, that the reporting level of the DOE audit staff at NPRC is being elevated to the Director, NPRC. The IG also advised us that it is increasing its audit coverage of NPRC and, to help alleviate its staffing problems, plans to contract out some of the audit work.

Recommendation

Although the IG is increasing its coverage of NPRC operations, and the reporting level of the NPRC audit staff is being raised, the latter group is still reporting to a level directly responsible for the matters being reviewed. Accordingly, we recommend that the Secretary of Energy direct that the NPRC audit staff report to a management level that is independent of the officials who are directly responsible for the operations they review, such as to the IG; Assistant Secretary, Fossil Energy; or the Under-Secretary, Energy.

PLANNED CONSTRUCTION OF ADDITIONAL OFFICE SPACE AT NPRC

According to DOE, additional office space is needed for staff at NPRC, and new construction is planned, but we question whether the merits of leasing space in nearby Bakersfield have been fully considered.

NPRC's main administration building, constructed in 1977 and located at NPRC, is approximately 35 miles from Bakersfield, California. At the time of our review, about 215 DOE, Chevron, and contractor personnel occupied the building at NPRC. Twenty eight additional contractor personnel were located in trailers around the administration building, and 149 other personnel were located 3 miles away in other temporary facilities.

In April 1982 the NPRC contractor requested additional office space, amounting to 12,000 square feet, to relocate its subcontracting and purchasing personnel from the temporary facilities. However, later design plans proposed a 43,100 square foot addition at an estimated cost of $6 million, apparently for the entire 177 personnel not in the main building. The enlarged facility was planned for 426 persons.

It appeared only minimal consideration was given to the alternative of leasing space in Bakersfield, about 35 miles away. The NPRC Director had made limited comparative cost estimates related to moving to Bakersfield, but we found had overstated the disadvantages of using such space. For example, the Director estimated that leasing space in Bakersfield would require 121 daily round trips to NPRC at an annual cost of $2.4 million (including $2 million in the salaries of personnel while traveling and $400,000 in actual transportation costs). These estimates were based on re-locating 260 employees to Bakersfield, including technical engineering personnel who would be required daily at NPRC, and assuming that all personnel would travel separately, rather than using either car or van pools. It would not appear to us that 260 employees would need to move to Bakersfield--particularly engineering personnel--since only 177 were located in other than the present administration building. By retaining 215 people in the present building, including all engineering personnel, we believe that most trips to NPRC would be eliminated, and these might be further reduced through van or car pools.

Further, we found at the time our review was completed that commercially leased space was available in Bakersfield to house the personnel at an annual cost of $1.20 to $1.50 a square foot versus NPRC's estimated construction cost of about $90 a square foot.

The Director, NPRC, in a memorandum dated August 5, 1983, expressed concern that leasing space in Bakersfield, thus having staff in two different locations, could be inefficient. However, Chevron officials believe that separating administrative personnel from engineering personnel would not be a problem. In that regard, Chevron's finance, accounting, and data processing personnel are located in San Francisco, and operate Chevron's holdings throughout the San Joaquin Valley, apparently without any effect on their efficiency. The Vice President of Chevron's Western Region said that had he been consulted, he would have recommended moving a significant number of NPRC employees to Bakersfield.

In March 1985 we were advised by the Director of ONPOSR that NPRC had received approval for building construction and that the design phase was starting. We understand that the latest plans are to build a small structure in place of the temporary buildings and enlarge the present administration building or construct a new building adjacent to it. This will result in additional space estimated at 46,207 square feet, making a total of 91,355 square feet for 423 employees.

Recommendation

Due to the relative high cost of constructing a new facility at NPRC compared to leasing space in Bakersfield, we recommend that the Secretary of Energy fully consider the leasing alternative, before authorizing new construction.

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At your request, we did not obtain written agency comments on this report. We did, however, discuss the results of our work with Naval Petroleum Reserve officials in California and Washington, D.C., and have incorporated their comments where appropriate.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time we will send copies to the Department of Energy and other interested parties and make copies available to others upon request.

Sincerely yours,

J. Dexter Peach
Director