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REVIEW OF THE UNIVERSITY OF CALIFORNIA'S MANAGEMENT CONTRACT FOR LOS ALAMOS NATIONAL LABORATORY

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON ENERGY AND
COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

MAY 1, 2003

Serial No. 108–14

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REVIEW OF THE UNIVERSITY OF CALIFORNIA'S MANAGEMENT CONTRACT FOR LOS ALAMOS NATIONAL LABORATORY

THURSDAY, MAY 1, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:40 a.m., in room 2123, Rayburn House Office Building, Hon. James C. Greenwood (chairman) presiding.

Members present: Representatives Greenwood, Walden, Tauzin (ex officio), Deutsch, and Schakowsky.

Also present: Representatives Radanovich, Markey, Eshoo, Stupak, and Udall.

Staff present: Ann Washington, majority counsel; Michael Geffroy, majority counsel; Yong Choe, legislative clerk; and Edith Holleman, minority counsel.

Mr. GREENWOOD. Good morning. This hearing of the Oversight and Investigations Subcommittee of the House Energy and Commerce Committee will come to order. We welcome our witnesses and our guests, and the Chair recognizes himself for the purpose of an opening statement.

The subcommittee meets today for the third time this year to hear testimony related to the management situation at Los Alamos National Laboratory. Currently operated by the University of California, the lab is one of the Nation's premiere research facilities on matters critical to our safety and security. Yet, as we have learned in the course of our investigation, the lab has also been a premiere site of serious property mismanagement and even theft.

Our February and March hearings concentrated on concerns raised by current and former lab employees about lab procurement and property management systems. I believe the issues identified at those hearings as well as the continued diligence of this committee prompted the unprecedented Department of Energy announcement yesterday that forms the backdrop to this hearing. The DOE announced its decision to put the Los Alamos contract up for competition for the first time in the lab's 60-year history. This decision is long overdue and one that members of this committee on a bipartisan basis have been calling for for many years.

The University of California has operated Los Alamos under contract with DOE since 1943. At no time during its long reign as operator of the facility has UC ever been faced with the possibility

of having to compete for this privilege. Given the length of time UC operated without the threat of competition, it appears that it has been lulled into a state of irresponsible complacency.

Let me add that progress has been made to improve the situation. The university has become much more involved in the daily operations of the lab in the past 6 months, and I am pleased with some of its efforts to get lab management back on track by replacing much of the senior staff, but it remains to be seen if those efforts will effect any meaningful change at the lab.

We heard at our last hearing from Joe Salgado, the former principal deputy director of the lab, who said that Federal money was treated like monopoly money, which is hardly a description of the kind of fiduciary responsibility expected and required of DOE contractors.

The lab argues that the amount of identified abuse of Federal money is just a drop in the bucket when compared to the lab's budget as a whole, and that perhaps is why the abuses have not garnered the required attention. I appreciate the point, but this multibillion dollar facility is operated on taxpayers' money, and as a steward of that money for the American public I am not comfortable with that explanation. As I have said before, when this same lab is responsible for safeguarding not only taxpayer money but the Nation's most sensitive nuclear secrets there is little room for error.

So I salute the Department's decision to compete this contract, to identify the best administrator for the lab. These are steps that the prior administration and prior secretaries have been too afraid to take, even in the face of repeated scandal and repeated promises of reform. In the testimony today we will hear from both the Department and the university on factors associated with this decision and exactly what will be sought in the competitive process.

On our first panel we will hear from Deputy Secretary of Energy Kyle McSlarrow and Ambassador Linton Brooks of the National Nuclear Security Administration. These gentlemen have been involved in the decision to compete the contract, and they will explain their rationale for their decision. I look forward to their testimony and to learning how DOE will improve its own oversight of UC or its successor.

Next we will hear from the DOE Inspector General, the Honorable Greg Friedman. Inspector General Friedman's office has audited various aspects of Los Alamos management, ranging from nuclear safety to procurement problems. Recently, his office released an audit questioning over $14 million in costs charged by the lab to DOE and controls on classified and unclassified computers. I am particularly interested in his views regarding what standards the Department should set when competing this contract.

Finally, we are joined by a panel of senior officials from the University of California: current University President Dr. Richard Atkinson; Vice President for Financial Management Ms. Anne Broome; University Auditor Mr. Patrick Reed; and, reappearing for the third time before us in this investigation, Mr. Bruce Darling, Interim Vice President for Laboratory Management.

The university faces some tough questions if it intends to put itself in the competition for the LANO contract. What would UC do

to banish what appears to be a lax attitude within the current lab culture? I trust our witnesses today will be able to shed some light on these and similar areas of inquiry. Let me thank all of the witnesses for attending this very important hearing today.

I now recognize the ranking member, Mr. Deutsch, for his opening statement.

Mr. DEUTSCH. Thank you, Mr. Chairman.

This is a historic occasion, one that I know Mr. Dingell has looked forward to for many years. He apologizes for not being here but will submit a statement for the record.

For 60 years the Department of Energy's contract to operate the Los Alamos National Laboratory has been awarded to the University of California without any competition to see if another entity could better run the lab. Despite numerous congressional and other investigations over the years that have found serious security, safety environmental management problems at the laboratory, there has not been a single attempt by the Federal Government to compete that contract until now. It is my hope that these hearings will ultimately result in finding the best contract to carefully use the taxpayer's money and run a laboratory that produces excellent science while being run like a business.

Like all institutions which are seldom challenged about how they operate, the university and the laboratory's management became arrogant and defiant over the years. When problems were uncovered, they made promises to Congress and others about how they were going to fix them, promises that the university took few steps to fulfill, that the Department of Energy did not enforce.

Whistleblowers who tried to bring problems to management attention were punished and, even if they won decisions, finding retaliation, establishing remedies, were hounded by the university's full legal forces until many of them were ruined financially and emotionally. Some had been employees for decades. One person who contacted us recently managed to keep his job but had been without a work assignment for 7 years.

What happened most recently to Glen Wobb and Steven Dorn, two former police officers who were hired to professionalize criminal and security investigations and then fired when they actually attempted to do so, is only the most recent example in a long chain of unsuitable behavior by the university and the laboratory.

Three years ago, UC promised to fix their security management weaknesses. One of those commitments was to implement best business practices. Yet today the Inspector General of the Department of Energy will testify he does not believe that Los Alamos can provide adequate assurances that classified, sensitive or proprietary information is appropriately protected because of poor controls over laptop computers containing classified information.

In the committee's own investigation we have found missing hard drives and other classified electronic media for which there are no acceptable explanations. In addition, the entire business financial system by which the laboratory is supposed to document and control how it spends Federal money is in shambles, as is its internal auditing system.

These systems are so bad that the Inspector General concluded in a recent report that DOE has less than adequate assurances

that costs claimed by the university for operation of the laboratory are allowable under the contract. Mr. Chairman, what that means is that DOE can't have any confidence in the course claimed under this entire billion dollar contract.

This is the third year in a row that the IG has come to this conclusion. That is how you get the thefts like we have heard about at previous hearings and the careless use of taxpayer funds by workers who think the Federal Government owes them top-of-the-line shoes, coats, shirts and gloves. One employee bought 13 pairs of allegedly work-related shoes in 18 months, 12 of which were running and sports shoes.

Joseph Salgado, the former deputy director of their laboratory, testified that taxpayers' money often was treated like monopoly money.

And what has been the response to procurement problems, poor property management and lack of effective business controls? There have been many well-publicized investigations. But while these investigations were ongoing, the Department and the university were quietly negotiating new fiscal year 2003 performance standards for Los Alamos standards drafted by the university that put science and technological goals at the forefront and pay little attention to inadequate business systems and controls that have brought down the top management at the laboratory.

There is one sentence, "Implement effective controls and business systems by assisting existing controls were needed. Strengthen controls to insure effective stewardship of public assets." DOE cannot even tell us what percentage of the performance fee will be allocated to this objective, which was only one of 40.

Mr. Chairman, we must ask whether any of the problems that we have been discussing for the last several months are going to get fixed when it doesn't appear that they would even seriously affect the performance fee. Despite anything said today, despite any promises made today by either the Department of Energy and the University of California, this is the only document that deserves our attention because it is where the money is.

I look forward to the testimony.

Mr. GREENWOOD. The Chair thanks the gentleman and recognizes the chairman of the full committee, the gentleman from Louisiana, Mr. Tauzin.

Chairman TAUZIN. Thank you, Chairman Greenwood.

The hearing this morning marks a milestone of sorts because this morning we will talk about the University of California management contract for Los Alamos not only in terms of what should happen but in terms of now what will happen, putting the lab's management contract out for bid for the first time in its 60-year history. The subcommittee's exposure of the management problems of Los Alamos is truly shaking things up, Mr. Chairman; and you deserve extreme amounts of credit for doggedly pursuing this matter on behalf of the full committee and, by the way, the American public which relies, as we do, on the sensitive work of the lab to make our lives safer and more secure.

We should also recognize the decisive actions taken by Secretary Abraham and his management team at DOE for confronting the problems at the lab and doing something meaningful about them.

The Secretary's announcement yesterday to compete the lab's management contract is the equivalent of a political earthquake. It shouldn't be. Periodic competition should be normal. It should be the necessary procedure for such an important contract. But it is a big deal precisely because it has never been done before, ever; and, as a result, the pressure of competitive bidding, one of the most powerful cleansers of management problems, has never really bore down on those responsible for the lab's contract.

We should commend Secretary Abraham for his aggressive action to fix Los Alamos, especially because the current 5-year contract was literally dumped in his lap by the previous administration just days before they left office. And they knew better. Remember, it was the prior administration that talked tough after the last round of lab scandals involving Los Alamos and the University of California.

Yet not only didn't they follow through on the tough talk, Secretary Abraham's predecessor took the remarkable step of ordering this flawed contract be extended for a new 5-year term without competition literally 2 days before President Bush and Secretary Abraham took office; and he did so even though that prior contract was not due to expire for nearly 2 years, when there was ample time for the new administration and the Congress to review and to conduct a thorough examination of any potential contract extensions.

It may be ironic, but one of the very first acts as chairman of the Commerce Committee in January, 2002, that I conducted was to call on DOE and request that any action on the current UC contract be delayed until the new administration committee had an opportunity to review it. And that simple request was rejected. I have with me the letter of January 22, 2001, to the Department making that case. Our concerns, of course, sadly were borne out, and it hasn't been easy to deal with.

The Secretary has had additional challenges thrust upon him when he was trying to sort them out. He had to deal with a new entity, the National Nuclear Security Administration, also created over this committee's objections. NNSA produced a new layer of bureaucracy between the Secretary and the managers at the nuclear weapons labs that was supposed to improve accountability and oversight. And he had to deal with the long delay in the confirmation of Kyle McSlarrow, his Deputy Secretary, who would be his right-hand man on these matters. Because of that delay, the crucial position in the Department of the officer in charge of DOE operations was vacant during much of the lead-up time leading to the recent controversy at Los Alamos.

Despite all this, the Secretary and his new Deputy Secretary have stepped up to the plate to address the situation aggressively, even before the latest announcement, by pressuring UC to make sweeping changes in the lab's management and UC's oversight of the lab.

An NNSA colleague, Ambassador Linton Brooks, also has provided able leadership in this crisis, which is an encouraging sign that we're finally on the right course. I want to agree with Ambassador Brooks' own comments yesterday that NNSA and its oversight of the lab over the past several years has not been up to par,

not what Congress was promised when we took this gamble by further insulating the nuclear weapons lab from central DOE management.

I look forward to hearing from both of you on this morning.

Mr. Chairman, let me welcome the witnesses today, with three excellent and knowledgeable panels, to discuss these important developments to provide some answers about the future of Los Alamos and of the University of California's contract with it and to provide, perhaps, some sense that when we're finally closing a very sad chapter in the history of the lab so that we finally open a new one.

In a conversation I had with Senator Domenici yesterday I congratulated him on reaching the same conclusion that Secretary Abraham had, that it's time to bid this contract out, that it's time to give Los Alamos a credible platform upon which it can proceed, instead of having this specter of poor management and the questions always being asked about what's being done about it and what's being done to correct it constantly on the shoulders of the managers of that most important lab for this Nation's safety and security.

Mr. Chairman, again, my very deep thanks on behalf of the full committee for your subcommittee's actions and doggedly pursuing this matter and leading to this conclusion by the Department; and hopefully this wrap up hearing where we can look forward now to a new chapter, as I said, in the history of this extraordinarily important asset to America.

I yield back the balance of my time.

Mr. GREENWOOD. The Chair thanks the gentleman and recognizes for an opening statement the gentleman from Michigan, Mr. Stupak.

Mr. STUPAK. I'll waive my opening statement, Mr. Chairman.

Mr. GREENWOOD. The Chair recognizes the vice chairman of the subcommittee, Mr. Walden of Oregon.

Mr. WALDEN. Thank you, Mr. Chairman. I, too, will waive my opening statement so we can proceed with the hearing.

Mr. GREENWOOD. Very well. We appreciate that.

[Additional statement submitted for the record follows:]

PREPARED STATEMENT OF HON. JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Thank you, Mr. Chairman, for holding this hearing to discuss the very significant decision by the Department of Energy (DOE) to competitively bid the contract to operate the Los Alamos National Laboratory. Although we do not have details about how the competition is going to be run, I applaud Secretary Abraham for this decision. Prior Energy Secretaries tried, but failed, to force needed changes short of this step. They did not realize that the University of California was too obstinate, arrogant, and entrenched to make needed changes.

The most recent failed DOE effort was Appendix O, which was added to the contract by the University after the Wen Ho Lee and the lost hard drive incidents, and the cost overruns and schedule delays of the National Ignition Facility. These were just the latest in two decades of "chronic security and other management-related problems." On October 26, 2000, then Committee Chairman Tom Bliley and I wrote a letter to then-DOE Secretary Bill Richardson after he had decided to extend the UC contract for another three years. We knew then that the promises made by the University in Appendix O, which included a new vice president for laboratory management, would not work, and we asked the Secretary to compete or renegotiate the contract. As we stated:

> "As the briefing the Members last week amply demonstrated, these five action items [in Appendix O] fall far short of the fundamental restructuring necessary to bring new management expertise and accountability into the operations of these labs. *Indeed, these actions are, for all practical purposes, either meaningless or already provided for in the current contract.* When pressed about the details of these five actions, or how they would be implemented, neither DOE nor UC was able to offer any substantive explanations—saying only that the specifics would be worked out during contract negotiations."

(October 26, 2000, letter from Reps. Tom Bliley and John Dingell to Secretary Bill Richardson, p. 2. (emphasis added))

In July of 2000, Dr. John McTague, who became the University's vice president for laboratory management, had written to Secretary Richardson proposing this position for a person who would "assess and assure the performance of the laboratory directors, as well as technical excellence of programs, major project management, personnel systems, safety, security, and business practices." Dr. McTague said the UC oversight role of the laboratories was "poorly defined and inadequately manned." (July 16, 2000, letter from Dr. John McTague to Secretary Bill Richardson, p. 2.)

Dr. McTague got that job, but promptly used it to negotiate FY 2003 performance standards for the laboratory that elevated scientific tasks and denigrated even further the value placed on adequate security, safety, environment, financial controls, and business practices. These standards were adopted lock, stock, and barrel by the Department barely a month ago—after the procurement scandal had broken, after the broken property management system was identified, after Messrs. Walp and Doran were fired in just the latest maltreatment of whistleblowers and problem-raisers, after the lab director and more than a dozen other people were removed from their jobs, and after the audit function at Los Alamos was taken over by the University's auditor. Yesterday, Ambassador Brooks claimed that these standards were negotiated before any of this happened—although the University did not sign off on the implementation plan until April 13—and that perhaps they would have to be renegotiated to reflect current events.

There is a great deal of blame to spread around, but most of it belongs on the backs of the University of California, which never integrated the laboratories into its financial and management control structures, and the Department of Energy, which failed to hold the University accountable. Los Alamos must make real change—a change in which employees who in good faith bring problems to management's attention and openly discuss them without paying for it with their careers and their financial and emotional well-being. Until this happens, there will not be a free and open discussion of problem areas, nor will there be proper remedies. But the University's recent responses on questions Rep. Markey and others have raised about specific whistleblower cases are not particularly encouraging. As this competition goes forward, the issue of openness and responsiveness should be a critical factor in assessing bids.

Mr. GREENWOOD. In that case, the Chair welcomes our guests. Our first witnesses are the Honorable Kyle E. McSlarrow, Deputy Secretary of Energy at the Department of Energy, and Ambassador Linton F. Brooks, Under Secretary for Nuclear Security and Acting Administrator for Nuclear Security at the National Nuclear Security Administration within the Department.

We welcome both of you gentlemen. Thank you for being here.

I think you're aware that this is an investigative hearing, and it is the practice of the subcommittee when holding investigative hearings to take testimony under oath. Do either of you object to giving your testimony under oath this morning?

Mr. MCSLARROW. No, Mr. Chairman.

Mr. BROOKS. No, sir.

Mr. GREENWOOD. Okay. Pursuant to the rules of the committee and the House, you are entitled to be represented by counsel. Do either of you wish to be represented by counsel this morning?

Mr. MCSLARROW. No.

Mr. BROOKS. No.

Mr. GREENWOOD. In that case, if you would stand and raise your right hand, I'll give you the oath.

[Witnesses sworn.]

Mr. GREENWOOD. You're under oath.

We will start with you, Secretary McSlarrow. You're recognized for your opening statement.

TESTIMONY OF HON. KYLE E. MCSLARROW, DEPUTY SECRETARY OF ENERGY, U.S. DEPARTMENT OF ENERGY; AND HON. LINTON F. BROOKS, UNDER SECRETARY FOR NUCLEAR SECURITY AND ACTING ADMINISTRATOR FOR NUCLEAR SECURITY, NATIONAL NUCLEAR SECURITY ADMINISTRATION, U.S. DEPARTMENT OF ENERGY

Mr. MCSLARROW. Mr. Chairman, distinguished members of the committee, thank you for the opportunity to discuss with the committee our review of the University of California's management of Los Alamos National Laboratory, the recommendations we have made to the Secretary and his decisions.

The starting place for our inquiry is our national security. Secretary Abraham has said repeatedly that he has no more important responsibility than his obligation, together with the Secretary of Defense, to certify to the President the safety and reliability of the nuclear weapons stockpile. The basis for our security is in obvious and important ways dependent on the credibility of our nuclear deterrent, and those laboratories and facilities and the people who manage and work in them are rightly considered national treasures. Thus, when the problems of last fall surfaced, Secretary Abraham viewed the various investigations, whether ones directed by the Inspector General or Congress, whether civil or criminal, as necessary but additional to his responsibilities. He therefore directed us to conduct a review and make recommendations with the goal of ensuring that the management of the lab was one in which he, Congress and the public could have total confidence.

Ambassador Brooks will provide more detail on our report in a moment, but let me highlight a few conclusions.

First, the problems identified, while unacceptable, are primarily related to management of business systems. There is no indication that the science performed by the lab and the university is anything other than world class.

Second, the University of California, under the personal direction of its President, Dick Atkinson, has responded forcefully and effectively. This is in no small measure also due to the leadership of the university Senior Vice President, Bruce Darling, and the lab's Interim Director, Admiral Pete Nanos.

Third, both the fact that the university contributes enormous value to the science that underpins the national security mission of the lab and the great strides they have made over the last 5 or 6 months lead us to conclude that termination is not in the interest of our country.

Fourth, though this is a much more complex issue than is present in even very large government procurements normally, our conclusion is that our administration's presumption of competition is not overcome in circumstances where business systems have fallen so short of an acceptable level; and we therefore recommended and the Secretary approve a decision to announce yesterday our in-

tent to compete the LANL contract which expires in September, 2005.

Finally, Mr. Chairman, we recognized that this issue is part of a larger set of issues about competition of the so-called federally funded research and development centers, our national laboratories. The Secretary recognized last year that there is some fundamental policy issues that need to be explored.

On the one hand for example, long-term, enduring relationships are likely to be extremely valuable in accruing the intellectual capital in which this country has invested. On the other hand, lack of competition can lead to complacency, as you mentioned.

Because these are issues that the Secretary needed to be confronted, he established a blue ribbon commission which is due to report to him in the late summer on its recommendations on how we should approach performance oversight and competition in the context of bidding on national laboratories. Thus, how we compete this contract with regard to Los Alamos will be informed by the results of that commission as well.

Mr. Chairman, I will conclude there and let Ambassador Brooks provide you more detail on the decisions made by the Secretary. Thank you.

Mr. GREENWOOD. Thank you, Mr. Secretary.

Mr. Brooks. Ambassador Brooks.

TESTIMONY OF HON. LINTON F. BROOKS

Mr. BROOKS. Mr. Chairman, members of the subcommittee, thank you for the opportunity to appear on this important issue.

The Deputy Secretary has addressed the Department's approach to competition and the immense importance Secretary Abraham and all of us place on maintaining the highest standards for our nuclear facilities. I'd like to turn to the conclusions that we've reached and the actions we are taking with respect to the future relationship between the University of California and Los Alamos National Laboratory.

These conclusions and recommendations are set forth in our joint report to the Secretary of Energy which was released yesterday, and with your permission I would like to formally submit that report and the Secretary' response for the record.

I want to state also for the record that we have received superb cooperation from both the University of California and the Los Alamos National Laboratory in conducting our review. Our report covers the details of the problems uncovered at Los Alamos and the university's response. The problems are well-known to this committee, and Dr. Darling has outlined the university action in great detail in previous testimony, so I am not going to cover those here.

As the Secretary of Energy has made clear, the problems represent a systemic management failure. I would only note the conclusions of the report, that the university's actions were broad, forceful and effective and that, "It is difficult to see how any organization could have done more to deal with the problem than the University of California has since December, 2002."

Our review suggests that there are multiple causes of the failure of business systems at Los Alamos.

First, prior to November of last year, the university's supervision of Los Alamos was ineffective in the area of business process. The university focus was almost entirely on other areas, including science, security, environment and project management.

Second, the National Nuclear Security Administration's direct Federal oversight was narrowly focused on specific performance measures called out in the contract, rather than on overall effectiveness and the interface between different areas; and I will say more about this in a moment.

Third, in hindsight, warning signs appear to have been ignored. Following the problems of several years ago involving Wen Ho Lee and the hard drives, neither the university, the laboratory, the National Nuclear Security Administration, nor the Department examined in sufficient detail whether these were symptomatic of broader management problems.

Finally, cultural problems beyond the control of the university or the Department played an important role. The Los Alamos culture exalted science and devalued business practices; and changing this culture will be the most difficult long-term challenge facing the laboratory, no matter who runs it.

As Deputy Secretary McSlarrow indicated, our review also confirmed that the university brings substantial value to the mission of Los Alamos. Los Alamos' mission depends on attracting and retaining world-class scientific talent, and the academic prestige of association with a world-class university is a clear benefit in both recruiting and retention.

In addition, there are formal agreements for scientific cooperation with four of the component campuses of the university. These areas of cooperative research directly advance the national security mission of the laboratory.

And, finally, an important and often overlooked benefit of the university is to foster a culture of scientific skepticism and peer review. That attitude within the laboratory and between Los Alamos and Livermore National Laboratories is, in my view, absolutely crucial to the success of the stockpile stewardship program and to the ability to certify the safety and reliability of the nuclear weapons stockpile.

Our report recommends and the Secretary has approved a series of actions.

The most important of these are, first, that the university continue to manage Los Alamos through the end of the current contract in September, 2005. The vigorous action the university is taking to correct the problems, the significant value the university brings in the area of science and the disruption to the mission of the laboratory and morale from early termination all make retaining the university through the end of the current contract the most appropriate course. Termination of the contract would not improve the management of Los Alamos in the near term, because the university is fully engaged in an effective and comprehensive program.

Second, we recommended and the Secretary approved that the Department announce its intent to compete the Los Alamos contract when it expires in September, 2005. Given the Department and the administration's strong preference for competition and the

widespread nature of the problems uncovered, it's difficult to argue for any other course.

Third, however, we urged that the University of California compete for the contract in 2005 perhaps in association with another entity with business and project management experience. The university has brought immense benefits to the laboratory and the country over the past 60 years, and it is important to note that a decision to compete is not a repudiation of the university but simply a recognition that its performance in the area of business management did not rise to the exceptionally high standards required to overcome the presumption of competition in the Department's policy.

Next, we begin now to develop the appropriate criteria for evaluating the future competition. Normally, those criteria would not be developed until next year, but the results of the competition are going to have to preserve the many advantages offered by the current association with the university, while also ensuring continuation of the reforms now being initiated; and finding the proper criteria to achieve these results will be complicated and should begin at once.

Further, we recommend that the Secretary reject in advance any notion of split responsibility for the laboratory in which different contractors perform the science and business operation functions. Some have argued that having the science and business portions of the laboratory managed by separate contractors would let us have the best of both worlds. I do not believe that the laboratory director should report to two entities. Indeed, a major part of the problem at Los Alamos is fragmentation between the science and the business communities; and a dual reporting approach would make the problem worse, not better.

We also recommend, finally, that if we devise a mechanism to insure that if the university does not continue to operate Los Alamos following 2005 the pension benefits of current Los Alamos employees are fully protected. Failing to do this could lead to a significant challenge to morale and potentially to a devastating exodus of the most experienced employees. It is important to note that the vast majority of Los Alamos employees have done nothing wrong and are continuing to perform in an exceptional manner.

Let me turn now to the Federal role of discovering and correcting problems of this type.

One element of the Federal responsibility, of course, is to insure the university lives up to its own obligations. But, as the report makes clear, the National Nuclear Security Administration shares responsibility for allowing these problems to develop.

Prior to November of last year, the Federal oversight role was limited to a stove-piped review of performance set forth in specific elements of the contract, when in fact what was called for was a broader, more cross-cutting and more aggressive role. Our reviews focused on performance in individual areas, rather than in the intersection and relationship among those areas. The report, recognizing this weakness, recommends that all current and future DOE contracts be reviewed in order to insure that performance reviews capture the cross-cutting information necessary to form a complete picture of performance.

The National Nuclear Security Administration has begun this process through our revised approach to evaluating Los Alamos and Livermore National Laboratories. Under Appendix F of the contract, we review broad cross-cutting areas and involve the laboratory directors, the senior leadership of the university and the senior leadership of my organization, including myself personally, in these reviews.

In your opening statement, Mr. Chairman, you noted that we had not established a weights for the criteria within those reviews. That's by design. We believe that one should look at cross-cutting areas in order to gauge overall performance and that we run the risk of falling into the trap that got us here if we start looking mechanically at business services as some specific percentage, and so we believe that this overall approach to review and most particularly the engagement of the senior leadership will let us focus on the relationship of all the performance elements.

Federal oversight in the past was also hampered by fragmentation and lack of clarity in roles and responsibilities within the National Nuclear Security Administration. For example, before December of last year, the Albuquerque operations office assessed business practices performance of Los Alamos, while the Los Alamos site office assessed other practices. This fragmentation has long been recognized, including by Congress.

As a result and unrelated to the specific problems of Los Alamos, in December of last year I implemented a major reorganization of the National Nuclear Security Administration, abolishing a layer of management and placing authority and responsibility for Federal oversight in site office managers—in the case of Los Alamos, Ralph Erickson, who has appeared before this committee, who will now report directly, without any intervening layers of management, to my Principal Deputy.

I expect that, in the aggregate, these changes will significantly improve the quality of Federal oversight.

Mr. Chairman, let me conclude with two points.

First, it is important to recognize that the overwhelming majority of Los Alamos employees in all areas, including business services, are honest, dedicated, competent and hard-working. Ultimately, the value of this laboratory does not lie in expensive technology, it lies in people. And the failures of Los Alamos were real, but they are the failures of a few, and as we move to correct these failures it is important to keep that fact in mind.

Second, I want to reiterate Secretary McSlarrow's emphasis on the overriding importance of national security in all of the decisions we've made. In approving our report, Secretary Abraham said, "The management of the nuclear weapons complex is my most important responsibility as Secretary of Energy. Under the university's stewardship, the science of Los Alamos has consistently been of the highest caliber. But it is important that business services be as good as the science. In approving your recommendations it is my intention to make it clear that, in dealing with nuclear weapons, only the highest standards of performance are acceptable." All of us in the Department remain committed to that goal.

Thank you for your attention, sir; and I look forward to your questions.

[The prepared statement of Hon. Linton F. Brooks follows:]

PREPARED STATEMENT OF HON. LINTON F. BROOKS, ACTING UNDER SECRETARY OF ENERGY FOR NUCLEAR SECURITY AND ACTING ADMINISTRATOR, NATIONAL NUCLEAR SECURITY ADMINISTRATION

Mr. Chairman, members of the subcommittee. Thank you for the opportunity to appear before you on this important issue. Deputy Secretary McSlarrow has addressed the Department's approach to competition and the immense importance Secretary Abraham and all of us place on maintaining the highest standards at our nuclear facilities. I would like to turn to the conclusions we have reached and the actions we are taking with respect to the future relationship between the University of California and Los Alamos. Theses conclusions and recommendations are set forth in our joint report to the Secretary of Energy which was released yesterday. With your permission, I would like to submit that report and the Secretary's response for the record. Before I do, I want to formally state for the record that we have had superb cooperation from both the University of California and the Los Alamos National Laboratory in conducting our review.

Our report covers the details of the problems uncovered at Los Alamos and the University's response. The problems are well known to this Committee and Dr. Darling has outlined the University actions in great detail, so I will not cover them here. As the Secretary of Energy has made clear, they represent a "systemic management failure." I would only note the conclusion of the report that the University's actions were "actions were broad, forceful, and effective" and that "It is difficult to see how any organization could have done more to deal with the problem than the University of California has since December 2002."

Our review suggests that there are multiple causes of the failure of business systems at Los Alamos:

- Prior to November 2002, the University's supervision of Los Alamos was ineffective in the area of business processes. University supervision was almost entirely focused on other areas including science, security, environment, and project management.
- The Department of Energy and the NNSA's direct Federal oversight was narrowly focused on specific performance measures called out in the contract, rather than on overall effectiveness. I will say more about this in a moment.
- In hindsight, warning signs may have been ignored. Following the Dr. Wen Ho Lee and hard drive incidents, neither the Laboratory, the University, NNSA, nor the Department examined whether broader problems existed at Los Alamos.
- Finally, cultural problems beyond the control of the University or the Department played an important role. The Los Alamos culture exalted science and devalued business practices. Changing this culture will be the most difficult long-term challenge facing the Laboratory no matter who manages it.

As Deputy Secretary McSlarrow indicated, our review also confirmed that the University brings substantial value to the mission of Los Alamos. Los Alamos missions depend on attracting and retaining world-class scientific talent. The academic prestige of association with a world-class university is of clear benefit in both recruiting and retention. In addition, there are formal agreements for scientific cooperation with four of the component campuses of the University of California. These areas of cooperative research directly advance the scientific mission of the Laboratory. Finally, an important, little-noted benefit of the University is to foster a culture of scientific skepticism and peer review. This attitude, both within the Laboratory and between Los Alamos and Lawrence Livermore National Laboratories, is absolutely crucial to the success of the Stockpile Stewardship Program and to the ability to certify the stockpile.

Our report recommends, and the Secretary has approved, as series of actions. The most important include:

- **That the University of California continue to manage Los Alamos through the end of the current contract in September 2005.** The vigorous action the University is taking to correct the problems uncovered at Los Alamos, the significant value the University brings in the area of science, and the significant disruption to the mission of the Laboratory and the morale of the employees from early termination all make retaining the University through the end of the current contract the most appropriate course. Termination of the contract would not improve the management of Los Alamos in the near-term; the University appears to be fully engaged in an effective and comprehensive program.

- **That the Department announce its intent to compete the Los Alamos contract when it expires in September 2005.** Given the Department's and the Administration's strong preference for competition, and the widespread nature of the problems uncovered at Los Alamos, it is difficult to argue for any other course of action.
- **That we urge the University of California to compete for the contract in 2005, perhaps in association with another entity with business and project management experience.** The University has brought immense benefits to the Laboratory and the country over the past 60 years. It is important to note that a decision to compete is not a repudiation of the University, but simply a recognition that the University's performance in the area of business management did not rise to the exceptionally high standards required to override the presumption of competition in Department orders.
- **That we begin now to develop appropriate criteria for evaluating a future competition.** The results of the competition in 2005 should preserve the many advantages offered by the current association with the University while also ensuring continuation of the reforms now being initiated and strengthening business functions. Devising the proper criteria to achieve these results while avoiding unforeseen consequences will be complicated and should begin at once.
- **That we reject in advance any notion of split responsibility for Laboratory operations in which different contractors would perform the science and business operations functions.** Some have argued for having the science and business portions of the Laboratory supervised by different contractors. The Laboratory Director should not report to two entities. A major part of the problem at Los Alamos is fragmentation between the science and business communities within the Laboratory. A dual reporting approach would make this problem worse, not better.
- **That we devise a mechanism to ensure that, if the University does not continue to operate Los Alamos following the 2005 competition, that the pension benefits of current Los Alamos employees are fully protected.** Failing to do this could lead to a significant challenge to morale and, potentially, a devastating exodus of the most experienced employees. It is important to note that the vast majority of Los Alamos employees have done nothing wrong and continue to perform in an exceptional manner.

Let me turn briefly to the Federal role in discovering and correcting problems of this type. One element of our Federal responsibility, or course, was to ensure that the University lives up to its own obligations. But as the report makes clear, National Nuclear Security Administration shares responsibility for allowing these problems to develop. Prior to November 2002, the Federal oversight role was limited to a mechanistic review of performance as set forth in the contract when in fact a broader, more aggressive role was called for. Our reviews focused on performance in individual areas rather than the intersection between those areas. The report, recognizing this weakness, recommends that all current and future DOE contracts be reviewed in order to ensure that performance reviews capture the crosscutting information necessary to form a complete picture of performance. NNSA has begun this process through our revised approach to evaluation of Los Alamos and Livermore National Laboratories under Appendix F of the contract. We review broad, crosscutting areas and involve the Laboratory Directors, the senior leadership of the University, and the senior leadership of NNSA, including myself, personally in these reviews.

Federal oversight was also hampered by fragmentation and lack of clarity in roles and responsibilities within the National Nuclear Security Administration. For example, before December of 2002, the Albuquerque Operations Office assessed business practices at Los Alamos, while the Los Alamos Site Office assessed other performance areas. This fragmentation problem has long been recognized, including by the Congress. As a result, on December 20, 2002 I implemented a major reorganization within NNSA, abolishing a layer of management and placing authority and responsibility for Federal oversight in the site office managers, who will now report directly to my Principal Deputy. I expect that these changes will significantly improve the quality of Federal oversight.

Mr. Chairman, let me conclude with two points. First, it is important to recognize that the overwhelming majority of Los Alamos employees—in all areas, including business services—are honest, dedicated, competent, and hard working. Ultimately, the value of the Laboratory lies not in expensive technology, but in people. The failures at Los Alamos are real, but they are the failures of a few. As we move to correct these failures, it is important to keep this fact in mind.

Second, I want to reiterate Secretary McSlarrow's emphasis on the overriding importance of national security in all of the decisions we have made. In approving our report, Secretary Abraham said

> The management of the nuclear weapons complex is my most important responsibility as Secretary of Energy. Under the University's stewardship, the science at Los Alamos has consistently been of the highest caliber. But it is important that business services be as good as the science. In approving your recommendations, it is my intention to make it clear that, in dealing with nuclear weapons, only the highest standards of performance are acceptable.

All of us remain committed to that goal.

Thank you for your attention and I look forward to your questions.

DEPARTMENT OF ENERGY
WASHINGTON, DC 20585
April 26, 2003

MEMORANDUM FOR THE SECRETARY

FROM:
Kyle McSlarrow, Deputy Secretary
Linton F. Brooks, Acting Administrator,
National Nuclear Security Administration

SUBJECT: Los Alamos National Laboratory

On December 24, 2002, you concluded that events at Los Alamos National Laboratory reflected a "systemic management failure." Although this conclusion was primarily aimed at the management at Los Alamos itself, you also directed us to conduct an examination of the relationship between the University of California, as the responsible contractor, and the Los Alamos National Laboratory. We have also explored the relationship among the University of California, Los Alamos, and the National Nuclear Security Administration, Department of Energy.

The University and the National Nuclear Security Administration share responsibility for allowing these problems to develop. Prior to November 2002, the University's supervision of Los Alamos was ineffective in the area of business processes. The Federal oversight role was limited to a mechanistic review of performance as set forth in the contract when, in fact, a broader, more aggressive role was called for, particularly in light of the problems that developed at Los Alamos in the late 1990s.

Although the University was slow to take action to correct these failures, once it became engaged its actions were broad, forceful, and effective. It is difficult to see how any organization could have done more to deal with the problem than the University of California has since December 2002. Further, the University brings substantial value to the mission of Los Alamos, in science, recruiting, retention and fostering a culture of scientific skepticism and peer review. Therefore, given the extraordinary disruption that would flow from an immediate termination, we do not believe contract termination is in the best interests of the national security missions conducted at Los Alamos.

We recommend:

- That the University of California continue to manage Los Alamos through the end of the current contract in September 2005.
- That you direct the NNSA Administrator to examine the utility of a contract modification institutionalizing some of the reforms made by the University over the last few months.
- That the Department announce its intent to compete the Los Alamos contract when it expires in September 2005.
- That we urge the University of California to compete for the contract in 2005, perhaps in association with another entity with business and project management experience.
- That you direct the NNSA Administrator to begin now to develop appropriate criteria for evaluating a future competition, taking into account the results of the Blue Ribbon Panel when available.
- That you further direct the NNSA Administrator to ensure that any future competition includes provisions for retaining the current Los Alamos workforce following September 2005.
- That you reject in advance any notion of split responsibility for Laboratory operations in which different contractors would perform the science and business operations functions.
- That you direct the NNSA Administrator to devise a mechanism to ensure that, if the University does not continue to operate Los Alamos following the 2005

competition, the pension benefits of all Los Alamos employees on the rolls as of September 30, 2005, or previously retired, are fully protected.

- That in dealing with future competitions, the Department explore ways in which to not only take into account truly outstanding performance but also to encourage contractors who might fall short during a contract term to strive to develop plans to correct problems so that they may compete and succeed.
- That you direct that all current and future contracts be reviewed in order to ensure that performance reviews capture the crosscutting information necessary to form a complete picture of performance.
- That you direct us to continue to monitor progress and subsequent information from either internal or external reviews in order to provide additional recommendations as facts and circumstances develop that warrant additional action.

Attachment: Complete report

REPORT BY THE DEPUTY SECRETARY OF ENERGY AND THE ACTING ADMINISTRATOR OF THE NATIONAL NUCLEAR SECURITY ADMINISTRATION ON THE FUTURE RELATIONSHIP BETWEEN LOS ALAMOS NATIONAL LABORATORY AND THE UNIVERSITY OF CALIFORNIA

APRIL 26, 2003

Introduction. In accordance with your direction in your letter of December 24, 2002, we have conducted an examination of the relationship between the University of California and the Los Alamos National Laboratory. Our examination included the following:

- Review of briefings to the University Regents, internal University of California reports, and similar documents between 2001 and the time of the relief of the Los Alamos National Laboratory Director in 2003.
- Review of all relevant Inspector General and Office of Independent Assessment and Oversight reports covering Los Alamos. We paid particular attention to those Inspector General reports covering the period since the problems at Los Alamos surfaced; a list is attached.
- Review of the Appendix O process and material (Appendix O was put in place during contract renewal in 2001 to correct perceived security problems; it is further discussed below).
- Review of testimony given by witnesses to the Subcommittee on Oversight and Investigations of the House Energy and Commerce Committee.
- Interviews with former Vice President for Laboratory Management, John McTague, former National Nuclear Security Administration (NNSA) Administrator, General John A. Gordon, and the Los Alamos Site Manager, Ralph Erickson.
- A daylong meeting with senior Los Alamos and University officials at Los Alamos, including a separate meeting with Federal site office management officials who have contract oversight responsibilities.
- A number of meetings with Senior Vice President for University Affairs Dr. Bruce Darling, who also serves as Interim Vice President for Laboratory Management, along with phone calls with Dr. Darling several times a week.
- A similar set of meetings and phone calls with Interim Laboratory Director, Dr. George "Pete" Nanos, and his senior staff.
- Conversations with various Regents of the University of California to review our conclusions.

This memorandum reports the results of our assessment and our recommendations for the future Los Alamos—University of California relationship.

Background. The University of California has operated the Los Alamos National Laboratory since 1943 under contract with the Department of Energy and its predecessors. The contract has routinely been extended without competition, most recently in January 2001 just 2 days before the Bush Administration took office. The University also operates Lawrence Livermore National Laboratory under an identical, but separate contract, as well as the Lawrence Berkeley National Laboratory. The University has traditionally regarded its management of the laboratories as a public service to the nation. As one indication of this, the University has taken the position that its operation of the laboratories should be revenue neutral. That is, the University retains no fee for operating the laboratories and seeks to use no University of California funding to do so. The fee paid by the Government is returned to the laboratories for additional laboratory-directed research and development, after deducting the costs of that portion of the University Office of the President

involved with overseeing the laboratories, paying expenses not otherwise reimbursable, and establishing a reserve to cover significant losses.

During the late 1990's two major concerns arose with Los Alamos National Laboratory, both involving security. The first was the case of Dr. Wen Ho Lee, a Los Alamos scientist who was ultimately convicted of mishandling classified material. This case raised extensive questions about the adequacy of security at the Laboratory. These concerns were reinforced in May 2000 when two hard drives containing Restricted Data could not be located for an extended period of time. The hard drives were ultimately located in a secure area within Los Alamos, but the Laboratory's inability to locate them, coming on top of the concern raised by the Wen Ho Lee case, further exacerbated security concerns.

Security concerns were among the reasons that Congress created the National Nuclear Security Administration. Despite this, no senior Los Alamos manager was terminated, reassigned, or demoted as a result of either of these incidents, although some formal reprimands were issued and two lower-level employees were reassigned.

Notwithstanding these security concerns, the University's contract to manage Los Alamos was extended non-competitively in January 2001. The current contract expires on September 30, 2005. In extending the contract, the Department imposed a number of requirements to correct the perceived problems with the management of Los Alamos. The new requirements were codified in a separate appendix to the Los Alamos contract called Appendix O. An identical appendix was included in the contract for Lawrence Livermore National Laboratory.

Appendix O committed the University to establish a position of Vice President for Laboratory Management and made the first incumbent of that position subject to departmental approval. It also committed the University to take a series of discrete steps to improve management. To enforce these commitments, Appendix O established a series of quarterly reviews between the Department, the University, Los Alamos, and Livermore. By its own terms, Appendix O expired on September 30, 2002. At that time, the NNSA, on behalf of the Department, concluded that all the requirements of the Appendix had been met. None of these requirements related to business services.

The precipitating incidents. Beginning in the summer of 2002, a series of problems with business services at Los Alamos came to light. The problems themselves originated several months earlier, but were not widely recognized outside the Laboratory until the summer of 2002. These problems included:

- Questions concerning the effectiveness of controls over Government purchase cards (credit cards). Several laboratory employees (all now terminated except one, where disciplinary action is pending) used a laboratory-issued purchase card to make fraudulent purchases, including an attempt to purchase an automobile. Actual loss to the Government was only about $3000, but the massive audit conducted by the University in response to the issue revealed an additional $195,246 worth of purchases where documentation was inadequate or missing (some documentation was destroyed in the Cerro Grande fire) along with $125,000 in employee recognition awards that exceed the approved DOE threshold. Although no additional cases of fraud were uncovered, the University chose to reimburse the Government the entire sum of both questionable items for a total of about $320,000.
- A scheme by two employees (both now terminated) apparently used doctored purchase orders to order material for their personal use. The incident is still under investigation by the FBI. The amount of the apparent theft exceeded $300,000, but all but about $50,000 has been recovered. The University has reimbursed the Government for the loss.
- Questions concerning the adequacy of property controls. Newspaper revelations indicated that the laboratory was unable to account for $1.3 million worth of controlled property, including such pilferable items as computers. Although the most spectacular allegations (a missing fork lift, for example) were ultimately resolved, substantial amounts of property remained un-located.
- The Laboratory's action in firing two investigators within a few days of those same investigators raising concerns with the Inspector General. You, the University and the Inspector General have all stated that the Laboratory's action in firing the inspectors was "incomprehensible." We share that assessment. While the Inspector General's investigation did not substantiate the allegation that Laboratory management deliberately hid criminal activity, this incident (in which the University played no role) demonstrated the degree to which the Laboratory's management was out of touch and ineffective.

Taken individually, it is possible that none of these incidents would call into question the adequacy of Laboratory management. Taken in the aggregate, however,

they revealed systemic weaknesses in business practices at Los Alamos. These weaknesses were further confirmed by additional Inspector General audits in unrelated areas, including:

- An audit of firearms control that revealed significant weaknesses in procedures and accountability, although all firearms were ultimately located.
- An interim audit that determined that control over laptop computers was inadequate. Computers were not properly controlled, not adequately safeguarded against theft, and not always acquired in accordance with approved procedures. Computers that could not be located were written off without a formal inquiry and theft of laptop computers was not always reported to the appropriate office.
- An audit of the allowability of incurred costs that assessed that just over $14 million (about 0.3 percent out of the total of $5.4 billion examined) was improperly charged to the government under existing rules. The three areas of concern were travel and conference costs not adequately documented, provision of business meals, and an audit function evaluated as inadequate.[1]

The fact that there was not greater fraud and theft at Los Alamos is a tribute to the character of the vast majority of men and women working there, and not to the efficacy of the management systems in place. The actual loss to the Government could have been far greater and the business practices in place in 2002 would not have been able to identify and therefore prevent such a loss.

There is no evidence that the lax approach to business processes and business issues extended to science or security. The fear that such practices might spread, however, was—justifiably—a primary motivation for insisting that the University of California move promptly to correct the problems.

University of California response. The University was relatively slow to respond to the public allegations of business practices problems. University response was initially limited to providing assistance as requested by the Laboratory Director and did not include any action to ensure that the Laboratory Director was taking sufficient steps to examine the problem. The University engagement began in earnest in mid-November following the commissioning of an Inspector General investigation (requested by the Laboratory) and a series of increasingly embarrassing press accounts. University engagement increased still further following the intervention of the Secretary of Energy in November and December 2002.

Once the University became engaged its actions were broad, forceful, and effective. The University made significant personnel changes in Laboratory management, including accepting the resignation of the Laboratory Director, terminating the Principal Deputy Director, and transferring, downgrading, or terminating 16 other officials including the Chief Financial Officer, Laboratory Auditor, Security Office Director, and the heads of the procurement and purchase card programs. Given the size of the Los Alamos management team, these represent sweeping changes.

The University mobilized substantial auditing resources to examine issues in depth. It used teams of extremely senior officials to investigate the issues. University senior officials (for example the University Auditor) essentially devoted full time to Los Alamos issues. The University permanently subordinated the Laboratory auditor to the University Auditor and temporarily subordinated all Laboratory business functions to the University Vice President for Financial Management. It directed a series of external reviews by Ernst and Young, PriceWaterhouseCoopers, and a team headed by a former DOE Inspector General. These were major reviews; the Ernst and Young review, for example, involved 20 people at the Laboratory. It is difficult to see how any organization could have done more to deal with the problem than the University of California did after about mid-December 2002. In particular, we have been impressed with the performance to date of both the Interim Vice President for Laboratory Management, Dr. Bruce Darling, and the Interim Los Alamos Director, Dr. George "Pete" Nanos.

The University's steps were not limited to Los Alamos. Although we did not investigate actions at other laboratories, the University appears to have been vigorous in taking the lessons from Los Alamos and applying them to the Lawrence Livermore and Lawrence Berkeley National Laboratories. The University required these Laboratories, as well as the University auditor, to examine their own internal procedures to ensure similar problems did not arise elsewhere. The University also used senior officials at these Laboratories to assist at Los Alamos.

The University and the new Laboratory leadership are viewing the necessary improvements broadly, not narrowly. Although the specific issues that came to light

[1] Although the Laboratory has generally agreed with all the findings of outside audits, it disagrees with this specific audit, contending that virtually all the costs should be allowable. Final determination of allowability will be made by the Contracting Officer in accordance with established DOE procedures.

in late 2002 dealt with business practices, the University and the Interim Laboratory Director are taking the opportunity to look at Laboratory practices in all areas, including project, program, environmental, procurement, and nuclear facilities management. While the responsibility for implementing this broad approach belongs to the Interim Director, the University selected that Director and has been strongly supportive of examining all areas of Los Alamos management. This increases the chance that the changes being made will endure.

Finally, the University is in the process of putting in place a new governance model involving strengthened internal management and oversight and a strong external governing Board with members having strong backgrounds in industry, defense and science. The new Board will have some of the responsibilities of the Regents and will be able to hold both the University administration and Laboratory Management accountable. We are not yet able to evaluate the efficacy of this new governance model, but it is a clear indication that the University sees its task not simply as implementation of a temporary "get well" program but as a transformation of its model of oversight.

The cause of the problems. Our review suggests that there are multiple causes of the failure of business systems at Los Alamos:

- **Prior to November 2002, the University's supervision of Los Alamos was ineffective in the area of business processes.** University supervision was almost entirely focused on other areas including science, security, environment, and project management. Briefings to the Regents never discussed business practices nor was the subject a focus of the former Vice President for Laboratory Management. Internal documentation relating to University oversight in this period is silent on business practices.
- **The Department of Energy and the NNSA's direct Federal oversight was narrowly focused on specific performance measures called out in the contract, rather than on overall effectiveness.** Appendix O was focused on issues other than business services. Most discussions were in areas of safety or of having Los Alamos and Livermore work together. NNSA's own supervision focused on areas such as safety and security, rather than business services and tended to assess performance within "stovepipes," while many of the actual problems were failures of appropriate connections between stovepipes. A division of responsibility between the Los Alamos Site Office and the former Albuquerque Operations Office further weakened NNSA oversight, with oversight of business practices coming almost exclusively from Albuquerque.[2]
- **In hindsight, warning signs may have been ignored.** Following the Dr. Wen Ho Lee and hard drive incidents, neither the Laboratory, the University, NNSA, nor the Department examined whether broader problems existed at Los Alamos. For years, there has been general acknowledgement of a "Los Alamos way" that was unique and that devalued business practices. Evaluations of Los Alamos in recent years always showed it slightly inferior in overall performance to the other two weapons laboratories, but never by enough to cause strong concern. Because there was no precipitating event, no one at any level acted on these indicators.
- **Cultural problems beyond the control of the University or the Department played an important role.** The Los Alamos culture exalted science and devalued business practices. Changing this culture will be the most difficult long-term challenge facing the Laboratory no matter who manages it.

The value of the University. In evaluating our options, it is important to recognize that the University brings substantial value to the mission of Los Alamos, in both obvious and less obvious ways. Stockpile Stewardship and other Los Alamos missions depend on attracting and retaining world-class scientific talent. The academic prestige of association with a world-class university is of clear benefit in both recruiting and retention.[3] In addition, there are formal agreements for scientific cooperation with four of the component campuses of the University of California. These areas of cooperative research directly advance the scientific mission of the Laboratory.

Finally, an important, little-noted benefit of the University is to foster a culture of scientific skepticism and peer review. This attitude, both within the Laboratory and between Los Alamos and Lawrence Livermore National Laboratories, is absolutely crucial to the success of the Stockpile Stewardship Program and to the ability

[2] The NNSA reorganization implemented in December 2002 is designed to centralize responsibility to the Site Manager and thus avoid this fragmentary oversight in the future.

[3] At least some prospective employees at both Los Alamos and Livermore in recent months have stated that they were uninterested in affiliating with a national laboratory that is not connected with the University. We lack data on how extensive this belief is.

to certify the stockpile. A senior laboratory official at Los Alamos has told us, for example, that the culture of peer review is the only thing that allowed the successful dual revalidation of the W76 warhead conducted a few years ago.

In addition to the actual value that the University brings, an important consideration is the widespread perception among Laboratory employees at both Los Alamos and Lawrence Livermore National Laboratories that the University association is critical to the mission of the Laboratory. Examples of this perception abound and have been a constant theme of our discussions with laboratory employees. We received petitions from 2,500 Los Alamos employees and 3,000 Livermore employees stressing the value of the University association. We received a similar, separate communication from the Los Alamos Fellows, those senior scientists at Los Alamos not part of management. We have reviewed public statements by distinguished figures such as Edward Teller, arguably the most famous living nuclear weapons designer. Even if we disagreed with these assertions of the University's value (which we do not), we need to take account of the widespread perception among the people who actually carry out the important national security mission of the Laboratory that the University association is critical to that mission.

At the same time, the national security missions carried out at Los Alamos require the total confidence of Congress and the public as well as of Los Alamos employees. An erosion of that public trust undermines not only the University but our national security as well. Our recommendations are, therefore, premised on a view that ensuring public confidence is merited is crucial for our country, the University and Los Alamos.

Problems with immediate termination. We are aware of forceful calls that the University contract with Los Alamos be terminated immediately. While the University can be faulted for having allowed the problems to develop, we believe that immediate termination would undermine the national security mission at the lab without measurably addressing the problems that Los Alamos faces today. Further, the Department, and since its creation, the NNSA, share responsibility for lax oversight of business practices. In our view, immediate termination is undesirable for several reasons. Such a step would be highly disruptive to the things that are going well at Los Alamos, especially science. It would also hamper the implementation of the internal reforms the University has put in place. Immediate termination would lose the very real benefits of the University association and, because of this, would be devastating to morale.[4] Finally, any decision for immediate termination would almost certainly have a counterproductive effect on other contractors facing similar problems in the future. If this vigorous get well program put in place by the University leads only to termination, no future contractor will have any incentive to put this much of an effort into remediation of major problems.

Recommendations. Based on the above, we recommend:

- **That the University of California continue to manage Los Alamos through the end of the current contract in September 2005.** The vigorous action the University is taking to correct the problems uncovered at Los Alamos, the significant value the University brings in the area of science, and the significant disruption to the mission of the Laboratory and the morale of the employees from early termination all make retaining the University through the end of the current contract the most appropriate course. Termination of the contract would not improve the management of Los Alamos in the near-term; the University appears to be fully engaged in an effective and comprehensive program.
- **That you direct the NNSA Administrator to examine the utility of a contract modification institutionalizing some of the reforms made by the University.** If the University continues to operate Los Alamos through 2005, it will be important to ensure that the current momentum for improvement continues. Some institutionalization of the reforms may assist in this area. We believe that discussions between Los Alamos, the NNSA, Los Alamos Site Office, and the University are necessary before determining exactly what changes require codification.
- **That the Department announce its intent to compete the Los Alamos contract when it expires in September 2005.** Given the Department's and the Administration's strong preference for competition, and the widespread nature of the problems uncovered at Los Alamos, it is difficult to argue for any other course of action. Because the question of competition for National Laboratories

[4] The prospect of termination may already have had an adverse effect. As of April 8, 266 Los Alamos employees (68 with critical skills) have applied for retirement. In contrast, there were only 177 retirements during all of 2002. Retirement requests at Livermore are currently running at roughly twice the 2002 rate.

is the subject of your recently chartered Blue Ribbon Panel, the mechanics of implementing this decision should take into account the results of the Panel's report.[5]

- **That we urge the University of California to compete for the contract in 2005, perhaps in association with another entity with business and project management experience.** The University has brought immense benefits to the Laboratory and the country over the past 60 years. It is important to note that a decision to compete is not a repudiation of the University, but simply a recognition that the University's performance in the area of business management did not rise to the exceptionally high standards required to override the presumption of competition in Department orders.
- **That you direct the NNSA Administrator to begin now to develop appropriate criteria for evaluating a future competition, taking into account the results of the Blue Ribbon Panel when available.** The results of the competition in 2005 should preserve the many advantages offered by a world-class academic institution while also ensuring continuation of the reforms now being initiated and strengthening business functions. Devising the proper criteria to achieve these results while avoiding unforeseen consequences will be complicated and should begin at once.
- **That you further direct the NNSA Administrator to ensure that any future competition includes provisions for retaining the current Los Alamos workforce following September 2005.** The staff of Los Alamos is a national treasure that must be preserved. It is important to establish now that a competition in 2005 will not result in a changed workforce. Otherwise we will face both a serious morale problem and the prospects of a significant exodus of staff in the mistaken belief that their jobs are at risk.
- **That you reject in advance any notion of split responsibility for Laboratory operations in which different contractors would perform the science and business operations functions.** Some have argued for having the science and business portions of the Laboratory supervised by different contractors. We urge you to reject this approach. While the University might well benefit from a partnership with industry, the Laboratory Director should not report to two entities. Further, the Interim Laboratory Director believes that a major part of the problem at Los Alamos is fragmentation between the science and business communities within the Laboratory. A dual reporting approach would make this problem worse, not better.
- That you direct the NNSA Administrator to devise a mechanism to ensure that, if the University does not continue to operate Los Alamos following the 2005 competition, that the pension benefits of all Los Alamos employees on the rolls as of September 30, 2005, or previously retired, are fully protected. While the Los Alamos employees who have contacted us are generally concerned about the impact on science and mission of losing the association with the University of California, many are also concerned with their benefits under the University's pension system. It is important to reassure employees, that, regardless of the outcome of the future competition, those benefits will be protected. Otherwise, we could face a significant challenge to morale and, potentially, a devastating exodus of the most experienced employees.
- **That you direct us to continue to monitor progress and subsequent information from either internal or external reviews in order to provide additional recommendations as facts and circumstances develop that warrant additional action.**

Lawrence Livermore National Laboratory. The University of California also manages the Lawrence Livermore National Laboratory under a separate, but essentially identical, contract as the contract with Los Alamos. Our review did not explicitly cover Lawrence Livermore National Laboratory and we believe that there is no need to make even a preliminary decision on whether to extend or compete the Lawrence Livermore contract when it expires in September 2005. Such a decision can clearly be deferred and can await, among other things, the results of the recently established Blue Ribbon Panel. There is no legal reason why the Department could not choose to compete the Los Alamos contract and extend the Lawrence Livermore contract, and the Secretary should continue to hold that option open.

[5] The Blue Ribbon Panel, formally the "Blue Ribbon Commission on Use of Competitive Procedures at the Department of Energy Laboratories," was established on January 3, 2003 as a subsidiary body to the Secretary of Energy Advisory Board. It is tasked with examining the Department's policy on competition for management of national laboratories and is expected to make its report by July 2003.

Additional issues. An important aspect of the problems of Los Alamos has been the potential loss of Congressional and public trust resulting from the revelations of the serious management deficiencies at the Laboratory. This problem was exacerbated by two factors:

- The current Government rules on property accountability significantly overstate the value of the unaccounted for property. Government rules require that property be carried at its original cost. Thus, for example, an obsolete computer that would not fetch $50 at a yard sale is carried at its original purchase value of several thousand dollars. A 35 year-old forklift, which any business would have written off as an asset through depreciation years ago, is carried at its original cost. As a result, the apparent dollar value of un-located property overstated the actual magnitude of the problem and diverted the attention from the more systemic problems. The Secretary should direct that the Department seek authority to revise government property accounting rules to be more consistent with those used in the private sector.
- The grading system at Los Alamos, adapted from other Government systems, is based on a scale of Outstanding, Excellent, Good, Satisfactory, and Unsatisfactory. This scale suffers from what might be called "rhetorical grade inflation." Thus, a mark of "Excellent" conveys a sense of exceptional performance, when, in fact, it is used for routine performance. The Secretary should direct that in future contracts the NNSA Administrator use a descriptive system that will more accurately reflect the intent of a particular grade.

The grading problem is simply one example of a broader set of concerns raised over the issues relating to competition of Federally Funded Research and Development Centers such as Los Alamos. Although it was not specifically established with any one facility in mind, the Blue Ribbon Panel discussed above was created in part because it became clear that any decision to compete was increasingly perceived as a repudiation of an incumbent contractor. This is a view that has undoubtedly grown over many decades, but it has had unfortunate consequences. Incumbent contractors view their choices as being either a series of contract extensions, or loss of the contract. As a result, incumbent contractors often assert that they will be unwilling to participate in a competition.[6] We recommend that the Department explore ways in which to not only take into account truly outstanding performance but also to encourage contractors who might fall short during a contract term to strive to develop plans to correct problems so that they may compete and succeed.

An equally important concern is the overall "stove piped" nature of the NNSA evaluation system in place at Los Alamos (and elsewhere). The contract entered into in January 2001 established a performance review process that considered individual areas in isolation. By failing to consider relationships between different processes, it failed to detect overall systemic problems and thus failed to capture the type of management failures that we are addressing in this memorandum. As a result, the performance review process assigned an "Excellent" rating to the Laboratory management almost simultaneously with the Secretary of Energy stating publicly that there was a "systemic management failure." We therefore recommend that all current and future contracts be reviewed in order to ensure that performance reviews capture the crosscutting information necessary to form a complete picture of performance.[7]

Concluding observation. We believe it is important to recognize that the overwhelming majority of Los Alamos employees—in all areas, including business services—are honest, dedicated, competent, and hard working. Ultimately, the value of the Laboratory lies not in expensive technology, but in people. The failures at Los Alamos are real, but they are the failures of a few. As we implement changes, we urge that all levels of the Department emphasize this fact at every opportunity.

Inspector General Reports consulted

Completed reports

Report Number	Title	Date Issued
L-03-06	Recruitment and Retention at the Los Alamos and Lawrence Livermore National Laboratories	11/27/2002

[6] The wide spread perception that no incumbent DOE contractor has ever prevailed in a competition is one manifestation of this attitude. The perception is wrong. There are at least four instances where incumbents have retained contracts following competition, including one Federally Funded Research and Development Center (National Renewable Energy Laboratory). Still, the perception exists and needs to be dispelled.

[7] Recent changes in NNSA evaluation procedures are designed to ensure a focus on broad management issues. It is important that these changes be pursued vigorously.

Report Number	Title	Date Issued
S02IS013	Inspection of 2001 Safeguards and Security Survey of Los Alamos National Laboratory	01/12/2003
IG-0584	Special Inquiry: Operations at Los Alamos National Laboratory	01/28/2003
IG-0587	Inspection of Firearms Internal Controls at Los Alamos National Laboratory	02/21/2003
IG-0591	Allegations Concerning the Reporting of a Radiological Incident at LANL	03/20/2003
IG-0596	University of California's Costs Claimed And Related Internal Controls for Operation of Los Alamos National Laboratory.	04/16/2003
IG-0597	Inspection of Internal Controls Over Personal Computers at Los Alamos National Laboratory (Interim Report).	04/24/2003

Reports not yet made public but where we have reviewed draft findings
The Dual Axis Radiographic Hydrodynamic Test Facility (Draft Report)
Ongoing reports to which we have not yet had access[8]
LANL's Nuclear Materials Stabilization Program
Various Law Enforcement Sensitive reports on criminal activity

Mr. GREENWOOD. Thank you, Ambassador.

The Chair recognizes himself for 10 minutes for the purpose of inquiry.

From the Wen Ho Lee situation in 1999 to the missing hard drive management failures at Los Alamos, consistent gender and minority employment discrimination lawsuits, billion dollar cost overruns and the most recent allegations of counterintelligence and business operations problems, the University of California has faced a variety of challenges in its management of its national laboratories over the past 5 years. A question for both of you gentlemen is what caused DOE and NNSA to finally decide to compete the Los Alamos contract? What was the proverbial straw that broke the camel's back? What was the most important consideration in the decision to pursue competition?

Mr. MCSLARROW. There were a number of factors, but in terms of isolating the central precipitating factor I would say it was a recognition that the management itself at Los Alamos was not on top of the problems and a recognition that, if that were true, it required the university to step up to the plate and insure that it was fixed; and we didn't see that. That's something that took place over a period of meetings and discussions last fall.

This country made a decision fundamentally a long time ago that this kind of big-time science and national security work is going to be done with contractor-operated facilities, and that places an enormous burden on the actual management of any facility and the contractor who's responsible for oversight. So it's hard to isolate a particular incident, but I think that would be the central point.

Mr. BROOKS. I would add, Mr. Chairman, that in some ways the focus on particular incidents is what got us into this problem, that the incident standing alone can be looked at and there are reasons for each of them. The problem has been that the aggregate revealed a broad pattern of management problems, and I think that probably was the most important recognition and that's what in my statement I alluded to, trying to focus our future oversight more on interrelations and broad issues rather than dealing on an incident-by-incident event. So I think it was the interrelationship of everything, rather than any specific incident that, at least in my mind, led to this conclusion.

[8] We have no reason to believe that any of the ongoing investigations and audits would change the recommendations of this report.

Mr. GREENWOOD. Mr. Ambassador, you, in your opening statement, referred to the culture at the lab and said that that is the most difficult thing—the most difficult challenge is to change that culture. A culture like that does not develop in a vacuum. It develops fundamentally, it seems to me—I think it's human nature for cultures to develop when there are no consequences either in sufficient oversight or no consequences to actions. We hold the management at the lab responsible for that. We hold the university responsible for that. We also have to hold the Department responsible for that.

Now I know that the top management of the Department changes with elections. But who were the folks who have been consistently at the Department whose job it was to provide this oversight? And what consequences do they face?

Mr. BROOKS. Mr. Chairman, I believe that the problem with the Department oversight was not primarily failure of individuals but failure of structure.

Mr. GREENWOOD. Well, somebody has a responsibility to create that structure. An individual has the responsibility to create that structure.

Mr. BROOKS. Yes, sir, I do; and that's what I'm doing. And that's what my predecessor had determined to do. So we had a structure in NNSA which Secretary Abraham and Deputy Secretary McSlarrow inherited and my predecessor inherited when he started to stand up NNSA in which there was confused roles and responsibilities between headquarters and the field and multiple layers of organization within the field; and, therefore, it is not possible to point with certainty to the single individual. We're changing that. We're right now looking forward.

You point to two people. You can point to me, and I can point to my site manager, and everybody else in my organization is supposed to support one or the other of us. So I have not attempted to go back and identify specific individuals in the past, because I think the problems in the past were organizational and structural and that's the reason we are in the process of implementing this major reorganization that we announced in December.

Mr. GREENWOOD. I think you said that there was not a focus on business management. Did you mean to say that the University of California was not focusing on business management or the Department was not focusing on business management?

Mr. BROOKS. The university was not focused on business management. And, to be fair, in looking back at our interactions with the university since this administration came in, I don't think we were encouraging them to focus on business management. We were——

Mr. GREENWOOD. Well, in fact, they were rated on business management; and I think they were given an excellent rating.

Mr. BROOKS. They were.

Mr. GREENWOOD. So I guess what I'm trying to figure out, is it that no one was focusing on it? Is it that a review that granted them an excellent rating, was that—in retrospect, was that a cursory and superficial review? How can you rate—how can you rate—decide to rate business management, rate it excellent and then our

committee staff over a short period of time takes a cursory look and finds the kinds of things that we found.

Mr. BROOKS. Because we were using a mechanistic approach which set up criteria; and if you met those criteria, didn't look at whether they tracked with other criteria and didn't look back to say are you doing a sensible result. So that our problem with the former rating system was that it was narrow and stove-piped.

Mr. GREENWOOD. Let me ask you this question. How many labs does the Department oversee?

Mr. BROOKS. The Department oversees 10; the National Nuclear Security Administration oversees three of those.

Mr. GREENWOOD. Okay. Is what's true—just in talking about the way reviews are conducted, whether they're mechanistic, whether they can be described otherwise and whether they are adequate or not, does that apply to the other labs for which the Department has responsibility? Are their things done differently?

Mr. BROOKS. I can only speak for the two other labs which I have responsibility for, and I'll let the Deputy speak for the rest of the Department.

The system at Livermore is essentially identical to Los Alamos both in its past and in its future. The system at Sandia, because that's a separate contract, is comparable; and in all of those cases we are moving to a broader new method of oversight.

Evaluation, in my opinion, always walks between two dangers. One is, if you try to be very, very objective, quantifiable, X percent of that, Y percent of this, you can lead to a result where you're not looking at the connections between areas. That's the problem we're in now. The other thing is, if you use broad, subjective judgment, you run the risk of that judgment being influenced by external factors. What we are trying to do now is apply broad subjective judgment but in areas where we can actually tell.

I believe that the system that we have put in place with Appendix F with the University of California, the new model of oversight that we are putting in place with the Federal employees is going to be substantially better. But we'll know that better in a year. We'll know that really well in 2.

So I think we are moving in the right direction, but I don't want to assert that I can prove that all the problems are solved because I can't prove that yet.

Mr. GREENWOOD. Well, to make it very simple, we in the Congress are responsible to make sure, and particularly this committee, that taxpayers get the most bang for the buck.

Mr. BROOKS. Yes, sir.

Mr. GREENWOOD. I think what everybody said is the bang is pretty good. Okay. The science, the work that's done there has been excellent. But its stewardship of the taxpayers' dollar has not. And I think what we're looking for not only at Los Alamos about across the board is that the Department of Energy has in place individuals who get up in the morning and think about whether or not the taxpayers dollars are being well protected there and not used like monopoly money but used like the hard-earned dollars that the taxpayers provide to the project.

Mr. BROOKS. At the three labs that I supervise I'm confident I have people like that because I picked them.

Mr. GREENWOOD. Okay. Let me just let the Deputy Secretary respond with regard to the supervision of the other labs.

Mr. MCSLARROW. Like the Ambassador, I'm confident that we have the right people who get what you just said. The Secretary has made very clear to me and I've made very clear to everybody else one of the things that we were not happy with when we came into office was a lack of line management control.

We've made a number of organizational changes. Obviously, the most difficult was NNSA, standing up that organization, but we've made great strides. But it's been true on the other side of the Energy Department as well; and I know exactly who to go to and who's responsible for these kinds of decisions. The President, through his management agenda and what we've done in terms of contract management, have made a number of changes that lead me to be very confident. That's not to say we're not going to have any problems. But if you're going to have problems, you've got to identify them early, and you have to fix them. You've got to know who's responsible, and I think we're well on our way to achieving that.

Mr. GREENWOOD. The Chair recognizes the gentleman from Florida for 10 minutes.

Mr. DEUTSCH. Thank you, Mr. Chairman.

Thank you, Ambassador Brooks, and thank you for your personal work and your staffs' work on the enriched uranium issue. I appreciate your help.

Ambassador Brooks, it appears that you and Mr. McSlarrow think that most of these problems were of relatively recent origin, even though the DOE Inspector General has been bringing business control problems to DOE's attention for years. For example, the Inspector General said in 2000 and 2001 that it could not sign off on the allowability of costs for Los Alamos. Where was DOE, where was NNSA at that point in time?

Mr. BROOKS. I tried to say in my statement that, in hindsight, there were a number of warning signs where the reaction was to deal with the specific problem and not look to see if it was systemic. And the answer is that, in failing to look and see if we had systemic problems, we were not where we should have been.

On the other hand, with the greatest respect, 2001 was a different leadership team, and so I wasn't there, and I don't want to try and characterize why people made particular decisions that they made.

We have been trying to look at this broadly. We have looked at the past Inspector General reports, and that's one of the things we discovered, was this pattern.

Mr. DEUTSCH. Right. I guess the question, though, is that the IG—this is not the first year that the IG has not signed off and, you know, acknowledged these problems. And I guess the question in 2000 and 2001 also is why should we believe that this year is going to be any different than the prior 2 years?

Mr. BROOKS. I don't think you should. I don't think there is any reason for you to. I think you should wait for a year and see because you're going to be able to tell by then.

As I attempted to make clear in my opening statement and as the university has made clear in its discussion, we are beginning

a process. None of the witnesses you hear today will suggest that we have, "solved the problems at Los Alamos." What we will suggest, I believe, is that we are on the right direction to solve them with the right management attention and the right sense of urgency. But as both you and the chairman commented in your opening statement, it took us a long time to get here and I think it is going to take us a while to get off. So I can't speak for failures before I got here. All I can tell you is that Secretary Abraham has made it very clear to me, Mr. McSlarrow has made it very clear to me that he doesn't expect us to fail this time. And I spent a long time in the military. I understand direct orders very well.

Mr. DEUTSCH. Right. Appendix O agreed to in 2000 which was supposed to fix all problems included a provision that the Vice President of Management was supposed to implement best business practices in support of core mission requirements. We didn't find any evidence that Dr. McTague made any attempt to do this, nor do we find any evidence that DOE followed up on this requirement. Can you explain the response—your response of allowing the university's activity or no follow-up on this issue?

Mr. BROOKS. I think you've just quoted my statement, sir. That's exactly the problem, that neither the university nor we followed up on that part. And I can't explain it. I mean, in hindsight, knowing where we are now, we should have been more vigorous on that. We were focused—in our minds, on the problems that led to Appendix O were primarily in other areas, and that's where we focused.

I think the lesson that you get out of this is that high-level attention tends to fix problems. We focused on problems of security, and largely those problems have improved. We didn't focus on business services.

The idea of the new model of oversight is to make sure we focus on everything. One of the things we have to do that we have not yet done that is alluded to in our report is look to see whether we need to change the contract, including Appendix F, to make sure we don't fall into that trap again.

Mr. DEUTSCH. Okay. I think this is a really different question, and I'm just trying to get to the same failures that occurred. Can you explain to us why DOE didn't seem to care about the lack of independence of the lab's auditors and its failure to complete literally hundreds of audits on time?

Mr. BROOKS. No, I can't explain that, sir. And let me tell you what I can say. As you know, while it's a matter of some dispute in terms of cost allowability terms, the Inspector General has consistently found that the audit function at the lab was ineffective. The university has found that. I cannot explain now, of my own knowledge, why we didn't stumble on that fact earlier. I mean, in hindsight, it's glaringly obvious; and I can't explain why my oversight didn't find that.

Mr. DEUTSCH. All right. Thank you.

Mr. GREENWOOD. The Chair recognizes the gentleman from Oregon for 10 minutes for questioning.

Mr. WALDEN. Thank you very much, Mr. Chairman.

Ambassador, you've recommended that Los Alamos contract not shift between science and—not be split, I mean, between science and management. My understanding is that there are other na-

tional labs like Oak Ridge and even Hanford out in the Northwest, for example, that have managed to sever significant portions of their management responsibilities among different contractors. Why is it that you've rejected that concept out of hand at the beginning? Or Mr. Secretary.

Mr. MCSLARROW. If I could just—because I'm much more familiar than the Ambassador with those other sites. I would say while the site may actually have some different contractors, when you look at a lab and the facility that's doing the science there they do have a contractor who has integrated business and science. So what's different about Los Alamos, for example, is it's the same contractor at the same site and all the missions are all there. As you well know, at Hanford and sites like that, you've got a lot of different things going on. At least for the Los Alamos lab it is integrated.

Mr. WALDEN. But you don't think that could happen. You don't think it makes any sense to look at——

Mr. BROOKS. No, because the mission is so integrated at the lab, I don't. And I do believe, as I tried to say in my opening statement, that if the problem is that science and business services are not connected, you don't solve that problem by having them report to different people. You solve that problem by having the people they report to value both of them as the interim laboratory director does now and then by having the overall management be somebody who has expertise in both of them.

Now our report, in urging the university to compete for the contract, acknowledges that it may want to bring in some kind of partner. But that's a decision for the future. So I don't mean to reject drawing on outside expertise, but these are at the macro level single mission laboratories, and I think they need to be run by a single person.

Mr. WALDEN. All right. In your statement, apparently to committee staff, you said you were trying to work around the problems related to the costs of bidding on a project the size of Los Alamos and that you wanted all the entities who bid to be on a level playing field. I've heard estimates that it may cost as much as $25 million to simply bid on this contract. Is that an accurate number, a ball park number and how would you work around that?

Mr. BROOKS. That is a higher figure but not dramatically higher than estimates I have heard. I've heard numbers more like 10. But large procurements are very expensive. We believe that it is possible to find the mechanism which would allow the university to compete without—the university's operation of the lab financially has all been on a cost-neutral basis.

Mr. WALDEN. I understand.

Mr. BROOKS. The State doesn't make any money off of it. The State doesn't spend any money. The current rules on what the university can use retained earnings for were drafted in an era when, as several of your colleagues stated, there was a de facto assumption that this was going to go on noncompetitively forever.

We believe that it is quite possible to modify those rules, but when you're dealing with things that involve procurement regulations and law, I really am reluctant to get into any kind of detail in an area in which I lack expertise.

One of the reasons I want to start now is to make sure that, on the one hand, I'm positive I can do this. But I can do it in a way that is both seen and actually is fair to both the incumbent contractor and somebody else who wants to do it. A level playing field means just that to us.

Mr. WALDEN. I guess as I read some of the information here today from—I think it was the Secretary, perhaps, and the documentations or the memorandum from the Deputy that I just wondered, if I'm a university taking a look at this or some other group taking a look at this contract, do you think what's written here basically says that the University of California has done a great job or a good job, has addressed the management problems—I mean, I read that in here—and should be encouraged to reapply? Would those be words of discouragement to anybody else taking a look at it if, in fact, they have got to also roll the dice on maybe $10 million or more? I mean, is it a——

Mr. BROOKS. Well, they're not intended to be.

Mr. WALDEN. But if you were an outside person looking at this and read that——

Mr. BROOKS. But it is true, sir, that while we need someone who can run—as the Chairman said, and can make sure the taxpayers' money is being spent efficiently, this is big science. This is enormously complex science. We are dealing with conditions in the nuclear world that don't exist in nature except on the sun, and so you need someone to understand how to run big science. That doesn't mean it has to be the University of California. It doesn't even mean it has to be a university. But it does mean that people who don't understand how to run big science are not likely to be appropriate competitors.

We intended those words to make it clear that the deck is not stacked in either direction. But we also intend them to say that we'd like very much to have the university in the mix because, if the university prevails, that's good. If the university doesn't prevail, it will be because somebody is even better at mixing, running big science and running as a wise stewardship the taxpayers' money; and then that's good for the country, too.

Mr. WALDEN. Is it your view then that the university system has done the job on the science side?

Mr. BROOKS. Yes, sir.

Mr. WALDEN. Has had some management issues that they need to address and maybe have addressed now?

Mr. BROOKS. Well just as with me, the jury is still out on the permanence and efficacy of the reforms. I don't think, and I'm pretty sure that my university colleagues will say this, nobody should believe that when we walk out of this hearing today, the effort to put Los Alamos back on the management footing it should be on is over. We need to be vigilant. The university has given every indication that they intend to be vigilant. But I do believe—for the very reason that we didn't recommend termination, the university has certainly shown that it has the capability and the assets and the desire to deal with these problems, and I do not want to preemptively cut the Nation off from having that in the mix in 2005.

Mr. WALDEN. As you prepare the Los Alamos bid, how far down the management structure at the lab do you expect potential bidders to go?

Mr. BROOKS. I don't have the foggiest idea, and I don't mean to be flip about that. In the normal course, we would be having the discussion of whether to compete next year, and then we would be working on the details. And so what we have decided is to move that decision forward by a full year, decide how we are going to compete so that we have plenty of time to work out the details.

Mr. WALDEN. You have 30 months before the next contract expires. I am sure you don't want a lapse in the science and activities at the lab?

Mr. BROOKS. No, sir.

Mr. WALDEN. How far down do you go, and when do you contract out?

Mr. BROOKS. We have only a single example, and if you look at Sandia Laboratory, when the contractor there changed, there were replacements sort of at the senior manager level, but at Sandia, like at Los Alamos, like at Livermore, people rise up primarily in the science, and for that matter in the business area, and so most of the people were retained. It is a customary thing in large procurements in this Department and in others that the overwhelming majority of the workforce would be retained, and particularly important in the nuclear weapons area because there aren't any substitutes. But I can't answer that, but if you look at 8,000 employees at Los Alamos, the percentage is going to be—who I would expect to change—regardless would be small.

Mr. WALDEN. When do you think the contract would be ready to put out for bid?

Mr. BROOKS. Well, based on history, you would expect that late in 2004 right near the end of the year, you would issue an RFP. You would expect that you would receive bids in the spring of 2005. You would expect that you would then, you know, make—the Secretary would make a decision so that you had time for an orderly transition.

Mr. WALDEN. That gives you time for that orderly transition?

Mr. BROOKS. That is historical evidence. At the moment I have no reason to assume that this will be anything other than on a comparable schedule. But I don't want to misstate the amount of thought we have given to those details. We focused on the question of whether, and we recognize we need to get started to get the criteria right. But in terms of the mechanical process in preparing an RFP, that is a year from now at least.

Mr. WALDEN. I have overrun the clock. Thank you very much, Mr. Chairman.

Mr. GREENWOOD. Chair thanks the gentleman, and the Chair recognizes the gentleman from Michigan Mr. Stupak for 10 minutes.

Mr. STUPAK. Thank you, Mr. Chairman.

Mr. Brooks, you talked about the big science, and I agree they do wonderful work down there and brilliant work, but what is it in big science that prevents us from properly handling computers with classified information on? Why would big science prevent us from—just lose them, we can't find them?

Mr. BROOKS. It wouldn't, and it shouldn't, but it has. It is not that the science prevents it. It is a focus exclusively on science as what is important.

Mr. STUPAK. Then why not split it? If we want to focus exclusively on science, why not have a contract for science, and why not have a contract then for management so we don't have these problems?

Mr. BROOKS. Because I believe that it is not practical to split it, that at some level——

Mr. STUPAK. Then how do you get big science to understand that, as it says in the OIG report, thefts of laptop computers have to be reported. How do you get science to do it, then, if you're not going to break it up and bring in a different type of management style?

Mr. BROOKS. You get science to do that by making it clear that there are consequences for failure. The university has done that at the top, and the Director is trying to implement that culture.

Mr. STUPAK. What are the consequences? We have been doing this since the late 1980's when Mr. Dingell was chairman. We have been on these labs to clean this up, and it is now about 14 years later. What are the consequences of failure? What I heard so far today is, I can't talk about what happened in the past because we have a new program coming. How many new programs do we start and stop? It seems every hearing we have here, and I have been on this committee now for 10 years, we have a new program that is going to clean this up. That program fails, so when we get the witnesses come back, we can't talk about it, those are the past failures. Where is the responsibility here?

Mr. MCSLARROW. Can I respond? The responsibility resides with the Secretary first and foremost, and with me as the chief operating officer. And what's different, Congressman, is over the last year as these problems surfaced, first we made clear to the university that people had to be held accountable. They agreed. They made sweeping management changes at the laboratory, and now we have announced this decision, two things that never happened before. So it is now a new ballgame.

Mr. STUPAK. What sweeping changes in the laboratory management? You have a new Director.

Mr. MCSLARROW. New Director and new Principal Director, and almost every top officer out there has been replaced.

Mr. STUPAK. And we were out there in January, myself, the chairman, a bunch of us, and, you know, the top people say that, but when you talk to the people who are doing the real work, it's just going to be more of the same. It is more like, we won't let this person or—I mean, when you have things like computers that are stolen or missing, and it says right here that they're required to do it, it's all in this OIG report, and no one does it, it tells me that there is a culture there that has to be changed, and I don't see it changed.

Mr. MCSLARROW. I couldn't agree more, and people have to be held accountable.

Mr. STUPAK. Are you going to hold yourselves accountable?

Mr. MCSLARROW. Absolutely.

Mr. STUPAK. What are the consequences if it doesn't work?

Mr. MCSLARROW. If we fail, we leave.

Mr. STUPAK. So my impressions from your answers to Mr. Walden and Mr. Brooks is U.C. is going to be allowed to compete on this contract in 2005?

Mr. BROOKS. Yes.

Mr. STUPAK. And to use your words, they have many advantages over other bidders. So they already have a leg up in the bidding process.

Mr. BROOKS. I did not intend to say many advantages over other bidders, because that's a question for the competition.

Mr. STUPAK. You said they have many advantages.

Mr. BROOKS. That have brought value to this laboratory.

Mr. STUPAK. Will that value then be in bonus points or extra incentive to award the contract back to U.C.?

Mr. BROOKS. I don't know that. The reason that the report the Secretary has directed us to start is that—that is a complex question that I need to work on. The reason we're going to start on the criteria now a year before we would is to make sure that we do things that are equitable and fair and——

Mr. STUPAK. I also thought you said—and again, you didn't submit your testimony, so I am going from what I heard—you said U.C. could not have done more to change things here.

Mr. BROOKS. That's a quote out of our report, and I believe that to be correct.

Mr. STUPAK. Well, it's been about 14 years, and they haven't changed anything. Why is it suddenly now going to be just peachy?

Mr. BROOKS. I don't know that it is. What the report says, and what I was quoting in my testimony, in my oral statement, was that since December it is difficult to see how anybody could have done more or acted more vigorously than the university has.

Mr. STUPAK. Since December of——

Mr. BROOKS. 2002.

Mr. STUPAK. So for the last 4 months they have been doing pretty good.

Mr. BROOKS. And our assessment is that—the university is fully capable of speaking for itself, but our assessment is that since President Atkinson realized that the problems were severe, he has been vigorous and has directed and thrown a lot of the university resources in. And in fact, it is difficult to see what else anybody could have done—that doesn't alter the fact that we shouldn't have gotten into the problem. That doesn't alter the fact that you make about a long time. That's one of the reasons the Secretary has made a decision to compete.

Mr. STUPAK. We have thrown a lot of resources in the last 4 months, and things are looking pretty good. What are the vigorous actions that U.C. has undertaken to make sure this stops and it gets improved here on out? What are the vigorous actions?

Mr. BROOKS. I think that President Atkinson and Senior Vice President Darling will provide you some details, but let me just suggest some: The permanent subordination of the auditor to the university and the repeal of an internal procedure sometimes called the loyalty oath, which could have confused auditors in thinking that they were supposed to worry about reputation rather than fact; the near full-time presence of the university auditor despite his other responsibilities in Los Alamos to supervise the reorga-

nization of the auditing function; the bringing in of Price Waterhouse to do a massive audit; the bringing in of an outside team headed by a former inspector general to do a massive audit of purchase cards; the 20 full-time Ernst and Young employees that have been brought in to conduct a detailed management review.

Mr. STUPAK. That's all fine, but when we were here in January, they gave us the same line when we asked the simple question, well, can you tell us how many computers have been missing, and they couldn't. They couldn't say, according to our records so many computers were purchased in the last year, but where they are now, we don't really know. What good is an audit if you can't verify things that are supposed to be there?

Mr. BROOKS. I believe we have the first ever, certainly the first in a very long time, complete physical inventory of every piece of controlled equipment, a process which is now 90 percent complete and has not been done, to the best of my knowledge, at any national lab to precisely get to the question of whether or not the records match the reality.

Mr. STUPAK. Do you have a timetable as to when, in your mind, this thing is supposed to be—we have got 4 good months in—is there a timetable like by the end of the year where things have to be improved or heads are going to roll?

Mr. BROOKS. The inspector general when he testified before this committee said somewhere between 6 months and a year would be the right time for this committee to look again and see whether we have been able to sustain this. That's a reasonable estimation.

Mr. STUPAK. If the chairman holds a committee hearing next January, January 2004, and things aren't going well, and we still have missing computers, classified computers, it's my understanding that you guys are going to resign?

Mr. BROOKS. Actually the way I read the Secretary's letter, I may not have to. The Secretary has directed me to keep him informed in his tasking back to me, and I didn't read that as bring him excuses. So I don't know whether we are going to resign. It depends how bad things are. But I know the Secretary does not take responsibilities lightly, and he has been pretty clear that he expects this to get better.

Mr. STUPAK. Like I said, this has been going on since the late 1980's. Are you talking about all these audits? We have had these before. You talked about this loyalty oath and all that. That is all fine and dandy, but I don't see any of that changing the problems at Los Alamos. I really don't see it. I don't see how it gets back anything. You have reports in here where two computers used to process classified information were missing for 1½ years, and no one even says anything about it.

Mr. BROOKS. In that particular report, we need to distinguish problems here. One of the problems with Los Alamos is they have multiple unconnected systems.

Mr. STUPAK. The distinguished problem to me is basically saying this is the reason why it happens, and we give them an excuse, and then we let them off the hook, and then we go on and we are back again in another year going through the same old, same old, same old since late 1980's, and it's got to stop or change until people are held accountable.

Mr. BROOKS. I don't disagree with that. What I was attempting to point out was you have to make sure you understand what the real problem is so you can fix that, otherwise we won't know if we have fixed the problem.

Mr. GREENWOOD. The time of the gentleman has expired.

The gentlelady from Chicago Ms. Schakowsky is recognized for 10 minutes.

Ms. SCHAKOWSKY. Thank you, Mr. Chairman.

For me it is deja vu all over again, as Yogi Berra said. I was the ranking member on the Government Efficiency Subcommittee of the Government Reform Committee, and Chairman Steve Horn and I had a number of hearings. In this case we were looking into practices at the Department of Defense, and again, when the GAO or the IG took a look, they found persistent problems wherever they looked. And in fact, the inspector general of the Department of Defense said that the Department cannot accurately track—accurately track $1.2 trillion in transactions. That is not to say all of it's lost, we just don't know, can't match it up. And then we looked at purchase cards in various departments and branches of the government, and we found the same thing.

And so when you say there's just a few people because most people are honest, I would agree with you. But there's just a few people here, a few people there, a few people there, and I would also posit that everywhere there are those people, and if a culture isn't in place and systems aren't in place, those few people are going to continue to take advantage of a situation. So I would not be sanguine about the notion that we are just talking about a problem at Los Alamos with a few people, and that we better take a look everywhere.

But let me get down to my specific questions about the situation that we are facing here. My understanding is that there is a FY—there are new—I am looking at an fiscal year 2003 performance standards now and that they represent a completely different approach to performance standards; is that true?

Mr. BROOKS. Right.

Ms. SCHAKOWSKY. And that the University of California's performance fee is based now on attaining these objectives; is that correct?

Mr. BROOKS. Correct.

Ms. SCHAKOWSKY. And that these objectives are very mission-oriented, and the mission is defined as providing good science and technology; is that correct?

Mr. BROOKS. Correct.

Ms. SCHAKOWSKY. Well, I want to ask you today then, because we are talking about performance standards for 2003, why only 1 of the 40 objectives addresses all of the procurement, auditing and business control problems that we're discussing today? I'm looking at performance measure 8 under operations, and this is the only one that directly addresses this problem, implement effective controls and business systems by assessing existing controls and, where needed, strengthen controls to ensure effective stewardship of public assets.

Mr. BROOKS. I think you raise a perfectly valid point. Let me put it in context and tell you what I'm going to do. In the report that

we submitted to the Secretary, we alluded to the fact that we might require some contractual changes now to make sure that these reforms that have started continue. We didn't specify what the changes are because we need to discuss it with the site, with the laboratory and with the university. One of those contractual changes might well be to give greater visibility to this in the performance objectives. At the moment, for obvious reasons, business services has very high visibility and great attention for the leadership of the laboratory, the university and the Department.

The point of the performance objectives change that you suggest I should consider and that I had already concluded I needed to consider is to make sure that it doesn't once again fall below our radar scope. But I would not accept the view that the number of times something is mentioned is a necessary measure of the importance we place on it. One of the reasons we went to this system was to try and focus on the overall mission. But——

Ms. SCHAKOWSKY. Let me ask you then, have you assigned a value to each standard?

Mr. BROOKS. We have not. And the reason we have not is because we fear that we will fall back into the trap that led to the results of an evaluation of excellent business systems virtually simultaneously with the Secretary's, quote, systemic management failure. And the trap was that we got stovepiped. And so what I want to do is I want to be able to focus on everything.

There's a level of performance—I mean, if you assign the value to business systems, and you look at the old system, it's about 15 percent. I don't—since that's the old system, let's not get into a debate about whether that's the right number, but the old system did say that 50 percent of the score of the lab was based on its mission accomplishment, and that's stockpile, stewardship and science, and any reasonable system is probably going to weight that very heavily. The problem with systems that go to specific weighting values is they lead to the trap where something can be a completely unsatisfactory element, but it's a small weight.

Ms. SCHAKOWSKY. Let me just say I get your point. But, Ambassador Brooks, I've been told that DOE can't tell us how—I've been told that we can't know how DOE is going to evaluate these objectives. The university wrote the objectives. Are we going to let them decide which ones are important and which ones aren't?

Mr. BROOKS. No. We do this through a series of meetings between the university, the laboratory senior leadership, my own senior leadership, including myself, organized by the site office manager, who in the legal sense is the contracting officer. The formal responsibility for evaluation falls on the site office manager, with approval by me, and we're not going to change that. We're not arguing about who is responsible for the evaluation, we're arguing about how to go about evaluating this enormously complex enterprise.

Ms. SCHAKOWSKY. Let me get in my final question. The inspector general just released a report that said that you can't be sure that you have control of your classified information because you don't have control of the classified laptop computers, and yet you state that security has not been affected by these sloppy business prac-

tices. How can you come to the conclusion of no problems in your report?

Mr. BROOKS. The inspector general's report looked at one particular system, which is a property accountability system. There's a separate disconnective system that's part of the stovepiping problem I mentioned earlier that controls classified material, and that has suggested to us that there is no compromised classified material.

I would be happy to submit a longer answer—this is a somewhat complicated issue—for the record.

[The following was received for the record:]

The Department of Energy Inspector General (IG) report identified 5 laptop computers being used for classified processing that were not identified on the Los Alamos list of computers accredited for classified processing. Three of the identified computers are supporting another DOE organization and managed in accordance with the requirements of the work sponsor. One of the laptops was a substitute for an older desktop system and the procedures for updating the security documentation and lists were not properly followed. This error was corrected during the IG inspection at Los Alamos. The IG report did not identify the specific laptop computers and Los Alamos has been unable to identify any other laptop that might have been referenced by the IG team. The IG report identified one laptop computer listed as approved for classified processing but lacked a valid property number. This laptop belongs to another government organization and would not have a Los Alamos property number. The IG report also identified several laptop computers that were still identified as accredited for classified processing but were no longer in use. These laptops were all in the process of sanitization in preparation for declaring them as excess property. Removal of the laptops from the list of accredited systems is the last step in the retirement of a laptop and is not performed until the unit is removed from the security area and all information is sanitized from the system.

Mr. BROOKS. The conclusion in the report is also based on a series of inspections conducted both by the inspector general and the Office of Independent Oversight late last year. So I don't want to say there's never—I mean——

Ms. SCHAKOWSKY. That's what I want you to say, that there's never a security problem, and that we know that there isn't, and because we can't identify where all this equipment is, I think Americans have a right to have a slightly queasy feeling about that.

Mr. BROOKS. Yes, ma'am. But I believe in this particular case there is not a problem.

Ms. SCHAKOWSKY. Let me ask this in my remaining time. It appears—and I'm looking at the—on page 2, precipitating incidents that the problems were not widely recognized outside the laboratory until the summer of 2002. It seems that you think that they were of recent origin even though the DOE inspector general has been bringing business control problems to the DOE's attention for years. For example, the inspector general said in 2000 and 2001 that it could not sign off on the allowability of costs for Los Alamos. So where were you?

Mr. MCSLARROW. As these IG reports came in we were implementing the recommendations of the IG, the purchase card in particular, at the Department. It was not an IG investigation at DOE, it was one at DOD which our management team brought to the Secretary's attention, and he directed late in the spring of last year the enormous purchase card investigation that was complexwide. And then the whistle-blowers came out of that, and we went to the FBI.

When we talk about the precipitating incidents, you are quite right to suggest——

Ms. SCHAKOWSKY. The whistleblowers who were fired you're speaking of?

Mr. MCSLARROW. No. These are different people.

Mr. BROOKS. That's part of our problem.

Mr. MCSLARROW. Part of the cultural change is that people believe they can't go to management and tell the truth and be rewarded, and that's one of the things we have to change from the Fed side to the contractor side.

To go to your point about precipitating incidents, we are not suggesting that all of this stuff started with the discovery of the purchase card problem. What we're saying is that precipitated the crisis that culminated in the firing of the two whistleblowers you were just referencing. This is what we have to change. And I believe with the university's action in terms of the sweeping management changes, I don't think there is anybody left at Los Alamos that doesn't get that people are going to be held accountable today. That's different.

Mr. GREENWOOD. The time of the lady has expired.

The Chair recognizes the presence of the gentleman from New Mexico Mr. Udall, and although not a member of the committee, is not permitted to ask questions, but we appreciate his interest on behalf of his constituents.

The Chair recognizes the gentlelady from California, Ms. Eshoo for 10 minutes.

Ms. ESHOO. Good morning, Mr. Chairman, and my thanks to you again for the legislative courtesies that you have extended to me as a member of the full committee, but not a member of this subcommittee, to participate.

Good morning, both of you, and welcome to the committee. Let me just get right to the questions. I appreciate what you have said so far, and I have listened carefully to the questions of my colleagues on the committee, which are excellent ones.

The purpose, of course, today of this hearing is to discuss the decision of the Department that has been made about recompeting the management and the operation of the lab, and focusing in on the reasons for the decision, and what exactly the Department is looking for in seeking a new Administrator of Los Alamos. So I'm going to stick—I'm going to focus right in on that.

When you spoke of big science, who is out there that is in the world of big science that would—in the Department's view would be in contention for this? Do we have many players in the country relative to this?

I also want to note, it was a curiosity—excuse me for interrupting—that the contract with the University of California was signed April 14, 1943. I was 4 months old—4 months and a day. So there's a long history here.

At any rate, can you address that? And I know—I have a series of questions. I know I have 10 minutes, which is generous, and I want to make use of that time.

Mr. MCSLARROW. First I don't think we should be in a position of naming anybody in particular.

Ms. ESHOO. Are there many contenders? Are there 5 or 10?

Mr. MCSLARROW. Every university who does big science is potentially somebody who could bid on this. And I would note at Oak Ridge National Laboratories and Brookhaven National Lab, we actually have a combination of a university—in Oak Ridge's case.

Ms. ESHOO. So there are many?

Mr. MCSLARROW. So I think——

Ms. ESHOO. So the Federal Government has many options.

Mr. MCSLARROW. Yes, ma'am.

Ms. ESHOO. In setting up for competition, what are the rules of the road that the Department—having experienced this chapter with the University of California, what are the new things that you are looking for, that you will establish? What is the criteria that will change?

Mr. BROOKS. Ma'am, that's too important to shoot from the hip on, and that's why the Secretary directed that I start now a year ahead of when you would normally start to work on the criteria to make sure that they will lead to the result we want, which is the same good science that we have had, but with an improvement in the stewardship.

Ms. ESHOO. Would you say that the science—the big science has been superb, good, mediocre, and that it is the management, the oversight, the business part of keeping the books and the management of the personnel and all that goes with that—which is serious, and I am not diminishing that. We wouldn't be here today were it not for the things that have happened that certainly are not defensible, and I would not seek to defend something that isn't defensible. But is there a bright line between the two?

Mr. BROOKS. Certainly I would say the science at Los Alamos has been world class, and there are few competitors, and most of the competitors are other DOE-managed national labs. And as the Secretary said in his tasking, what we seek is business that's as good as the science.

Ms. ESHOO. So it's the business management that the Department is going to focus on?

Mr. BROOKS. While preserving the science.

Ms. ESHOO. Most certainly. I assume that for the good of our country.

I want to move to the two other contracts that the university has, Lawrence Livermore and Berkeley Labs. Are they part of this? Do those contracts expire in 2005? Are they negotiated at the same time? How are those handled?

Mr. BROOKS. The Lawrence Livermore contract expires at the same time, and although it's a separate contract—two contracts are essentially identical.

Ms. ESHOO. Are those going to be recompeted?

Mr. BROOKS. Our report says that there's no need to make that decision now because we're making a decision to compete a year ahead of when we would normally make it because of problems we believe to be unique to Los Alamos. Because those problems do not now exist at Livermore, our report says, and the Secretary has agreed, that there's no need to make the decision with regard to Livermore at this time. And that decision——

Ms. ESHOO. Let me understand this. The Secretary is implying or has stated that those will not be recompeted?

Mr. BROOKS. He's stating he doesn't have to make a decision on that today. And what our report said was there's no legal reason why you couldn't extend Livermore and compete Los Alamos. That's not saying that is a decision. They're saying there's no legal reason why we couldn't do that, and there's no policy reason why we have to make the decision now.

Ms. ESHOO. If you're going to open something up for recompetition, you have to prepare for that.

Mr. BROOKS. Yes, ma'am. But normally that would all start next year. Remember, we're a year ahead of schedule. So that's a decision we haven't made because there's not a need to make it.

With regard to Berkeley that's not a lab under my responsibility.

Mr. MCSLARROW. We're in the process of extending that contract right now. So it's a matter of contract negotiation, but that decision has already been made.

Ms. ESHOO. What role will the Department play in the timeframe leading up to recompetition to make sure that the reforms that you have already described—and I don't need to reiterate that because that's already part of the record—what role will the Department play to make sure that these reforms are sustained? What are you doing?

Mr. BROOKS. Two things. First, in terms of the competition itself, that's the reason why I need to start on these criteria right now, to figure out how to get the criteria to maximize the chance of getting them right.

Second, as I described earlier, we have altered the oversight approach used by the National Nuclear Security Administration, and we intend to push very vigorously to make sure that that approach achieves what it is expected to achieve, which is more effective oversight that looks at the entire lab.

Ms. ESHOO. I'm not so sure I know what that description means in terms of having legs on it, but I accept what you're saying.

Has the Department itself taken a good hard look at itself to see where it may have failed in its oversight?

Mr. BROOKS. Yes, we have, although not as a direct result of Los Alamos. As a result——

Ms. ESHOO. I would like to suggest that that be the case. And I say that because this a marriage.

Mr. BROOKS. Yes, ma'am.

Ms. ESHOO. It's a marriage. And in marriages, as we know, it's not just up to one person. Certainly the University of California bears responsibility in this, and the Congress has a responsibility in terms of its oversight, taxpayer money. I don't have to go into all of that. We have had many hearings on that. But I also think in the executive branch that the Department of Energy and those that are—if you're responsible for setting up the criteria and letting a contract, that you, too, have a responsibility in this marriage. So I think that we need to bring balance to this. And I think it's very important for the Department to weed through what it does, how well it does it, what the steps are that you take, and that you report back to the Congress in this. It's a real opportunity, I think, for the Department as well.

Mr. BROOKS. Yes, ma'am. I agree with that completely. What I meant to say was that we already knew we had that problem, and we were starting to try and fix it before these incidents surfaced.

Ms. ESHOO. What did you identify was the problem?

Mr. BROOKS. The problem within the National Nuclear Security Administration was the lack of clarity on roles and responsibilities, duplication and too many layers of management. As a result, in December we eliminated a layer of management and centralized responsibility for oversight in site office managers.

Ms. ESHOO. There's something from the inside of the Department just as there has been—as we have examined the culture that we've called it at Los Alamos, this has spanned a long period of time. This is not Democrats. It's not Republicans. This is something that has been more than an irritant inside of DOE and those that are responsible, and that's why I raise it.

I see that the clock is ticking away, and I thank you both for your testimony today.

And again, Mr. Chairman, I thank you for the courtesies that you have extended to me.

Mr. GREENWOOD. The Chair thanks the gentlelady and recognizes the gentleman from Massachusetts Mr. Markey for 10 minutes.

Mr. MARKEY. Who in the DOE was responsible specifically for the oversight of Los Alamos?

Mr. BROOKS. When you say was——

Mr. MARKEY. Or is.

Mr. BROOKS. Me.

Mr. MARKEY. You are?

Mr. BROOKS. Yes, sir.

Mr. MARKEY. How long have you had that job?

Mr. BROOKS. Since last summer, sir.

Mr. MARKEY. Who had the job before you?

Mr. BROOKS. General John Gordon.

Mr. MARKEY. Was there anyone under him who had the specific responsibility?

Mr. BROOKS. Specific responsibility I want to distinguish between now and then. Now, under my supervision, the immediate responsibility is Mr. Ralph Erickson, who has appeared before this committee, he is the site manager of the Los Alamos site. Before December of last year, responsibility was fragmented between Mr. Erickson and the manager of what was then called the Albuquerque Operations Office, and there was some ambiguity about who was responsible in headquarters.

What we did in December was to clarify responsibilities by putting the authority and responsibility in the hands of the site manager, having him report directly without any intervening layers. So that's why I stress "was," because the answer is different today than it was during the period when these problems were developing.

Mr. MARKEY. Is anyone who was responsible before you took over still on the job?

Mr. BROOKS. Well, I mean—site officers.

Mr. MARKEY. Who is in a position to have known what the problems were, did not correct them, and, subsequent to your taking charge, remained in place?

Mr. BROOKS. I think the answer to that is no, but I don't want to suggest it's because we did some kind of house cleaning. I mean, we abolished a layer of management, and those people have gone to do other things. Mr. Erickson himself was only assigned to the Los Alamos site last summer.

Mr. MARKEY. Let me move to the case of Dee Cotler, who worked for Livermore until 1997 when she was fired after she testified that she had witnessed sexual harassment at the lab. The lab said she hadn't been retaliated against, but rather was fired for improperly using her telephone and her computer. It turned out that she made a whopping $4.30 worth of personal calls. That's what she's being persecuted for. She sued, and she won a million dollars. The university appealed. She then asked for her legal fees, about $700,000, to be paid by U.C., and she won that as well.

The University of California continues to appeal. The university has run up at least $800,000 in legal fees fighting this case for 6 years, bringing the grand total to $2.5 million all supposedly because of a $4.30 telephone call, and so far that's the only charge against her. And she has to live every day of her life trying to explain why she was fired, and that makes it tough in terms of her prospective employees.

DOE actually reimburses more than 95 percent of all legal fees incurred by its contractors, including those incurred in the case of Dee Cotler. Would you agree taking a hard look at procedures and standards that DOE uses to determine whether contractor legal fees should be reimbursed would be a good idea?

Mr. BROOKS. Certainly. I would be happy to take a look at it. I am not sufficiently familiar with the specific case, however, to comment on that case now. But the basic principle of looking at what legal fees are reimbursable, I would be happy to look at that.

Mr. MARKEY. You have never heard of the case?

Mr. BROOKS. I have heard of the case.

Mr. MARKEY. You have never reviewed this case?

Mr. BROOKS. I have not reviewed this case because I regard it as an issue between the university and a former university employee, so I have not personally reviewed the case.

Mr. MARKEY. You're saying that as the person in charge, knowing that $2.5 million has already been expended by the university on a $4.30 phone call, that you haven't looked at that yet?

Mr. BROOKS. Yes, sir. That's what I said.

Mr. MARKEY. Well, I don't think that's good. This seems like a pretty big expenditure, and especially if it sets precedent or it's just a continuation of precedent in terms of a disproportionate response to something which seems to me to be very suspicious, you know, to punish a whistle-blower.

Mr. BROOKS. Your point is well taken, and certainly the point about not punishing whistle-blowers, I think there's no question about the Secretary's or the Deputy's or my view that that is unacceptable. I need to look into this case.

Mr. MARKEY. It is very troubling to me, to be honest with you, sir, that someone who basically came forward on a sexual harass-

ment case is in turn, you know, punished for a $4.30 phone call, and the bill has run up to $2.5 million, and you haven't looked at the case yet after a year on the job. From my perspective, it just seems to me that this would jump out as one of the 5 or 10 things you would have to look at, you know, to make a determination as to whether or not there is a systematic attempt here to squelch whistle-blowers from identifying problems in the management of the facility. So why wouldn't you have—since you say you are familiar with the case, why wouldn't you have spent a little more time on it trying to find out whether or not $2.5 million——

Mr. BROOKS. I obviously don't have as good an answer as I would like. I thought of it as an old case being handled in the legal system, and I had no evidence that it was part of a systemic problem at the laboratory, but you make a good point, and I will look at it, sir.

Mr. MARKEY. You don't think it is sufficient evidence in and of itself that someone who makes a charge of sexual harassment, is basically upheld, you know, by the facts in the case, and then subsequently is brought under a 6-year withering assault that ultimately costs $2.5 million over a $4.30 personal phone call is a big indication of mismanagement or cover-up at the labs?

Mr. BROOKS. Once again, you correctly point out that I should have looked at it, and I will, but since I haven't, I am not in a position to comment.

Mr. MARKEY. During the Energy and Commerce markup, Chairman Tauzin and Chairman Greenwood and Mr. Barton and I worked out some language that would limit the reimbursement of legal fees to its contractors in cases where the contractors lose a whistle-blower case. The contractor would have to pick up the tab for future appeals unless the adverse ruling is overturned in the end. The point was twofold. First, it creates a financial incentive for contractors to settle the case. And second, it potentially saves the taxpayers a lot of money.

Do you agree with those provisions as described and as they're now included in the energy bill that's left the House of Representatives?

Mr. MCSLARROW. We'd have to give you an exact answer on the wording, but in the spirit of what you have just described, I don't think we would have a problem with it at all. And we have made it clear to other contractors when they've done things wrong and they had to pay for it, we're not going to reimburse them for that. I don't think that's any different than what you described.

Mr. BROOKS. And I would point out that the university has preemptively—as I said, I am not familiar enough to comment on the case, but in the Los Alamos incidents, the university has said it will not seek reimbursement in several cases where there's no particular evidence that there's been wrong, but the records are sufficiently sloppy that you can't tell. But the principle that you established is a perfectly sound one.

Mr. MARKEY. Is it your belief, Ambassador Brooks, that the science being done at other DOE labs such as Sandia and Oak Ridge is inferior to that at Los Alamos and Livermore?

Mr. BROOKS. No. I think the science at all the national labs is a national treasure. I am most familiar with the work being done

at the three weapons labs, and I have steadfastly resisted any attempt to rank the quality of the science because it's all very, very good, and it's all somewhat different.

So, no, I don't contend that only Los Alamos and Livermore do good science. I contend they are among the people who do the best.

Mr. MARKEY. Do you think that scientists will leave Los Alamos if the contractor is changed?

Mr. BROOKS. I hope not. I am concerned with the possibility of large-scale retirements, but I believe that with this much time, we can make sure that the competition is such that individuals don't feel that they have to leave. If the new contractor or the renewed contractor both preserves the spirit of scientific inquiry, which is an important part of what the university has brought, and if, as is customary in these contracts, we require that the workforce—since there really isn't an alternative to this workforce in many areas—is retained, I don't think it is certain that people will leave. I think it is a danger, and we are working hard to make sure that people understand that the competition is about making Los Alamos better, not about changing its scientific character.

Mr. GREENWOOD. The time of the gentleman has expired.

The Chair thanks the witnesses for your testimony and your cooperation. We look forward to seeing you in 6 months to a year from now. You are excused.

The Chair calls forward our next witness, the Honorable Gregory H. Friedman, inspector general at the U.S. Department of Energy.

Welcome, Mr. Friedman, and thank you for being with us. You're aware this is an investigative hearing, and it is the practice of this subcommittee to take testimony under oath in these circumstances. Do you have any objection to testifying under oath?

Pursuant to the rules of the subcommittee and the House you are entitled to be represented by counsel. Do you choose to be represented by counsel?

Mr. FRIEDMAN. No.

Mr. GREENWOOD. Raise your right hand.

[Witness sworn.]

Mr. GREENWOOD. You are under oath, and are recognized for 5 minutes for your opening statement, sir.

TESTIMONY OF GREGORY H. FRIEDMAN, INSPECTOR GENERAL, U.S. DEPARTMENT OF ENERGY

Mr. FRIEDMAN. I am pleased to be here at your request to testify on the Office of Inspector General's reviews of management practices at the Los Alamos National Laboratory.

As you are aware, yesterday the Secretary announced his decision to retain the University of California as the operator of the laboratory through the end of the current contract in September 2005 and to open management of Los Alamos to full competition when the contract expires. In reaching this decision, the Secretary adopted a series of recommendations made by the Deputy Secretary and the Acting Administrator for the National Nuclear Security Administration. As was noted in yesterday's announcement, recent reviews completed by the Office of Inspector General were considered as part of the decision process. I would like to briefly discuss two of these reviews this morning.

At the request of the National Nuclear Security Administration, the Office of Inspector General reviewed the allowability of the $5.2 billion charged to the contract for the last 3 fiscal years, and we evaluated related internal controls. Based on the audit, we questioned $14.6 million in potential unallowable costs, including the following: $3.7 million for working meals that were inconsistent, in our judgment, with acquisition regulations; $7.4 million for travel in excess of contract limits; and $3.5 million for an internal audit function that did not, in our professional judgment, meet Department requirements.

Additionally, the Office of Inspector General conducted reviews focused on accountability of laptop computers at the laboratory and found inadequate internal controls over classified and unclassified laptops. For example, laptops reported as unlocated were written off the laboratory property inventory without a formal inquiry. Thefts of computers were not always reported to the appropriate laboratory security office. In at least two cases, laptops were being used to process classified information even though they were not accredited to do so. And some computers were accredited for classified processing, but were not on the laboratory master property inventory list.

These Office of Inspector General reviews, as well as several others noted by the Deputy Secretary and the Acting Administrator in their report to the Secretary, disclosed significant internal control weaknesses in the laboratory's management systems. Our recent work at Los Alamos and other Department locations has led us to develop a list of lessons learned that we believe can serve as a path forward as the Department works to strengthen its management practices in the administration of its major contracts.

Specifically, in our view, the Department needs to ensure that its contractors establish robust, effective and reliable business systems; promote contractor governance models that adequately protect the Department's interests; foster a culture where contractors fully understand and honor the special responsibility associated with managing taxpayer funds at Federal facilities; promote an environment where both Federal and contractor employee concerns can be raised and addressed without fear of retaliation; develop quantifiable, outcome-oriented metrics and maintain a system to track critical aspects of contractor performance; and finally, to rate and reward contractors commensurate with their accomplishments.

Given that contract administration has been a significant longstanding challenge to the Department of Energy, the Office of Inspector General will continue to evaluate the Department's progress as it works to address this issue.

Mr. Chairman and members of the subcommittee, this concludes my statement. I will be pleased to answer any questions that you might have.

[The prepared statement of Gregory H. Friedman follows:]

PREPARED STATEMENT OF GREGORY H. FRIEDMAN, INSPECTOR GENERAL, U.S. DEPARTMENT OF ENERGY

Mr. Chairman and Members of the Subcommittee, I am pleased to be here at your request to testify on the Office of Inspector General's (OIG) reviews of management practices at the Los Alamos National Laboratory (Laboratory).

In February of this year, I testified before this Subcommittee regarding our Special Inquiry report on *Operations at Los Alamos National Laboratory* (DOE/IG-0584, January 2003). That report noted a series of actions taken by Laboratory officials, which obscured serious property and procurement management problems and weakened relevant internal controls. In March, I testified before the House Committee on Government Reform on the Department of Energy's (Department) contract administration activities, including the need for the Department to more effectively manage certain aspects of contract operations at Los Alamos.

In light of criticism regarding internal control weaknesses at the Laboratory, the National Nuclear Security Administration (NNSA) requested that the OIG perform an audit of the costs incurred by the Laboratory for Fiscal Years 2000 through 2002. Today, I will discuss the results of this review, as well as our recent report on computer controls at the Laboratory. Based on the record developed from these and previous reviews, we concluded that the business operations at the Laboratory have not been given adequate attention. This conclusion is consistent with the findings of a series of reviews commissioned by the University of California (University), the Laboratory's operating contractor.

COSTS CLAIMED AND RELATED INTERNAL CONTROLS

Consistent with NNSA's request, my office sought to determine the allowability of the $5.2—billion charged to the contract for the last three fiscal years and to evaluate relevant controls. Our report, University of California's Costs Claimed and Related Internal Controls for Operation of Los Alamos National Laboratory (DOE/IG-0596, April 2003), questioned the allowability of $14.6 million in costs claimed and identified a number of internal control weaknesses.

Questioned Costs

We identified potentially unallowable costs incurred by the Laboratory between Fiscal Years 2000 and 2002. This included about $3.7 million for working meals that were inconsistent with acquisition regulations, $7.4 million for travel in excess of contract limits, and $3.5 million for an internal audit function that did not meet Department requirements.

The majority of the $3.7 million in questioned meals was provided by the same contractor that provides services to the Laboratory's cafeteria. The remainder was for meals at restaurants in Los Alamos, Santa Fe, and Albuquerque, New Mexico. In our judgment, the number, frequency, and apparent routine nature of most meals provided indicated that the Laboratory was not exercising care to distinguish situations when working meals truly were in the Government's best interest. In addition, the Laboratory had a more restrictive policy for using University funds, than for using Government funds, on meal expenses. When University funds were being used, the approval of the Director's office was required, but when Government funds were being used for meals at the Laboratory, Group Leader approval was sufficient.

The University also charged $7.4 million to the contract for travel costs that were not in compliance with Federal Travel Regulations. Travelers were reimbursed for lodging that exceeded established General Services Administration rates, conference fees that had no accompanying receipts, and various other costs that were not in accordance with the Federal Travel Regulations. After the completion of our review, we were informed that the Laboratory was able to locate additional supporting documentation that was not available during our audit. NNSA may be able to use this documentation to assist in making final allowability determinations. However, the absence of documentation at the time of our review calls into question the travel claim review process used by the Laboratory.

Finally, we questioned as unreasonable about $3.5 million charged to the contract by the University for the cost to operate a Laboratory audit function that did not meet the requirements of the contract. Specifically, the function was not organizationally independent, did not adequately plan and execute its internal audit work, and did not conduct timely follow-up reviews.

Control Weaknesses

During our review, we noted a series of internal control weaknesses that contributed to an environment where questionable costs could be incurred and claimed. These weaknesses related to:

- The Laboratory audit function;
- Financial system reconciliations;
- Payroll and travel approval processes;
- Financial management personnel turnover; and,
- Financial system review and approval.

Laboratory Audit Function—A quality internal audit function is crucial to effective program management. The University contract required the Laboratory to establish an audit function that was acceptable to the Department. We concluded that, for the period Fiscal Year 2000 through Fiscal Year 2002, the Los Alamos National Laboratory's internal audit function did not meet Department requirements.

For example, the audit function did not prepare a plan to audit subcontracts for the three years reviewed, although subcontracting represented about one-half of the expenses of the Laboratory. Of particular concern to us was the fact that the Laboratory provided documentation indicating unaudited subcontract costs of over $1 billion at the time of our review. Further, for one of the subcontracts that had been audited, the results of the examination (including $12.8 million in questioned costs) had not been reported to the Department's contracting officer. Given the dollar value of the subcontracts to be examined and weaknesses in reporting, we concluded that the subcontract audit function at the Laboratory needed substantial strengthening.

Financial System Reconciliations—The review also identified weaknesses in reconciling cost data from the Laboratory's financial systems. The Laboratory has over 60 feeder systems that provide cost information to its Financial Management Information System (FMIS). The University had not established a process to periodically reconcile costs generated by these systems. University officials told us that reconciliations could be completed, but only with great difficulty. We were able to reconcile the payroll system to within $1.4 million of payroll costs in FMIS and the travel disbursements system to within $2.3 million of costs in FMIS. However, the absence of a process to periodically reconcile costs, and our inability to completely reconcile payroll and travel data, led us to conclude that the costs claimed by the University could be misstated and the universe of costs subjected to audit could be incomplete.

Payroll and Travel Approval Processes—The Laboratory also permitted payments to be made based on electronic signatures of administrative personnel or, in some cases, subcontractor support staff. Supervisors made only 15 of the 120 electronic approvals checked in our sample. The written policy for approvals stated that travel claims and payroll time sheets required supervisory approval—Deputy Group Leader and above—using either online electronic signature or hardcopy signature prior to paying travels claims and salaries. Although we were able to verify in some instances that hardcopy signatures did exist, our primary concern was that the Laboratory's Business Operations Division made payments based exclusively on the electronic signatures without any process, test-basis or otherwise, to verify supervisory approval of transactions.

Financial Management Personnel Turnover—During our review we also noted that there had been substantial turnover in Laboratory personnel responsible for financial management activities. While we recognized the challenge of retaining qualified personnel, the fact remained that excessive turnover left a void in the Accounting Department's ability to fully understand and execute the interfaces and capabilities of the Laboratory's financial management systems. In particular, Accounting had been severely affected, with five of seven managers (71 percent) having less than one year of experience in their current positions.

Financial System Review and Approval—Finally, the University had not obtained Department approval for its financial systems. Although the University's contract required such approval, we found no evidence that the Department approved the Laboratory's existing financial systems. Further, the University had initiated a 5year, $70 million overhaul of its existing system without required Department approval.

Management Response and Corrective Actions

In response to this report, NNSA indicated that corrective actions had been taken or were planned. Planned actions included improving controls and conducting a review of the allowability of the $14.6—million in questioned costs. Although the University took strong exception to our characterization of questioned costs and internal control weaknesses, University officials informed us of several recent changes intended to address weaknesses in the audit function at the Laboratory. For example, the University reported that it had established an independent reporting structure for the audit function. If successfully implemented, the NNSA and Laboratory initiatives should address the identified internal control concerns.

CONTROLS OVER LAPTOP COMPUTERS

The Office of Inspector General also recently issued an interim report focusing on accountability of laptop computers at the Laboratory, *Inspection of Internal Controls Over Personal Computers at Los Alamos National Laboratory* (DOE/IG-0597, April 2003). The Laboratory maintains approximately 30,000 desktop and 5,000 laptop

computers for processing a broad range of classified and unclassified information. We determined that internal controls over classified and unclassified laptop computers at the Laboratory were inadequate. Laptop computers were not appropriately controlled or adequately safeguarded from loss, nor were they managed in accordance with security requirements.

The Laboratory's process did not assure that required inventory controls were followed when new computers were acquired using purchase cards. During Fiscal Years 2001 and 2002, the Laboratory used purchase cards to acquire over 1,000 new personal computers. Laboratory policy identifies computers as "sensitive items" due in part to their susceptibility to theft. Sensitive items should have property numbers assigned to them when they are acquired, and if the item was acquired using a purchase card, this number should be entered into the purchase card database. We found that the purchase card database was incomplete, in this regard, for 70 percent of the computers acquired during this period. In addition, laptop and desktop computers were acquired using purchase cards even after the Laboratory limited such purchases. A number of other control weaknesses were identified. For example:

- Laptop computers reported as "unlocated" were written-off of the Laboratory property inventory without a formal inquiry;
- Thefts of laptops were not always reported to the appropriate Laboratory security office; and,
- Laboratory employees were not held accountable in accordance with Laboratory requirements for the loss of their assigned Government computers.

The review also disclosed weaknesses in controls over classified computers. For example, during our review, the Laboratory provided us a listing of laptop computers that had been "accredited" for use in processing classified information; however, several discrepancies were found. Specifically, we identified instances where laptops used for classified processing were not on the list. In two of these cases, the computers were being used to process classified information even though they were not accredited to do so.

Based on these and other discrepancies, we concluded that the Laboratory could not provide adequate assurance that classified, sensitive, or proprietary information was appropriately protected. We referred these findings to the Department's Offices of Counterintelligence and Independent Oversight and Performance Assurance and the NNSA's Office of Defense Nuclear Counterintelligence for further review and appropriate action.In summary, our reviews have disclosed significant internal control weaknesses in the Laboratory's management systems. In response to our recent reports and those of other external reviewers, the University has indicated that it has implemented a number of reforms.

CONCLUSION

The environment described in my testimony today can—as was the case with many issues raised in previous reviews—be attributed in large measure to management decisions and policies that did not assure the interests of the Federal taxpayers were adequately protected. In this context, our recent work at Los Alamos and at other Department locations has led us to develop a list of lessons learned that can be used by the Department to strengthen its management practices. Specifically, the Department needs to:

- Ensure that its contractors establish robust, effective, and reliable business systems;
- Promote contractor governance models that adequately protect the Department's interests;
- Foster a culture where contractors fully understand and honor the special responsibility associated with managing taxpayer-funded Federal facilities;
- Promote an environment where both Federal and contractor employee concerns can be raised and addressed without fear of retaliation;
- Develop quantifiable, outcome-oriented metrics and maintain a system to track critical aspects of contractor performance; and,
- Rate and reward contractors commensurate with their accomplishments.

To assist the Department in addressing the weaknesses discussed today and measure progress against these lessons learned, my office will continue to review the situation at Los Alamos National Laboratory and other contractor-operated facilities.

Mr. Chairman and Members of the Subcommittee, this concludes my statement. I will be pleased to answer any questions.

Mr. GREENWOOD. Thank you, Mr. Friedman.

As you pointed out in your opening statement, the IG has done considerable audit work at Los Alamos from firearms control, to general operations, to costs claimed. This committee has uncovered what we think are some questionable procurement practices at the lab with local vendor agreements. Our investigators have uncovered hundreds of thousands of dollars in purchases using the local vendor agreements that do not seem to have legitimate business purposes, in my eyes.

For example, we identified purchases of shoes for fiscal year 2001 and 2002 totaling $881,488.97. Now I understand that there are business needs arguably for some lab employees to be provided with safety shoes, but this other amount seems excessive to me. I find this particularly irksome since on my way to Washington this week, I bought myself a new pair of shoes, and they cost me $139. I did not use my Federal credit card for those shoes. I used my personal credit card for those shoes.

And looking at an item that our staff just pulled off of the data that we collected, we don't just see work boots here. We see a total of 7,476 pairs of shoes purchased in this 2-year period, including 615 pairs of New Balance sneakers, athletic shoes; 566 pair of Nike shoes; Rockport shoes. We even have nine pairs of Tevas, which are sandals. I'm not sure that anybody at Los Alamos is required as a part of their work to wear sandals to work. But the list goes on. Adidas, Asics, Bates, Carolina, Dexter, HH, Doc Martens, Durangos, Golden Retrievers, et cetera. These are all brands of shoes we identified, as well as in that 2-year period 517 coffeemakers. Now, I understand that offices have coffeemakers, but it's hard to imagine that you need to replace 517 of them at one facility. Four hundred ninety-one pair of gloves, et cetera.

Does the—does your—have you done any work in this area? Have you looked at these kinds of procurements?

Mr. FRIEDMAN. Mr. Chairman, I believe the number now is 18 civil and criminal investigations ongoing at Los Alamos. And it's entirely possible, but I can't attest to that as I sit here this morning, but those issues are under investigation as we speak. But I certainly would be interested in the information, and if they're not under review, we will certainly consider that.

Mr. GREENWOOD. It looked like to me both in the case of the footwear and the gloves is that somewhere someone in the laboratory decided that somebody needed to have safety boots. So there was some decision made that certain footwear could be reimbursed, and that people just went nuts, and people passed catalogs, I assume, and purchased shoes from these vendors, and nobody ever bothered to look. And that's a tiny little microscopic analysis that we made of the procurement at the lab, and we came up with these results, and it's pretty discouraging, as it should be.

Given your extensive background in working with DOE facilities, do you think that the University of California can pull itself up by its business operation bootstraps and start running those portions of the lab effectively and efficiently?

Mr. FRIEDMAN. Well, I think in all fairness as we tried to analyze the situation, Mr. Chairman, the university has taken fairly dramatic action, and that's certainly been bolstered by the actions of Secretary Abraham and the Deputy Secretary as announced today.

I think the jury is out, as was said earlier, and remains to be seen, and we will have to look at it in the months ahead to see what the status of their business systems is after they have implemented and executed the fixes that they have announced.

Mr. GREENWOOD. Is it customary for DOE officials to consult with you and your employees when they are, for instance, designing a system to attract new bids? Are they likely to come to you and say it's your role to look for, among other things, misspent Federal dollars, weaknesses in the system, failures to maintain integrity? What is your advice as to how we should design a contract so that we can minimize the likelihood that this will happen in the future? Is that likely to happen?

Mr. FRIEDMAN. It's likely to happen, and it has happened in the past.

Mr. GREENWOOD. I would certainly hope that if it doesn't happen, that you will take the initiative to remind those others in the Department that you have some helpful advice as they design this.

The Chair relinquishes the balance of his time and recognizes the gentleman from Florida.

Mr. DEUTSCH. Thank you, Mr. Friedman. It's good seeing you again.

Mr. GREENWOOD. Before I do, the Chair would like to recognize some visitors that we have in the audience. We have four visitors from Kenya who are with us today, and if they would stand for a moment and say hello.

Gentleman is recognized.

Mr. DEUTSCH. You have been investigating and reporting on problems at Los Alamos for many, many years. The inspector general has appeared at many, many hearings held by this committee to report on his office works. Do you agree with Ambassador Brooks that the culture at Los Alamos—that business practices is beyond the control of DOE or the university?

Mr. FRIEDMAN. I don't want to characterize what Ambassador Brooks said. I don't know precisely—I didn't catch that phrase precisely. What I would say is you cannot have a well-managed laboratory and cannot have good science unless as a corollary you have good business practices. So to the extent that they have fallen down in the area of business practice, I think it reflects on the entire operation at the laboratory.

Mr. DEUTSCH. I think the question really is—and, again, for the extensive hearings that we have had and the investigation, I mean, I think what we have talked about is systemic problems, literally a culture, as I think the chairman alluded to as well. The phrase "Monopoly money"—or in terms of—or you don't get the number of instances, 18 investigations. It's not one bad apple. It's not one person who has a criminal intent. I mean, I just don't see that from 18 examples that we're aware of in a short investigation. I think really the question is—is that—just the culture of the institution and is that part of the thing that needs to change. And it also reflects on the university as well in terms of its position, in terms of the new proposal, in terms of the bid process that exists.

Mr. FRIEDMAN. Well, I think the answer to your question is that they are cultural issues and environmental issues at the laboratory. Since 19—since fiscal year audits inspections at Los Alamos—

and 33 of those dealt with financial systems, business management systems, procurement and the like, as I indicated earlier, in the 6 or 7 points where contractors fully understand and honor the special responsibilities associated with managing taxpayer-funded Federal facilities, so it seems to me there is a higher standard that exists.

Mr. DEUTSCH. To deal with the sort of cultural or systemic problems that we see or that we—I say if we all, in a sense, acknowledge exists at the lab.

Mr. FRIEDMAN. Well, my responsibility, as I understand it, is to make sure the taxpayers have a seat at the table when the business decisions or the science decisions are made at the laboratory, No. 1; and, number 2, to raise problems as we come across them. We've done that aggressively, I think, over time; and I think it's for others, actually, to implement the recommendations once we've made them.

Mr. DEUTSCH. You have made some fairly devastating conclusions about the financial controls, business systems, property management and the internal audit operations at Los Alamos. In fact, in your cost reports you have drawn the following conclusion, and I'm quoting: The Department, in our judgment, has less than adequate assurance that the costs claimed in the operation of the laboratory are allowable under the contract.

This is from page 11 of your report. Are you saying that DOE cannot be assured that any of the over $1 billion spent at the laboratory is allowable because there is no acceptable method to check it?

Mr. FRIEDMAN. What I'm saying is that there were enough issues that were raised in terms of the three main components of the costs that we have questioned as well as the fact that there is a substantial backlog of subcontract costs which have never been audited that raise enough questions that reduce our assurance, our level of confidence that all of the costs claimed were allowable.

Mr. DEUTSCH. I mean, the statement that I quoted from is an extraordinarily broad statement. It's really the equivalent of a company's auditor refusing to sign off on their financials because they can't verify that. Is that effectively what you're saying is the situation at Los Alamos?

Mr. FRIEDMAN. That's what we are saying; and, as was pointed out earlier in the hearing, we disclaimed an opinion on the 2000 and 2001 statements of cost claims submitted by the contractor as well.

Mr. DEUTSCH. All right. So, again, you issued similar disclaimers on your cost audits for 2000, 2001, correct?

Mr. FRIEDMAN. Correct.

Mr. DEUTSCH. All right. Were the University of California and DOE aware of this?

Mr. FRIEDMAN. Absolutely.

Mr. DEUTSCH. And what was their response to these reports?

Mr. FRIEDMAN. Lethargic is the only way I can describe it. I think the intensive management oversight really took place within the last 6 to 9 months. There has been energy expended by Secretary Abraham and Kyle McSlarrow and Ambassador Brooks and

by the university as well. They've taken a real interest in what's gone on, it seems to me, at Los Alamos.

Mr. DEUTSCH. We have been told that the financial controls and audit functions at Lawrence Livermore National Lab, which is also run by University of California, are better. Is that correct? And, if so, why is that?

Mr. FRIEDMAN. That's our view, that it's run on a more professional basis; that they report more fully and completely; and it's a better quality team.

Mr. DEUTSCH. I mean, could you elaborate why or speculate why?

Mr. FRIEDMAN. I can't look in the, you know, frankly, in the minds of the people who are doing it. All I can tell you it is a more professional operation that is more responsive. It is an operation which does a more comprehensive review of costs that are incurred at Livermore. At least, that's been our finding to date.

Mr. DEUTSCH. How does Los Alamos compare financial controls in place by other contractors? Is it the worst you've ever seen?

Mr. FRIEDMAN. As far as we're concerned, it's the worst that we've come across in the Department of Energy complex.

Mr. DEUTSCH. You've also questioned the cost of the entire internal audit operation because it was not independent as the contract required. An independent auditor doesn't report to the people he's auditing, is that correct?

Mr. FRIEDMAN. That's correct.

Mr. DEUTSCH. Has the audit function ever been independent?

Mr. FRIEDMAN. There was a period of time, if I recall the history, in which it may have been independent, but that was probably 6 or 7 years ago at the earliest; and I can't really attest to that as I sit here today.

Mr. DEUTSCH. Did the DOE staff responsible for Los Alamos know that many planned audits weren't being done and that the allowable cost audit relied on judgmental sampling techniques from which results could not be projected?

Mr. FRIEDMAN. My understanding is that they were not fully conversant with the work that was done by the internal audit group.

Mr. DEUTSCH. And you mentioned, you know, the issues with the subcontractor audits. How did the lab get so far behind in its audits of subcontractors?

Mr. FRIEDMAN. Well, there has been some change in the way that Los Alamos has operated over time in that at this point in time a huge portion of the money that the Department of Energy spends through Los Alamos is spent through subcontractors. So the demand for a subcontract audit certainly has increased, or at least so it seems to us. There may be staffing problems, a lack of adequate staffing. There may be a lack of interest in contract audit function. But, in any case, the backlog was significant.

Mr. DEUTSCH. What are you going to do about that, the subcontracting auditing problems?

Mr. FRIEDMAN. What am I going to do about it?

Mr. DEUTSCH. I mean, what are they going to do about it? I mean, what's your recommendation in terms of——

Mr. FRIEDMAN. My recommendation is that, considering the fact that there's at least a billion dollars in unaudited funds—at least there was at the time of our review—that the university better be

very, very aggressive in going after that money to make sure that those costs are allowable under the terms of the subcontracts and that the taxpayers' interests are properly represented.

Mr. DEUTSCH. I mean, does the lab presently have the staff to make all of those audits?

Mr. FRIEDMAN. I'm sorry.

Mr. DEUTSCH. Does staff exist to actually do that?

Mr. FRIEDMAN. Well, they do have staff there. I don't know whether it's sufficient in terms of numbers or expertise to do all of the work.

Mr. DEUTSCH. The university told our staff recently that it intended to do a full overhaul of the financial systems. You found that this initiative was not approved by the DOE as required by the contract. Has DOE taken any steps to approve or disapprove this change in the financial system?

Mr. FRIEDMAN. I'm not aware of any one way or the other, Mr. Deutsch.

Mr. DEUTSCH. Would your impression be the same as ours that that, in fact, is required under the contract?

Mr. FRIEDMAN. That's what we state in our report, and we believe that to be the case.

Mr. DEUTSCH. I mean, it just seems that they're doing a major overhaul, I mean based on these problems; and they're not even interacting with you at this point about that overhaul.

Mr. FRIEDMAN. Well, in fairness, in response to our report I think the university indicated there was more interaction than would be suggested. But the fact of the matter is that we believe the requirements of the contract suggest that approval of the Department of Energy is required, and that approval certainly was not obtained.

Mr. DEUTSCH. Let me just ask one final question. DOE has given Los Alamos high marks for its protection of classified material. But you state that you found such weaknesses in the lab's control of computers used for processing classified data that you, I'm quoting, do not believe that Los Alamos can provide adequate assurance that classified, sensitive and proprietary information is appropriately protected. How do you reconcile these high marks with your failing grade?

Mr. FRIEDMAN. Well, I can't reconcile the position that anybody else has taken. What I—I think the most—one of the most important points is that, of the laptop computers that were used for classified work, two of the computers were not accredited. And I could go through the definition, but accreditation seems to us to be extremely important and calls into question whether the environment, the approved use, the location was appropriate.

Mr. DEUTSCH. Thank you.

Mr. GREENWOOD. The gentleman from Michigan, Mr. Stupak, is recognized for 10 minutes.

Mr. STUPAK. Mr. Chairman, I wonder if I could just pass for a minute. I just got back. I just want to review a couple of things, and I'll come right back. Can I pass for now?

Mr. GREENWOOD. Yes. The Chair failed to recognize the presence of the gentleman from Oregon. Mr. Walden is recognized for 10 minutes.

Mr. WALDEN. All right. Thank you, Mr. Chairman.

Sir, part of the impetus of this committee's work with regard to Los Alamos was the improper treatment of two whistleblowers who were terminated from their positions at the lab, as you know. Your office issued a report on that action in January of 2003, I believe, where you found the terminations to be unsubstantiated. Has your office looked at any other recent whistleblower concerns at Los Alamos? And, if so, what action are you recommending or taking? And do you have an opinion on whether or not the whistleblower protection policy of Los Alamos is sufficient?

Mr. FRIEDMAN. Well, I am not aware of any other whistleblower reviews that we're doing at present. There may be one or two that I'm not aware of. But I certainly think that the climate at Los Alamos was unacceptable in terms of treatment of whistleblowers and the concerns about retaliation.

There have been surveys done of employees there—not recently, but within the last year or 2—in which a preponderance of employees have indicated they were concerned about raising serious issues to management for fear of retaliation. So I think it's extremely important that the environment and the climate be one which people feel free to raise concerns, that concerns are addressed and that there is no retaliation.

Mr. WALDEN. Do you think it would be prudent to do a new survey—given that we're being told that people have been fired, management is changing, the university has responded aggressively, would it be prudent now to do another internal survey, a confidential survey of employees to see if they feel like the climate's changed?

Mr. FRIEDMAN. I—the survey that I referred to was not one that my office did. It was—someone else had done that. But I think it is a very interesting idea, and let me think about that and consider it.

Mr. WALDEN. Okay. Because it just seems to me—I mean, we are being told things have changed. It appears they have. I wonder if internally the culture believes that it's changed or not, and so I think this would be interesting.

I had a couple of questions, too, off of the Deputy Secretary's memorandum for the Secretary where they detail out some of these issues about equipment and purchases and attempted to make charges and all, some of which has been refunded without question.

I guess one of them that drew my attention—this article, it says, questions concerning the adequacy of property controls. Newspaper revelations indicated the lab was unable to account for $1.3 million worth of controlled property, including such pilferable items as computers. Although the most spectacular allegations—a missing forklift, for example—were ultimately resolved, substantial amounts of property remain unlocated.

Can you enlighten me as to what they're referring to and the size of—what the term "substantial amounts" may mean?

Mr. FRIEDMAN. Well, I don't know what document you're referring to or what news article you're referring to. I don't think I could put bounds on that. I don't know for sure.

Mr. WALDEN. Just for the record, it is Deputy Secretary Kyle McSlarrow's memorandum to the Secretary dated April 26.

Mr. FRIEDMAN. Okay. I've seen the memo. I have not studied the memo, so I'm not precisely sure what he's referring to.

But let me give you a sort of a real-time example as we just completed a review of laptop computers and we found that a number of unlocated laptop computers were simply written off the inventory records at the end of the year, and that seems to be a not uncommon methodology for handling unlocated sensitive property and nonsensitive property.

Mr. WALDEN. And how recent is that review?

Mr. FRIEDMAN. That review was issued last week.

Mr. WALDEN. Last week?

Mr. FRIEDMAN. Yes.

Mr. WALDEN. How recent were those computers written off?

Mr. FRIEDMAN. That was at the end of the fiscal year, so within the last 6 months.

Mr. WALDEN. And how many were written off, do you recall?

Mr. FRIEDMAN. I think the number was 20, if I recall correctly. But I'm not positive. I'd like to provide that for the record if I could.

Mr. WALDEN. Certainly. I'd appreciate that.

Mr. FRIEDMAN. I want to be precise with you.

Mr. WALDEN. Of course. And I respect that. You can't be the repository of every single detail on every issue we raise, I recognize.

[The following was received for the record:]

The number of computers written off during fiscal years 2001 and 2002 is 22.

Mr. WALDEN. There's also a reference in this that says, an audit of firearms control that revealed significant weaknesses in procedures and accountability, although all firearms were ultimately located. Have you looked into that issue?

Mr. FRIEDMAN. Yeah, that was a report that we issued about 1½, 2 months ago in which we were ultimately able to identify all the firearms. The problem was that the master inventory list that Los Alamos keeps was inconsistent with the list that the subcontractor maintains, and the subcontractor is responsible for police functions at the laboratory.

Mr. WALDEN. And how far apart were those lists? Were they significant?

Mr. FRIEDMAN. Well, 200 out of 1,400 or something like that. It was a significant number, yes.

Mr. WALDEN. Of various weapons.

Mr. FRIEDMAN. Primarily side arms, protective force weapons.

Mr. WALDEN. And can you give me some idea about—were they just simply in a different place than where one person thought they were, or had they wandered away and came back?

Mr. FRIEDMAN. No. Simply stated, they were—it's a little more complex, so bear with me for a second. In general, the system at Los Alamos was such that the arms that were received from the Department of Energy or through other sources went directly in some cases to the subcontractor, not through Los Alamos itself. As a consequence, they were either delayed or never made it to the master inventory list; and we were concerned that the university and the laboratory itself ought to have the comprehensive, complete list of firearms that are available at the site.

Mr. WALDEN. So am I correct then in understanding it wasn't that the weapons disappeared. It's just they weren't on the inventory list that you thought they should be on.

Mr. FRIEDMAN. That is correct. And nobody had taken the time to reconcile the lists, in which case they would have identified the problem. It took us to come in and do it.

Mr. WALDEN. According to a February 5, 2003, memo from you to Acting Administrator Linton Brooks of the NNSA, your office encountered, quote, unquote, significant dysfunction at Los Alamos during your review. Specifically, you note the lab management failed to comply with your request for information regarding an April 10, 2002, internal lab memo. In your recent report on costs claimed, there's more than one occasion stated where you felt that the lab was not as forthcoming in producing information and documents to your office as would be expected. Have you addressed this issue specifically, with NNSA or DOE? And, if so, what have they pledged to do to alleviate this problem in the future? Are you getting the cooperation that you expect and deserve?

Mr. FRIEDMAN. Interestingly enough, we have discussed it with the Department of Energy at both levels. But we discussed it primarily with the chief auditor of the University of California, and within hours we received the information that we had requested. So the University of California stepped in and immediately overrode the reluctance on the part of the working-level people at Los Alamos to provide the information that we needed.

Mr. WALDEN. When your auditors go in and ask these questions of the working level at the lab, what are you told? Why are you told they won't give you the information? Or do they just—give me the insight there. What do you run into?

Mr. FRIEDMAN. I can't really characterize it. It probably—there's a recognition it may be embarrassing, that it may reflect negatively upon the lab. I'd be speculating and I hate to do that because I don't know really what was going on in these people's minds. What I do think is important, though, was that we have faced this time and time again, and clearly,——

Mr. WALDEN. Is it changing though?

Mr. FRIEDMAN. Well, as I say, Patrick Reed, the auditor for the university, stepped in and immediately provided the information that we were looking for.

Mr. WALDEN. But do you feel like you're going to have to go back to the university auditor on a regular basis? Do you feel like—I guess I'm trying to get at, is the culture really going to change at the hands-on level in the lab, or do you have to keep going up to some auditor somewhere above them to get the culture to change? Because I think that all interacts with who's controlling the lab and do we have problems still there? Do we have files disappearing? Do we have lack of cooperation?

Because I've got to tell whoever's out there that is not cooperating, if they think they're embarrassed because of revealing information, not revealing, hiding and deceiving or trying to ignore your investigation is going to cause them a whole bunch more problems than cooperating. We know there's a problem. We're trying to get at it and solve it.

Mr. FRIEDMAN. Well, I agree with your observation; and if the experience we've had with Mr. Reed, Vice President Darling and others is reflective of what's going to happen in the future, we have solved the problem. But if that's not the case, they'll be hearing from me, as will the Secretary.

Mr. WALDEN. All right. Thank you Mr. Chairman.

Thank you, sir. Appreciate your work.

And I return the balance of my time.

Mr. GREENWOOD. The Chair thanks the gentleman.

The gentleman from Michigan—no, the—yes, the gentleman from Michigan, Mr. Stupak, is recognized for 5 minutes.

Mr. STUPAK. Thanks, Mr. Chairman.

Mr. Friedman, are you familiar with the performance standards set for Los Alamos for fiscal year 2003?

Mr. FRIEDMAN. I have seen them. I have not studied them. We are in the process of looking at them very carefully right now.

Mr. STUPAK. Well, let me ask you this, if I may. According to the document, there is an attachment, Appendix F. In it's an implementation plan carrying out the scientific mission as the most important objective of the laboratory; and they go on to say, procurement and property management, business controls, financial management, environmental clean-up and control, security and health and safety are all lumped together in objective No. 7 of the nine objectives. The implementation plan was signed by the university on April 13. Does this indicate to you that the university or DOE are going to give any real emphasis to fixing the problems that we're discussing here today?

Mr. FRIEDMAN. Well, I'm concerned by the—what appears to be a relative imbalance in terms of the criteria that have been established, and I agree with your observation. I—at this point, though, we're studying the issue. We have not reached any final conclusion, so I can't give you a definitive answer.

Mr. STUPAK. Well, the—and Mr. Walden has mentioned a little bit about it, the culture that's there. I mean, besides putting out these mission statements, how do you really change a culture when you have classified computers missing or a person can order a Mustang using the credit card—Los Alamos credit card? How do you change that?

Mr. FRIEDMAN. Well, I think it's a complex—it's a simple question, Mr. Stupak, but it requires a complex answer. But to put it in a word is "accountable." You have to hold individuals accountable, and you have to hold contractors accountable, and you have to be prepared to take severe and drastic action, both in the case of individuals and in the case of contractors if their performance does not meet government standards and they do not understand that they're working for the taxpayers.

Mr. STUPAK. And in your reports, have you seen any accountability? For instance, the person who ordered the Mustang—we were out there in January, and that occurred in September. So it's 4 or 5 months later. They're still there. I mean, what kind of a message does that send to the rest of the employees about do whatever you want to do and you're not going to be held responsible?

Mr. FRIEDMAN. That matter is the subject of a current investigation. I couldn't comment on it in public.

Mr. STUPAK. Well, I'm just more asking for a signal. But——

Mr. FRIEDMAN. Well, if the environment is what you're referring to, there have been very significant personnel changes at Los Alamos. They've been described earlier today. Perhaps more are needed. I don't know. The director has said he's going to look at those issues as they come about.

Mr. STUPAK. But yet you were concerned about the whistleblowing going on there, that people who wanted to come forth with serious concerns about what's going on at Los Alamos, they're afraid to because they didn't feel they'd be backed up by whether it's the whistleblower protection plan or by the superiors who are in charge. Isn't that true?

Mr. FRIEDMAN. That's correct.

Mr. STUPAK. So that—if they're concerned about not being backed up, whether it is a whistleblower or other serious concerns that they may bring forward, whose responsibility is that? Is that the Department's or is that the University of California who has the contract to manage it?

Mr. FRIEDMAN. Well, I think it's a shared responsibility. I think the University of California has to make a commitment, which I think they have certainly verbalized over the last several months, that whistleblowers are—they're going to be treated with respect, that their concerns are going to be addressed. I think the Department and the Department handlers are responsible for ensuring that the university meets that commitment.

Mr. STUPAK. I'm sorry I missed the first part of your hearing. I had to go up to—I mean, your testimony. I had to go up for some meetings. But how long have you been doing audits at Los Alamos?

Mr. FRIEDMAN. As an office, the Office of Inspector General for the last 25 years.

Mr. STUPAK. Okay. You personally.

Mr. FRIEDMAN. Personally, for the last 20 years.

Mr. STUPAK. Have you seen any accountability of people there? You know, it seems like we had a problem, and no one's willing to accept responsibility. We've just passed it off. We come up with a new program every year to change the problems, and nothing ever gets changed.

Mr. FRIEDMAN. Frankly, I have seen no change save what has transpired in the last 6 to 9 months.

Mr. STUPAK. Thank you. I'll yield back. But I can probably sneak another one in here, too.

Mr. GREENWOOD. The time of the gentleman has expired.

Mr. STUPAK. All right.

Mr. GREENWOOD. The Chair recognizes the gentlelady from California for 5 minutes.

Ms. ESHOO. Thank you, Mr. Chairman.

Welcome back, General Friedman. It's good to see you, and thank you for your public service.

I have three questions. In the 20 years that you have been doing the work that you've done as you just stated, have you inspected the Department relative to the contract?

Mr. FRIEDMAN. Yes. And——

Ms. ESHOO. And how recently?

Mr. FRIEDMAN. We do that regularly.

Ms. ESHOO. And what have you discovered or recommended?

Mr. FRIEDMAN. Every year for the past 4 or 5 years we have identified contract administration, which is the way we characterize it, contract management. As a management——

Ms. ESHOO. And if you were to issue a report card, is it a passing grade? Is it a high grade? Is it a low grade?

Mr. FRIEDMAN. No. We have treated it as one of the top 10 management challenges facing the Department in which they have not done an adequate job.

Ms. ESHOO. That they have not done an adequate job.

Mr. FRIEDMAN. That's correct.

Ms. ESHOO. And in what area specifically?

Mr. FRIEDMAN. Well, every facet of contract administration, ensuring that you have a governance program in effect in which Federal managers who are ultimately responsible for the expenditures of funds know what's going on at the various contractors and are held accountable for their aspect of contractor operations.

Ms. ESHOO. So there is a—there are shortcomings inside of the Department in the responsibility—in the role that they play relative to the contract.

Mr. FRIEDMAN. In my view, yes.

Ms. ESHOO. Thank you. Were you asked by Deputy Secretary McSlarrow or Ambassador Brooks to evaluate UC's reform measures at Los Alamos? And, if so, was your assessment reflected in their report to Secretary Abraham?

Mr. FRIEDMAN. Let me be clear answering your question. There were aspects of the work that we've done over the past 6 or 7 months at Los Alamos that were specifically requested by the Department. However, I, to the best—if I understand your question, we have not been asked to evaluate the specific components of the corrective action plan that have been proposed.

Ms. ESHOO. So, am I understanding this correctly, the assessment that you did was not reflected in the report to Secretary Abraham in the report, your analysis?

Mr. FRIEDMAN. I'm sorry.

Ms. ESHOO. The IG's analysis.

Mr. FRIEDMAN. We may be confusing your question. We have analyzed 6 or 7 different programmatic areas in the past several of months, several of which were specifically requested by the NNSA.

Ms. ESHOO. I understand the request. But following it down the road——

Mr. FRIEDMAN. I have not, on a stand-alone basis, evaluated the corrective action plan that the University of California has proposed and that the Department of Energy has discussed today.

Ms. ESHOO. So it's not part of Secretary Abraham's assessment then. Either through your review or anyone else's.

Mr. FRIEDMAN. Again, I want to make sure I don't give you any bad information here. Secretary Abraham, as his announcement identifies, has used the work that we've done in part in reaching the decision that he has reached.

Ms. ESHOO. I think the operative phrase here is "in part," and I just want to move on. Do you think that there's been adequate time for the reforms to take root at Los Alamos, and do you—would

you suggest that they be examined again in the next handful of months?

Mr. FRIEDMAN. There has not been enough time for them to take root, and there has not been appropriate time for us to do an evaluation. And I do think they ought to be—they need to be reviewed both by the Department and probably by the university itself over the next period of time.

Ms. ESHOO. Well, I think that's very important. Because if, in fact, and it's legitimate, that this committee of investigation and oversight has been highly critical as the abuses and the mismanagement have been reviewed and hammered, if, in fact, and we know that they have been put into place, those reforms really need to be reviewed, both for the good of the contractor if there is to be—whomever the future contractor is, as well as the performance of the Department itself.

When you testified before the committee in February, you said it was appropriate to evaluate the reforms that UC is making at Los Alamos. And it hasn't been 6 months yet, and I just want to set that down for the record. But since you spent time reviewing the operations at Los Alamos, can you give the subcommittee your impression so far today that you've made and, in your determination, are they successful? I know that you said earlier that they, you know, everything—it's in progress. But can you give us an interim report, so to speak?

And I have to stop now. But I think that you can answer.

Mr. FRIEDMAN. I'm reluctant to do that because we have not done a comprehensive review.

I will tell you this. It's clear that the university has taken dramatic sweeping action to change individuals, to change policies, to change procedures; and we will have to see how effective that is. Time will tell.

Ms. ESHOO. Thank you, Chairman Greenwood.

Mr. GREENWOOD. The Chair thanks the gentlelady; and, General Friedman, we thank you for being with us again.

Before I let you go, you mentioned I think 18 open investigations. Would you supply the subcommittee with the details of those investigations, please, in writing subsequent to today?

Mr. FRIEDMAN. Subject to information that may be criminal activity sensitive, I will do so in writing. Otherwise, I'd rather do it in a verbal setting. But I will certainly do that with the assistance of staff.

Mr. GREENWOOD. Work that out with our staff.

Mr. FRIEDMAN. Certainly.

[The following was received for the record:]

At a briefing held for subcommittee staff on May 13, 2003, those details were provided by John Hartman, Assistant Inspector General for Investigations.

Mr. GREENWOOD. We thank you very much for being with us, and you are excused.

We call forward our third panel consisting of Dr. Richard C. Atkinson, President, University of California; Mr. Bruce Darling, Senior Vice President, University Affairs, Interim Vice President for Laboratory Management at the University of California; Ms. Anne Broome, Vice President for Financial Management at the Univer-

sity of California; and Mr. Patrick Reed, University Auditor at the University of California.

We welcome all of you. Thank you for your patience.

Mr. ATKINSON. Mr. Chairman, members of the committee——

Mr. GREENWOOD. If I can ask you to hold for a second, are we waiting for Mr. Darling? Okay. I need to put you all under oath, and so we'll do that all at one time.

Mr. Darling's thinking, I sat here for 2½ hours. He chooses the 1 minute that I leave the room.

Mr. DARLING. That seems to be my pattern, Mr. Chairman.

Mr. GREENWOOD. Thank you, sir. I think all of you have heard me to say to the other witnesses that this is an investigative hearing and that it's our practice to take testimony under oath. So I would ask if any of you have any objections to giving your testimony under oath. Okay.

I should also inform you that, pursuant to the rules of this committee and the House, you are entitled to be represented by counsel. Do any of you wish to be represented by counsel? Okay.

In that case, if you would stand and raise your right hands please.

[Witnesses sworn.]

Mr. GREENWOOD. You are under oath.

Dr. Atkinson, you are recognized for your opening statement.

TESTIMONY OF RICHARD C. ATKINSON, PRESIDENT, UNIVERSITY OF CALIFORNIA; BRUCE B. DARLING, SENIOR VICE PRESIDENT, UNIVERSITY AFFAIRS, INTERIM VICE PRESIDENT FOR LABORATORY MANAGEMENT, UNIVERSITY OF CALIFORNIA; ACCOMPANIED BY ANNE BROOME, VICE PRESIDENT FOR FINANCIAL MANAGEMENT, UNIVERSITY OF CALIFORNIA; AND PATRICK REED, UNIVERSITY AUDITOR, UNIVERSITY OF CALIFORNIA

Mr. ATKINSON. Mr. Chairman and members of the committee, I have a formal statement which I'd like to submit for the record, but I think I'd rather simply summarize that statement in brief form, and then I will turn to Senior Vice President Darling to bring the committee up to date on some of the issues that have been raised in earlier hearings, and then we'll be open for questions and comments.

Mr. GREENWOOD. Very well. We appreciate that, Mr. Atkinson.

Mr. ATKINSON. Let me begin by taking note that I've read carefully the report prepared by Deputy Secretary McSlarrow, and Ambassador Brooks. I am fully in accord with their analysis of the situation and understand very well the reasons that led them to the decision that has come from the Department of Energy, and I accept that decision. In my formal statement I indicate that I recognize that the university has full responsibility for the business and management issues at Los Alamos, and we are committed to dealing with those problems and restoring the American public's confidence in our management of the laboratories.

I do want to indicate that I am very proud of the record of the University of California, the 60-year record of the university in managing these laboratories. I won't review that record, but just since 9/11, if one follows those events carefully, you will see that

the work that has flowed from Livermore and Los Alamos has been absolutely critical to our response to this Nation's response to those initiatives.

Clearly, along with those accomplishments, we have serious problems at Los Alamos. I will not review those problems, but in my testimony I am concerned with why there are such problems at Los Alamos. In the process of the testimony, I indicate some of the factors that I believe are responsible for that.

I do want to indicate that between the Vice President, Mr. Darling, Vice President Broome and the auditor, Mr. Reed, and particularly—and also the Interim Director, Pete Nanos, that we are responding and I think responding aggressively to the issues. I won't go into the details of why I think we have problems or why those problems arose at Los Alamos. You can question me on that later if you're so interested in pursuing that in more detail. Let me just simply say that we are focused on the issues.

At the end of my testimony I review the issue of whether the university will choose to compete for the contract when the end of the contract period occurs. I outline some of the issues that the university will have to grapple with in making that decision; and then finally, in my closing remarks, I indicate that the university—no matter what the decision is on the part of the university to compete or not compete, I assure the Congress that for the next 2½ years the university will be focused on the issues before us and will do our very best to resolve the issues.

With that, I turn to the Vice President.

[The prepared statement of Richard C. Atkinson follows:]

PREPARED STATEMENT OF RICHARD C. ATKINSON, PRESIDENT, UNIVERSITY OF CALIFORNIA

Good morning, Mr. Chairman, Mr. Deutsch, and members of the Committee: This is my first opportunity to participate in this Committee's proceedings on the business and management practices at Los Alamos National Laboratory.

Let me reiterate Senior Vice President Darling's previous testimony that the University of California takes full responsibility for these business and management problems at Los Alamos. As president of the University, I want to assure you that we remain committed to strengthening financial controls and to restoring the American public's confidence in Los Alamos and the University's management of it. This has been the charge to my senior management team, as well as to the new leadership at Los Alamos, and it will remain the charge for as long as the University is entrusted with this responsibility.

The Committee has heard testimony from the University about the problems at Los Alamos and the range of corrective actions that have been taken. Rather than retrace those steps, I would like to provide you with a slightly different perspective that goes to the most critical question of all, which is how did this happen?

I have been president of the University of California for eight years. During that time, I have been enormously proud of the University's continuing contributions to our nation's security through its management of the national labs. Building on the legacies of Ernest Lawrence and Robert Oppenheimer, Los Alamos and Livermore have moved front-and-center in the effort to bolster homeland security, especially in the areas of counter-terrorism, non-proliferation, and prevention and preparedness for nuclear, biological, and chemical attacks. These labs continue as the nation's leader in findings ways to use the most advanced scientific and computational assets to simulate nuclear testing and to ensure the continued viability of our nuclear weapons stockpile. We must never lose sight of those critical contributions to the nation's security.

Along with its accomplishments, Los Alamos has had problems. It has been a time of considerable pain to me personally and to the University as an institution. It has forced us to ask hard questions about our management and to take strong action. The record will show that the University has responded quickly and that it has re-

sponded well. New performance provisions have been written into our contracts, and in every instance we have met or exceeded the new requirements.

Still, the question remains: Why these continuing problems at Los Alamos? As context, let me remind you that the University is a $15 billion enterprise, larger than many Fortune 500 companies. We employ 160,000 faculty and staff at our ten campuses, five medical centers, numerous community-based health facilities, an extensive network of agriculture extension centers and three national laboratories. And we remain, undisputedly, the world's premier research institution.

By necessity, for a University system so large and geographically dispersed, our management structure is decentralized. Considerable authority is delegated to our campus chancellors and laboratory directors. For the most part, this arrangement has worked well. There is clear accountability and sound management of our education, scientific, research and business and finance systems.

So the question again—why the problems at Los Alamos?

The last six months has been dedicated to probing that question at the very highest levels of the University. I appointed Senior Vice President Darling as interim vice president for laboratory management and enlisted the expertise of UC vice president for financial management Anne Broome and University Auditor Patrick Reed, as well as numerous other top University officials. They have worked seven-day weeks since last December, focusing almost solely on laboratory management issues while still performing their other University responsibilities. I wish to publicly thank them today for their invaluable service, not just to the University but also to the nation.

Through their efforts, as well as those of Interim Director Pete Nanos and his new management team at Los Alamos, we have made considerable progress in implementing the changes necessary at the Laboratory. We are also beginning to understand why there was such a fundamental management breakdown at the Laboratory.

I believe it comes down to two things: First, former Laboratory senior management did not address the problems in a timely or appropriate manner. And second, neither the University nor the NNSA provided adequate oversight to detect problems that should have been more readily apparent.

Let me focus first on Los Alamos leadership. As President, I appoint the ten campus chancellors and three laboratory directors. All are accomplished scholars (among them is a Nobel Prize winner), but they also must be able managers who can run complex organizations that require a careful balance between science and research and sound business management. I rely on the chancellors and laboratory directors to alert me early to potential problems and to obtain assistance of my top leadership team in whatever area necessary.

That did not occur at Los Alamos. The former managers of Los Alamos were slow to inform me about the procurement problems. When I became aware, I acted quickly, including replacing the top two managers.

But I don't entirely fault Los Alamos management. As part of the last contract negotiation, we created a new Vice President for Laboratory Management position to provide better day-to-day management of the national laboratories. The first vice president was John McTague, whose leadership and private sector experience led to strong improvements in management and oversight in a number of key areas, including security, safety and business efficiency. Under Dr. McTague's leadership, for example, UC engaged industrial firms to obtain important expertise in security and project management to reassess and strengthen the labs' internal systems in these areas.

However, an unintended consequence of the new management structure was to isolate laboratory management from other Office of the President functions. Laboratory management did not seek the necessary expertise of our auditors and financial management team, as it should have when problems arose at Los Alamos.

For this reason, we are devising a new governance structure that much more fully integrates the Office of the President into laboratory management, much as it already is—with great effectiveness—at our campuses.

There should have been other early warning systems. Among them are the Department of Energy and the National Nuclear Security Administration, which have more than 190 employees at Los Alamos and Livermore issuing numerous audits, reports, and assessments. The NNSA's steady stream of "excellent" ratings suggested to me that laboratory operations were fundamentally sound. I heartily agree with the recommendation by Deputy Secretary McSlarrow and Ambassador Brooks that this rating system be revised, but would add my own recommendation that it's time to reevaluate the broader DOE and NNSA management structures. I hope this will be a subject for further discussion.

More change is needed, both at the University and at Los Alamos, and I pledge these changes will be made. These include implementing the recommendations from the independent reviews conducted by PricewaterhouseCoopers and Ernst & Young, acting on the various Inspector General findings, and enforcing the strong whistleblower policies already in place.

But perhaps our greatest challenge is to ensure that our reforms are sustained over time. That said, we are gratified that the Secretary of Energy has recognized the extent of our efforts and has decided against termination of the Los Alamos contract.

With the Secretary's announcement yesterday, we are now about to enter into a new chapter in our 60-year history of managing the national laboratories as a service to the nation for which the University receives no financial gain. I am concerned, as we move forward, that we not lose sight of the broader national security objectives now at stake at a particularly critical time in our nation's history.

Those objectives are what drive my answer to the obvious question before me today—will the University now compete for the contract to manage Los Alamos National Laboratory? My first instinct is to respond: "Yes." We want to compete—and we want to compete hard—in order to continue the tradition of excellence in science and innovation that has characterized our 60 years of managing the national laboratories. We want to compete in order to maintain the world's premier nuclear design workforce. And we want to compete because we believe, with every fiber of our institutional being, that continued UC management is in the absolute best interests of the nation's security.

But there is another question at stake here, and that is whether the University of California should compete. The answer to that is less clear, and it goes to the fundamental nature of these particular government laboratories and the historical reasons why the University was first asked to manage them.

Let me hasten to add that I am in the last five months of my presidency. The decision whether to compete will have to be made by my successor and by the Board of Regents. In making their decision, they will have to grapple with a number of critical issues. Among them:

- First, what will be the conditions of the competition, including issues of criteria, statement of work, partnership and organizational structure, and how will these be impacted by the recommendations to the Secretary by the Blue Ribbon Commission?
- Second, is it even appropriate for the University to pursue a federal business contract? It is one thing to manage the national weapons laboratories at the request of the federal government because of the unique scientific capabilities of the University, and quite another to actively pursue what could now be interpreted as a business venture. I am not sure our faculty or the people of California would support such action by the Board of Regents.
- Third, what will be the relationship between the Department of Energy, the National Nuclear Security Administration, the Federal Bureau of Investigation and the contractor? The current relationship is clearly not working as effectively as it should.
- And finally, our principal contribution over the last 60 years has been to ensure the science and technological excellence of Los Alamos. That factor should be a primary consideration in the future contract, otherwise the University should not compete.

Our hope is that these questions can be answered in the months ahead so that the University can make an appropriate decision about whether or not to compete. We believe we would be a strong competitor and an even stronger long-term manager of Los Alamos. As the world's premier research university, the University of California is uniquely positioned to provide this service to the nation.

In closing, I want to emphasize that the University, for the remaining term of the contract, will continue to perform our obligations to the nation even as we continue to resolve the business and administrative deficiencies at Los Alamos. Our goal remains to raise the Laboratory business practices to the same level of quality as the science and weapons programs. We owe this to the American people whose security is dependent on the Lab.

Thank you for this opportunity to address the Committee. I would be pleased to answer your general questions, and my colleagues are available to respond to specifics. Senior Vice President Darling, who you all know, is overseeing day-to-day management issues at the Laboratories. With your permission, I would like him to briefly summarize actions the University has taken since the last hearing.

Mr. GREENWOOD. Mr. Darling you're recognized.

TESTIMONY OF BRUCE B. DARLING

Mr. DARLING. Good afternoon Mr. Chairman, Mr. Deutsch.

Mr. GREENWOOD. You need to push the button on your microphone.

Mr. DARLING. Thank you.

Good afternoon Mr. Chairman, Mr. Deutsch and members of the committee. I appreciate the opportunity to appear before you for the third time, and I would like to inform you about actions taken by the University of California since your last hearing on March 12. These are part of our continued efforts to improve the business and management problems at Los Alamos National Laboratory.

We have made progress on a number of fronts at Los Alamos, from nearing completion of the comprehensive property inventory to addressing the backlog of property identified as missing, lost or stolen. Let me focus on some of the items that have been of particular interest to this committee.

In recent weeks, we released the findings from two independent reviews. After 2 months of work by 20 consultants from Ernst & Young, we've released 70 reports—excuse me, seven reports containing 90 recommendations that cover the full range of Los Alamos business practices, including property management. The laboratory is already implementing these recommendations.

Procurement practices were the subject of a separate review conducted by the external review team chaired by former DOE Inspector General John Layton and assisted by forensic accountants from PricewaterhouseCoopers. The external review teams report identified internal control weaknesses in laboratory procurement and recommended a number of corrective actions which are being implemented. In addition, I should say these are in addition to corrective actions that were already under way at the lab in advance of receiving this report. The external review team identified $14,530 in potentially inappropriate transactions out of a total of $2.3 billion in procurement. This information has been brought to the attention of the DOE Inspector General.

Los Alamos management is also investigating five lists of transactions that required additional documentation and review. In the last week we've responded to two Inspector General reports on the allowable costs audit. We believe that the majority of the costs claimed for business meals and travel reimbursement are allowable under the contract and Federal guidelines. However, even so, we will review our guidelines with the National Nuclear Security Administration and make appropriate policy revisions after that consultation.

The Inspector General also criticized the performance of the Los Alamos Audits and Assessments Office. As you've heard in previous testimony, the internal audit function is one that we have pursued very aggressively. As a result, the recommendations contained in the report are already being implemented.

The Inspector General's most recent interim report was on internal controls over personal computers. We agree that the administrative processes that account for classified computers are flawed in ways that make verification difficult. The laboratory is correcting those problems. But I do wish to emphasize one important point. Los Alamos has verified that every single classified computer

has been properly secured and that at no time was classified information compromised or at risk as a result of these records deficiencies.

At the last hearing, I was questioned about specific whistleblower cases at Los Alamos and Livermore National Laboratories. In response, I sent a letter to Chairman Greenwood addressing the university's whistleblower policies which we also reviewed in prior hearings as well as the cases in question. My letter also addresses a practice related to reimbursement for legal costs, and the reports that I've seen show no evidence to support the assertion of a culture of retaliation against whistleblowers. On the contrary, the university has redoubled its efforts to insure that employees know about our comprehensive whistleblower policies; and they are encouraged to express concerns without fear of retaliation.

In addition, I've personally met with attorneys for a number of the whistleblowers whose cases were brought to my attention; and I've arranged for those attorneys to meet with the university's general counsel to discuss possible ways to settle the cases through alternative dispute resolution.

We're also working to resolve a number of outstanding personnel matters. You will recall that on the date of the last hearing the university attorneys were meeting with the U.S. Attorneys Office in Albuquerque to obtain crucial information on the so-called Mustang case. We also hoped the meeting might provide other valuable information. However, the U.S. Attorneys Office did not wish to engage in substantive discussions at that time. The university will, however, continue to pursue this as soon as the U.S. Attorneys Office is willing to do so.

Similarly, in regard to the Mustang case, the U.S. Attorney is not pursuing prosecution of the matter; and the FBI has closed its investigative file on the matter. Yesterday, the FBI denied our Freedom of Information Act request for the FBI investigative file so that we could further pursue the matter. Our attorneys are now reviewing the basis for that denial to determine what steps we should take next to bring the matter to a satisfactory conclusion.

Finally, I do wish to mention that at its next meeting the university board of regents will approve additional audit procedures for the national laboratories. The purpose is to expand the scope of the external auditors review of the three UC-managed national laboratories to include a more in-depth review of the labs' financial controls. We want to be sure that the financial controls are functioning effectively going forward.

Unrelated to Los Alamos but of critical concern to the university and already mentioned this morning are the recent indictments in an FBI case that revealed the association of a Lawrence Livermore National Laboratory employee with one of the individuals indicted. In response, the lab and the university moved quickly to deny the employee access to his offices, to place him on investigative leave, to relieve him of his laboratory badge, to deny him physical and computer access to the laboratory, to change the locks on his office, and seal those offices so that the offices, the files and the computers were immediately secured. In addition, we requested the suspension of the individual's clearance, which DOE acted on immediately.

We've also initiated a classified administrative inquiry which is now under the direction of the National Nuclear Security Administration. The lab and university are providing full support and cooperation to that review; and, as you know, the employee has since resigned.

Mr. Chairman, that concludes my remarks. Vice President Broome, University Auditor Reed and I will be happy to address these issues in greater detail or answer any other questions you may have.

[The prepared statement of Bruce B. Darling follows:]

PREPARED STATEMENT OF BRUCE B. DARLING, SENIOR VICE PRESIDENT, UNIVERSITY OF CALIFORNIA

Good morning, Mr. Chairman, Mr. Deutsch, and members of the Committee: I appreciate the opportunity to once again report to you on actions the University of California has taken since the last hearing to address the business and management problems at Los Alamos National Laboratory.

In recent weeks we have released the findings from two independent reviews. They include seven reports on core business practices and internal controls at Los Alamos by Ernst & Young. Twenty consultants spent two months examining the organization, business systems and practices, and the required skills of the Laboratory's Business Division. Ernst & Young provided us approximately 90 recommendations that cover the full range of LANL business practices, including property management. The Laboratory is in the process of implementing these recommendations.

Laboratory procurement practices were the subject of a separate extensive review conducted by the External Review Team chaired by former DOE Inspector General John Layton and assisted by forensic accountants from PricewaterhouseCoopers. In their report, the team identified various internal control weaknesses and deficiencies that increased the Lab's vulnerability to fraud, waste and abuse.

The External Review Team recommended a number of corrective actions, including an evaluation of staffing needs across all procurement functions; new controls in the Just-in-Time program; and safeguards to limit purchases under Local Vendor Agreements. These recommendations are in the process of being implemented in addition to a number of corrective actions that already were underway at the Lab. These include reducing both the number of individuals allowed to make Local Vendor Agreement purchases and the number of property distribution sites, known as "drop points." All drop points are now secured except for 45 that will be secured or eliminated in the near future.

In addition, the External Review Team identified $14,530 in potentially inappropriate transactions out of a total of $2.3 billion in procurement transactions during a two-year period. This information has been brought to the attention of the Inspector General. In addition, five lists of transactions were submitted to Los Alamos management for additional documentation and review. We are in the process of investigating these transactions and thus far we have not uncovered any fraudulent activity, although some may be determined to be unallowable due to the lack of a clear policy governing the purchase of required clothing items.

In the last week we have also responded to two Inspector General reports. On the allowable costs audit, we believe that the majority of costs claimed for business meal reimbursement are allowable under the contract. Even so, we will review our guidelines with NNSA and make appropriate policy revisions. We also believe the majority of travel claims questioned by the Inspector General are consistent with the applicable Federal Travel Regulation guidelines and are allowable costs. Los Alamos has researched and resolved 100 percent of the sample items on which the Inspector General based its "projected questioned costs."

The Inspector General also criticized the performance of the Los Alamos Audits and Assessments organization. As you have heard in previous testimony, the Internal Audit function has been one of the areas UC has pursued very aggressively. As a result, the IG report recommendations have already been implemented and are the subject of ongoing corrective efforts.

In regard to the Inspector General's most recent interim report on internal controls over personal computers, we agree that the administrative processes associated with the accounting of classified computers are flawed in ways that made verification of accountability difficult. The Laboratory is correcting these procedures. But let me stress one very important point: Los Alamos has verified that all classi-

fied computers have been properly secured and at no time was classified information compromised or at risk as a result of these problems.

At the last hearing, I was questioned about specific whistleblower cases at the Los Alamos and Livermore national laboratories. In response, I sent a letter to Chairman Greenwood addressing the University's whistleblower policies and the cases about which I was asked. My letter also addresses our practice related to reimbursement for legal costs and it reiterates my testimony at the last hearing that I have seen no evidence to support the assertion of a culture of retaliation against whistleblowers. On the contrary, the University has redoubled its efforts to ensure that employees know that comprehensive whistleblower policies are in place and that they are encouraged to step forward with concerns without fear of retaliation.

I have met with representatives for a number of the whistleblower cases at the two Labs to hear their perspectives on those cases and the underlying causes. In addition, I have arranged for meetings with the University's General Counsel to discuss possible ways to settle the cases rather than through ongoing litigation, such as through our alternative dispute resolution efforts.

We are also working to resolve a number of outstanding personnel matters. You will recall that on the date of the last hearing, the University's Deputy General Counsel and the former U.S. Attorney in San Diego were meeting with representatives of the U.S. Attorney's Office in Albuquerque. The purpose of the meeting was to obtain crucial information about the "Mustang case" from the U.S. Attorney's meeting with the Los Alamos Lab's Principal Deputy Director and Laboratory Counsel, as well as to better understand the past working relationship—and to improve the future working relationship—of the Laboratory and the U.S. Attorney's Office. We also hoped that the meeting might provide valuable information about a pending personnel action. At the meeting, however, the U.S. Attorney's Office deferred a substantive discussion of these issues.

Similarly, in regard to the "Mustang case," we have sent on two separate occasions a team of University investigators to visit the owner of AllMustang.com in Phoenix to obtain additional documents that could enable us to establish who made the attempted purchase of the Ford Mustang. It is our understanding that the U.S. Attorney is not pursuing prosecution of this matter and the FBI investigation has been closed. We have served a Freedom of Information Act request of the FBI investigative file, but we were denied a copy of the file by the FBI yesterday. Our attorneys are reviewing the basis for the denial in order to determine the next course of action. We are, however, still pursuing the matter vigorously and we hope to bring the matter to conclusion soon.

On the TA-33 matter, the FBI case is continuing. The lab has inventoried all of the equipment and supplies improperly acquired, and has recovered all but approximately $50,000 of more than $300,000. The merchandise has been put into use by the Lab's major service subcontractor. PricewaterhouseCoopers has been engaged to assist in reviewing records of purchasing from the vendor from whom the TA-33 purchases were made. The Lab intends to pursue recovery from the vendor for any residual amounts not otherwise recovered.

Additionally, the Laboratory continues to work on the backlog of property identified as missing, lost or stolen. All open cases have been investigated with no findings of significant cases of theft. Those regarded as suspicious have been referred to the Inspector General.

As you know, the Laboratory initiated a comprehensive property inventory, known as a "wall-to-wall" inventory. I am pleased to report that the Lab continues to be well ahead of schedule and to date has accounted for 97 percent of the total inventory value.

Finally, I want to make you aware that at the next meeting of our Board of Regents on May 14 and 15, the Board will take action to approve additional audit procedures for the national laboratories. The purpose will be to expand the scope of the external auditors' review of the three UC-managed national laboratories to include a more in-depth review of the labs' financial controls to assure the leadership of the University that the financial controls are functioning effectively.

Unrelated to Los Alamos, but of critical concern to the University is the recent indictment in an FBI case which revealed the association of a Lawrence Livermore National Laboratory employee, who was formerly a senior FBI agent, with one of the individuals indicted. In response, the Lab and the University moved quickly to deny the individual access to his offices; to place him on investigative leave; to relieve him of his Laboratory badge; to deny him physical and computer access to the Lab; to change the locks on his offices and seal them so that his offices, files and computers were immediately secured; and to request the suspension of his clearance, which DOE acted on immediately. The University also initiated a detailed classified "administrative inquiry," which is now under he direction of the National

Nuclear Security Administration with the Lab and the University providing full support and cooperation. The employee resigned prior to completion of this inquiry.

That completes my introductory remarks. Vice President Broome, University Auditor Reed and I will be happy to speak to each of these issues in greater detail as well as to answer your questions.

Mr. GREENWOOD. Thank you, Mr. Darling. You've been very helpful at all of our hearings, and I appreciate it.

Let me address a question to you, Dr. Atkinson. You indicated that the university has not made a decision as to whether to compete for this contract or not. What, in your mind, will be the criteria that the university uses to make that decision?

Mr. ATKINSON. Well, Mr. Chairman, the Secretary has a blue ribbon panel examining the issue of what competition should look like, the criteria that should be included. Senator Domenici will be holding a series of hearings on this issue over the course of the summer. I will want to see just what their conclusions are and how those conclusions are represented in the document.

Second, there is the issue that the university has never competed for this contract. We've always viewed it as a national service. We were asked by the Federal Government to do this. I would say that for the first 50 or 45 years of the 60 years we had a marvelous relationship between the university and the Federal Government. Incredibly productive. And I think the results speak for themselves. The last 10 years have been complicated years. And I must say that when I look to the future, I would want to be—I would like to see a different kind of relationship established between the university and the Department of Energy.

When I last signed the contract, I spoke to a group of about 30 senior members in the Department of Energy; and I said that if the relationships between the Department and the university continued as they had in the recent past—and this is now several years ago—that I would not be signing the contract.

Mr. GREENWOOD. What was it that you didn't like about that relationship?

Mr. ATKINSON. Mr. Greenwood, that question was asked at the time. I don't think I want to go through all the details. I think one has to have a—this is a very special laboratory. It's a science laboratory. It's a one-of-a-kind laboratory. The recruitment of—you really want me to get into all the details?

Mr. GREENWOOD. Well, I don't want you to take 7 hours to do it. But I just would like to know in general, what—I mean, we have to decide. The Federal Government has to decide, the Congress has to oversee the operation of this laboratory for the foreseeable future, and we want to contemplate who's likely to compete for this and what would motivate them to compete or not to compete. And since the University of California has had the contract for all of these years, it would be helpful for us to know how satisfactory it has been or it has not been for the contractor here to have this contract. So if you could shed some light on what caused you at the last signing of the contract to be less than thrilled with the relationship that you had with the Federal Government, I think it would be very helpful to us.

Mr. ATKINSON. And the university, when it entered into this arrangement entered into it with a view that it would be a cooperative relationship, there'd be an effort on the part of the Federal

Government to work closely with the university to identify and resolve problems, and that was the relationship that evolved and I think was a very successful relationship. In the last decade, I think that relationship has changed. It's changed in many different ways.

Mr. GREENWOOD. And let me understand what that means. Do you mean that the Department has been hands off? In other words, you said that it was—you wanted a cooperative, close working relationship and that has changed. Has that changed in that the Department has not been aggressively involved in identifying issues of concern and helping to resolve them? Have they been hands off? Have they been meddling too much? Have they been quarrelsome?

Mr. ATKINSON. Mr. Chairman, it's a range of issues. I'm not going to—I can't—again, I don't think I want to identify specific individuals.

Mr. GREENWOOD. I'm not asking you to.

Mr. ATKINSON. What I'm saying is that we have not had a cooperative relationship and in many different areas, and I think there's been—although I have said that I thought the report that was delivered to the Secretary was an excellent report and a very fair report, I agree with that remark. On the other hand, there are a number of events that do disturb me.

When I became president there were a number of issues—this is 8 years ago—that I focused on with regard to the laboratories. I must say that the business area was not one of them because I had thought at the time that was in good shape.

I certainly observed with interest year by year the various reports from the Department of Energy that we were in—being ranked very highly. So I would like a view to be established that there is a joint responsibility for some of the problems. But that may be asking too much. But I think I was trying to respond to your question as to whether or not we would bid for the contract. I think I pointed out that we've done this as a national service.

Mr. GREENWOOD. Well let me ask you about that, because I've—you said that a moment ago, and Mr. Darling has said that. When you say that, do you mean that you felt that it's your view that having this relationship, having this contract has not been a benefit to the university?

Mr. ATKINSON. Mr. Chairman, you can get any answer to that question from anyone one you would like.

Mr. GREENWOOD. I'd just like your answer.

Mr. ATKINSON. I do not, in total, believe—first of all, I believe the university has lost considerable money running this laboratory; and I can give you specifics of that. I think that there's certainly been benefit for our scientists to interact with the scientists at Los Alamos, and I think that's been wonderful for the country and for the scientists at Los Alamos. But I think they would have had that access if someone else were running the laboratory. So I think we've carried a heavy burden in running these laboratories. We've done it as a matter of national service.

Mr. GREENWOOD. Well, what do you think would—it would seem to me that if you're sitting here today saying we lose money, a lot of money, we have an uncooperative relationship with the Department of Energy, and our scientists could probably have this experi-

ence regardless of who managed it, I can't see any reason for you to want to bid on this.

Mr. ATKINSON. Well, I think that's an interesting conclusion you have come to.

Mr. GREENWOOD. Well, is it a conclusion to which you have come?

Mr. ATKINSON. No, it's not. I haven't come to that conclusion yet. I mean, this is very important. It's important for the country. The future of this country is going to be very much dependent on what happens at those laboratories, and we're conscious of our responsibility. We're conscious of our historical commitment. And we're going to maintain a great concern about the future. And, you know, I'm willing to tolerate a great deal of problems running those laboratories if I think it's productive for the country; and that is the overriding factor. If you——

Mr. GREENWOOD. It seems to me that what we should have here is a situation in which, whoever manages the contract, whether it's your university, another university or private company, doesn't lose money, has a cooperative relationship with the Department that is productive for both, on both parts and that the contractor feels that the contractor gets some benefit, that it's a good thing to have this contract.

Mr. ATKINSON. I agree with you totally.

Mr. GREENWOOD. And so—because no one's going to compete for a contract—and I wouldn't compete for a contract in which it looked like it was all an unpleasant burden that I just do out of a need for service, and then I become embarrassed when things go wrong, because that's always your reputation at the university.

Mr. ATKINSON. Mr. Chairman, we agree totally with you.

Mr. GREENWOOD. Okay, so it seems to me what we ought to be about and what we would certainly need your help with and hopefully between now and when the contract is bid that you would help the Department think through how it would design a process by which whoever bids would feel entirely differently about this, would not lose money, would feel happy with the relationship and would feel that they're getting some benefit out of the relationship.

Mr. ATKINSON. Mr. Chairman, in my testimony, I pledge that for the next 2½ years that we will do all that we possibly can to insure the future success of those laboratories.

Mr. DARLING. And, Mr. Greenwood, I would just add to Mr.—to the President's remarks that I have had those discussions with the Department of Energy and with the National Nuclear Security Agency and I have begun a process of doing exactly that for the very reason that you outlined in your earlier comments.

Mr. GREENWOOD. Okay. I'm interested in your comment about losing money. Generally, how does it happen that the university loses money here? Because it's been my understanding that essentially that the operation was one in which all costs were recovered.

Mr. ATKINSON. Well, I'll just give you one example. In the long history of this relationship, we have a policy whereby the sons and daughters of scientists or staff at the laboratory can attend the University of California as in-State residents, paying in-State residents fees and receiving financial aid which, for the University of California, is quite significant. We do work very hard at financial

aid. We've never been reimbursed for that. We've never sought the reimbursement for that. Over the years, that's been a huge amount of money.

Mr. GREENWOOD. Well, that sounds like it's probably not a good idea for the next contract then.

Mr. ATKINSON. Well, that's not the way I view it. I mean, those are the sorts of things that I don't want to have in the contract. Another example——

Mr. GREENWOOD. But, I mean, the employees—it's not been my experience, looking at the numbers, that the employees of the laboratory are particularly underpaid. They're paid quite well. So to provide to them a benefit of free college education for their sons and daughters is an expensive proposition and in that a new contractor may not want to take that on.

Mr. ATKINSON. Well, that may well be. But part of the relationship here is the relationship of the university with the scientists of the laboratory, trying to maintain a very close relationship. Once someone goes to the laboratory and focuses their long-term career in the laboratory, they're in a certain sense isolated from the larger scientific community. Their association with the University of California is extremely important to them. And part of this is to really assure them that we want their children at the university, that they are indeed full members of the university. And if you look across the laboratory particularly of the senior scientists you'll see that their children often have 2 or 3 degrees from the University of California.

I think it is a very important thing that we do. I am very proud of what we do.

The outreach efforts in northern New Mexico. We've put a great deal of effort into outreach efforts in the K through 12 schools and the like in this area. We don't—we have some mild reimbursement for that. But we don't have the full range of the reimbursement that's associated with all the efforts of the University of California to develop K through 12 preschool programs.

So I'm not complaining. I'm not saying that we've—that I'm complaining about the loss of money. I'm proud of the fact that we've done these things. But I think they're extremely important. I'm proud of them. And I just want to point out that we've not—I mean, a number of people think we've gained from this financially. We surely do not gain. No one would argue that.

Mr. GREENWOOD. I don't think any of the members of this committee have ever made such a statement.

Mr. ATKINSON. Well, I'm not saying you did but certainly a number of people think that's the case.

Mr. GREENWOOD. Okay. My time has expired, and I would notify the witnesses that I have to leave for another commitment, and Mr. Radanovich will be chairing the balance of the hearing. Thank you for your cooperation this morning.

The Chair recognizes the ranking member, Mr. Deutsch.

Mr. DEUTSCH. Thank you, Mr. Chairman.

I'm going to ask unanimous consent that a letter from attorneys representing, I guess, whistleblowers that was referred to in your testimony be submitted for the record and—just so we have it available.

Ms. Broome, in an interview with committee staff, you indicated that the current Los Alamos business operation staff was inadequate for that task and that new people have been—or new people would be hired. Can you tell us why new people with new ideas and better skills should come to Los Alamos after what happened to individuals including Mr. Wobb, Mr. Dorn with their new ideas and better skills?

Ms. BROOME. Well, that's not a simple question. I would hope that the opportunities at Los Alamos would be sufficient to attract new staff. As we've indicated, it's probably the most exciting area in terms of science, we feel; and I feel very confident that we are going to be able to improve. We have already improved a number of the business practices at Los Alamos.

This would be a very challenging position, for instance, to senior financial officers to come in and to be able to make the improvements. So I am confident that we will be able to attract people.

We've done a number of things in that connection already. For instance, one important thing that we have started is a program of internships for MBAs and for business students within the New Mexico area. We think it's important to grow our own people so that we don't have to bring people in on a massive scale. But we'll be able to bring people along.

Mr. DARLING. And, Mr. Deutsch, if I just might add, I think your question was, given the past, why should they come for the future. And I think if you look at the changes we've made in personnel, in systems, in policies and procedures, the commitment that we have made to the laboratory from a new director through the entire organization, I think that people should see that there's a new tone being set and I hope we can recruit them to be part of accomplishing what we should be accomplishing for the United States.

Mr. DEUTSCH. You know, one of the—I guess a follow-up question to that is, really, how long are you going to be there? I mean, how long do you expect the management or the new systems to be in place, the new people to be in place to insure that there is, in fact, a new day where the main goal is not seeing how quickly cosmetic changes are there, can be made, so that, you know, that DOE auditor doesn't see anything wrong at the next point in time?

Mr. DARLING. Mr. Deutsch, I would urge you to remain skeptical. I would urge you to remain skeptical until you see the kind of actions that cause you to be otherwise.

And I would just say that we have—as I have said before, we've changed 18 senior management at the laboratory, beginning with the director and others. We have committed over $5 million of the university's money for which we will not seek reimbursement for the government to carry out the kind of reforms and changes that admittedly should have been made earlier, were not but are being made now. And so I would say that there is a real tone change not in just individuals but in practices and policies, in systems.

Mr. DEUTSCH. One of the questions that I raised earlier and I think a number of other members raised as well is, I guess having sat through several of these hearings we are in this culture at Los Alamos which says don't make waves. What's going to happen if these new employees make waves?

Mr. DARLING. That is a troubling issue for us. And as I testified at the earlier hearings, this is something we are focusing on to change dramatically. Since interim Director Nanos has arrived, since Vice President Broome took over the business operations, since Auditor Reed took over the audit operations, we have received a flood of complaints, concerns, and other issues that reflect that there was indeed a pent-up desire to speak out but a fear of doing so. I think with that flood of comments, e-mails, letters, personal remarks, we are beginning to see in the employees of the laboratory a sincere belief that the new management is open to those concerns and now it's our responsibility not to let them down and to uphold those changes.

Ms. BROOME. Can I add to that? In connection with the business process improvement work that we have done that hopefully I will have an opportunity to tell you about, we made the employees a very significant part of the improvement. In fact, in addition to all the external reviews, we had the internal financial management conduct self-assessments so that we could get their views and make them part of the solution to correct these problems. They are very much a part of this solution. We have a very open policy in dealing with people. I listen to numerous people with regard to what they think is the problem and how we might fix it. I'm a big believer that the people who do the work know a great deal more about the problems than somebody sitting at a higher position.

Mr. DARLING. I would also like to ask the auditor to talk about the new whistle-blower policies and the changes that are being made in that regard as well.

Mr. REED. Thank you for the opportunity to comment. The first step I think in changing the culture is giving the people the confidence to come forward. Then it is up to us how we treat them and how we treat their issues going forward.

As you're aware, I believe in late January or early February, we instituted a Pinkerton hotline service to create a new avenue for employees to come forward with increased confidence of confidential treatment. We received 13 phone calls so far on the Pinkerton hotline, almost all of them in the first few weeks of that service, with the last call being March 17. We have received a flood of letters, e-mails, phone calls, that Vice President Darling alluded to. I have been approached in the parking lot. I have advertised my e-mails and telephone number. The volume of whistle-blower complaints in our fraud, waste, and abuse inventory that we're investigating in my internal audit unit has grown by sixfold since the first of December. I think it's a positive thing, I think it signals employees willing to come forward and talk to us and I think the fact that we have seen a continued influx of calls but less use of the Pinkerton hotline signals to me that people are willing to come forward to us. As I said, that's a start, getting them to feel confident to come forward.

Now, how we treat them and how we treat their issues is critical. We are implementing the university's new whistle-blower policies which create a process for managers to recognize when a whistle-blower complaint is being made, how to funnel those into a central process where they are worked and handed off to the right investigators, communications back to the whistle-blowers so they get a

closed loop, and, at the same time, the whistle-blower retaliation policy which protects people from retaliation is being implemented.

I think that there is a change being made, although I understand fully that it would take a long time before the workforce is confident that there is a change and that they can come forward without fear of retaliation.

Mr. DEUTSCH. There's no question that the lab has done great things. No one has ever questioned that. And I would agree, Dr. Atkinson, a very unique role in American history in the world of science. And clearly that didn't occur without a culture of discussion and critique and—you know, in terms of science. And one of the things we talked about is clearly the lab at the same time, you know, there's an expectation that it's run within a business practice model and I guess, you know, can—in terms of—I don't want you to spend as much time running the lab as a business, as a science. That's clearly the higher goal.

I think what we have talked about it becomes problematic at so many levels. And I guess is there anything we can do on the business model side to encourage some of this robust discussion that exists, just to get some of that from management, from employees to really have that? Is there anything that you can focus in to do that? I assume in other branches of the university, you are much more successful at it than you are at this location.

Mr. ATKINSON. Mr. Deutsch, in a certain sense you have already done it. The committee's investigation here has really focused our attention. Clearly we were not focused carefully enough. We should have identified these problems. There's reasons for our failure to identify them, but those are not satisfactory reasons. And there's no question we will be fully focused on them in the remaining 2½ years as we serve as the contractor.

Mr. DARLING. As we commented in prior hearings, you're right. We have 10 campuses. The university is a $15-billion-a-year enterprise, larger than all but 125 companies on the Fortune 500 list. We have not experienced these problems at our 10 campuses or at the other two labs. We clearly had serious problems at this lab and I hope we have shown you some sense of our desire to get on top of these issues and improve them in the last few months.

Mr. DEUTSCH. Thank you.

Mr. RADANOVICH [presiding]. Thank you, Mr. Deutsch. Regarding your request to submit for the record, I ask unanimous consent for without any objection that might be to include this in the record. There being no objection, so ordered.

Thank you and welcome to the panel. It's good to see you again.

Let me start off by asking a couple of questions. Dr. Atkinson, regarding I guess a more recent situation several weeks ago, apparently it was disclosed by auditors at Los Alamos that employees were selling proprietary computer programs and using the proceeds from the sale to purchase computers and equipment outside of the Los Alamos procurement system. And apparently there was either a division of—a division supervisor who knew and allowed these sales to continue for several years. Can you tell me the current status of this investigation and whether you can state with any confidence that these foreign sales did not contain classified information and how the University of California intends to address this

situation? Apparently there was some thought that there was even foreign sales going on.

Mr. DARLING. I would like to make a few brief comments. This is a case in which a scientist at the laboratory became frustrated with the technology transfer mechanism in the laboratory which allows an individual to take an invention or discovery, license it to an outside company, and then use the proceeds to benefit the laboratory and the science and thereby also benefit the American economy by creating jobs and new companies. This individual, upon becoming frustrated, decided to take this matter into his own hands and basically entered into a licensing agreement with companies without the laboratory or the university's knowledge. And indeed we have heard there were licenses made to companies in foreign countries.

I would just reiterate that it is unclassified. We are investigating this matter seriously. The individual is fully cooperating. And I would like my colleagues to give you more information about it.

Mr. REED. The issue arose in mid-February and we immediately engaged PricewaterhouseCoopers to assist us in the investigation. As Senior Vice President Darling has said, the software involved is unclassified software and the individuals are cooperating. We have disclosed the matter to the Inspector General's office since day one. We have communicated daily with them on this matter, and yesterday delivered a draft report to both Ralph Erickson at the contract office and the Inspector General's office. That draft report concludes that there was diversion of revenue, that there was avoidance of university and lab policies, that there were export control violations. But as was stated, the software is unclassified. In 1996, Commerce Department approval to license the software was granted. Some of the sales occurred before that date. None of the sales occurred to prohibited countries, but there are still very much policy issues and issues of export control that officers at the laboratory are looking at.

Mr. RADANOVICH. Mr. Reed, can you tell me the status of the employees that were guilty of this? Are they still employed?

Mr. REED. The employees, because of their cooperation, have been left in the employ of the lab and are not on administrative leave, but we will be issuing a final report in the next several days, and lab management and the Department of Energy Inspector General will proceed with their own courses of action.

Mr. RADANOVICH. Apparently in the draft report—and I don't know if you could illuminate what the policy is between acting during the time that the draft report is out to the time that the final report is out—but apparently the division manager knew about this and was already included in the draft report.

Mr. REED. There were a number of people at the laboratory who knew of this over the years. The beginning of the sale of the licensing occurred in the mid-1990's, so this has been an ongoing event for a number of years. People who knew and either had the same belief that the engineer—software engineer who developed the code knew that the technology transfer program did not serve them well, and this was justified in some fashion because they were trying to bring the money back into the labs. I think there was some justification. And there are others who knew who may not have

had the specific knowledge of the mechanisms by which funds were flowing. It is problematic that a division director knew, and that's got to be dealt with as a separate personnel matter.

Mr. RADANOVICH. You'll act on that once the final report is in?

Mr. REED. We'll refer our findings to management for their action.

Mr. RADANOVICH. There's an issue regarding the pension fund that I want to ask and I'll leave it up to you, Doctor, or anybody else who wants to address it. There is a very generous pension plan for Los Alamos employees, apparently not as good at other national laboratories. And there's an issue as to what happens to that pension plan once—if this goes up to bid and somebody else is the bid winner. Can you—is it in your opinion—let me read this question: Other national laboratories across the Nation don't have pension plans nearly as generous as that as the University of California.

Do you believe it is essential to effectively manage Los Alamos, that future contractors offer an equivalent pension plan for future Los Alamos employees?

Mr. ATKINSON. Let me just say that the laboratory's pension plan is the University of California's pension plan. I don't consider it particularly generous. It is the case that the regents have been remarkably effective in the investment of the pension plan, and as a result we have not been having to ask employees to pay into the pension plan for some period of time.

In terms of the termination of the contract, there would be no problem of separating out the funds that are identified for laboratory employees and the rest of the university. So I see that as no obstacle to dealing with a termination of the university. The issue of what another contractor should do in terms of benefits, I don't have anything hard on that.

Mr. DARLING. Mr. Radanovich, I might just add, because no employee of the university nor the university, or, in this case the Federal Government, has had to make a payment to that pension plan for the last 10 years, the University of California saved nearly $1 billion in pension payments over this period of time. That is a large amount of money due to the outstanding investment of those funds by the university. And I don't know if you can say that about any another DOE contractor.

Mr. RADANOVICH. Thank you. In the event of a change in contract, how does the university intend to treat the surplus in the pension fund for Los Alamos employees?

Mr. ATKINSON. There's absolutely no problem there. The legal grounds for separation are very clear. Whatever the proportion of the funds are that relate to the employees of Los Alamos, those will go to the employees. It's not an issue. As I understand the way the contract is written, if there's a deficit in the pension plan, the Department of Energy is obliged to make up that deficit at the time of segregation of the lab employees from the university. If there is a surplus, that surplus would travel with the laboratory employees to the new contractor.

As you heard this morning, Ambassador Brooks made the statement that one of the conditions for the new contract competition will be that any new contractor would be obliged to provide the pension plan to new—to the employees of that new contractor.

Mr. RADANOVICH. Can you answer—and let us move on. I am very concerned if a contract left U.C. And went to someone else that—the potential loss of talent that might be accompanied with that. So—and again, I'll leave it to you, Doctor, and anybody else who wants to respond to this, but other national labs, for example, Sandia or Brookhaven, have changed their management contractors and not suffered a loss of scientific talent.

Can you explain why this is not the case with Los Alamos? I need to get that into the record clearly.

Mr. ATKINSON. It's a judgment as to whether they've lost any in their scientific work. Different people have differing opinions about that. And I think you would find a number of people who feel that the work of a number of the laboratories has gone down in recent years. Now, what was the question?

Mr. RADANOVICH. Why is U.C. At Los Alamos different than other research laboratories in that if the contract were to change, my fear is that we are going to lose a lot of talent.

Mr. ATKINSON. I'm not sure how to answer that. Are you of the view you will lose talent?

Mr. RADANOVICH. It's suspected if the contract were to leave U.C. And go to somebody else, there would be a brain drain of the talent in U.C., that some might retire early. Perhaps Mr. Darling.

Mr. DARLING. It's intriguing, while the hearings have been going on over the past few months, the Department of Defense has been facing a very serious problem. The Department of Defense manages a number of Department of Defense laboratories to serve the military needs of the Nation. Those laboratories are, in the judgment of the Defense Science Board, the highest policy adviser to the Secretary of Defense not achieving their mission for the United States defense. One of the reasons is that, because they are Federal employees, they have adopted a civil service employment system which is not able to recognize scientific talent, not able to recruit scientific talent or reward it. So if you read the Defense Science Board report which goes back over a 10-year period, the Defense Science Board is actually recommending that the Department of Defense no longer manage those laboratories but, rather, have private sector contractors or preferably universities take over those so that the missions can be better met. So that is setting the context about this.

I should comment, at Los Alamos and at Livermore, the number of retirements in the first 4 months of this year is double the period in prior years and we have seen a huge spike upwards in the month of April as this—as the decision by the Secretary was looming. I cannot tell you, since the decision was made yesterday, whether that will continue or whether it will settle down. I hope indeed that it will settle down, and so we'll have to wait and see over the next few weeks and months.

Mr. RADANOVICH. Can you tell me, too, Mr. Darling, most of the people that would qualify for what is considered an awfully good pension, can you tell me the difference between those who might want to retire, say, people that are in their fifties and what might be the difference between employees there in their fifties and, say, in their twenties.

Mr. DARLING. One of the big concerns we have, the Nation has a very limited number of individuals—I'll be very direct—11 at Los Alamos, 16 at Livermore—that comprise the only individuals who have ever designed a nuclear weapon for this country—excuse me, headed a team that designed a nuclear weapon and then had an opportunity to test that weapon to make sure that it will do what is required of it should the President be required to use nuclear weapons. With that in mind, the median age of those individuals is 57 years old. Many of them have been at the laboratory for their entire careers. And under the university's pension system they could retire today with their retirement very close to their current salaries. They have indicated—many of them have said they are not prepared to go through a change in contractor. I hope, and deeply and personally hope that that is not the case, and we will do everything we can to assure them so that that does not take place, but that is a very serious risk to this country.

Mr. RADANOVICH. Thanks, Mr. Darling. My time is up. I would like to ask a couple more questions, though. I would like to recognize Mr. Stupak.

Mr. STUPAK. Thank you. Dr. Atkinson, in your statement here, I am looking at the first page, paragraph number 5.

Mr. ATKINSON. I will need to get a copy of the statement.

Mr. STUPAK. You say: Ask hard questions about our management and take strong action. Record will show that the university has responded quickly and has responded well. New performance provisions have been written into our contracts, and in every instance we have met or exceeded the new requirements.

How do you know you have met or exceeded the new requirements?

Mr. DARLING. President Atkinson also makes the point a little later on in his opening remarks that the Department of Energy has the responsibility to evaluate that. And one of the troublesome aspects of this whole episode, Mr. Stupak is that the laboratory was receiving excellent ratings in all of these areas. We did not—let me back up and say—first of all, we are not making any excuses.

Mr. STUPAK. I just want to know, have you done something, evaluations or audits or something to back up these words? Everyone is saying all these things are going great. I haven't heard anyone say we had this audit and we passed this and did that. That's what I am trying to ask.

Ms. BROOME. Would you like me to address the audits?

Mr. STUPAK. I just want someone to answer my question. We have had earlier testimony that the last 4 to 6 months, things have been better there. How do you know it? How do you know it's better?

Ms. BROOME. I think by the controls we're putting in and the testing of these controls. As an example, the largest problems we had were in the area of procurement, and we developed a whole procurement quality assurance function and we instituted audit procedures to be—to ensure that procurement procedures are being followed. The initial results of those audit procedures show that the appropriate procurement techniques are being followed.

Mr. STUPAK. Who did that review to make sure things were being followed?

Ms. BROOME. That is being done by the staff at Los Alamos, under my direction.

Mr. STUPAK. Let me ask then, and go Mr. Darling, to the computers. You were talking about the computers and I believe you said computer problems have been corrected and they're all secured. Is that basically what you said?

Mr. DARLING. If I may, there are 164 classified laptop computers at Los Alamos National Laboratory. The DOE Inspector General's interim report raised question about four of those classified computers. We have located all of them.

Mr. STUPAK. You located those four?

Mr. DARLING. We have those four. They have been secured and in a proper place at all times. This is a further reflection of the improper administrative procedures at the laboratory that did not have a complete inventory of those, and I would be happy to walk through each and every one of those four.

Mr. STUPAK. I don't want to take all my time on these computers. He says there are 22 unlocated laptop computers and this report is April 24, so it's about 8 days old. So in the last 8 days, the four classified ones you said have been found?

Mr. DARLING. Four classified ones were never lost. They were simply not on the inventory that the DOE Inspector General consulted in order to track them. We've had a procurement property management in a number of areas, some very serious problems in not having items appropriately at the lab show up on the data bases for recordkeeping. That is what we had here. The Inspector General just consulted the property management report. Did not look at the list of classified computers where those computers show up.

Mr. STUPAK. They show up, but they have been physically found?

Mr. DARLING. They do exist and they are in a secured area.

Mr. STUPAK. What about the 10 that he claims that are stolen?

Mr. DARLING. One of the problems that we do have, sir, and we have acknowledged this in prior hearings in which you were not in attendance, is that there has been a lax set of procedures for handling missing, lost, or stolen property. Individuals have not been held responsible and the lab has not pursued those so-called unlocated computers or other property to see what they are. We are now putting in place procedures to do that. We are embarrassed by it and we intend to make sure that this does not happen again.

Mr. REED. If I might add.

Mr. STUPAK. Of these 18 or these 22, 4 have been found. Let's say there's 18 out there. In your testimony, the computers that have been secured——

Mr. DARLING. I was referring to the classified computers.

Mr. STUPAK. From this day forward, you're saying they're secured.

Mr. DARLING. I'm saying they were secured and they're presently secured.

Mr. STUPAK. How about the hard drive that was missing when I was out there in January? Has that been found?

Mr. DARLING. There was a hard drive carrier that was properly located in a secured area. There was not a hard drive in it. There is no——

Mr. STUPAK. But your inventory report shows a hard drive with a hard drive in it.

Mr. DARLING. That's correct—well, I can't recall that. Your memory is better than mine. We have no evidence to believe that there was a hard drive. We don't know whether there is. That remains unresolved.

Mr. STUPAK. And everyone's clear now at Los Alamos that if a computer is missing you have to report it to somebody, right?

Mr. DARLING. Before you do, Pat, I just want to refer to other so-called classified removable electronic media, which is what the hard drive is. We are trying to move away from having hard drives used for classified information because of the concerns you raised. So the laboratory has begun to move—at the Nicholas Metropolis Center where Mr. Greenwood, and I believe you may have visited as well, in January—toured a new environment where you don't have a removable media used for classified material. We have instituted procedures whereby there will be at the exit of a classified building—I guess the best analogy would be like when you leave a library or store, there is a device that lets you know when you are exiting the building. We have instituted a number of highly increased rate of randomized checks to make sure that individuals' briefcase and other materials are looked at on a regular basis. So we are trying to, in every way we possibly can, make sure that classified material is accounted for, as you would expect us to.

Mr. STUPAK. Mr. Reed, you mentioned about the Pinkerton, your confidential line there. You have had 13 calls, right?

Mr. REED. Yes, sir.

Mr. STUPAK. Have you verified those complaints in those 13 calls?

Mr. REED. Well, those 13 calls represent one intake source.

Mr. STUPAK. Just answer my question. Thirteen calls, what did you do with the information?

Mr. REED. All the complaints that come in to us, I can't tell you precisely on those 13 which are closed or open. But we have not found any significant theft of property from those complaints or the—or other significant investigation.

Mr. STUPAK. Of these 13 calls, were they about thefts of property and things like that?

Mr. REED. They range from thefts of property to——

Mr. STUPAK. Let's say theft of property. Did you check, and was in fact property stolen based on that call?

Mr. REED. We have had 104 intakes.

Mr. STUPAK. I am just talking about the 13 now.

Mr. REED. Those come into the process and all complaints come into the process. We have worked all the missing property cases; 35 are closed, 69 are still open.

Mr. STUPAK. How about just these 13? I am only dealing with stolen property.

Mr. REED. I would have to get you the information.

Mr. STUPAK. See, the point I am trying to make: You put up this confidential line, change the tone and tenor of this place, and you have this confidential line and people call in; they trust it for a minute here, and if you're not getting back to them and if you're

not verifying what's going on, they just think oh, hell, it's the same thing that went on before.

Mr. REED. I'm sorry to have confused you. We are working on each one of these cases. I am having difficulty as we sit here pulling the Pinkerton cases out from those who reported these matters to a different channel.

Mr. DARLING. And Mr. Stupak, if I may add, one of the features of the anonymous whistle-blower hotline is that an individual can call anonymously, can report an event, they are then given a case number. We are then obliged, or obliging ourselves to then call back the outside hotline to inform what the progress is so the individual can still anonymously call in and check up on the progress of that case by case number without revealing their——

Mr. STUPAK. I understand all that and I am trying to figure out if you're doing it, because you are never going to restore the confidence unless they know what's going to happen.

Mr. DARLING. I completely agree with you.

Mr. STUPAK. This division manager that the Chairman asked about, on this software that had been going outside the system that has been going on for a long time, you indicated in the preliminary report no disciplinary action has been taken. Maybe OIG might do something. But my impression is the university is not going to do anything.

Mr. REED. Not to confuse you again, the report has just been provided to management in draft form as of the day before yesterday. The decision not to put the—I will call it the perpetrator of the licensing scheme—was made back in February because of their cooperation. The report disclosed 2 days ago was the first disclosure of who had an awareness of what was going on. Mr. DARLING. We have terminated 18 individuals. Every individual that has been brought to our attention involved in theft where the investigation has been concluded—the auditor, the deputy director, the director, the head of security, the deputy head of security, the chief financial officer, the head of the procurement program, the head of the purchase card program—all of those individuals have either been terminated or removed from the laboratory or reassigned for the very reasons you mentioned. Persons must be held personally accountable for their actions and we intend to do so.

Mr. RADANOVICH. Your time is up.

Mr. STUPAK. I just wanted to ask him about the Mustang case. No decision on that one yet?

Mr. DARLING. The Mustang case is one of the ones that we had hoped to obtain additional information from the U.S. Attorney in Albuquerque. Because we did not do so because the FBI refused our Freedom of Information Act request to obtain information, we have sent two individuals out to the vendor in Phoenix to obtain additional documentation that might tie that purchase to a specific individual. Mr. Reed can comment further, but we are not where we would like to be in that investigation.

Mr. STUPAK. You don't have to wait for law enforcement to take any internal action.

Mr. DARLING. Yes. In accordance with our contract when there is a theft, we are first obliged to notify the Department of Energy Inspector General or Federal law enforcement officials. They then

take possession of the case. We put the individual on investigative leave. We were not allowed to take any actions whatsoever in the case until they had handled it. It was only at the last hearing where they relinquished the authority and where we could for the very first time begin to pursue our own investigation.

We have pursued personnel action and that action is pending. So we have not—we have been pursuing it aggressively since we were given the authority to do so.

Mr. RADANOVICH. I'm afraid the time is up. We will be going up for another round of questions. So if anybody has any further questions they want to ask, there will be the opportunity, but I would like to recognize Ms. Eshoo.

Ms. ESHOO. President Atkinson, Vice President Darling, Mr. Reed and Ms. Broome, welcome. It's good to see you. When Chairman Greenwood was asking—and I would like to set this down for the record—about the dollars that the university has expended over the years and in terms of a benefit for in-state tuition for employees, I would like to just highlight and underscore what that means. If any of us had as a benefit that our children would have a deeply discounted reduced tuition to Harvard or to Yale, we wouldn't spend a nanosecond to struggle to come to the conclusion that that is a great, great benefit. And so I think that needs to be appreciated here. That isn't anything that is insignificant.

And if I might say, the University of California has in its combined 10 campuses, has duly earned the reputation of being the greatest public university in the world. It is not without her problems and certainly some of them is what has brought us here today. But I would think if anyplace is going to recognize what a great university's role is in terms of our Nation and the betterment of our Nation, certainly the Congress should recognize that as we review both the contract, the problems that have occurred, and the longtime stewardship of the university.

On page 7 of the recommendations to Secretary Abraham, there is a footnote. And what I would like to do is just to highlight that again, Mr. Chairman, as you pursue the questions relative to pensions, and I do have some questions on that. But that footnote talks about the prospect of termination already having an adverse effect.

Now, we are talking about a benefit that accrues to our country relative to the role of the contract and what happens with the science. As of April 8, 266 Los Alamos employees, 68 with critical skills—and maybe someone from the panel would like to identify what a critical skill is—have applied for retirement. In contrast there were only 177 retirements during all of 2002. Retirement requests at Livermore are currently running at roughly twice the 2002 rate. So I think that good, bad, or whatever is in between, that this is all having an effect.

My question to you is, No. 1—and I know that it's difficult to look down the road, but, President Atkinson, as you described the relationship over the years—as I said earlier, I was 4 months and 1 day old when the first contract was entered into and I am not suggesting that you were around then doing this—do you believe, and the problems that you have I think pretty frankly alluded to—

do you believe that U.C. Will recompete for this contract as it becomes available in 2005?

Mr. ATKINSON. It is just too early for us to make a statement on that. There are a lot of factors that have to be taken into account and I think it will take about 6 months. As I said, we'll have to see the report from the blue ribbon committee. I hope there are people on that committee who thoroughly understand the issues of nuclear weapons and research related to nuclear weapons, and we'll have to wait and see the outcome of Senator Domenici's hearings. And I think it will be very interesting to see what the judgment is of people on just how this should be competed. I have no problem with the issue of competition if that's the direction in which the country wishes to go. There has been some worry that it will be very costly for the university to compete.

Ms. ESHOO. The $25 million figure I have seen, is there any credence to that?

Mr. ATKINSON. Of course there is. You heard the Ambassador speak about that. It might be high, it might be low, but it's going to be a very significant amount. But of course those moneys are returned to the contractor as part of the overhead whether they win or lose over the course of a series of contracts. For the University of California, though, I don't worry about that. The fact is we're not going to compete in that mode. We're not going to go out and hire special writers or special film crews. We can put a proposal together in 2 or 3 weeks with 10 or 12 people, and that will be the investment that we make in the proposal.

We will stand by our record. Clearly our record in the area of business practices at Los Alamos in the last period of time—and that may go back 7 or 8 years—has been abysmal and it has to be corrected. I hope by the time the 2½ years is up, we will have corrected it. And I hope that the record will clearly indicate where the university stands as a competitor in the process. But I do not like the idea of the word "competition." The university has never sought this contract. We were asked to do this and we did it as a national service. We're very proud of our national service. And if the country has come to the view that it should be done in some other way, we will happily bow out.

Ms. ESHOO. Explain, if you would, the scenario of change. Big science has been referred to more than once during this hearing today. Big science calls for big minds. Certainly there are not big salaries that go with this. But we need to retain this intellectual property, as it were, for our Nation's security. What happens? What exactly happens with a change of contract? Is it simply that the big minds that relate to the big science become employees of someone else? Is that overstated? Is that understated?

Mr. DARLING. Straightforward answer is we have no experience with this because of the nature of the university's relationship with DOE. I am sure there are defense contractors or other laboratories that can give you answers to those. Those are some of the issues we have to look into. The figure of $25 million came from Admiral Nanos, who is the current interim Director of Los Alamos. He was before in charge of the Navy's Sea Systems Command, and before that the entire U.S. And U.K. Nuclear weapons program. He said, in his experience letting large contracts with U.S. Defense contrac-

tors, that is what they would typically spend to put in a proposal for a contract the size of Los Alamos National Laboratory.

Ms. ESHOO. Well, Mr. Chairman, I don't have that much time left. I don't know when the next hearing is, if there are going to be future hearings. I think in fairness to investigation and oversight, the issues that have not only been uncovered but reviewed by the INO subcommittee or the full committee, that in my view we should come back and revisit the progress that the university is making and have the committee make a further determination if in fact there is progress. I believe that it is early on, but there have been important steps taken.

To the University of California, as a Californian, as an American, I think the university is a great university. This has been a very, very difficult, embarrassing chapter in the life of the university.

I would say to the committee and to my colleagues in the Congress that with the toughness of the questions and the review and the oversight, that we continue to keep in mind that through this oversight that we have pressed for and are making progress relative to the business management of Los Alamos. I have not heard once where our national security has been impaired as a result of the university's work on this project. So I hope that we will come back and revisit it and review the progress of what the university has put into place, the sustaining of the reforms. And I hope that at the end of this process, whatever the determination of the university is, to continue on with the contract or to bring to a close its service to the Nation, that we will end on a note of great dignity.

So I thank you, Mr. Chairman, for again extending this legislative courtesy to me. And I thank the university's representatives, the president, the vice president and those that have accompanied them here today in the Congress.

Mr. RADANOVICH. Thank you. I concur with your remarks. I want to start off by saying that I have confidence in the high quality and scientific and technical work at Los Alamos that has been performed by the University of California.

Let me ask this question. I think that—and recognizing the long service that U.C. Provided to the national security interests of the United States over many, many years—if the issue does come up, and since the Secretary of Energy said that this will come up to competitive bid—and this doesn't make money, why would the University of California—assuming that the University of California were to bid, which you know is an assumption, why would the university, assuming that, want to keep the contract?

Mr. ATKINSON. Well, I think I said before that we view this as a service to the Nation and we had a unique contribution to make here and I am very proud of that contribution. And you know, if we continue in the future, it will be—I won't view it as a competition, let me simply put it that way. I will view it as the university's record is there. We are happy to write a proposal. It will not be, as I said, a $25 million proposal. And the Department of Energy can make its decision. I just hope that knowledgeable people are involved in making that decision.

Mr. RADANOVICH. Again, continuing to have confidence in the high quality of work the University of California has given at Los

Alamos, I also believe that the lab recognizes that the business administrative practices of the lab need to be revamped so they will rise to the level of quality—similar to the quality of the science of the lab.

In that regard, what corrective actions, Mr. Darling, does the U.C. Plan to take in the future to strengthen financial controls and restore the American public's confidence in Los Alamos and the university's management of it?

We have a vote. We will wind this thing up in about 10 minutes.

Mr. DARLING. Mr. Radanovich, I think what we're going to do is build on the changes that we have begun to make, but not stop there. We will continue in a relentless way to understand the problems, the issues, and the opportunities at the laboratory. We will implement all the recommendations that have come from our own reviews as well as from the reviews of the outside groups we have brought in, such as PricewaterhouseCoopers and Ernst and Young, and then we will assess our performance over time. We will invite the Department of Energy to do so and involve outside reviewers in doing so, and I would invite you to do the same.

Mr. RADANOVICH. Ms. Broome, I do have a question for you regarding business operations. What plans does U.C. Have to review the business operations at its other DOE facilities, which are of course Lawrence Livermore and Lawrence labs at Berkeley?

Ms. BROOME. Currently we have a review going on at the Lawrence Livermore laboratory by Ernst and Young, the same firm which reviewed all the business processes at Los Alamos. We will be receiving a report from them probably by next week, initial report. We invited them obviously in to get—also an independent view of our business practices, though while as was testified earlier, we believe that those business practices don't have the issues that we have at Los Alamos, but we wanted an independent.

Mr. RADANOVICH. To make sure.

Mr. DARLING. I would just add to that, the moment we returned from Los Alamos on November 25, where a group of us went out to look at the business problems, we made available our report, its nine recommendations, to the two other laboratory directors. Mr. Reed engaged the auditors of those two laboratories in reviewing the very issues, and we continued in that pattern up to this very day. Every issue that comes up, we informed other laboratories to assess whether there are similar problems. We have not seen the extent of those problems at the other two laboratories.

Mr. RADANOVICH. Mr. Darling, while we are engaged here, can you give me an idea of what's termed as wall-to-wall inventory and the progress of that initiative?

Mr. DARLING. This was addressed briefly by Ambassador Brooks. The so-called wall-to-wall inventory is a comprehensive inventory of every piece of property at the laboratory that is known as control. That means it has a value in excess of $5,000 or is otherwise a sensitive item of property that could disappear easily, such as a computer, cell phone, or other such items. The last one that was done was 1998. This is the first time it is done. It is about 97 percent complete at this point in time. And I know Vice President Broome could provide more details about it.

Mr. RADANOVICH. If you could briefly, too. I want to accommodate Mr. Stupak.

Ms. BROOME. I would like to assure you that the lab is 10 weeks ahead of schedule. We brought in Pricewaterhouse to do a complete review of all the procedures and controls surrounding the taking of this physical inventory, and they will actually be doing test checks as well to verify the results of this inventory.

Mr. RADANOVICH. In closing, my last remarks may not require an answer but I do want to put on the record my concern for the fact that this was put up to bid in the first place, because there are many other national laboratories in the United States that are not for various reasons. And my big concern is the loss of talent that's there that's able to apply for pensions and leave some expertise that may not be found anywhere else in the United States.

Thank you. Mr. Stupak.

Mr. STUPAK. Just a couple of questions still bugging me on the audits.

Mr. Reed, would you agree that the Inspector General's evaluation of the audit function at Los Alamos—would you agree that the evaluation was a rather negative evaluation?

Mr. REED. I agree there are problems and I agree that there were problems with independents, with performance.

Mr. STUPAK. You're the university's auditor.

Mr. REED. That's correct.

Mr. STUPAK. Why didn't you know the condition of the Los Alamos function before these events occurred then?

Mr. REED. If I could address those individual components. The independent issue, I think, is one of professional and individual objectivity. It's not structure. We have changed the structure. But the structure that was in place in that laboratory was the same as Livermore up until we decided to conform it.

Mr. STUPAK. Wouldn't you get the audit reports that were done internally?

Mr. DARLING. Mr. Stupak, I testified about this at earlier hearings. I want to say as directly as I said then, the auditor of Los Alamos National Laboratory did not fully provide the information to the university and indeed rebuffed the university when the university made attempts to find it out.

Mr. STUPAK. Didn't the university ask?

Mr. REED. Let me also say that—because I thought about that question a lot. If there is one concept that I personally feel like I bought in too much is that they had so much DOE oversight that the university was redundant. I am not blaming the DOE, but I think it was the lab keeping us at bay to some extent.

Mr. STUPAK. What's the plan to get credible audits done on time? Because they say internally they're understaffed.

Mr. REED. Well, we have a lot of resources to help us. As of yesterday, we had completed the backlog of all that follow-up work. All 280 follow-up items have been completed. We have hired additional staff on a temporary basis to help us put together a plan to have the subcontractor audits caught up to date by September 30. We have submitted—myself as university auditor—a plan for next fiscal year's audit program that will be submitted to the regents in 2 weeks for approval that meets my full expectation.

Mr. STUPAK. Is it really a good business practice to have auditors reporting to the people they audit?

Mr. REED. No.

Mr. STUPAK. Why did it happen at Los Alamos then?

Mr. REED. The way that we mitigated that was to have a dual-reporting structure in place so the auditor there also reported to me. But again I think in this case that was not an effective reporting channel.

Mr. STUPAK. Your new structure, is that going to be temporary or permanent?

Mr. REED. Permanent.

Mr. RADANOVICH. I want to thank the panel for being here. Forgive me for closing this so shortly, but we have to get out to vote. Appreciate your testimony and also the performance of University of California over the last 50 years. Thank you very much.

[Whereupon, at 1:30 p.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

COMMITTEE ON ENERGY AND COMMERCE
Subcommitte on Oversight and Investigations
Review of the University of California's Management Contract for
Los Alamos National Laboratory, Day 3 - May 1, 2003

Tab	Document Description	Date
1	Darling Letter to Chairman Greenwood re: Questions Regarding Whistleblowers	4/24/03
2	DOE/IG Report: UC's Costs Claimed and Related Internal Controls for LANL	4/16/03
3	E&Y Report: LANL Payroll Processes and Internal Controls	4/15/03
4	E&Y Report: LANL Cash Receipts and Work for Others Processes and Internal Controls	4/15/03
5	E&Y Report: LANL Information Technologies General and Selected Application	4/15/03
6	E&Y Report: LANL Banking Processes and Internal Controls, Including DOE Funding	4/15/03
7	E&Y Report: LANL Property Management and Property Accounting Processes	4/15/03
8	E&Y Report: LANL Budget Execution Processes and Internal Controls	4/15/03
9	E&Y Report: LANL Accounts Payable Processes and Internal Controls	4/15/03
10	Layton Report #2	4/7/03
11	DOE/IG Report: Inspection of Internal Controls Over Personal Computers at LANL	April-03
12	DOE/IG Report: Opearations at Los Alamos National Laboratory	January-03
13	Appendix F - Standards of Performance	FY03
14	Abraham Letter to Atkinson re: Review of the UC Contract	12/24/02
15	Layton Report #1	12/2/02
16	DOE/IG Report: Management Challenges at the Department of Energy	December-02
17	Appendix L - Program Performance Improvement Initiatives	1/18/01
18	Appendix O - Program Performance Initiatives	1/18/01
19	Abraham Memo/Response to Duputy Secretary McSlarrow and Ambassador Brooks Memo	4/29/03
20	Deputy Secretary McSlarrow and Ambassador Brooks Report to Secretary Abraham	4/26/03
21	UC President Atkinson's Statement Regarding Secretary Abraham's Statement	4/30/03
22	LANL Interim Director Nanos Statement Regarding Secretary Abraham's Statement	4/30/03
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Tab 1

UNIVERSITY OF CALIFORNIA

BERKELEY • DAVIS • IRVINE • LOS ANGELES • MERCED • RIVERSIDE • SAN DIEGO • SAN FRANCISCO

SANTA BARBARA • SANTA CRUZ

OFFICE OF THE SENIOR VICE PRESIDENT-
UNIVERSITY AFFAIRS AND
INTERIM VICE PRESIDENT-
LABORATORY MANAGEMENT

OFFICE OF THE PRESIDENT
1111 Franklin Street, 12th Floor
Oakland, California 94607-5200

April 24, 2003

BY HAND DELIVERY

Honorable James C. Greenwood
Chairman, Subcommittee on Oversight and Investigations
The Committee on Energy and Commerce
2125 Rayburn House Office Building
Washington, D.C. 20515

Re: Response to Questions Regarding Whistleblower Policies at University of California Managed National Laboratories

Dear Chairman Greenwood:

During the course of your hearings in March and follow up discussions with Committee staff, it became clear that Members of the Energy and Commerce Committee are troubled by allegations they are hearing from current and former employees and contractors at Livermore and Los Alamos related to the University's whistleblower policies. As a matter of policy and principle, the University of California strongly believes that employees should be encouraged to disclose acts of malfeasance, fraud or abuse without any fear of retaliation or punishment. Additionally, the University is committed to ensuring that employees and contractors who have been accorded whistleblower status are treated fairly and equitably. Accordingly, I appreciate this opportunity to respond to the questions that Members have raised regarding policy and specific cases involving the University.

I recall that Rep. Markey expressed concern about the costs of defending and settling whistleblower claims and whether it was appropriate for the University to seek reimbursement from the Department of Energy for such costs. The terms and conditions of the University's contract with the Department of Energy for managing the national laboratories permit the University to seek reimbursement for such costs where appropriate. I understand that this contractual condition is consistent with Department of Energy terms and conditions in most, if not all, contracts to manage and operate DOE facilities. In cases brought by persons claiming to be whistleblowers, federal regulations instruct DOE to determine a contractor's entitlement to reimbursement "on a case-by-case basis after considering . . . the relevant facts and circumstances, including federal law and policy prohibiting reprisal against whistleblowers."

48 C.F.R. § 931.205-47(h)(2)(iii). In accordance with this provision, the University generally seeks reimbursement for the costs of defending and settling whistleblower cases; DOE has the discretion either to permit or disallow such reimbursement in particular cases. An assessment of the strength of whistleblower claims--*i.e.*, whether the University or one of the laboratories acted improperly--is undoubtedly part of DOE's consideration of the "facts and circumstances" of each case in determining whether to permit reimbursement.

Additionally, Rep. Markey expressed concern about whether the reimbursement policy outlined above acts as a disincentive to settling whistleblower cases by insulating the University from the costs and consequences associated with protracted litigation. On the contrary, in addition to the Department of Energy's discretion to review each case, the General Counsel of the Regents or the Board of Regents itself approves all litigation settlements. We pursue policies designed to minimize litigation costs regardless of the source of funds for covering such costs. For example, in many cases, the University attempts to resolve claims through alternative dispute resolution, which is usually less costly than litigation. Officials at the Lawrence Livermore laboratory inform me that the lab has received eight whistleblower complaints in recent years from an employee population of 7,800. The University used alternate dispute resolution in each case. Four of these cases are pending in federal or state court following arbitration decisions that were favorable to the lab. At the Los Alamos laboratory there have been six cases over the past five years from the Lab's 8,000 employees. Alternate dispute resolution or direct settlement negotiations were employed in each case. Two of the cases went to a hearing, although none went to court.

On the other hand, the University has a responsibility to the Regents, the Department of Energy and the taxpayers to defend claims against the University zealously where the facts and circumstances warrant such a defense. Additionally, almost all of the law firms hired by the University and the laboratories are retained at discounted rates in recognition of the public status of the University and the laboratories. These policies and others underscore the University's keen understanding of the importance of limiting the amount of resources--whether State or federal--expended in litigation.

Rep. Markey also indicated at the hearing that he believes the University's invocation of the state sovereign immunity defense in certain lawsuits, including some brought by persons claiming whistleblower status, precludes those persons from obtaining a fair hearing of their grievances. While the UC Office of General Counsel can respond to questions about this issue in greater detail, I am pleased to provide an overview of this issue for Members of the Committee. Representative Markey's question goes to the issue of whether the Eleventh Amendment shields the University from claims asserted by whistleblowers in the federally-funded national laboratories operated by UC. The Eleventh Amendment does restrict certain suits and remedies in *federal* court but does not, in anyway, prevent whistleblowers or other citizens or entities from pursuing legitimate claims against the University in *state* court. Indeed, in the late 1990s the Supreme Court ruled that the University is entitled to the Eleventh Amendment defense specifically in suits where the damages might be paid by the Department of Energy. *See Regents of the University of California v. Doe*, 519 U.S. 425, 431 (1997). I understand that some Members of Congress have expressed concern in recent years about the

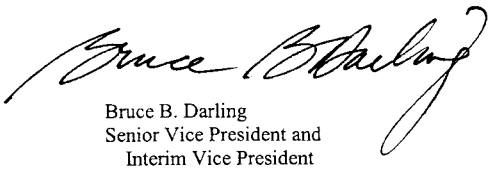
Supreme Court's interpretation of state sovereignty issues. Nonetheless, I believe that the University's position is consistent with our obligations under current law as an entity of state government.

I also want to address an issue that arose at both hearings: the suggestion that the University and the laboratories have a culture of retaliating against whistleblowers. While I have not seen any evidence to support this allegation from a historical perspective, the University can in no way condone any culture or environment that encourages this perception among employees. As I testified before the committee in March, the University has redoubled its efforts throughout the campuses and the labs to ensure that employees know that comprehensive whistleblower polices are in place and that they are encouraged to step forward with concerns. Creating and maintaining a transparent environment in which wrongdoing is consistently and promptly reported to senior management is one of the University's most important goals in its management of the laboratories. Robust whistleblower reporting and whistleblower protection policies are essential to achieving this goal. Accordingly, we pledge to remain committed to ensuring the vitality of the whistleblower reporting and protection policies at the laboratories.

Finally, several Members of the Committee, as well as staff, have asked questions about specific ongoing cases involving the University. The UC Office of General Counsel has prepared a summary of the facts and circumstances of those cases and that summary is attached for your information. As with all ongoing litigation, we are constantly assessing our positions in these cases to ensure that they are in the best interests of the University and the Department of Energy, that they are fair to all of the parties involved in accordance with the facts, and that they are in accordance with applicable law. Pursuant to the policy outlined above, the University is seeking reimbursement for the cost of defending and/or settling these cases.

Thank you for this opportunity to address your concerns. If you have any additional questions please contact me.

Sincerely,



Bruce B. Darling
Senior Vice President and
Interim Vice President

cc: Deputy General Counsel Lundberg
Assistant Vice President Sudduth

Donald Adrian

Donald Adrian was the CEO of a Louisiana-based company called Icon Industrial Controls Corporation ("ICON"). ICON and Lawrence Livermore National Laboratory (LLNL) collaborated on a government-sponsored project to develop software code for use by DOE and the Department of Defense. Sometime after the collaboration began, the FBI raided ICON and eventually closed the company. LLNL completed the software work with two nonprofit entities in Louisiana.

After ICON was closed, Mr. Adrian filed a False Claims Act lawsuit against LLNL and others in federal court in California, alleging that LLNL submitted incorrect billings to the government. In February 2002, ICON's claims against LLNL were dismissed on the ground that False Claims Act suits cannot be brought against state entities. Mr. Adrian has appealed this ruling.

The Department of Justice (DoJ) is investigating the Laboratory's involvement in the ICON contract and two federal subcontracts involving ICON and LLNL. The Laboratory is cooperating fully with the DoJ investigation, including pursuing settlement.

Janet Benson

Janet Benson was employed in LLNL's Education Program from 1992 until 1996 when she was medically separated from the Laboratory. In 1993, Ms. Benson filed a fraud, waste, and abuse claim against the program's director. Some time later, Ms. Benson's colleagues complained that she was unreasonably difficult to work with, and some of her job duties were removed. Ms. Benson claimed retaliation against the new program director. Later, Ms. Benson refused to move into the Education Program's new building because of the potential for an adverse reaction to the new carpeting and paint in the building and she also refused to work in two other buildings where the program tried to accommodate her. The medical evidence indicated that Ms. Benson's symptoms were psychosomatic. After a year of refusing to work in any building at the Laboratory on the ground that she would have a potentially fatal reaction, Ms. Benson was medically separated in 1996.

In 1994, Ms. Benson filed a whistleblower retaliation complaint with DOE. The Inspector General found no retaliation. After a 6-day hearing in 1999, an Administrative Law Judge found no evidence of retaliation and upheld the separation. Ms. Benson appealed to the Director of the Office of Hearing and Appeals, who concluded that, despite the Laboratory's success in the administrative proceeding, Ms. Benson was entitled to reimbursement of $50,000 of her $180,000 in attorney's fees. The Laboratory has appealed this ruling to the Secretary of the Department of Energy (DOE).

Michelle Doggett

Michelle Doggett joined LLNL in 1988 and became a Senior Resource Analyst in the Energy Manufacturing and Transportation Technologies (EMATT) program in April 1995. In January 1997, she reported alleged financial irregularities in her program to the Office of Investigative Services. The case was referred to law enforcement authorities and the employee involved was terminated after an internal investigation. Ms. Doggett also alleged that a senior EMATT

manager fostered a hostile work environment and engaged in inappropriate billing practices. An internal investigation found $32,700 in improper charges, which were refunded to DOE. In addition, the department involved underwent sexual harassment training in February of 1997, and no further inappropriate behavior occurred.

On October 1, 1997, Ms. Doggett was promoted to Lead Resource Manager and received a large salary increase. Shortly thereafter, Ms. Doggett complained that she was suffering from stress as a result of her position. She was offered a comparable position in another program, which she turned down. At Ms. Doggett's request, she was permitted to work at home three days a week while an investigation was conducted into the behavior of the senior EMATT manager. In late 1997, the senior EMATT manager was removed from his position.

On February 20, 1998, Ms. Doggett informed her superiors that she would be on sick leave until March 1, 1998. She continued to extend her sick leave and on May 12 she asked for and received an 11-month leave of absence to recover from "stress." Ms. Doggett's leave statement provided that upon her return she would not necessarily return to her previous position, but would return to a position with the same pay and classification. In February 1999, Ms. Doggett returned to work at 60 percent time. Her position was in a different LLNL department, but her salary and classification were unchanged.

In July 1999, Ms. Doggett notified her supervisor that she would be resigning from the Laboratory on August 3, 1999. After resigning, Ms. Doggett claimed that she was constructively discharged. In July 2000, in an effort to resolve the ongoing dispute, LLNL offered Ms. Doggett employment at her previous classification level and at a salary reflective of increases sustained since her departure. She never responded to LLNL's offer; instead, she filed a lawsuit against the Laboratory.

Dee Kotla

Dee Kotla is a former LLNL employee. In 1996, while testifying in a deposition in a sexual harassment lawsuit, Ms. Kotla voluntarily admitted that she had operated an outside business on Laboratory time and using Laboratory resources. In the process of responding to document requests in the lawsuit, the Laboratory discovered a file concerning Ms. Kotla's outside business on her computer. The information regarding this computer file was turned over to Laboratory Police. The police discovered a large amount of data on the file used by Ms. Kotla to run an automotive fleet maintenance business. The police also discovered that shortly after being advised that her computer was to be searched, Ms. Kotla entered the Laboratory late at night and used a high-level administrative password to circumvent the police's attempt to protect the data, and deleted much of the data from her file. After an extensive investigation by her supervisor, a determination was made that Ms. Kotla's actions merited termination as she had engaged in a serious violation of Laboratory policy. This action was consistent with the Laboratory's actions in four similar cases.

Despite these facts, a California State court jury found that Ms. Kotla's termination was partly in retaliation for her testimony in the sexual harassment case and awarded her damages in the

amount of $1 million. The judge reduced the damages award to $750,000 and also found that Ms. Kotla was entitled to $1.1 million in attorney's fees. LLNL has appealed this judgment.

K-Tek Corporation[1]

During the mid-1990's LLNL and K-Tek Corporation ("K-Tek") discussed the possibility of K-Tek obtaining a license to the Laboratory's micro impulse radar technology. In July 2000, LLNL offered K-Tek a license to the University's patents because they related to K-Tek products; K-Tek responded in January 2001, stating that it was not interested in a license. Thereafter, the University conducted an investigation of patent infringement, including obtaining an infringement opinion from outside counsel.

In June 2002, as a result of K-Tek's refusal to license, the University filed a patent infringement action. K-Tek has now entered into a settlement agreement with the University and taken a license to the University's patented technology, which includes payment to the Laboratory of a $125,000 license/settlement issue fee and a $25,000 minimum annual royalty for each year beginning in 2003. Once the minimum annual royalty is reached, K-Tek will pay the Laboratory a 2% royalty from worldwide sales.

Charles Quinones and Matthew Zipoli

Charles Quinones and Matthew Zipoli are former security officers at LLNL who were terminated for support of, and participation in, an August 6, 2001 "sick-out" involving 47 security officers during Hiroshima Day demonstrations. Over the years, there have been protests and demonstrations at the Laboratory on this date, creating an especially compelling need for security forces. Messrs. Quinones and Zipoli had been warned not to participate in the sick-out. It is without question that Mr. Quinones supported the sick-out as made clear by telephone conversations before the sick-out occurred. Messrs. Quinones and Zipoli had previously complained about certain safety and security issues at LLNL, but their supervisors were not aware of these complaints until well after their terminations.

Messrs. Quinones and Zipoli filed a series of actions as a result of their terminations. They filed a grievance under the union agreement, a whistleblower retaliation complaint with the University, whistleblower complaints with the Department of Labor, and an unfair labor charge with the California Public Employment Relations Board ("PERB"). An independent arbitrator heard their grievance and issued a binding decision on December 13, 2002. The arbitrator sustained the Laboratory's contentions that Mr. Quinones supported and "may well have incited" employee participation in the sick-out, did not act in accordance with his responsibilities as a union officer under the labor agreement, and was not truthful in explaining his actions, and upheld Mr. Quinones' termination. The arbitrator found no direct evidence of support for the sick-out by Mr. Zipoli, but found that he was not "legitimately out ill" and that he "participated in and indirectly lent support to the sick-out in violation of the . . . agreement." The arbitrator

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[1]This is not a whistleblower case, but it is included in this letter because it was recently inquired about by Rep. Markey's staff.

determined that a 30-day suspension was an appropriate sanction for Mr. Zipoli's actions. Mr. Zipoli has since been reinstated to his position.

On February 18, 2003, the PERB rejected the charge that Messrs. Quinones and Zipoli were discriminated against because they engaged in protected activities. They have appealed that decision. Messrs. Quinones and Zipoli also have filed a complaint in federal district court in San Francisco relating to their terminations. A mediation has been scheduled in an attempt to resolve this matter.

Mary Singleton, et al.

Mary Singleton and five other plaintiffs filed a lawsuit in California State court on behalf of current and former female employees at LLNL, alleging gender discrimination in the Laboratory's salary and promotion practices. The essence of the plaintiffs' claims is that the relative value ranking system used to calculate yearly pay increases results in unequal pay for women.

In response to a motion for class certification, the court certified a class defined as "all current, former and future female employee at the Laboratory in scientific, technical and administrative series on or after October 1, 1988 to the present." The court subsequently narrowed the scope of the class to females in relevant job classifications who were employed at the Laboratory after February 20, 1997.

The court indicated that it was willing to reconsider the class certification issue including possible subclasses, after discovery. Extensive discovery has taken place, much of it at the behest of plaintiffs and as a consequence the case has been very expensive. On January 3, 2002, following extensive briefing and several hearings, the court substantially revised its original class order. The court divided the class into 30 different sub-classes and ordered the plaintiffs to locate class representatives for each class.

This case has been difficult and extremely expensive, primarily based upon the discovery demands and other actions of the plaintiffs. During the course of litigation, the plaintiffs have reduced their demands and attempts to settle the case continue through mediation. Trial is scheduled to commence on September 22, 2003.

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

Tab 2

Audit Report

University of California's Costs Claimed and Related Internal Controls for Operation of Los Alamos National Laboratory

U. S. DEPARTMENT OF ENERGY
Washington, DC 20585
April 16, 2003

MEMORANDUM FOR THE SECRETARY
FROM: Gregory H. Friedman (Signed)
Inspector General

SUBJECT: INFORMATION: Audit Report on the "University of California's Costs Claimed and Related Internal Controls for Operation of Los Alamos National Laboratory"

BACKGROUND

Since 1943, the University of California has operated the Los Alamos National Laboratory (Laboratory) under contract with the Department of Energy and its predecessor agencies. Now part of the Department's National Nuclear Security Administration (NNSA), the Laboratory has critical national security responsibilities, including helping to ensure the safety, security, and reliability of the nation's nuclear weapons stockpile. Recently, Los Alamos and the University have been criticized for perceived internal control weaknesses at the Laboratory, particularly as they relate to

property loss and theft.

In light of these issues, NNSA requested the Office of Inspector General to perform an audit of costs incurred by Los Alamos National Laboratory. Consistent with that request, we sought to determine the allowability of the $5.2 billion charged to the contract for Fiscal Years 2000 through 2002 and evaluate relevant controls.

RESULTS OF AUDIT

Our review identified potentially unallowable costs of about $14.6 million that were charged to the contract, including the following:
• $3.7 million for "working" meals;
• $7.4 million for travel costs in excess of contract limits; and,
• $3.5 million for an internal audit function that did not meet Department requirements.

As part of our review, we also identified a series of internal control weaknesses that contributed to an environment in which these potentially unallowable costs could be incurred and claimed.

Specifically, we found control weaknesses in the following areas:

• Laboratory audit function;
• Financial system reconciliation;
• Payroll and travel approval processes;
• Financial management personnel turnover; and,
• Financial system review and approval.

Further, we identified a significant backlog in the completion of required audits of Laboratory subcontracts. Given the fact that subcontracting represents about half of all Laboratory expenditures, we concluded that this issue was of concern.

Recent reports by the Office of Inspector General and others have disclosed similar problems regarding the business operations of the Laboratory. For example, our recent special inquiry report on *Operations at Los Alamos National Laboratory* (DOE/IG-0584, January 2003), described actions taken by Laboratory officials that weakened or overrode property and procurement management controls. We also issued reports in 2002 that noted problems with the Los Alamos internal audit function. In addition, a recent external review of the University's purchase card program at Los Alamos concluded that a number of critical weaknesses existed that left the Laboratory vulnerable to fraud and abuse.

As a result of the identified weaknesses, the Department, in our judgment, has had less

than adequate assurance that costs claimed by Los Alamos National Laboratory are allowable under the contract. To address this situation, we recommended that NNSA recover unallowable costs and require the University to improve internal controls that ensure costs are allowable.

In response to the control weaknesses, the University of California has announced an aggressive corrective action plan. The questioned costs described in this report, however, can – as was the case with many of the issues raised in the previous reviews – be attributed in large measure to management decisions and policies that did not ensure the interests of the Federal taxpayers were adequately protected.

MANAGEMENT REACTION

NNSA generally agreed with the audit recommendations contained in the attached report and indicated that corrective actions had been taken or were planned. These planned actions included conducting a review of the allowability of the $14.6 million in questioned costs identified in this report. NNSA also commended the University of California for positive steps that it has recently undertaken to improve and strengthen the control environment of the Laboratory.

Attachment

cc: Deputy Secretary
Acting Administrator, National Nuclear Security Administration

UNIVERSITY OF CALIFORNIA'S COSTS CLAIMED AND RELATED INTERNAL CONTROLS FOR OPERATION OF LOS ALAMOS NATIONAL LABORATORY

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LOS ALAMOS COSTS AND CONTROLS

BACKGROUND

The University of California (University) has operated the Los Alamos National Laboratory (Laboratory) under contract with the Department of Energy (Department) and its predecessor agencies since 1943. The Laboratory's financial accounts are integrated with the Department's, and the results of financial transactions are reported monthly according to a uniform set of accounts. Now part of the Department's National Nuclear Security Administration (NNSA), the Laboratory has critical national security responsibilities, including helping to ensure the safety, security, and reliability of the nation's nuclear weapons stockpile.

During Fiscal Years 2000 through 2002, the University incurred $5.2 billion in costs under its contract (W-7405-ENG-36) with the Department in over 6 million separate transactions. These expenditures were made on the Government's behalf at the Laboratory to carry out its missions and functions. The contract requires the University to comply with the Federal Acquisition Regulation (FAR) for allowable cost determinations. We evaluated costs incurred under the contract for allowability using a combination of statistical and non-statistical methodologies.

RESULTS OF AUDIT

Questioned Costs

Our audit disclosed that costs claimed by the University for Fiscal Years 2000 through 2002 were generally allowable. However, we question the allowability of $14.6 million claimed during that period as shown in the table below.

	Total Costs	Costs Questioned
Working Meals	$ 4,179,584	$ 3,660,383
Travel Claims	101,725,002	7,383,069
Performance Awards	2,190,299	53,247
Audit Function	3,503,175	3,503,175
Totals	$ 111,598,060	$ 14,599,874

A discussion of each category follows.

Results of Audit
Page 6

Working Meals

Total Costs	Transactions[1]	Projected Questioned Costs
$4,179,584	13,534	$3,660,383

We question as unreasonable $3,660,383 that the University charged the contract for

meals and entertainment. The majority of the questioned meals were provided at the Laboratory by the operator of the cafeteria and included recurring costs for coffee supplies, breakfast items, and other meals. The remainder was for meals at restaurants in Los Alamos, Santa Fe, and Albuquerque. In most cases, the meals were provided to Laboratory employees and guests. In some instances these meals were also provided to Department employees. We estimated the questioned amount based on the results of a random sample projection, using statistical sampling software provided by the Defense Contract Audit Agency (DCAA). We did not question meals that were related to bona fide conferences or professional meetings, or those that were paid for through the employee morale fund.

The FAR does not specifically address working meals, but does contemplate that such costs could be allowed if associated with certain meetings, conferences, and symposia. All costs, however, must be consistent with prudent business practices. In our judgment, the number, frequency, and apparent routine nature of most meals provided indicates that the University was not exercising care to distinguish situations where working meals truly are in the Government's best interests. Other sources of information, while not binding on this contract, indicate that these types of costs are unallowable on Government contracts. The DCAA Contract Audit Manual requires meals to be an integral part of meetings to be allowable. In an October 2002 Advisory Opinion, the Chief Counsel of the Department of Energy's Chicago Operations Office concluded that, generally, meals for contractor employees are unallowable because the cost of meals is considered a personal expense of the individual.[2] In addition, according to the Defense Acquisition Homepage, meals for contractors are

[1]Each of these transactions potentially included meals for multiple individuals.
[2]While the opinion did outline some exceptions to the general rule, it emphasized that, absent a specific contract provision or advance agreement regarding the allowability of the cost, each cost should be evaluated on a case-by-case basis against considerations including reasonableness of the cost, integrality to the associated business function, and other FAR and DEAR provisions.

generally unallowable, and for a business meal to be allowable, it must be an inseparable part of a meeting agenda. It also states that incidental business discussions during a meal do not make the meal costs allowable.

The Laboratory has an internally generated "Cost Allowability Guide" that establishes certain criteria for the allowability of meal costs. In practice, the working meals policy has been interpreted by the University as allowing meals in association with an extremely broad range of activities. In response to our concerns that this policy was unreasonable, the University provided a written justification. The University's primary position was that the FAR, the contract, and the Department of Energy Acquisition

Regulations (DEAR) did not specifically address the allowability of meals. However, we confirmed that the FAR is clear that a contractor is not allowed the presumption of allowability when a cost is not specifically addressed in the FAR.

In addition, the University believes that its policy describes when a meal is a "reasonable business expense." However, we noted that meals paid for with University funds must be approved two supervisory grade levels higher than those paid for with Government funds. Thus, the University of California has a more restrictive policy on meal expenses than the policy it has implemented at Los Alamos, the latter being reimbursed through appropriated funds. We could not reconcile this inconsistency. Lastly, the University established these guidelines without consulting or obtaining approval from the contracting officer because the policy was considered "an internally generated guidance document."

Travel Claims

Total Costs	Projected Questioned Costs
$101,725,002	$7,383,069

We question $7.4 million charged to the contract by the University for travel costs that were not in compliance with Federal Travel Regulations (FTR). In November 1999, a modification to the contract required the University to follow the FTR for travel reimbursements for its employees. The FTR limits reimbursements for lodging to rates

established by the General Services Administration (GSA)[3] and requires receipts for all costs over $75. However, we found that travelers were reimbursed for lodging that exceeded established GSA rates, conference fees without providing a receipt, and various other costs not in accordance with the FTR.

To determine the questioned amounts, we:

- Randomly selected 386 travel transactions with a value of $846,800;
- Identified the associated travel claim and evaluated the claim for compliance with the FTR; and,
- Projected costs, not in compliance with the FTR, using statistical sampling software provided by the DCAA.

In our sample, we found 109 travel claims with $53,868 costs questioned:

Cost Type	Questioned Transactions	Questioned Costs	Rationale
Conferences	40	$37,073	Costs were not supported by a receipt
Lodging	54	6,670	Exceeded GSA rates without justification

Other Errors	33	10,125	Various errors
Totals	109*	$53,868	

- *This column does not total 109 because some transactions contained multiple errors.*

Subsequent to our review, we were informed that the Laboratory was able to locate additional supporting documentation, which was not in the payment files at the time of our review. This information should be utilized by the Department in determining allowability of specific items questioned in this report. However, the delay in providing the information and the fact that the information was not in the payment files calls into question the scrutiny of travel claims by the Laboratory prior to payment.

[3]According to the FTR, reimbursement for actual expenses is warranted when: lodging or meals are procured at a prearranged place; costs have escalated because of a special event; or, lodging and meals expenses within prescribed allowances cannot be obtained nearby and costs to commute from a nearby location consumes savings that would be achieved.

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Performance Awards

Total Costs	Costs Questioned
$2,190,229	$53,247

We question $53,247 in cash awards charged to the contract. The University funds the Contract Worker Award Program to recognize the efforts of subcontractor employees. This award program was not specifically allowed by the contract, but the University received Departmental approval in 1996 to fund these awards. The cost of this program was limited by the University to 0.1 percent of the salary base for the subcontractors. These limits were $62,210 in 2000, $67,753 in 2001, and $64,429 in 2002.[4] However, we found that the University exceeded these limits by $50,247.

Also, the contract provided for costs related to employee morale activities to fund a variety of programs to enhance employee morale with an overall limitation of $16 per employee. In addition to the contract, the University imposed additional limitations that specifically prohibited use of the fund for individual cash awards. However, we found that the University charged $3,000 to this fund in FY 2002 for individual cash awards for four employees.

Audit Function

Total Costs	Cost Questioned
$3,503,175	$3,503,175

We question as unreasonable $3,503,175 charged to the contract by the University for costs of operating an audit function that did not meet the requirements of the Department's Cooperative Audit Strategy or standards established by the Institute of Internal Auditors. Specifically, the audit function was not organizationally independent; did not adequately plan its audit work; and did not conduct timely follow-up reviews. These shortcomings are discussed in more detail in the Related Controls section of this report.

Results of Audit

[4]These limits were imposed by the University on a "cap year" that ran from April 1st to March 31st in any given year.

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As part of our review, we identified internal control weaknesses that contributed to an environment where the questioned costs identified in this report and potentially other questionable costs could be incurred and claimed. A discussion of each identified control weakness follows.

Laboratory Audit Function

An effective internal audit function is crucial to effective program management. The University's contract requires the Laboratory to establish an audit function to conduct audits at the Laboratory that are acceptable to the Department, including an annual allowable cost audit and subcontract audits as needed. It also requires the University to make the results of these reviews available to the contracting officer. The Cooperative Audit Strategy, as set forth in the Department's Acquisition Guide, provides the criteria used to determine whether a contractor's audit function is acceptable. Among other requirements, the acquisition guide requires the audit functions to be organizationally independent and prepare a satisfactory audit plan. In addition, the Institute of Internal Auditors' standards recommend establishment of an audit follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action. In our judgment, the Los Alamos audit function, which includes internal and subcontract audit functions, did not meet these requirements.

Independence

The Laboratory's audit function had reporting relationships with various levels of University and Laboratory management. However, we determined that the manager responsible for the chief auditor's performance appraisals and annual salary increases was also responsible for areas that were the subject of both internal and subcontractor audits, including the procurement, property, and accounting functions. In our opinion, this relationship led to an impairment of independence.

An apparent lack of independence was also evident in the Laboratory's reporting of audit findings to the Department. When the audit function issues an audit report, it also issues a Management Action Plan (MAP) and enters required management actions into the Laboratory's Issues Tracking system (I-TRACK). We compared the findings in the audit reports to the related MAP and I-TRACK actions and found that the MAP and I-TRACK

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contained significantly more detail. However, only the audit reports are issued to the Department, while the MAP and I-TRACK are treated as internal documents. For example, we noted that an internal audit conducted in 2000 identified potentially unallowable costs listed at $117,247 in the MAP. However, the associated audit report issued to the Department did not include specific information about these costs. Although the issue was identified in the report, the value of the questioned costs was not. At the time of our review, the costs had not been recovered. It should also be noted that the Office of Inspector General encountered reluctance on the part of the audit function to share MAP and I-TRACK documents with our audit team.

Finally, we found supervisory documentation warning the audit function against throwing "grenades" and encouraging the function to "work with management." Such admonishments could have encouraged a reluctance to report audit findings to the Department.

Planning and Performance of Audits

We also found that the audit function did not adequately plan internal or subcontract work. During our review period, the internal audit function typically only completed one-third of the audits planned, while the subcontract audit function did not prepare audit plans.

The internal audit function planned up to 13 audits per year for a total of 32 audits planned from FY 2000 to FY 2002, but during that same time, completed only 11 audits (34 percent). According to the University, the internal audit group is expected to complete between 70 and 85 percent of its audit plans. This lack of production by the internal audit function may be attributed to spending 15 percent of available time on advisory services[5] and 31 percent on audits that were started but not completed. While the internal audit function did not follow its plans, the subcontract audit function did not prepare an audit plan at all for FYs 2000 through 2002.

In addition to overall planning, we found the allowable cost audit for FY 2000, which was specifically required by the contract, was not adequately planned. The audit did not cover the full scope of operations and relied on judgmental sampling techniques from which results could not be projected. In addition, the audit did not reconcile the costs shown on the Statement of Cost Incurred and Claimed[6] to

[5]Advisory services addresses management's concerns in areas such as human resources, security, and various consultations. The results of these services are not distributed to the Department.

[6]The annual statement the University submits to the Department as an accountant of costs incurred for the year.

either the Laboratory's Letter-of-Credit or its Financial Management Information

System (FMIS)[7].

Subcontract Audits
The Laboratory had responsibility for auditing selected subcontracts under its purview and had completed 70 audits during the last three fiscal years. However, at the time of our review, the Laboratory provided documentation that indicated a backlog of 500 subcontract audits for contracts with a total value of $1.2 billion. The backlog included the incurred cost audits and close out audit of Johnson Controls Northern New Mexico (Johnson Controls) that accounted for over $150 million per year charged to the Department. The FY 2001 audit of Johnson Controls began in March 2002 and is still ongoing. The FY 2002 incurred cost and closeout audits of Johnson Controls have not been started. After we completed our fieldwork, the Laboratory provided a revised list for closeout audits that indicated a backlog of 77 audits with contract values of $1.1 billion. As indicated above, the Laboratory has not developed a plan to address the backlog of required audits.

By the terms of its contract, the Laboratory was required to provide for the timely involvement of the Department's contracting officer in resolution of subcontract cost allowability. In at least one instance, the audit function conducted a subcontract audit that identified potential questioned costs of approximately $12.8 million, but a report was never provided to the contracting officer.

Follow-up
The audit function did not follow-up on issues identified in its audit reports in a timely fashion. We found several instances where there was a significant delay between the time management closed an audit finding and the time the audit function verified that appropriate action was taken to close the finding. In some cases this delay was 6 years or more. For example, the internal audit function issued two audits on the purchase card program, resulting in 10 findings requiring management action that closely mirrored recent findings of an external review team. Management closed all of the audit findings issued between December 1996 and December 2000, but the audit function did not indicate verification of these actions until February 2003 and had not conducted follow-up reviews. The audit function also had a considerable backlog

[7]These reconciliations would have shown the auditors that all costs charged by the University were subject to audit.

of open actions. We noted that there were at least 260 open actions in I-TRACK at the end of FY 2002 that required management closure or audit function verification.

Recent Actions
In response to a draft of this report, the University informed us of several actions they had recently taken or were planning to take to address weaknesses in the audit function

at the Laboratory. Specifically, the University reported that it had: revised the reporting structure; made staffing changes; started assessing its practices to enhance productivity and timeliness; engaged in a program to catch-up on delinquent audit follow-up activities; and, begun development of performance measures. In addition, the University stated that it was planning to create a Laboratory audit committee adhering to the University of California model for campus audit committees. If successfully implemented, these initiatives should address the internal control concerns related to the Laboratory audit function identified in this report.

Financial System Reconciliation

The University has established over 60 feeder systems at the Laboratory that provide cost information to the Financial Management Information System (FMIS) and ultimately to the annual statement the University submits to the Department as an account of costs incurred for the year. However, the University has not established a process to periodically reconcile costs generated by these systems to FMIS. We attempted to reconcile the costs generated by both the payroll system and the travel disbursement systems. We were able to reconcile the payroll system to within $1.4 million of payroll costs in FMIS (0.08 percent of total payroll costs) and the travel disbursements system to within $2.3 million of costs in FMIS (2.31 percent of total travel costs). University officials told us that a complete reconciliation could be completed, but only with great difficulty. As a result of these inconsistencies, costs claimed by the University could be misstated and the universe of costs subjected to audit could be incomplete.

Payroll and Travel Approval Processes

The University established controls over travel reimbursements and time and attendance at the Laboratory that allowed payments to be made based upon electronic signatures of administrative staff or, in some cases, subcontractor support staff.

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The written policy for approvals stated that travel claims and payroll time sheets required supervisory approval -- Deputy Group Leader and above – using either online electronic signature or hardcopy signature prior to paying travel claims and salaries. In cases where supervisors manually approved these payments, the University allowed them to delegate electronic approval of the costs to administrative staff. We found that supervisors made only 15 of the 120 electronic approvals that we checked. Although in some instances we were able to verify that hardcopy signatures did exist, our primary concern was that the Business Operations Division made payments based exclusively on the electronic signatures. Thus, these payments were made without any process, test-basis or otherwise, for verification of supervisory approvals.

Financial Management Personnel Turnover

During our audit we noted that there had been substantial turnover in Laboratory personnel responsible for financial management activities. As of March 2003, 43

percent of the managers (Team Leader and above) in the Business Operations Division had less than one year of experience in their current positions at the Laboratory. In particular, Accounting, a sub-component of this division, had been severely affected. Five of seven managers (71 percent) had less than one year of experience in their current positions at the Laboratory. While we recognize the challenge of retaining qualified personnel, the fact is that excessive turnover left a void in the Accounting Department's ability to fully understand and execute the interfaces and capabilities of the Laboratory's financial management systems. To clarify, we did not review, nor are we questioning, the professional credentials and core qualifications of the financial management personnel. Rather, our concern is position-specific experiences of personnel in the Business Operations Division.

Financial System Review and Approval

We also found that the University did not obtain Departmental approval for its existing financial system or approval for a new financial system currently under development. These systems typically consist of the organization, processes, and computer applications for accounting, purchasing, and property management. The contract requires Departmental review and approval of the financial systems, the purchasing systems,

and the property systems. The contract also requires Departmental approval of plans for new systems or major enhancements to existing systems. We found that both the property and purchasing systems were subject to review and approved by the Department on a regular basis. In addition, all the systems were subject to an annual self-assessment by the University and a Business Management Oversight Review by the Department. However, we found no evidence that the Department approved the Laboratory's financial systems. Furthermore, we noted that the University initiated an overhaul of its financial system that is expected to take 5 years at a cost of $70 million. As with the existing system, the new initiative had not been approved by the Department.

As a result of the control weaknesses identified in this report, the Department has, in our judgment, less than adequate assurance that costs claimed by the University for operation of the Laboratory are allowable under the contract. Absent a strong control structure, a definitive assessment of allowability of costs cannot be made. Based on the record we developed, in our judgment, business operations at the Laboratory have not been given adequate emphasis. As a result, the caliber of business operations is simply inadequate given the nature and size of operations at Los Alamos and the requirements of the University's contract with the Department of Energy.

To address the issues discussed above, we recommend that the Administrator of the National Nuclear Security Administration:

1. Direct that a determination of allowability be made on the $14,599,874 in questioned costs identified in this report, in accordance with the provisions of contract clause I.100 for costs determined to be unallowable, and recover costs and penalties as appropriate.

2. Require the University to either develop and implement a policy for meals that makes them expressly unallowable, or establish a contractually binding arrangement with the Department that recognizes meal costs allowability in very narrowly defined scenarios consistent with current regulatory guidance.

3. Require the University to:

    - Obtain prior approval and provide adequate justification for exceeding lodging and meal rates established by the GSA and require travelers to provide receipts for all costs over $75 prior to providing final reimbursement;

Diminished Assurance

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b. Amend current approval policies to allow only Group Leaders or above to approve payroll and travel costs, and eliminate from all financial systems the capability to delegate electronic approvals below the Group Leader Level; and,

c. Conduct yearend reconciliations of costs from feeder systems to the FMIS.

4. Require the University to re-align its audit function to:
a. Report directly to the University of California or be overseen by an audit committee consisting of members independent of Laboratory management;
b. Enhance its audit planning process to reconcile with its existing resources and address the backlog of subcontract audits; and,
c. Establish a follow-up process to ensure that management actions have been effectively implemented in a timely fashion.
5. Take action to review and approve the Laboratory's financial systems.
6. Working in conjunction with the Chief Financial Officer and the Chief Information Officer, establish the University's project to overhaul the financial systems as a line item project.

MANAGEMENT REACTION

Management generally agreed with the recommendations and indicated that corrective actions had been taken or were planned. Management's comments are included as Appendix 3. Management also provided technical comments from NNSA and the Laboratory. These comments are addressed in the report as appropriate. In its official comments, management specifically recognized actions already taken by the University and new Laboratory management to strengthen the Laboratory's control environment and business practices as a result of this and prior reviews. They applauded the University's commitment to the formal improvement plan that had been instituted, specifically citing among other initiatives, the University Auditor assuming management of the Laboratory's audit function.

NNSA's plan to monitor corrective actions established how each recommendation would be managed. In this plan, with one exception, NNSA agreed to take the recommended actions or review the need to take action on each of our recommendations. The one exception related to our recommendation to require the University to obtain prior approval and provide adequate justification for exceeding lodging and meal rates established by the GSA. NNSA asserted that systems and documentation were in place.

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Subsequent to our review, we were informed that supporting documentation related to some of the questioned costs existed that was not available during our review.

AUDITOR COMMENTS

Management's comments were generally responsive to our recommendations.

With respect to our recommendation on approval and justification for exceeding lodging and meal rates established by the GSA, we believe that adequate systems and documentation were not in place. For the costs questioned in our sample, documentation of rationale for exceeding appropriate limits was not included in the travel claim and was not provided from other sources during our review. We did not question costs in excess of the limits that included a justification or explanation consistent with exceptions provided for in the FTR. We recognize that there are situations where it is acceptable to exceed the GSA limits but believe that the rationale should be documented in the travel claim.

While subsequently located documentation related to the costs questioned in this report can be utilized by the Department in determining allowability of specific items, it should be noted that the lack of availability of required documentation at the time of the review indicated a breakdown in internal controls that allowed the payment of these questioned costs without the appropriate supporting documentation. At the time of our review the required receipts or justifications for the costs we questioned were not

included in the payment file, nor was the Laboratory able to produce them from other sources during the 2 months of our review. While these costs may ultimately be deemed allowable, the underlying control problems need to be addressed.

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Appendix 1

OBJECTIVE

The objective of this audit was to determine whether the University of California has established 1) an adequate system of internal controls at Los Alamos National Laboratory to ensure that costs reimbursed under the contract are allowable; 2) an internal audit function that is operating effectively; and, 3) critical management systems that are approved, maintained, and updated in accordance with contractual requirements.

SCOPE

The audit was performed from January to March 2003 at the Los Alamos National Laboratory in Los Alamos, New Mexico. The scope of the audit included a review of expenditures for Fiscal Year 2000 through Fiscal Year 2002. Our scope excluded costs related to Johnson Controls of Northern New Mexico that totaled $410,784,452 during our review period.

METHODOLOGY

To accomplish the audit objective, we:
• Researched applicable laws, regulations, contract terms, policies, procedures, and guidance relevant to the University and the Laboratory;
• Interviewed the Albuquerque and Los Alamos Office contracting officers and other personnel responsible for monitoring accounting for allowable costs;
• Interviewed management and personnel from various Laboratory departments;
• Reviewed the University's internal controls over allowability of costs;
• Reconciled the University's expenses from FMIS to the amounts reported on the annual Statements of Costs Incurred and Claimed;
• Selected random samples of Travel, Meals and Conferences, Subcontracts, Payroll, and miscellaneous other expenses from FMIS and tested these transactions for cost allowability. We also selected and tested additional transactions on a judgmental basis. We evaluated these transactions statistically and nonstatistically and, as appropriate, projected these results to the relevant populations;

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Appendix 1 (continued)

• Evaluated the Laboratory's audit function for independence, planning, audit finding follow-up, and subcontract auditing;
• Evaluated the University's major accounting systems for contract compliance; and,
• Tested the University's compliance with various contractual cost ceilings.

The audit was performed in accordance with generally accepted Government auditing standards for performance audits. It included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objective. Because our audit was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. In performing this audit, we assessed the accuracy of data generated from the Laboratory's data-processing system.

An exit conference was held with NNSA and Laboratory Officials on April 10, 2003.

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Appendix 2

PRIOR REPORTS

• *External Review of The Purchase Card Program, Report of Findings, Los Alamos National Laboratory,* (Price Waterhouse Coopers Review, December 12, 2002). The Report concluded that internal control weaknesses existed in the program, which left the Laboratory vulnerable to fraud and abuse. Examples include failure to reconcile and approve monthly statements, failure to resolve disputed transactions, and purchase of restricted items in violation of Laboratory policies.

• *Internal Audit Report, Audit of the Procurement Purchase Card Program*, (IA-98-02, October 31, 1997). According to the report, the cardholders and approving officials did not always follow policies, procedures, and internal controls for the Purchase Card Program. As a result, managers do not have reasonable assurance that policies, procedures, and controls were adequate to ensure purchases were properly authorized and accurately charged, received, and reported.

• *Assessment of Changes to the Internal Control Structure and their Impact on the Allowability of Costs Claimed by and Reimbursed to Los Alamos National Laboratory Under Department of Energy Contract No. W-7405-ENG-3*, (WR-V-02-07, September 2002). Los Alamos provided meals on site without documentation showing participation

in the meals by individuals other than Laboratory employees. Los Alamos incurred the questioned costs for catered on-site meals because meals could be ordered from the Laboratory's cafeteria without evidence of non-lab participation and without an Associate Director's approval. In addition, Los Alamos reimbursed travel costs in excess of the Federal Travel Regulations (FTR) per diem rates. It was noted that employees incurred, and were reimbursed, excess lodging and M&IE costs.

• *Special Inquiry on "Operations at Los Alamos National Laboratory,"* (DOE/OIG-0584, January 28, 2003). The report noted a series of actions by Laboratory officials that had the effect of obscuring serious property and procurement management problems and weakened or overrode relevant internal controls. These actions created an atmosphere in which Los Alamos employees were discouraged from, or had reason to believe they were discouraged from, raising concerns to appropriate authorities. In short, management's actions – whether intended as a cover-up or not – resulted in delayed identification and resolution of the underlying property and procurement weaknesses and related security concerns.

• *FY 2002 Business Management Oversight Process Report.* The report summarizes the business and administrative performance of the University of California, Los Alamos National Laboratory, for FY 2002. The functional areas assessed had the following scores: personal property management - excellent, financial management - excellent, human resources management - outstanding, procurement management – outstanding, and information management - outstanding.

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Appendix 3

U. S. DEPARTMENT OF ENERGY
Washington, DC 20585
April 8, 2003

MEMORANDUM FOR William S. Maharay
Assistant Inspector General
for Audit Services

FROM: Anthony R. Lane /S/

Associate Administrator
for Management and Administration

SUBJECT: Comments to IG's LANL Cost Claimed Draft Report

Acknowledging that NNSA requested the Inspector General (IG) to perform an audit of costs incurred by Los Alamos, we appreciate the opportunity to have reviewed the draft report. The report, "University of California's Costs Claimed and Related Internal Controls for Operation of Los Alamos National Laboratory," questions the allowability of about $14.6 million incurred during the Fiscal Year 2000 - 2002-period. Therefore, NNSA will conduct a review of the allowability of these costs for the Los Alamos Site Manager, as the Contract Administrator/Contracting Officer, to make a determination of allowability or unallowability. (Unallowable costs are not paid by the Government.)

It is important to note in the report the progress that has been achieved by the University of California, Office of the President and the new Laboratory management. Both the University and the Laboratory have taken positive steps to strengthen the Laboratory's control environment and business practices. We applaud the University's commitment to the formal improvement plan that they instituted. The concerns identified in the draft audit report are among the issues the University has recognized and taken action on. As a result, a number of actions that are recommended in this report are already accomplished and/or are the subject of ongoing efforts that are supported by sustainable processes. As does the IG and NNSA, the University recognizes the need for a strong Internal Audit function. In early 2003, the University Auditor was asked to assume the management of the Laboratory's Internal Audit function. Since that time, the University Auditor has led a comprehensive initiative designed to revitalize the Internal Audit function providing assurance to NNSA, the University Regents, and management that the Internal Audit function meets the highest professional standards for independence and performance through a risk-based audit program that provides comprehensive audit coverage, timely and thorough investigations of all allegations of wrongdoing, and assistance to management on internal control improvement initiatives. We have provided a copy of a letter, dated April 3, 2003, from the Laboratory that provides technical comments to the draft report. Additionally, we have attached the NNSA management comments to the recommendations. This attachment lays out our plan to monitor corrective actions.

Appendix 3 (continued)

Should you have any questions regarding our response, please contact Richard Speidel, Director for Policy and Internal Controls Management at 202-586-5009.

Attachments

cc: Tyler Przybylek, General Counsel

and Acting Chief Operating Officer, NA-2.1
Ralph Erickson, Manager, Los Alamos Site Office
David Marks, Director, Field Financial Management, SvcCen/NV
Robert Braden, Senior Procurement Executive, NA-63

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IG Report No.: DOE/IG-0596

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2. What additional information related to findings and recommendations could have been included in this report to assist management in implementing corrective actions?

3. What format, stylistic, or organizational changes might have made this report's overall message more clear to the reader?

4. What additional actions could the Office of Inspector General have taken on the issues discussed in this report which would have been helpful?

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Tab 3

University of California
Los Alamos National Laboratory

Compliance and Operational Analysis
LANL Payroll Processes and Internal Controls

April 15, 2003

ERNST & YOUNG LLP

April 15, 2003

Ms. Anne C. Broome
Vice President-Financial Management
University of California
1111 Franklin Street
Oakland, California 94607-5200

Subject: Report of Compliance and Operational Analysis re: Payroll Processes and Internal Controls

Dear Ms. Broome:

Ernst & Young (E&Y) has completed a compliance and operational analysis of the Los Alamos National Laboratory (LANL) Payroll processes and internal controls, and our Report is attached. This report is intended solely for the information and use of the University of California Management.

Implementation of the recommendations contained in the attached Report will provide for an enhanced control environment for the payroll processes. We recommend periodic follow-up to determine accomplishment of the recommended actions.

We appreciate the cooperation and assistance provided to us during the course of our work. If you have any questions, please contact Mr. Brian F. Simmons at 214.969.8629.

Sincerely,

Brian F. Simmons
Central Region Director
Government Contract Services

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I. Overview

The University of California, Vice President - Financial Management retained Ernst & Young LLP (E&Y) to conduct an independent compliance and operational analysis of the Los Alamos National Laboratory (LANL) Payroll processes and internal controls.

In accordance with E&Y's Engagement Letter dated February 4, 2003, E&Y is pleased to provide the results of E&Y's analysis of LANL's payroll processes and internal controls. The E&Y report is comprised of three (3) parts: (I) an Overview/Background, (II) Procedures Performed, and (III) Observations and Recommendations.

The E&Y services were performed in accordance with the Statement on Standards for Consulting Services (CS100) of the American Institute of Certified Public Accountants (AICPA) as stated in the Engagement Letter. The Standards for Consulting Services (CS100) do not result in issuance of an opinion and does not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards, the objective of which is the expression of an opinion on the elements, accounts, or items of a financial statement. As a result, E&Y does not express an opinion on LANL's payroll processes and internal controls. The procedures performed by E&Y did not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards.

A. Background

The University of California is the designated operating contractor under a prime contract (W-7405-ENG-36) awarded by the Department of Energy (DOE) for operation of the LANL. A description of the overall duties of the operating contractor is contained in Paragraph C.001 of Modification Number M552, entitled Statement of Work. Paragraph I.096 of the aforementioned contract modification requires that:

> "The contractor shall maintain and administer a financial management system that is suitable to provide proper accounting in accordance with DOE requirements for assets, liabilities, collections accruing to the Contractor in connection with the work under this contract, expenditures, costs, and encumbrances; permits the preparation of accounts and accurate, reliable financial and statistical reports; and assures that accountability for the assets can be maintained."

The governing regulations for the operating contract are the Department of Energy Acquisition Regulation (DEAR). The DEAR implements and supplements the Federal Acquisition Regulation (FAR).

To fulfill LANL's financial management responsibility, LANL utilizes two handbooks: (1) The DOE Accounting Handbook and (2) an internally developed LANL Financial Management Handbook based, in large part, on the DOE Accounting Handbook. The DOE Accounting Handbook presents the DOE's standards, procedures, and operational requirements in support of accounting policies, principles, and applicable legal requirements for DOE operations. The LANL Financial Management Handbook describes the principle accounting, planning, and reporting requirements. The LANL Financial Management Handbook consists of six major topics: "Indirect Budget", "Data Warehouse", "Time & Effort", "Accounting", "Formal Budgeting", and "Related Resources."

Accounting policies that supplement the guidance contained in the Financial Management Handbook are contained in LANL's Accounting Resource Manual. LANL accounting policies are implemented by specific desk procedures.

The E&Y analysis of the payroll processes and internal controls focused on specific accounting functions that are performed in LANL's accounting organization (BUS-1). The Accounting organization consists of approximately 100 employees. The Accounting organization is further subdivided into smaller functional units: Travel, Accounts Payable and Contract Accounting, General Accounting and Work for Others (WFO), Property Accounting, Payroll, and support related functions.

The Payroll staff of 13 employees is responsible for processing wage and salary payments for LANL employees and affiliates (non-employee). Payments for Personal Service Agreements are processed through Accounts Payable.

As of January 2003, LANL headcount totaled 8,586 employees, 3,485 contractors, 939 consultants, 1,368 students, and 271 special program guests. Employee time and attendance (T/E) is processed through the regular bi-weekly payroll; non-employee T/E is processed through the affiliate payroll system. Employee payroll costs were $697.1 million in Calendar Year (CY) 2002 (affiliate payroll costs were $6 million in the calendar year). Approximately 96 percent of employees and affiliates pay is electronically direct deposit and the remaining 4 percent being distributed in-house.

DOE's Financial Stewardship Objective (from the DOE Financial Stewardship Model) for payroll is that: "All employees are properly and promptly paid in accordance with wage contracts for services actually performed and approved for appropriate charge numbers in a timely and cost efficient manner with adequate safeguarding of personnel records."

B. Summary of Observations

As a result of our analysis, we identified three observations related to the strengthening of payroll processes and internal controls. These observations related to uncompensated overtime, timekeeping awareness training, and timesheet approval.

II. Procedures Performed

A. Scope of Analysis

The scope of compliance and operational analysis of payroll processes and internal controls included the following:

- Understand the process for LANL's payroll activities.
- Assess written policies, procedures, and internal controls related to payroll functions for compliance with DOE and contract requirements.
- Perform interviews of key personnel.
- Analyze and understand the results of prior reviews on policies, procedures, systems, and practices.
- Sample selected transactions to determine if actual practices are in compliance with written policies, procedures, contractual, and DOE requirements.

B. Objectives of Analysis

The objectives of the payroll processes and internal controls were to:

- Document LANL's key internal controls including LANL's stated policies, procedures, systems, and forms.
- Analyze the consistency of application and adequacy of LANL's policies, procedures, systems, and forms to assess compliance with applicable contractual provisions.
- Determine whether sampled items, in accordance with relevant contract and operational requirements, were properly reviewed, approved, and appeared appropriate in the circumstances.

III. Observations and Recommendations

Based upon the procedures performed, we identified three (3) items/control enhancement opportunities in the Payroll internal control processes. Management should address the

control opportunities identified from our procedures to further strengthen internal controls in the Payroll processes. In our view, the observations and recommendations are presented in order of their importance. The items identified and the recommendations resulting from our procedures follow:

A. Payroll Process Observations

1. Uncompensated Overtime

a. Observation

Current LANL practice is that overtime is not recorded or allocated to projects worked by exempt employees charging labor direct. Therefore, if a direct salary exempt employee is working on multiple projects (charge codes) during the period that significant uncompensated overtime is worked, the actual distribution of labor costs may not be allocated to the projects worked. We noted that Group Leader Survey Data commented on a perceived high level of uncompensated overtime worked by exempt employees.

b. Recommendation

LANL should perform a study to determine whether or not the level of unrecorded overtime is significant. If the level of unrecorded overtime is significant, procedures should be instituted to provide for proper accumulation of time and allocation of associated costs for exempt employees considering all hours worked. If the level of unrecorded overtime is not significant, no further action would be warranted by LANL.

2. Timekeeping Awareness Training

a. Observation

LANL does not require periodic timekeeping awareness training to reinforce the importance of accurate, timely submission, and approval of timekeeping.

b. Recommendation

LANL should institute periodic timekeeping awareness training. The timekeeping training should reinforce the importance of accurate, timely submission, and approval of timekeeping for all employees and affiliates and each individual's responsibility.

3. Timesheet Approval

a. Observation

The Financial Management Handbook allows timekeepers to enter and approve employee time in the electronic system. When timekeepers enter and approve an employee's time, managers still maintain approval authority and are required to manually approve hard-copy printouts of the timesheets. Payroll can be processed with or without the manual signature. The E&Y procedures identified 11 out of 15 managers who manually approved time for 60 T/E printouts with the remaining 4 managers electronically approving the time. Of the 60 T/E printouts analyzed, 23 documented a manager's signature after the payroll process had begun and one T/E printout displayed a non-manager's signature. Of these 23 items, 5 were approved as of the date of our request for the records.

b. Recommendation

To enhance compliance with the approval requirement, we suggest that all timesheets be approved electronically. This should increase reliability of the timekeeping system approval process and reduce cost.

Tab 4

University of California
Los Alamos National Laboratory

Compliance and Operational Analysis
LANL Cash Receipts and Work for Others Processes and Internal Controls

April 15, 2003

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April 15, 2003

Ms. Anne C. Broome
Vice President-Financial Management
University of California
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Oakland, California 94607-5200

Subject: Report of Compliance and Operational Analysis re: Cash Receipts and Work for Others (WFO) Processes and Internal Controls

Dear Ms. Broome:

Ernst & Young (E&Y) has completed a compliance and operational analysis of the Los Alamos National Laboratory (LANL) cash receipts and WFO processes and internal controls, and our Report is attached. This report is intended solely for the information and use of the University of California Management.

Implementation of the recommendations contained in the attached Report will provide for an enhanced control environment for the cash receipts and WFO processes. We recommend periodic follow-up to determine accomplishment of the recommended actions.

We appreciate the cooperation and assistance provided to us during the course of our work. If you have any questions, please contact Mr. Brian F. Simmons at 214.969.8629.

Sincerely,

Brian F. Simmons
Central Region Director
Government Contract Services

Ernst & Young LLP is a member of Ernst & Young International, Ltd.

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I. Overview

The University of California, Vice President - Financial Management retained Ernst & Young LLP (E&Y) to conduct an independent compliance and operational analysis of the Los Alamos National Laboratory (LANL) Cash Receipts and Work for Others (WFO) processes and internal controls.

In accordance with E&Y's Engagement Letter dated February 4, 2003, E&Y is pleased to provide the results of E&Y's analysis of LANL's cash receipts and WFO processes and internal controls. The E&Y report is comprised of three (3) parts: (I) an Overview/Background, (II) Procedures Performed, and (III) Observations and Recommendations.

The E&Y services were performed in accordance with the Statement on Standards for Consulting Services (CS100) of the American Institute of Certified Public Accountants (AICPA) as stated in the Engagement Letter. The Standards for Consulting Services (CS100) do not result in issuance of an opinion and does not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards, the objective of which is the expression of an opinion on the elements, accounts, or items of a financial statement. As a result, E&Y does not express an opinion on LANL's cash receipts and WFO processes and internal controls. The procedures performed by E&Y did not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards.

A. Background

The University of California is the designated operating contractor under a prime contract (W-7405-ENG-36) awarded by the Department of Energy (DOE) for operation of the LANL. A description of the overall duties of the operating contractor is contained in Paragraph C.001 of Modification Number M552, entitled Statement of Work. Paragraph I.096 of the aforementioned contract modification requires that:

> "The contractor shall maintain and administer a financial management system that is suitable to provide proper accounting in accordance with DOE requirements for assets, liabilities, collections accruing to the Contractor in connection with the work under this contract, expenditures, costs, and encumbrances; permits the preparation of accounts and accurate, reliable financial and statistical reports; and assures that accountability for the assets can be maintained."

The governing regulations for the operating contract are the Department of Energy Acquisition Regulation (DEAR). The DEAR implements and supplements the Federal Acquisition Regulation (FAR).

To fulfill LANL's financial management responsibility, LANL utilizes two handbooks: (1) The DOE Accounting Handbook and (2) an internally developed LANL Financial Management Handbook based, in large part, on the DOE Accounting Handbook. The DOE Accounting Handbook presents the DOE's standards, procedures, and operational requirements in support of accounting policies, principles, and applicable legal requirements for DOE operations. The LANL Financial Management Handbook describes the principle accounting, planning, and reporting requirements. The LANL Financial Management Handbook consists of six major topics: "Indirect Budget", "Data Warehouse", "Time & Effort", "Accounting", "Formal Budgeting", and "Related Resources."

Accounting policies that supplement the guidance contained in the Financial Management Handbook are contained in LANL's Accounting Resource Manual. LANL accounting policies are implemented by specific desk procedures.

The E&Y analysis of Cash Receipts and WFO functions focused on specific accounting functions that are performed in LANL's Accounting organization (BUS-1). The Accounting organization consists of approximately 100 employees. The Accounting organization is further subdivided into smaller functional units: Travel, Accounts Payable and Contract Accounting, General Accounting and WFO, Property Accounting, Payroll, and support related functions. The General Accounting and WFO function consists of approximately 13 employees. Cash receipts and WFO is an activity performed in the General Accounting unit.

All WFO projects are performed on a reimbursable basis for three types of customers: for FY 2002, total WFO billings amounted to $246.5 million. The three types of customers, with respective billing amounts, were: Other Federal Agencies ($149.5 million), Non-Federal Agencies ($3.0 million), and Integrated Contractors ($94.0 million).

Three general types of transactions flow through the WFO process: (1) Cash Advances received for LANL work to be performed for integrated contractors, (2) direct billings to integrated contractors and Non-Federal Agencies for work performed by LANL, and (3) transfers in and out. For the last fiscal year, the approximate dollar volume of transactions flowing through the WFO function was: Cash Advances from integrated contractors ($703,000), Direct Billings ($5.9 million) and Transfers ($239.9 million). Cash Advances and Direct Billings result in cash receipts; transfers do not involve cash receipts.

Work For Others
FY 2002 Billings

	Total Billings (Millions)	Other Federal Agencies (Millions)	Non Federal Agencies (Millions)	Integrated Contractors (Millions)
Transfers	$239.90	$149.50		$90.40
Cash Advances	0.70			0.70
Direct Billings	5.90		$3.00	2.90
Total	$246.50	$149.50	$3.00	$94.00

In addition to the WFO function, the following functions process cash receipts: Travel, Payroll, Accounts Payable, and General Accounting.

B. Summary of Observations

As a result of our analysis, we identified nine (9) observations related to the strengthening of cash receipts and WFO processes and internal controls. The observations related to cash receipt control, segregation of duties, aged receivables, completed WFO project funds, monitoring WFO funds, bank account reconciliations, unbilled suspense accounts, WFO agreements and Office of Management and Budgets (OMB) requirements, cash receipts, and WFO desk instructions.

II. Procedures Performed

A. Scope of Analysis

The scope of the compliance and operational analysis of cash receipts and WFO processes and internal controls, included the following:

- Understand LANL's Cash Receipts and WFO processes for achieving compliance with the prime contract and DOE regulations.
- Assess the sections in LANL's Financial Management Handbook that address cash receipts and WFO for achieving compliance with LANL practices, prime contract, and DOE regulations.
- Assess LANL's written policies, procedures, and internal controls, as implemented, related to the cash receipts and WFO functions for compliance with DOE and contract requirements.
- Interviews of key LANL personnel.

- Analyze and understand the results of prior reviews on policies, procedures, systems, and practices.
- Sample selected transactions to determine if actual practices are in compliance with written policies, procedures, contractual, and DOE requirements.
- Assess the adequacy of the applicable EDP general and application controls.

B. Objectives of Analysis

The objectives of the cash receipts and WFO processes and internal control analyses were to:

- Document LANL's key internal controls including LANL's stated policies, procedures, systems, and forms.
- Analyze the consistency of application and adequacy of these policies, procedures, systems, and forms to assure compliance with applicable contractual provisions and DOE regulations.
- Determine whether sampled items, in accordance with relevant contract and operational requirements, were properly reviewed and approved.

III. Observations and Recommendations

Based upon the procedures performed, we identified nine (9) items/control enhancement opportunities in the cash receipts and WFO internal control processes. Management should address the control opportunities identified from our procedures to further strengthen internal controls in the cash receipts and WFO processes. In our view, the observations and recommendations are presented in the order of their importance. The items identified and the recommendations resulting from our procedures follow:

A. Cash Receipts and WFO Observations

1. Cash Receipt Control

a. Observation

LANL does not use an electronic lockbox or a single processing point for handling the receipt of checks. Currently, individuals in Payroll, Travel, Accounts Payable, General Accounting, and WFO receive checks. Receipts are kept in a locked safe pending preparation of the daily deposit transaction. Deposits of non-electronic receipts are generally made on a daily basis. A lockbox or a single central location for receiving all checks would enhance the internal control over cash receipts.

b. Recommendation

LANL should consider either obtaining a lockbox account at a bank or at minimum, centralizing the point of all cash receipts within the General Accounting unit to enhance internal control over cash receipts. Further, E&Y understands that LANL will be preparing a Request for Proposal (RFP) for banking services. E&Y supports this effort by LANL. E&Y further recommends that LANL solicit inputs on the RFP from several "Best in Class" banking institutions to determine whether or not LANL has identified within the RFP all of the optimal LANL banking process requirements.

2. Segregation of Duties

a. Observation

The WFO accountant receives checks, prepares the bank deposit, makes the journal entries to record cash receipts, has the ability to change invoice amounts, and performs the account reconciliation.

b. Recommendation

LANL should separate duties associated with the cash receipt function, including receipt of checks, processing checks for deposit, recording the cash receipt, and performing the reconciliation of the cash accounts to achieve effective internal control.

3. Aged Receivables

a. Observation

Per the LANL policy, collection efforts for WFO should be instituted for receivables that are outstanding for more that 180 days. The amount of aged receivables greater than 180 days is $993,231. Based on discussion with the WFO accountant, there have not been any attempts for collection of delinquent accounts receivable in the WFO area since November of 2002. The following is an aging schedule of the outstanding WFO receivables:

Age	Number of A/R	Total Amount
181-360 Days	13	$344,568
12-24 Months	14	$176,835
24-36 Months	5	$ 14,837
Over 36 Months	40	$396,991
Total	72	$933,231

b. Recommendation

LANL should review delinquent receivables on a regular basis and apply appropriate measures for collections. The aged accounts receivables should be reviewed to determine their collectibility status. WFO receivables over 180 days should be reviewed monthly to determine whether or not the amount should be: (1) reserved, at a minimum, or (2) written off as uncollectible. To implement best practices, LANL should consider changing the policy on collection efforts from 180 days to no greater than 90 days to more effectively manage the WFO Accounts Receivable function.

4. Completed WFO Project Funds

a. Observation

E&Y identified instances in which LANL has not returned/de-obligated funding associated with WFO completed projects. The following are four examples:

Sponsor	Effective Date	Completion Date	Funding Status (amount to be de-obligated)
Bechtel B&W	April 5, 2000	July 30, 2000	$ 2,073
Lawrence Livermore National Laboratory	Nov. 1, 1998	April 15, 1999	$11,078
Savannah River Operations	Sept. 20, 1996	Sept. 30, 1998	$22,584
Richland Operations Office	Sept. 6, 2001	Sept. 30, 2001	$ 4,906

We found no policies or procedures addressing this area.

b. Recommendation

LANL management should, with appropriate considerations for significance, develop procedures to de-obligate and/or return funds associated with completed WFO projects, but not used.

5. Monitoring WFO Funds

a. Observation

Currently, the budget analysts manually query the system to monitor the obligations against WFO agreement funding levels. This occurs three times a week. There are 565 active program codes associated with active WFO agreements. Once the obligations reach 99 percent or within $2,000 of the total funding ceiling, the budget analyst enters the system to suspend the program codes and prevent fund over-obligation.

b. Recommendation

LANL should consider developing a system generated warning report that would be sent to the responsible Budget Analyst informing the Budget Analyst that a WFO work order is approaching the 75 percent obligation threshold. To prevent over funding, LANL should consider lowering the 99 percent of the obligation threshold in order to provide sufficient time to take required action(s).

6. Bank Account Reconciliations

a. Observation

LANL has an established Bank Reconciliation Policy and associated Desk Instructions for Bank Reconciliations that require bank accounts to be reconciled to the associated General Ledger accounts on a monthly basis. However, General Accounting does not have a standard procedure for crediting items aged over 180 days. Based on a query of outstanding checks as of January 31, 2003, there were a total of 2,325 outstanding checks through September 30, 2002. Of the 2,325 outstanding checks, 213 unclaimed checks were greater than $1,000. The 213 unclaimed checks that were greater than $1,000 accounted for $717,541 of the $1,346,690 unclaimed checks. General Accounting has not determined whether these checks have been voided and new checks have been rewritten.

	Number of Outstanding Checks	Total Value of Outstanding Checks	Number of Checks > $1000	Value of Checks Exceeding $1,000
A/P	758	$ 750,338	85	$ 455,508
Payroll	194	$ 103,014	21	$ 59,383
Travel	1373	$ 493,338	107	$ 202,650
TOTAL	2325	$ 1,346,690	213	$ 717,541

b. Recommendation

General Accounting management should establish a practice to research outstanding checks greater than 180 days and develop a practice for crediting the amounts back, where possible, to the appropriate account(s) that were initially charged for the check amount.

7. Unbilled Suspense Accounts

a. Observation

LANL maintains suspense accounts for "Unbilled-Federal" (acct. 11420) and "Unbilled Reimbursable Programs" (acct. 11560). Charges for programs that have overrun their funding flow into these suspense accounts. Balances in certain program codes (OPIs) date back to 1996. The net account balances of the 11420 and 11560 accounts at the end of the 2002 fiscal year were $278,154 and $9,574 respectively.

b. Recommendation

LANL management should research the balances in the suspense accounts to determine collectability. Uncollectable items should be written off, as appropriate.

8. WFO Agreements and OMB Requirements

a. Observation

The OMB Memo, subject: "Business Rules for Intragovernmental Transactions" dated October 4, 2002 mandates that certain data elements be included in intragovernmental orders. Currently, the WFO agreements do not include:

- Electronic signatures on the agreements.
- Payment terms.

- E-mail address for the point of contact.
- Appropriation codes are not evident.

b. Recommendation

Incorporate the OMB requirements into LANL's procedures so that the OMB requirements are included in the WFO agreements.

9. Cash Receipts and WFO Desk Instructions

a. Observation

Cash receipts and WFO desk instructions need to be reviewed and updated, as appropriate. For example, desk instruction for cash receipts and WFO are not available on either the Accounting homepage or through a shared drive. The existing procedures do not contain such elements as: author, approver, origination date, approval date, and date of last revision.

b. Recommendation

LANL desk instructions should be incorporated online as a living document. The instructions should contain necessary date and authorship elements.

Tab 5

University of California
Los Alamos National Laboratory

Compliance and Operational Analysis
LANL Information Technologies General and Selected Application Processes and Internal Controls

April 15, 2003

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April 15, 2003

Ms. Anne C. Broome
Vice President-Financial Management
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1111 Franklin Street
Oakland, California 94607-5200

Subject: Report of Compliance and Operational Analysis re: Information Technologies General and Selected Application Processes and Internal Controls

Dear Ms. Broome:

Ernst & Young (E&Y) has completed a compliance and operational analysis of the Los Alamos National Laboratory (LANL) Information Technologies General and Selected Application processes and internal controls, and our Report is attached. This report is intended solely for the information and use of the University of California Management.

Implementation of the recommendations contained in the attached Report will provide for an enhanced control environment for the information technologies general and selected application processes. We recommend periodic follow-up to determine the accomplishment of the recommended actions.

We appreciate the cooperation and assistance provided to us during the course of our work. If you have any questions, please contact Mr. Brian Simmons at 214.969.8629.

Sincerely,

Brian F. Simmons
Central Region Director
Government Contract Services

Ernst & Young LLP is a member of Ernst & Young International, Ltd.

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I. Overview

The University of California, Vice President - Financial Management retained Ernst & Young LLP (E&Y) to conduct an independent compliance and operational analysis of the Los Alamos National Laboratory (LANL) Information Technologies General and Selected Application processes and internal controls.

In accordance with E&Y's Engagement Letter dated February 4, 2003, E&Y is pleased to provide the results of E&Y's analysis of LANL's information technologies general and selected application processes and internal controls. The E&Y report is comprised of three (3) parts: (I) Overview/Background, (II) Procedures Performed, and (III) Observations and Recommendations.

The E&Y services were performed in accordance with the Statement on Standards for Consulting Services (CS100) of the American Institute of Certified Public Accountants ("AICPA") as stated in the Engagement Letter. The Standards for Consulting Services (CS100) do not result in issuance of an opinion and do not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards, the objective of which is the expression of an opinion on the elements, accounts, or items of a financial statement. As a result, E&Y does not express an opinion on LANL's Compliance and Operational Analysis of LANL Information Technologies General and Application Controls. The procedures performed by E&Y did not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards.

A. Background

The University of California is the designated operating contractor under a prime contract (W-7405-ENG-36) awarded by the Department of Energy ("DOE") for operation of the LANL. A description of the overall duties of the operating contractor is contained in Paragraph C.001 of Modification Number M552, entitled Statement of Work. Paragraph I.096 of the aforementioned contract modification requires that:

> "The contractor shall maintain and administer a financial management system that is suitable to provide proper accounting in accordance with DOE requirements for assets, liabilities, collections accruing to the Contractor in connection with the work under this contract, expenditures, costs, and encumbrances; permits the preparation of accounts and accurate, reliable financial and statistical reports; and assures that accountability for the assets can be maintained."

The governing regulations for the operating contract are the Department of Energy Acquisition Regulation Supplement ("DEARS"). The DEARS implements and supplements the Federal Acquisition Regulation ("FAR").

The management of information systems ("IS") and technology functions are currently performed by separate departments/divisions within LANL. Information systems and related functions, such as application maintenance, are performed by the Information Management Group ("IM"). The Business Unit Services Group ("BUS") performs user administration functions and can assign authorities and responsibilities to the various programs and applications used by LANL. The Computing Communication Networking Group ("CCN") performs infrastructure and networking functions for LANL's network and communication systems.

The LANL utilizes a variety of computing platforms including International Business Machine ("IBM") Mainframe ("MVS"), IBM AIX UNIX ("AIX"), Digital Equipment Corporation ("DEC") VAX/VMS ("VAX/VMS"), and Microsoft Windows 2000 ("Windows 2000"). Several financial applications run on them. Some of these were developed in-house and some were purchased and customized. Below is a partial list financial applications we observed in conjunction with our analysis.

Business Process	Related System Application
General Ledger, Funding, and Budgeting	Financial Management Information System ("FMIS")
Forecasting	Resource Management Planning ("RPM")
Payroll	Payroll
Time and Effort Logging	Time and Effort ("T&E")
Property Management	Sunflower and IFS
Accounts Payable	PAID
Cash Reconciliation	Bank Reconciliation

LANL is in the process of implementing Oracle Financials ("Oracle"). It is anticipated that Oracle will replace the majority of the applications listed above.

B. Summary of Observations

As a result of our analysis, we identified thirty (30) observations related to the information technologies general control processes area and four (4) observations related to selected applications control processes. The observations in the information technologies general area related to (1) the Information Systems (IS) organization, (2) computer operations, (3) user access administration, (4) application change management, (5) logical security and, (6) policies and procedures. In the selected application area, our observations all related to selected application processes and controls.

II. Procedures Performed

A. Scope of Analysis

The scope of the compliance and operational analysis of Information Systems general and selected application processes and internal controls included the following for the applications listed above:

- Assess certain policies and procedures and the internal controls related to the maintenance and administration of LANL's operating systems and applications.
- Perform interviews of key personnel.
- Understand the processes for application/system changes and user access administration.
- Understand logical and physical security for the MVS, AIX, VAX/VMS, and Windows 2000 operating systems.
- Understand key application and interface controls in place.
- Understand backup and storage, disaster recovery and production control procedures.
- Sample selected program changes and user authorities to determine if actual practices are in compliance with LANL's policies and procedures, contract, and DOE requirements.

B. Objectives of Analysis

The objectives of the Information System processes and internal controls were to perform the following for the applications listed above:

- Become familiar with LANL's policies and procedures over the information system processes.

- Analyze the controls over the application change process to determine whether or not changes are approved, tested, and that proper segregation of duties is in place.
- Analyze the controls over the user access administration to determine whether or not employees are only granted the responsibilities needed to perform their duties.
- Analyze logical and physical security controls that restrict access and provide security over critical data and system configurations, as well as backup, recovery, and disaster recovery.
- Analyze selected controls to determine whether or not the integrity of data, application controls, batch procedures, and data entry are in place.

III. Observations and Recommendations

Based upon the procedures performed, we found thirty (30) items and/or enhancement opportunities in internal controls at LANL for Information Management general control processes and four (4) items related to application controls for the various business processes analyzed. Management should address the control opportunities identified from our procedures to further strengthen internal controls in the Information Management processes. In our view, the observations and recommendations are presented in the order of their importance. Our items and recommendations resulting from our procedures follow:

A. Information Technologies General Observations

1. **Information Systems (IS) Organization** – Proper organization of the various IS departments, Information Management ("IM"), Business Unit Services Group ("BUS") and Computing Communication Networking Group ("CCN"), is essential to reducing inefficiencies within business processes and promoting strong communication between the various information systems groups. We noted the following items related to the organization of the IS departments and functions.

a. Oracle Financials

(1) Observation

LANL is in the process of implementing Oracle Financials for several business processes. The Oracle implementation is expected to replace several old technologies at LANL. Additionally, LANL anticipates undergoing some process reengineering as part of the implementation. However, there is minimal focus on the

reengineering of business process controls and security. In light of the current risk environment at LANL and the number of items E&Y has noted within LANL's business processes, in our view, there is an increased amount of risk associated with the Oracle implementation project.

Oracle is a highly integrated Enterprise Resource Planning ("ERP") system. As such, a "processing error" or "bad data" is propagated throughout the system on a near real-time basis. Should broken or ineffective business processes be migrated to Oracle, LANL could spend a considerable amount of money and time reworking transactions and trying to improve the integrity of the system and the underlying data.

(2) Recommendation

LANL should strive to reengineer its business process controls and security to the greatest extent possible before going live on Oracle. Stronger business process controls and security focus should be performed during the implementation. This focus should be independent of the implementer to prevent any bias in this critically important area.

b. "End-of-Life" Technologies

(1) Observation

LANL is currently utilizing several "end-of-life" ("EOL") technologies. This includes systems that are both financial related, as well as operational. As a result, the maintenance of these systems becomes more difficult, support becomes more scarce, and resources to administer the systems become more difficult. EOL technologies are typically outpaced by the organization's business and processing needs, creating the need for increased IS complexity (i.e., customizations, etc.). Finally, it becomes more difficult to attract and retain experienced IS professionals as these people typically are attracted to newer technologies.

(2) Recommendation

Although current ERP planning appears to have considered some EOL technologies, LANL should develop a migration and transition strategy and plan that includes assessing all systems that are EOL, the applications that are on these systems (financial, operational,

engineering, etc.), and potential migration solutions. A timeline should then be developed to assist in the transition.

d. User Responsibilities

(1) Observation

The responsibility of assigning user rights (authorities) to specific applications and programs has been assigned to the various Division or Group Leaders within BUS. Each Division Leader has established unique processes for assigning responsibilities within the various applications and there is no common standard or enforcement of procedures. The current process of allowing multiple personnel to approve and assign user responsibilities provides limited accountability and monitoring of access control procedures.

(2) Recommendation

LANL should consider assigning user access responsibilities to one central group where formal access request forms can be utilized, documented, standardized, and controlled.

2. **Computer Operations** – Computer operations are those processes and procedures that are performed to assist in determining the availability and integrity of the systems supported. Without adequate controls over computer operations, management cannot be assured that data will be available and systems adequately monitored. Below are items that may present risk to LANL's computer operations.

a. Backup Tapes

(1) Observation

Backup tapes are shipped via Federal Express to Lawrence Livermore National Laboratory ("LLNL"). Magnetic media is sensitive to environmental changes. Due to the changing environments that the tapes will go through from LANL to LLNL and back again, it is highly possible that the data stored on the tapes could be damaged in routing and become unreadable.

(2) Recommendation

LANL should contract with an off-site storage vendor to provide safe tape storage. These vendors provide temperature controlled transportation and storage and can be contacted for quick responses when tapes need to be recovered.

b. Disaster Recovery Plan

(1) Observation

Although LANL has established and documented a "Disaster Recovery Plan" ("DRP"), this plan has never been tested and no funding has been allocated to execute this plan should the need arise.

(2) Recommendation

As a part of LANL's budgeting process, management should allocate funding to support the costs associated with executing LANL's DRP. LANL should, at a minimum, test their DRP on an annual basis to determine that the plan can recover LANL's business systems in an effective and timely manner.

c. Data Recovery Testing

(1) Observation

No formal data recovery testing is performed on the IBM, AIX, or VAX servers to test that the data being backed up could be restored if it were necessary. While data file backups have been restored in the normal course of business, the ability to accurately restore system files and all data is critical in the event of a disaster or other unforeseen event to protect the operations of LANL.

(2) Recommendation

LANL should perform routine data recovery tests on the IBM, AIX, and VAX servers to determine that data can be successfully restored. The results of this testing should be documented and retained for future reference. Any problems incurred while running the tests should be documented and resolved in a timely manner.

Detailed restoration instructions should be documented for use in the event that normal personnel are not available to perform the restores.

d. System Performance Monitoring

(1) Observation

There is no system performance monitoring performed for operating systems that are housed in the data centers, mainly concerning the "CCF" and "LDCC" buildings. Monitoring of system performance is necessary to determine that applications and data are available when needed. This will become even more critical once Oracle is implemented. LANL is in the process of considering implementing a monitoring tool.

(2) Recommendation

System performance monitoring should be implemented and performed on the operating system located in the "CCF" and "LDCC" data centers. Reports showing machine utilization should be generated and reviewed daily by appropriate personnel to help detect potential problems such as low disk space, Central Processing Unit ("CPU") functioning, and memory.

e. Payroll/Production Control

(1) Observation

Per discussion with the Production Control department, the Payroll department has the ability to launch/initiate the payroll batch process without the knowledge of the Production Control department. On occasion, the Payroll department has been known to start the batch process twice in the same setting thus, running the payroll twice. The only way that Production Control can stop it is if they notice it is running twice on their monitor and delete one of the batches.

(2) Recommendation

The scheduling and running of the payroll batch process should be the responsibility of the Production Control department. For a process as critical as payroll, batch processes need to be constantly monitored in order to identify errors at the earliest point in time.

This would allow Production Control to respond to errors and resolve them in a timely manner. Production Control should be the only group to regularly schedule the payroll batch process in LANL's production control software ("OPC") and have full control over the timing of the job runs.

3. **User Access Administration** – The administration of the user access process should include controls to prevent unauthorized access to sensitive applications and functions within those applications. User access controls are a mainline defense to maintaining the integrity of the system and the underlying data.

a. User Access

(1) Observation

There is an automated batch job that grants/alters system authorities via the Electronic Authority System ("EAS") and Signature Authority System ("SAS") tables for new/transferred employees. This batch job creates basic system authorities according to the user's organization and job code. Thereafter, a user's respective Line Manager (or those who have been delegated the authority) are responsible for modifying the user's system authorities based on the user's job responsibilities. All granted authorities are stamped with the grantor's system identification ("ID") and date/time. The decentralization and delegation of access administration responsibilities from the IS Department to individual business units creates a lack of segregation of duties. The logging of granted authorities constitutes a detective control; however, no preventive controls exist due to the lack of formal requests/approvals prior to the granting of rights. Additionally, the current distributed user access administration process are susceptible to being performed differently between managers. Finally, a process as this may prove to be administratively burdensome once LANL migrates to the Oracle environment.

(2) Recommendation

LANL should centralize the administration of system access rights to the IS function. This centralization will help with the proper segregation of duties and with implementing consistent procedures for granting and reviewing user access rights.

b. Control of System Access Rights

(1) Observation

During our review of system authorities for certain users, one employee appeared to have excessive authorities for a Deputy Group Leader in BUS 3, Budget. This person was granted default line management authorities with unlimited spending limits (999999999) for the following functions:

- Purchase alcohol or ethanol
- Purchase compressed/liquid gases
- Purchase chemicals
- Purchase controlled substances
- Purchase hypodermic supplies
- Purchase precious metals
- Purchase radioactive materials
- Purchase X-ray equipment

Authorities should only be granted to those people that need them to perform their job responsibilities. It appears from the above listing that these might not be authorities needed to perform the job responsibilities of a Deputy Group Leader in the Budget Department. The inherent risk of an employee, even at the Deputy Group Leader level, to compromise funds when given a virtually unlimited spending limit, is high.

(2) Recommendation

Ownership over user access reviews should be given to the IM groups. The IM groups should send out periodic access reports to LANL's business units and require that the Line Managers for each business unit validate and sign-off on the reasonableness of access rights granted to users in their groups.

c. System Authority Approval by Line Managers

(1) Observation

Line Managers receive monthly reports showing the system authorities that are currently assigned to users in their group. However, Line Managers are not required to sign-off on these

reports to evidence that they have been reviewed and that authorities are reasonable.

(2) **Recommendation**

Line Managers should be required to sign-off on reviews of system authorities and revoke any authorities that are not required as a part of a user's job responsibilities.

d. **Terminated Account Treatment**

(1) **Observation**

During our testing of user access, one active VMS account belonged to a terminated employee. While an automated process exists for the deletion/deactivation of end-user accounts, there is no process for the notification and removal of terminated VMS administrator accounts.

(2) **Recommendation**

A formal process should be implemented to delete/deactivate administrator accounts upon termination. This could be accomplished through the use of a termination checklist or interfacing the VAX with the EAS/SAS system to recognize terminations and automatically delete/deactivate the account.

Subsequent to our fieldwork, LANL has indicated that LANL has made the recommended change. To the extent that LANL has implemented the recommended action, no further action on the part of LANL should be required.

4. **Application Change Management** – Application Change Management is the process of applying controls over changes made to application functionality and reporting. Controls should be in place to help determine that all application changes are authorized, tested and incorporate a segregation of duties between who is allowed to make changes and who is able to promote those changes to the production ("Live") environment. Additionally, change management controls should provide for appropriate documentation over each step that is created and maintained in order to create accurate audit trails and accountability.

a. Program Change Management

(1) Observation

During our analysis we noted that authorization for application change requests were not always obtained prior to the start of development and, in some cases, change requests were made directly to the programmers from unauthorized personnel. Additionally, approvals for program change migration were not consistently being logged into LANL's program change management software application PVCS Tracker ("Tracker").

(2) Recommendation

All requests for application changes should go through the Help Desk and the Help Desk should verify that the person making the request is a designated Functional Expert. Programmers and Project Leaders should not directly accept change requests.

b. Documentation of Program Change Testing

(1) Observation

There is no logging or other documentary evidence that program change testing is being performed in a test environment. Additionally, user acceptance approvals are not consistently obtained and logged.

(2) Recommendation

A log should be created in each test environment that outputs program modifications. The log or script should record when objects are altered, who changed the object, error reporting, and other details involved with testing. End-user acceptance should always be obtained from a Functional Expert. This acceptance should be in writing (e.g., via email) and logged into Tracker. User acceptance should be a primary factor confirmed before authorization to migrate code to production.

c. Program Change Authority

(1) Observation

During our analysis we noted that developers have the ability to promote changes for Windows based applications. Additionally, we noted that for mainframe applications, developers are granted temporary Time Share Option ("TSO") accounts to migrate program changes and perform troubleshooting in the production environment. Allowing developers to promote changes to the production or live environment constitutes a lack of segregation of duties and conflicts with LANL policy, which states that only System Administrators and System Service Accounts should have production access.

(2) Recommendation

There should be a designated group responsible for moving changes to the production environment on each platform. This group should not have programming responsibilities and should be cross-trained to support and back up one another rather than using another programmer.

d. Program Change Control Notice

(1) Observation

Per discussion with the IM-8 director and per testing of a sample of ten application changes, we noted the required Control Notice, that is to be sent out via email each time there is a program change, is not being consistently utilized.

(2) Recommendation

In accordance with IM-8 Procedures, a Control Notice should be completely filled out and sent to appropriate individuals before the change is put into the production environment. A program code should not be approved for migration to Production until a Control Notice is sent.

5. **Logical Security** – Logical Security pertains to the use of the computer system to prevent inappropriate access to applications, files, data, and other

sensitive information systems components. Logical security includes the use of password and authentication controls for all systems and platforms. Below is a list of items that could be improved to enhance the overall security of LANL's financial systems.

a. Security Standard

(1) Observation

The majority of users log into LANL systems using LANL's token authentication card, CRYPTOCard. However, there is an alternate access path where "Desktop on Demand" users can access LANL's systems with a Windows 2000 user ID and password. Inconsistent security standards should not be utilized to access the same systems.

(2) Recommendation

A consistent security standard should be implemented to prevent unauthorized access to key financial applications. LANL should consider including "Desktop on Demand" access to the CRYPTOCard authentication systems.

b. Obsolete Accounts

(1) Observation

Within Resource Access Control Facility ("RACF") that controls security on the IBM mainframe, the "OPERATOR" attribute allows a user authority to perform maintenance operations and provides full authority to access RACF-protected resources unless specifically restricted. During our analysis of accounts with the "OPERATOR" attribute, E&Y noted that 11 accounts (out of a total of 25 non-revoked accounts with the "OPERATOR" attribute) were obsolete accounts that are no longer required.

(2) Recommendation

All accounts (especially privileged ones) that do not have a valid business reason should be removed or set to the status of "Revoke" on the system.

c. Access Audits

(1) Observation

Defining a RACF class as an "AUDIT CLASS" enables logging of access to the profiles on the RACF database. E&Y noted that only the "DATASET" class has been defined as an audit class. Not defining all active classes as audit classes creates the risk that unauthorized access to RACF class profiles may not be detected since an audit trail is not available.

(2) Recommendation

The "AUDIT CLASSES" parameter should be set to '*', which enables auditing of access to the profiles for all active RACF classes.

Subsequent to our fieldwork, LANL has indicated that it has made the recommended change. To the extent that LANL has implemented the recommended action, no further action on the part of LANL should be required.

d. External Verification

(1) Observation

The "JES – EARLYVERIFY" parameter allows batch jobs that do not have inherent security authentication /validation (ID and password) to use an external verification program (routine) to authenticate the validity of the batch job prior to execution. This setting is currently not enabled.

(2) Recommendation

The "JES –EARLYVERIFY" parameter should be activated.

Subsequent to our fieldwork, LANL has indicated that LANL has made the recommended change. To the extent that LANL has implemented the recommended action, no further action on the part of LANL should be required.

e. **Operations Audits**

(1) **Observation**

The "OPERATIONS" attribute grants users access to RACF-protected resources. Activating the "OPERAUDIT" parameter enables audit logging of transactions performed by users with the "OPERATIONS" attribute.

The "OPERAUDIT" parameter is currently disabled because of a system service account that is required to perform data and tape management. However, there were four actual user accounts with the "OPERATIONS" attribute. By not auditing the individual user account, LANL runs the risk that unauthorized access by accounts with the "OPERATIONS" attribute may not be detected since an audit trail is not available.

(2) **Recommendation**

Since activating the "OPERAUDIT" option is not practical for all accounts with the "OPERATIONS" attribute, due to the existence of the "HSM" account, auditing should be enabled at the profile level for actual user accounts with the "OPERATIONS" attribute.

f. **Password Backup**

(1) **Observation**

RACF provides the security over the IBM mainframe and the MVS operating system. The "RVARY" command is used to activate or deactivate RACF or switch RACF databases. If RACF is deactivated, users are allowed unrestricted access to data sets and general resources. The "RVARY" setting requires the computer operator to enter a password to utilize these commands and this password has been changed from the default system password. However, only one individual has knowledge of the "RVARY" password and the password has not been documented and secured in a safe location (e.g., safe deposit box or vault) for emergency purposes.

(2) Recommendation

The "RVARY" password should be shared with one individual who can act as a backup if the primary mainframe administrator is not available. The password should be documented and secured in a safe location (e.g., safe deposit box or vault) for emergency purposes.

Subsequent to our fieldwork, LANL has indicated that LANL has made the recommended change. To the extent that LANL has implemented the recommended action, no further action on the part of LANL should be required.

g. Shared Accounts

(1) Observation

During our review of RACF accounts, E&Y noted the use of a shared account "SYSTEM5." This shared account has certain special access rights to the database "DB2" and is shared to perform maintenance and troubleshooting on the database. This compromises the accountability of user(s) accessing the system.

(2) Recommendation

All generic shared accounts should be removed and replaced with unique accounts that can be traced to specific individuals to maintain accountability.

h. Supervisor Call Instructions

(1) Observation

E&Y noted that one out of the four supervisor call instructions ("SVC") that exist on the mainframe, "SVCPARM 254", was created to support an interface between the VAX and a product (SNS Gate) running on the IBM mainframe. The SNS Gate product was recently retired; therefore, this SVC is no longer required and can be removed. In our view, any user(s) can call a SVC, potentially leaving the user in an authorized state or in SUPERVISOR state, thus bypassing certain MVS controls.

(2) Recommendation

All SVCs that do not have a valid business reason should be removed. The System Administrator should modify any Supervisor Call routines that leave the user(s) in an authorized state to prevent the bypass of normal controls.

Subsequent to our fieldwork, LANL has indicated that LANL has made the recommended change. To the extent that LANL has implemented the recommended action, no further action on the part of LANL should be required.

i. Time Share Option Accounts (TSO)

(1) Observation

LANL's policy is to use a log to document TSO requests. During our analysis we noted that the log is not consistently used to document TSO requests.

(2) Recommendation

Requests and approvals for TSO accounts should be formally documented prior to the granting of access rights. Additionally, all documentation should be retained as an audit trail.

j. Universal Access Authority

(1) Observation

If a user or group is not specifically included in the default access list, then the Universal Access Authority ("UACC") setting determines the user or group's access. Based on our analysis, the UACC setting is appropriate for all listed data sets except the SYS1.MIGLIB data set, which is set to EXECUTE. No business reason could be provided as to why this data set was configured this way.

(2) Recommendation

LANL should review whether the SYS1.MIGLIB data set is required to be configured in this manner. If no valid reason exists,

then the UACC for this data set should be restricted to NONE or READ.

Subsequent to our fieldwork, LANL has indicated that LANL has made the recommended change. To the extent that LANL has implemented the recommended action, no further action on the part of LANL should be required.

k. Windows 2000/Sunflower

(1) Observation

E&Y analyzed the Windows 2000 environment for LANL's network and property management application server, Sunflower, and noted that the following parameters for both domains do not conform to leading best practices:

- Maximum Password Age: 180 days
- Minimum Password Age: 0 days
- Password Uniqueness: 0
- Time Reset Interval: 30 minutes
- Account Lockout Duration: 30 minutes

Additionally, the auditing for the Windows 2000 domain where the Sunflower application resides is not enabled.

(2) Recommendation

The settings for the Windows 2000 account policy parameters for the network and Sunflower domains should be consistent with leading best practice guidelines:

- Maximum Password Age: 90 days
- Minimum Password Age: 1 day
- Password Uniqueness: 10 passwords
- Time Reset Interval: 60 minutes or more hours
- Account Lockout Duration: Forever (until System Administration unlocks)

The audit feature for the Sunflower application domain should be enabled and configured in the following manner:

- Logon and Logoff: Failure
- File and Object Access: Failure

- Directory Service Access: Failure
- Account Management: Success and Failure
- Security Policy Changes: Success and Failure
- Restart, Shutdown, and System: Success and Failure

The System Administrator should review audit logs on a regular basis

I. VAX Parameters

(1) Observation

E&Y noted the following items regarding the VAX/VMS platform/operating system:

- VAX/VMS parameters "LGI_BRK_TERM" and "LGI_BRK_DISUSER" are not at the recommended setting.
- No review of VMS security alarms is currently performed.
- Many VMS accounts have not be used in over 90 days.
- The VMS platform currently being used is outdated.
- No process is in place to remove VMS administrator accounts upon termination.

(2) Recommendation

The below VAX parameters should be set as follows:

- "LGI_BRK_TERM --- 1"
- "LGI_BRK_DISUSER --- 0"

Subsequent to our fieldwork, LANL has indicated that LANL has made the recommended change. To the extent that LANL has implemented the recommended action, no further action on the part of LANL should be required.

Security alarms that are being tracked should be reviewed on a daily basis and any violations should be investigated and documented promptly.

A thorough review of all user accounts on the VAX should be performed, and any accounts that are no longer needed should be deleted or deactivated so that no unauthorized user(s) can access the VAX using these accounts.

The current VAX platform version is roughly ten years old. Due to the applications being run on the VAX (General Ledger, Affiliates, Stores), LANL should consider updating the system and/or migrating the applications to other platforms that are more reliable.

A process should be implemented so that all administrator accounts are deactivated or removed upon the termination of personnel.

6. **Policies and Procedures** – In reviewing the policies and procedures that support the Information Systems processes and applications, we noted that LANL policies and procedures for this area could be strengthened. Policies and procedures are an effective way to provide for common practices to be followed and for appropriate standards are maintained.

a. Maintain Policies and Procedures

(1) Observation

While we noted that policies and procedures have been developed over the information system processes, such as making changes to the various applications and for adding employees to LANL systems, we noted that there currently is no process in place within the information systems departments (i.e., IM, BUS, etc.) to help determine that information systems procedures are current and consistent with Government regulations.

(2) Recommendation

LANL should create a process for reviewing information systems policies and procedures. A LANL employee should be assigned the responsibility for performing this process. The goal should be to maintain policies and procedures to reflect the current information systems environment. Policies and procedures should reflect best practices, and current copies of policies and procedures should be readily available to all applicable users.

b. Password Standards

(1) Observation

During our analysis of Windows logical security, we observed the following: (1) the password expiration interval is configured to 180 days, (2) no history of a password (indicating that a password can be repeated), and (3) lockout duration of 30 minutes. Although

these meet LANL's organization- wide standards, the standards do not conform to leading security practices.

(2) Recommendation

LANL should update password standards to be commensurate with leading practices. Specifically, passwords should be forced to expire every 60-90 days, passwords should be prevented from being repeated for at least 10 times, and accounts that have been disabled due to unsuccessful attempts should require the assistance of the Help Desk or System Administrator to reset.

B. Selected Application Process Observations

1. **Application Controls** – Application controls are those functions or configurations within the financial applications that impact the processing of a transaction, prevent errors in the system as well as prevent irregularities. These application or "automated" controls are systematic and by their nature apply to all relevant transactions, thus increasing their overall effectiveness. Below are items that may present risk to LANL's application controls.

a. Procurement/Sunflower Interface

(1) Observation

The Sunflower interface from the Procurement Desktop application is unreliable. If an item that is not in the Sunflower catalogue is downloaded from Procurement Desktop, the asset information will not transfer into the Sunflower system.

(2) Recommendation

An automated program should be developed to create new catalogue entries into the Sunflower database for items that are downloaded from the Procurement Desktop but are not currently in the Sunflower catalogue. Additionally, each time a new item entry is created in the Sunflower catalogue, an exception report should be created to confirm that the new item was properly added to the catalogue.

b. Hazardous (non-nuclear) Materials in Sunflower System

(1) Observation

There is no capability or query available to track hazardous (non-nuclear) materials in the Sunflower system. There are a number of Government regulations that require the tracking of these types of materials.

(2) Recommendation

Dangerous assets and materials should have a separate identifier added to the database to improve tracking. In addition, hazardous materials should have the OSHA codes input into the Sunflower System.

c. Access to Sunflower

(1) Observation

There are approximately 14 System Administrators for the Sunflower property management system. Each of these administrators has access to change critical asset data and/or change other user access rights. The System Administrator function is usually limited to 3-5 people in order to control the number of people who could potentially affect the performance and availability of the application.

(2) Recommendation

LANL should review the current listing of System Administrators and limit the Administrator responsibility to only those users who are directly responsible for maintaining the system.

d. Cost Center Reports in Sunflower

(1) Observation

While Sunflower is able to produce reports by cost center alone, Sunflower does not have the capability to generate reports by both the cost center and Associate Director ("AD") division. Property Management is using a Microsoft Excel ("Excel") Macro in conjunction with manual calculations to report baseline status by

AD. This method increases the risk for calculation errors and is not an efficient process.

(2) Recommendation

Time and resources should be expended to develop the capability to report by AD division and cost center within Sunflower.

Tab 6

University of California
Los Alamos National Laboratory

Compliance and Operational Analysis
LANL Banking Processes and Internal Controls, Including DOE Funding

April 15, 2003

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April 15, 2003

Ms. Anne C. Broome
Vice President-Financial Management
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Subject: Report of Compliance and Operational Analysis re: Banking, including DOE Funding, Processes and Internal Controls

Dear Ms. Broome:

Ernst & Young (E&Y) has completed a compliance and operational analysis of the Los Alamos National Laboratory (LANL) Banking processes, including Department of Energy (DOE) funding, and internal controls, and our Report is attached. This report is intended solely for the information and use of the University of California Management.

Implementation of the recommendations contained in the attached Report will provide for an enhanced control environment for the Banking processes. We recommend periodic follow-up action be taken to determine accomplishment of recommended actions. Further, E&Y understands that LANL will be preparing a Request for Proposal (RFP) for banking services. E&Y supports this effort by LANL. E&Y further recommends that LANL solicit inputs on the RFP from several "Best in Class" banking institutions to determine whether or not LANL has identified within the RFP all of the optimal LANL banking process requirements.

We appreciate the cooperation and assistance provided to us during the course of our work. If you have any questions, please contact Mr. Brian F. Simmons at 214.969.8629.

Sincerely,

Brian F. Simmons
Central Region Director
Government Contract Services

Ernst & Young LLP is a member of Ernst & Young International, Ltd.

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I. Overview

The University of California, Vice President - Financial Management retained Ernst & Young LLP (E&Y) to conduct an independent compliance and operational analysis of the Los Alamos National Laboratory (LANL) Banking processes and internal controls, including DOE funding.

In accordance with E&Y's Engagement Letter dated February 4, 2003, E&Y is pleased to provide the results of E&Y's analysis of LANL's banking, including DOE funding, processes and internal controls. The E&Y report is comprised of three (3) parts: (I) an Overview/Background, (II) Procedures Performed, and (III) Observations and Recommendations.

The E&Y services were performed in accordance with the Statement on Standards for Consulting Services (CS100) of the American Institute of Certified Public Accountants (AICPA) as stated in the Engagement Letter. The Standards for Consulting Services (CS100) do not result in issuance of an opinion and does not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards, the objective of which is the expression of an opinion on the elements, accounts, or items of a financial statement. As a result, E&Y does not express an opinion on LANL's banking processes and internal controls, including DOE funding. The procedures performed by E&Y did not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards.

A. Background

The University of California is the designated operating contractor under a prime contract (W-7405-ENG-36) awarded by the Department of Energy (DOE) for operation of the LANL. A description of the overall duties of the operating contractor is contained in Paragraph C.001 of Modification Number M552, entitled Statement of Work. Paragraph I.096 of the aforementioned contract modification requires that:

> "The contractor shall maintain and administer a financial management system that is suitable to provide proper accounting in accordance with DOE requirements for assets, liabilities, collections accruing to the Contractor in connection with the work under this contract, expenditures, costs, and encumbrances; permits the preparation of accounts and accurate, reliable financial and statistical reports; and assures that accountability for the assets can be maintained."

The governing regulations for the operating contract are the Department of Energy Acquisition Regulation (DEAR). The DEAR implements and supplements the Federal Acquisition Regulation (FAR).

Appendix B of Modification Number: M455 of the basic contract provides for a three party agreement among the DOE, The Regents of the University of California, and Los Alamos National Bank (LANB) wherein a Special Bank Account, designated "University of California, Los Alamos National Laboratory, Contract Number W-7405-ENG-36, DOE Special Bank Account" will be maintained for the purpose of transferring funds from DOE to the University of California.

To fulfill LANL's financial management responsibility, LANL utilizes two handbooks: (1) The DOE Accounting Handbook and (2) an internally developed LANL Financial Management Handbook based, in large part, on the DOE Accounting Handbook. The DOE Accounting Handbook presents the DOE's standards, procedures, and operational requirements in support of accounting policies, principles, and applicable legal requirements for DOE operations. The LANL Financial Management Handbook describes the principle accounting, planning, and reporting requirements. The LANL Financial Management Handbook consists of six major topics: "Indirect Budget", "Data Warehouse", "Time & Effort", "Accounting", "Formal Budgeting", and "Related Resources."

Accounting policies that supplement the guidance contained in the LANL Financial Management Handbook are contained in LANL's Accounting Resource Manual. LANL accounting policies are implemented by specific desk procedures.

The E&Y analysis of the Banking processes and internal controls, including DOE funding, focused on specific accounting functions that are performed in LANL's accounting organization (BUS-1). The accounting organization consists of approximately 100 employees. The accounting organization is further subdivided into smaller functional units: Travel, Accounts Payable and Contract Accounting, General Accounting and Work for Others (WFO), Property Accounting, Payroll, and support related functions. General Accounting and WFO consists of approximately 13 employees. Accounting for Banking is an activity performed in the General Accounting and WFO unit.

The LANL banking service provider is the Los Alamos National Bank (LANB) utilizing eight accounts. The accounts are grouped as either "Business Accounts" (large volume) or as "Other Miscellaneous Accounts" (small volume). Three accounts are considered large volume "Business Accounts." Five accounts are considered small volume "Other Miscellaneous Accounts." With the exception of the "Director's Administrative Fund" all bank accounts were included as part of this analysis. The "Director's Administrative Fund" bank account was not included as part of this analysis because the "Director's Administrative Fund" bank account is

not charged to DOE under Contract Number W-7405-ENG-36. The accounts, along with dollar volume and number of checks that have cleared the bank for FY 2002 and FY 2003 through January, follow:

	FY 2002 Dollar Volume	FY 2002 Number of Checks	FY 2003 Thru Jan. Dollar Volume	FY 2003 Thru Jan. Number of Checks
Large Volume Accounts				
Accounts Payable	$ 1.3 billion	37,708	$ 510.2 million	13,937
Travel	$44.3 million	38,136	$ 14.3 million	11,885
Payroll	$666.8 million	14,399	$ 250.7 million	4,066
Small Volume Accounts				
UC Directed Research & Development	$ 750,000	5*	$ 0	0
Conferences	$ 342,000	115	$ 67,000	12
Work for Others	$ 176,000	5*	$ 123,000	29*
Special Projects	$ 2,500	7	$ 910	1
Director's Administrative Fund	$59,160	139	$14,318	27

* Represents wire transfers

B. Summary of Observations

As a result of our analysis, we identified ten (10) observations related to the strengthening of LANL Banking processes, including DOE funding, and related internal controls. Our analysis validated six of the findings in the Global Payment Advisors' Bank Account Controls Review, dated December 5, 2002, in the areas of negative cash balances, stop payment requests, wire transfers, banking authorizations, timing of electronic file transmission of checks, and automated clearing house (ACH) direct deposit of payroll. Based on our analysis, we did not validate the Global Payment Advisors' Bank Account Controls Review finding on the interface of Accounts Payable to the PayBase system as an issue and therefore, in our view, no further action on this item is warranted by LANL management. Additionally, we observed internal control enhancement opportunities in the following areas: the LANL and LANB ACH agreement, the LANL bank reconciliation system, and the banking desk instructions.

II. Procedures Performed

A. Scope of Analysis

The scope of the compliance and operational analysis of Banking processes and internal controls, including DOE funding, included the following procedures:

- Understand the process for LANL's banking activities.
- Understand the process for the Special Bank Account Agreement.
- Assess written policies, procedures, and internal controls related to Banking, including DOE funding functions for compliance with DOE and contract requirements.
- Perform interviews of key personnel.
- Perform a follow-up evaluation of certain issues in the Global Payment Advisors' *Bank Account Controls Review* dated December 5, 2002 related to banking including DOE funding.
- Analyze and understand the results of prior reviews on policies, procedures, systems, and practices.
- Sample selected transactions to determine if actual practices are in compliance with written policies, procedures, contractual and DOE requirements.

B. Objectives of Analysis

The objectives of the Banking processes and internal control procedures, including DOE funding analysis, were to:

- Document LANL's key internal controls including LANL's stated policies, procedures, systems, and forms.
- Analyze the consistency of application and adequacy of LANL's policies, procedures, systems, and forms to assess compliance with applicable contractual provisions.
- Analyze and assess compliance of LANL's activities with the Special Bank Account Agreement requirements.
- Evaluate certain issues identified in the Global Payment Advisors' *Bank Account Controls Review* dated December 5, 2002.
- Determine whether sampled items, in accordance with relevant contract and operational requirements were properly reviewed, approved, and appeared appropriate in the circumstances.

III. Observations and Recommendations

Based upon the procedures performed, we identified ten (10) items/control enhancement opportunities in the banking, including DOE funding, internal control processes. Management should address the control opportunities identified from our procedures to further strengthen internal controls in the banking, including DOE funding, processes. In our view, the observations and recommendations are presented in the order of their importance. The items identified and the recommendations resulting from our procedures follow:

A. Banking Process, Including DOE Funding, Observations

1. ACH/Direct Deposit of Payroll

a. Observation

E&Y's analysis of ACH/Direct Deposit of Payroll instructions validated the finding in the Global Payment Advisors' Bank Account Controls Review dated December 5, 2002. Automated Clearing House/Direct Deposit of Payroll instructions were being delivered to LANB on diskette via a courier.

The preparation of sensitive information on a floppy disk, together with hand delivery, poses an internal control risk of intentional or accidental change and/or erasure of important financial information.

b. Recommendation

LANL should work with LANB to develop a fully electronic interface that relies on state-of-the-art delivery and authentication tools and will increase efficiency as well as providing protection against the loss of sensitive data. The transmission should be encrypted for secure transmission of sensitive information between the two parties.

2. LANL Bank Reconciliation System

a. Observation

Twice a month (on the 15th and last day of the month) for large volume business bank accounts (Payroll, Accounts Payable and Travel), LANB prepares a floppy disk listing all checks that have cleared for the 15 or 16-day period. The disk is hand carried from the bank to the responsible LANL Bank Reconciliation Employee. The information on the disk is then uploaded into an excel spreadsheet that is linked to the LANL Bank Reconciliation System. Information on the disk is used as a basis to run various queries to determine if there are any errors or discrepancies.

The preparation of sensitive information on a floppy disk, together with hand delivery, poses a potential internal control risk of intentional or accidental change and/or erasure of important financial information.

b. Recommendation

LANL should work with LANB to implement full electronic transmission of the bi-monthly listing of cleared checks. The transmission should be encrypted for secure transmission of sensitive information between the two parties.

3. Negative Cash Balances

a. Observation

E&Y's analysis of Negative Cash Balances validated the finding outlined in the Global Payment Advisors' Bank Account Controls Review dated December 5, 2002. Appendix B of Modification Number M455 of the Supplemental Agreement to Contract Number W-7405-ENG-36, entitled Special Bank Account Agreement for Use with the Payments Cleared

Financial Agreement, referred to as the "Special Bank Account Agreement," the Covenants Section, paragraph (5) requires that the Financial Institution restrict all withdrawals to an amount sufficient to maintain the average daily balances of the accounts as close to zero as administratively possible, but not negative (underlining added for emphasis). For the large volume bank accounts (Payroll, Accounts Payable and Travel) daily balances were found to go negative regularly. For example, a review of daily bank balances for a three-week period in February 2003 disclosed the following number of negative daily balances for each of the accounts:

Account Days With Negative Balances (15 business days in the three-week period in February)	
Payroll	7 of 15 = 47%
Account Payable	8 of 15 = 53%
Travel	6 of 15 = 40%

The process of accepting negative daily bank balances does not comply with the requirements of the Special Bank Account Agreement contained in the DOE contract.

b. Recommendation

LANL in conjunction with LANB should implement procedures, along with appropriate controls, to more accurately estimate daily check transactions that will prevent daily balances from becoming negative.

4. Stop Payment Requests

a. Observation

E&Y's analysis of stop payment requests validated the finding in the Global Payment Advisors' Bank Account Controls Review dated December 5, 2002. The Banking Instruction Agreement, dated November 2002, states that the bank will accept stop payment requests by phone from LANL personnel authorized to make such requests. It goes on to state that the bank must receive a signed request, by an authorized person for the account, within 14 days, for the stop payment to remain active.

b. Recommendation

LANL should implement an on-line stop payment utility that allows the LANL to know immediately whether or not a check has been paid and then automatically place a stop payment if the check has not been previously posted. The on-line stop payment utility will also increase efficiency as well as provide protection against the loss of sensitive data. The transmission should be encrypted for secure transmission of sensitive information between the two parties.

5. Wire Transfers

a. Observation

E&Y's analysis of wire transfers validated the finding in the Global Payment Advisors' Bank Account Controls Review dated December 5, 2002. Outgoing Wire Transfers are initiated by LANL using a signed check supported by a Wire Transfer Form. The check and wire transfer forms are collected and transported to the LANB by a courier on a daily basis.

b. Recommendation

LANL should work with LANB to develop a system of electronic interfaces for wire transfers to provide safe and quicker transportation at a more economical rate. The system should provide for encryption, identification, and password protection.

6. Banking Authorizations

a. Observation

E&Y's analysis of banking authorizations validated the finding in the Global Payment Advisors' Bank Account Controls Review dated December 5, 2002. The Banking Instruction Agreement, dated November 2002, does not address the requirement that approval must be obtained from the University of California (UC) for the list of personnel authorized to: (1) order checks, (2) sign checks, (3) open and close accounts and (4) make wire and ACH transfers, as stated in the Standing Orders of The Regents of the University of California and LANL's Banking Policy as revised on 10/02.

b. Recommendation

The Banking Instruction Agreement should be updated to prevent the potential unauthorized use in establishing checking account authorization. The update should require that appropriate UC approvals be obtained as required by the Standing Orders of The Regents of the University of California.

7. LANL and LANB Automated Clearing House

a. Observation

The LANL and LANB Automated Clearing House (ACH) Agreement dated October 1, 1997 did not contain a complete set of authorized signatures.

b. Recommendation

The LANL and LANB ACH Agreement should be appropriately updated, dated, and signed by all three parties: LANB, DOE, and The Regents of the University of California.

8. Timing of Electronic File Transmission of Checks

a. Observation

E&Y's analysis of timing of the electronic file transmission of the checks generated during the day validated the finding in the Global Payment Advisors' Bank Account Controls Review dated December 5, 2002. The encrypted electronic file of all checks generated during the day is sent to the LANB each evening. However, the bank pays all checks at the time they are presented for payment. Since the electronic file is sent in the evening, it is possible for a payee to pick up his/her check during the day and present the check to the bank for payment, before the electronic instructions arrive at the bank.

b. Recommendation

LANL should work with LANB to develop an effective "Positive Pay" system. The system should provide the bank with the capability of comparing presented check information with electronic instructions prior to actual check payment. An effective "Positive Pay" system will increase efficiency as well as provide protection against the loss of sensitive data.

The transmission should be encrypted for secure transmission of sensitive information between the two parties.

9. Interface of Accounts Payable to PayBase System

a. Observation

E&Y's analysis of the interface from the Accounts Payable source system to the PayBase system did not validate the observation in the Global Payment Advisors' Bank Account Controls Review dated December 5, 2002.

The Accounts Payable personnel responsible for generating checks cannot alter the check run file once it has been transmitted to the PayBase system.

b. Recommendation

No action required by management.

10. Banking Desk Instructions

a. Observation

Banking desk instructions need to be reviewed and updated, as appropriate. For example, the first paragraph of desk instruction BUS-GA-040 states that: "The bank sends General Accounting a disk of all checks that have cleared LANL bank for the first 15 days. The disk is then prepared in formatted text (prn) format and sent down to CIC to be uploaded into our Bank Rec. System." The disk is no longer sent to CIC. The Bank Reconciliation Employee now directly uploads the disk to the Bank Reconciliation System, rather than send it to CIC. Also, the procedures do not contain such elements as: Standard coding/references, cross-referencing of procedures to policies, origination date, and approving official.

b. Recommendation

LANL desk instructions should be incorporated online as a living document. The instructions should contain the necessary data and authorship elements.

Tab 7

University of California
Los Alamos National Laboratory

Compliance and Operational Analysis
LANL Property Management
And
Property Accounting
Processes and Internal Controls

April 15, 2003

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April 15, 2003

Ms. Anne C. Broome
Vice President-Financial Management
University of California
1111 Franklin Street
Oakland, California 94607-5200

Subject: Report of Compliance and Operational Analysis re: Property Management and Property Accounting Processes and Internal Controls.

Dear Ms. Broome:

Ernst & Young (E&Y) has completed a compliance and operational analysis of the Los Alamos National Laboratory (LANL) Property Management and Property Accounting processes and internal controls, and our Report is attached. This report is intended solely for the information and use of the University of California Management.

Implementation of the recommendations contained in the attached Report should provide for an enhanced control environment concerning Property Management and Property Accounting. We recommend periodic follow-up action be taken to insure accomplishment of recommended actions.

We appreciate the cooperation and assistance provided to us during the course of our work. If you have any questions, please contact Brian Simmons at (214) 969-8629.

Sincerely,

Brian F. Simmons
Central Region Director
Government Contract Services

Ernst & Young LLP is a member of Ernst & Young International, Ltd.

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I. Overview

The University of California, Vice President - Financial Management retained Ernst & Young LLP (E&Y) to conduct an independent compliance and operational analysis of the Los Alamos National Laboratory (LANL) Property Management and Property Accounting processes and internal controls.

In accordance with E&Y's Engagement Letter dated February 4, 2003, E&Y is pleased to provide the results of E&Y's analysis of LANL's Property Management and Property Accounting processes and internal controls. The E&Y report is comprised of three (3) parts: (I) Overview/Background, (II) Procedures Performed, and (III) Observations and Recommendations.

The E&Y services were performed in accordance with the Statement on Standards for Consulting Services (CS100) of the American Institute of Certified Public Accountants (AICPA) as stated in the Engagement Letter. The Standards for Consulting Services (CS100) do not result in issuance of an opinion and do not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards, the objective of which is the expression of an opinion on the elements, accounts, or items of a financial statement. As a result, E&Y does not express an opinion on LANL's property management and property accounting processes and internal controls. The procedures performed by E&Y did not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards.

A. Background

The University of California is the designated operating contractor under a prime contract (W-7405-ENG-36) awarded by the Department of Energy (DOE) for operation of the LANL. A description of the overall duties of the operating contractor is contained in Paragraph C.001 of Modification Number M552, entitled Statement of Work. Paragraph I.096 of the aforementioned contract modification requires that:

> "The contractor shall maintain and administer a financial management system that is suitable to provide proper accounting in accordance with DOE requirements for assets, liabilities, collections accruing to the Contractor in connection with the work under this contract, expenditures, costs, and encumbrances; permits the preparation of accounts and accurate, reliable financial and statistical reports; and assures that accountability for the assets can be maintained."

In addition the Contract (W-7405-ENG-36) contains a number of contract provisions concerning Property Accounting and Property Management. For example, Paragraph I.103 (i) 1 (i) of the Contract incorporates the Department of Energy Acquisition Regulation Supplement (DEARS) 970.5245-1, "Property (DEC 2000), Alternate I (DEC 2000)" that states:

> "The Contractor shall establish, administer, and properly maintain an approved property management system of accounting for and control, utilization, maintenance, repair, protection, preservation, and disposition of Government property in its possession under the Contract. The contractor's property management system shall be submitted to the Contracting Officer for approval and shall be maintained and administered in accordance with sound business practice, applicable Federal Property Management regulations and DOE Property Management regulations, and such directives or instructions which the Contracting Officer may from time to time prescribe."

The governing regulations for the operating contract is the DEARS. The DEARS implements and supplements the Federal Acquisition Regulation (FAR).

To fulfill LANL's financial management responsibility, LANL utilizes two handbooks: (1) The DOE Accounting Handbook and (2) an internally developed LANL Financial Management Handbook based, in large part, on the DOE Accounting Handbook. The DOE Accounting Handbook presents the DOE's standards, procedures, and operational requirements in support of accounting policies, principles, and applicable legal requirements for DOE operations. The LANL Financial Management Handbook describes the principle accounting, planning, and reporting requirements. The LANL Financial Management Handbook consists of six major topics: "Indirect Budget", "Data Warehouse", "Time & Effort", "Accounting", "Formal Budgeting", and "Related Resources."

Accounting policies that supplement the guidance contained in the LANL Financial Management Handbook are contained in LANL's Accounting Resource Manual. LANL accounting policies are implemented by specific desk instructions.

The analysis of Property Accounting and Property Management focused on specific accounting functions that are performed within LANL's Accounting (BUS-1) and Property Management (BUS-6) organizations. The Property Accounting team consists of approximately 10 employees and the Property Management group consists of approximately 90 employees. The BUS-1 organization is subdivided into smaller functional units that include: Property Accounting, Travel, Accounts Payable and Contract Accounting, General Accounting and Work for Others (WFO), Payroll, and support related functions.

DOE's, as well as LANL's, Financial Stewardship for Property Accounting is that: "The receipt, maintenance, and disposal of all assets are properly recorded and accounted for in a timely and cost efficient manner with adequate safeguarding of records."

Property Accounting and Property Management perform the following functions:

- Review LANL Purchase Requests for accuracy of financial accounts and identify equipment to be assigned property tags.
- Review the accuracy and completeness of the financial information in the property database.
- Enter all initial information in the property database, except for property custodianship and location.
- Process property retirements from property database records.
- Maintain a property management system that manages, controls, and disposes of property.
- Assign personal accountability for individual assets to property custodians, who may be LANL employees, contract workers, or affiliates.
- Identify asset locations.
- Monitor and update property accountability statements on an annual basis.

Property Accounting and Property Management are responsible for tracking the following types of items:

- Capital – Tracked capital items must meet the following criteria: equipment purchased, constructed or fabricated, including modifications or improvements greater than $25,000 and have a useful life of over 2 years, exceptions include equipment designated as inherently experimental, used as special tools, or, by nature of their association with a particular scientific experiment, not expected to have a useful service life or an alternative future use.
- Controlled – Equipment with a purchase price greater than $5,000 and less than $25,000.
- Attractive – Items that can be readily turned into cash, including computers, recorders, cellular phones, etc. LANL maintains a DOE approved list of the specific items classified as attractive.

The total LANL assets being tracked are summarized in the following table:

Summary of Assets Tracked (Capital, Controlled and Attractive) as of February 13, 2003		
Description	**# Total**	**$ Total**
Capital Assets	4,693	$603,358,348
Controlled Assets	14,513	$160,591,790
Attractive Assets	59,753	$190,507,306
Other	25	$ 75,379
Assets Tracked	78,984	$954,532,824

B. Summary of Observations

Based on the procedures performed, we identified nine (9) items/control enhancement opportunities in the Property Management and Property Accounting and related internal control processes. Four (4) items are administered solely within Property Management and Property Accounting group and do not specifically involve other departments. They are as follows: Sunflower Database, Reconciliation Process, Attractive Asset Listing and Desktop Procedures. While the following three (3) items (Asset Identification, Receiving and Precious Metal Inventory) are processes that affect Property Management and Property Accounting, they are not, however, exclusively controlled by Property Management and Property Accounting. The last two (2) items (Assets-In-Progress and Warranty Information) require the cooperation of the Budgeting and Procurement groups. As such, the effectiveness of the Property Management and Property Accounting functions are dependent on the controls in other departments, including Procurement, Receiving and Budgeting departments. Property Management and Property Accounting accounts for and controls assets classified as controlled assets (e.g. capital or attractive). Therefore, if controlled assets are not properly identified within the Procurement and Receiving function, the ability for Property Management and Property Accounting to track such assets is significantly hampered.

II. Procedures Performed

A. Scope of Analysis

The scope of the compliance and operational analysis of Property Accounting and Property Management processes and internal controls included the following:

- Understand the process for LANL's Property Accounting and Property Management activities.
- Assess written policies, procedures, and internal controls related to Property Accounting and Management functions for compliance with DOE and contract requirements.
- Perform interviews of key personnel.
- Analyze and understand the results of prior reviews on policies, procedures, systems, and practices.
- Sample selected transactions to determine if actual practices are in compliance with written policies, procedures, contractual, and DOE requirements.

B. Objectives of Analysis

The objectives of the Property Accounting and Property Management processes and internal controls were to:

- Document LANL's key internal controls including the LANL's stated policies, procedures, systems, and forms.
- Analyze the consistency and adequacy of LANL's policies, procedures, systems, and forms to assess compliance with applicable contractual requirements.
- Determine whether sampled items, in accordance with relevant contract and operational requirements, were properly reviewed, approved, and appeared appropriate in the circumstances.

III. Observations and Recommendations

Based upon the procedures performed, we identified nine (9) items and/or enhancement opportunities in internal controls at LANL for Property Accounting and Property Management processes. Management should address the control opportunities identified from our procedures to further strengthen internal controls in the Property Accounting and Property Management processes. In our view, the observations and

recommendations are presented in the order of their importance. The items and recommendations resulting from our procedures follow:

A. Property Management and Property Accounting Observations

1. Identification of Controlled and Attractive Assets

a. Observation

Property requiring property control tags are not being consistently identified and tracked impairing the ability to account for the property. Assets are not properly identified in the procurement process.

There are five basic methods to procure property:

(a) Blanket Purchase Agreements and Not-to-Exceed Contracts
(b) Purchase Orders (PO)
(c) Just-In-Time (JIT) Vendors
(d) Local Vendor Agreements (LVA)
(e) Purchase Cards (P-Cards)

(a) Blanket Purchase Agreements and Not-to-Exceed Contracts. The Procurement documentation is not set up for individual asset descriptions and/or individual values, limiting the ability to individually identify items that should require property numbers. (Refer to Observation Number 2 below for additional testing concerning descriptions/values.)

(b) Purchase Orders. The Property Accounting Team Leader reviews all purchase orders prior to approval, and accordingly, has the ability to correct errors in financial account coding and identifying assets requiring property codes. We identified of four (4) purchase orders, had the wrong financial account code as received by the procurement department and one (1) did not properly identify the item as requiring a property tag. Additionally, two (2) purchase orders had unclear descriptions requiring additional research. It should be noted that the Property Accounting Team Leader identified and corrected these exceptions demonstrating that the approval control is working properly.

(c) Just-In-Time Vendors. JIT vendors have the ability to add "controlled" or "attractive" items to the catalogs without formal communication with LANL. As a result, vendors do not always identify new items that require property control numbers.

E&Y identified one (1) item that did not receive a property number. In this instance, the item was traced to the JIT vendor catalog and noted that such item was not identified as requiring a property number.

The JIT vendor agreement states that the JIT vendor was contractually required to identify items requiring a property number and affix the property number to the item.

(d) Local Vendor Agreements. No exceptions were identified as part of our test procedures concerning asset classification and bar coding. However, we did find that no secondary review of LVA transactions was being performed, similar to the other procurement methods, to determine that the transaction is in compliance with agreement terms, valid agreement exists (e.g. contract has not expired), proper coding and classification, etc.

Subsequent to our initial testing, it is our understanding that LANL has implemented a monthly Group Leader Stewardship Review that includes LVA's.

(e) Purchase Card. In the testing performed for the Purchase Card, we reviewed December 2002 activity and identified nine (9) instances in which purchases were made for property that appeared to require bar codes even though prohibited by the program.

Subsequent to our initial testing, we identified that the nine items were appropriately resolved by LANL's current 100% Purchase Card review.

b. Recommendation

The effectiveness of the Property Accounting and Management controls are, in part, interdependent with the Procurement functions:

We recommend the use of system edit checks be developed that contain "System Prompts" (e.g., "Does this item require a bar code?) and lists for the account name and number where the buyer must chose from an appropriate account listing (e.g. limit financial account coding choices to: capital, controlled, and attractive codes, where appropriate).

LANL should consider utilizing similar test procedures performed for the P-Card (i.e., database queries) on the LVA and the JIT accounts. LANL should consider incorporating penalty language for vendor non-compliance upon agreement renewal, or sooner.

Blanket Purchase Agreements – Require buyers to complete the PO using the Procurement Desktop (PD) for items purchased under blank POs (or not-to-exceed contracts). This should achieve the level of detail required for identifying items that are required to be tracked in the Property system.

Purchase Orders – Develop improved training for buyers on the TIPs system focusing on the fundamentals including, but not limited to, identification of items requiring property codes, financial account coding and description classifications to facilitate and expedite the review process. Develop a regular communication program between Property Accounting and Procurement to review "lessons learned" and address open issues in a timely manner.

JIT Vendors – LANL should review and approve all new items *prior* to a JIT vendor modifying the catalog of allowable purchases, including reference for the proper financial account code. A monthly review should be conducted for all JIT vendors with the ability to modify price, classification, and financial account coding in the catalog.

Local Vendor Agreements – (1) LANL should consider consolidating the LVA within the P-Card program; (2) Perform independent review LVA statements monthly or develop/generate system exception report(s) for items that should require property tags, but are not posted to Sunflower; (3) Implement a policy defining consequences of violating LANL's purchasing policies; (4) Implement a property audit/review process that has procedures to review for possible misuse of LVA contracts.

Purchase Cards – To further strengthen LANL's Purchase card program, we recommend that: (1) Require users to attend an enhanced training course focusing on the account coding and asset classification before the use of P-Cards are allowed and attend refresher courses for individuals not following procedures; (2) Implement a policy defining consequences of violating LANL's purchasing policies; (3) Develop a database to track violators of P-Cards policies to identify users needing additional training or other action; and (4) Explore options with P-Card vendor, Bank One, to automatically deny the purchase of certain items.

2. Sunflower Database

a. Observation

The database has incomplete or inaccurate fields among the approximately 80,000 active items, including no values, item description, or serial number, etc. The incomplete fields may impact the ability of both Property

Management and Property Accounting to track and account for the property numbered items. Other database attributes that require attention include:

- Assets with a value of $0 – 579 items.
- Assets with no description – 505 items valued at $4,445,105
- Assets with no manufacturer listed – 771 items valued at $20,556,762
- Assets with no model number – 522 items valued at $6,106,864
- Assets with no location – 1,164 items valued at $8,686,853

Assets with a value of $0 are accounted for on a subsidiary ledger. To the extent the subsidiary ledger is not timely reviewed and updated, assets may not be properly depreciated at the time the assets are placed in service.

b. Recommendation

We understand procedures are underway to address and reconcile items with $0 value related to Assets-in-Progress (Refer to Observation Number 3). Findings related to incorrect asset type coding, missing descriptions and other incomplete or inaccurate asset information should be coordinated with the wall-to-wall inventory team for resolution and correction in the Sunflower system.

LANL should also consider developing additional monthly exception reporting to eliminate incomplete and/or inaccurate database entries.

3. Reconciliation Process

a. Observation

Review and reconciliation of procurement programs, receiving reports and FMIS account sub-ledgers are not being performed monthly (as indicated below). We understand the wall-to-wall inventory, a mitigating control, is being compared to the Sunflower database. This procedure will not identify assets that should be tracked that are not physically located on-site.

The following is a current overview of the review processes underway:

(1) Review of P-Card Transactions – Approximately one year behind. (Note: This is a secondary control. The P-Card office reviews these transactions on a monthly basis to identify inappropriate use of the P-Cards)
(2) Review of JIT Purchases – Completed through December, 2002.

(3) Review of FMIS accounts 63800, 63810, and 60900[1] to verify that all items included in Sunflower – March 2002 for accounts 63800-63810 and November 2002 for 60900.
(4) Review backlog of Assets in Progress (AIP) – Approximately $209 million of the $286 million backlog has been addressed since December 31, 2002.
(5) Maintenance of the IPSE catalog has not been current in 3 years.

No review of LVA purchases is currently being performed.

The IPSE cost catalog was last prepared in FY00.

This item was contained in LANL's Property Accounting Control Risk Self-Assessment performed in January 2003.

b. Recommendation

Continued focus should be maintained on the regular review and reconciliation of procurement programs, receiving reports and FMIS account sub-ledgers. Improved communication and training on the definition of assets that require property numbers and the correct financial account coding should be implemented.

AIP accounts should be tracked by expected completion dates, with an exception report run for all accounts remaining in AIP status subsequent to expected completion date or alternate contingency date.

LANL should consider that tests procedures similar to those performed for the P-Card be utilized on the LVA accounts.

4. Attractive Asset Listing

a. Observation

The current definition of "attractive" assets is incomplete and inconsistent among divisions. The various attractive asset lists in circulation do not provide sufficient clarity for purchasers to identify all items requiring a property number. For example, we noted that the P-Card policy provided a general list of seven items[2] while the BUS Property Accounting policy

[1] FMIS account names are as follows: 60900 Capital Equipment purchased with Reimbursable Funds; 63800 Controlled Property Barcoded non-ADP Property (except capital equipment), and 63810 Controlled Property Barcoded ADP Property (except capital equipment).

[2] The P-Card policy, dated December 2002 indicates a generic list: "Sensitive items include cameras, computers, printers, radios, recorders, scanners, and telephones." Additionally, a training presentation dated October 1, 2002

provided additional descriptive detail and added two additional items[3]. Without consist policies for identifying property to be tracked, Property Accounting and Property Management, will not be able to effectively operate.

b. Recommendation

Develop and communicate a consistent list of capital, controlled, and attractive items to all LANL staff. Incorporate the single list into LANL policies, procedures and training documentation.

The master "attractive" items list should be periodically updated to include new items that can be readily converted to cash (e.g., flat screen monitors, video projectors).

Note: We understand Property Management team is committed to developing a comprehensive list of items requiring property numbers to be distributed to all LANL employees.

5. Receiving Process

a. Observation

Any Receiving Clerk can override Procurement's classification (capital, controlled, or attractive) for property requiring issuance of a property number.

Requestors can indicate a change in the delivery location without verification from receiving and without approval. Therefore, items not received in the Central Receiving department will not be "batch filed" and down loaded to the Sunflower database for appropriate property tracking.

Current desktop instructions are silent regarding specific requirements for identification of property requiring a property number.

Items acquired through certain types of contracts (primarily time & materials) do not automatically feed into the batch file and therefore, may not be identified and established in Sunflower.

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indicated sensitive items cannot be purchased; however, did not provide any documented clarification of a "sensitive" item. (Note: "sensitive" and "attractive" are used interchangeably.)

[3] The Property policy included two additional examples of sensitive items in addition to those included in the P-Card. Items added were: "Fire Arms" and "TV/VCR Combos."

b. Recommendation

LANL should develop a control process for assets received outside of the Central Receiving area that would include the identification, location, authorization, and appropriate tagging of property.

Review the design of the Sunflower and "TIP's" interface to enhance the identification, user level authorities, and transfer of information on property numbered assets.

6. Precious Metal Inventory

a. Observation

Precious Metal Custodians are not consistently submitting their direct Purchase Orders and Receipts for Precious Metals to Property Accounting. The only way these are found is once a year with the "Physical Validation".

This item was contained in LANL's Property Accounting Control Risk Self-Assessment performed in January 2003.

b. Recommendation

Precious metals procured through a purchase order should be accounted for and inventoried upon receipt. Direct purchases and receipts should not be permitted without validating that the transaction was entered into the IFS. Additional opportunities exist to streamline this process.

7. Assets-in-Progress

a. Observation

Property Accounting does not review job orders for Assets-in-Progress (AIPs) until after the work is completed. The job order package provides very little documentation of the scope of the actual project and the related costs. Property Accounting's review is limited to budget approval, cost calculation, and capital criteria. Individual cost items are not reviewed during this process. This limits Property Accounting's ability to track and identify the components of capital items that should be included in the capitalized cost, therefore, resulting in potential understatement of capital assets amounts and depreciation. Job orders do not provide a business reason for a project or sufficient detail to identify all costs associated with a project. Once a job order or AIP is closed, no evaluation of budget to actual with an explanation of variances is provided.

b. Recommendation

LANL should work with Budgeting to revise the current process for planning AIP projects. Revisions should include, at a minimum, a business reason for undertaking a project and a detailed list of expenditures to be included in the overall cost of the project including materials, labor, installation, shipping, etc. This detail will facilitate the review and reconciliation between budget and actual, as well as assist in validating that all costs related to a project are captured in the final cost to be depreciated.

8. Warranty Information

a. Observation

LANL does not currently have a database to track warranty information of items procured. Warranty information is tracked on a case-by-case basis when an asset requires maintenance. In some cases, warranty information is affixed to the asset. Depending on the asset, a Custodian may contact BUS-7 (technology) for assistance, may call Procurement, or may address the issue themselves. This lack of centralized tracking of warranty information ultimately leads to additional and unnecessary maintenance costs. Additional time is spent attempting to identify the warranty information. The scope of this issue cannot be quantified because warranty-related expense information is not tracked separately. LANL spent approximately $8 million dollars on the maintenance of computer and related equipment during FY 2002 and approximately $5 million dollars on the maintenance of other equipment.

b. Recommendation

Given the amount of funds spent on maintenance and repairs, we recommend LANL perform a preliminary assessment to determine whether or not dollars are being spent that should be covered under a warranty/service agreement. LANL should explore options for expanding Sunflower to track warranty information on assets purchased and tracked with property numbers. At a minimum, the database should contain the following information:

- Serial Number
- Manufacturer
- Vendor/Address/Phone number
- Requestor/Owner
- Cost (Basis)/Description
- Date of Purchase
- Warranty Period
- Warranty Coverage (parts, service, etc.)
- Warranty/Service Contact
- Warranty/Service Contact Phone Number
- Property Administrator Name
- Property Administrator Contact Information

9. Desktop Procedures

a. Observation

Certain Property Accounting Department Desktop Instruction topics are out-of-date, (e.g., reference to systems no longer in use) or simply did not exist. Our findings are summarized as follows:

- Several procedures were out-of-date and a number of procedures were not dated. For example, the "Lease-to-Own Buyouts" instruction was drafted July 1, 1996 and contains outdated information; and, "Property Transfers Slips," dated January 1997 need to be updated.
- There are no desktop instructions for the Sunflower system, AIP Reconciliation, Receiving Reports, Voucher and Audit AIP and CWIP Closings, Reimbursable and Special Project Equipment, Adds, and Deletes Report.
- Precious metals procedures for procurement of precious metals using purchase orders are inadequate.

This item was contained in LANL's Property Accounting Control Risk Self-Assessment performed in January 2003.

b. Recommendation

LANL should update the Property Management Procedures and Desktop Instructions with a priority placed on procedures for precious metals obtained through purchase orders.

Tab 8

University of California
Los Alamos National Laboratory

Compliance and Operational Analysis
LANL Budget Execution Processes and Internal Controls

April 15, 2003

ERNST & YOUNG LLP

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April 15, 2003

Ms. Anne C. Broome
Vice President-Financial Management
University of California
1111 Franklin Street
Oakland, California 94607-5200

Subject: Report of Compliance and Operational Analysis re: Budget Execution Processes and Internal Controls

Dear Ms. Broome:

Ernst & Young (E&Y) has completed a compliance and operational analysis of the Los Alamos National Laboratory (LANL) Budget Execution processes and internal controls, and our Report is attached. This report is intended solely for the information and use of the University of California Management.

Implementation of the recommendations contained in the attached Report will provide for an enhanced control environment for the budget execution processes. We recommend periodic follow-up to determine accomplishment of the recommended actions.

We appreciate the cooperation and assistance provided to us during the course of our work. If you have any questions, please contact Mr. Brian F. Simmons at 214.969.8629.

Sincerely,

Brian F. Simmons
Central Region Director
Government Contract Services

Ernst & Young LLP is a member of Ernst & Young International, Ltd.

ERNST & YOUNG LLP

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I. Overview

The University of California, Vice President - Financial Management retained Ernst & Young LLP (E&Y) to conduct an independent compliance and operational analysis of the Los Alamos National Laboratory (LANL) Budget Execution processes and internal controls.

In accordance with E&Y's Engagement Letter dated February 4, 2003, E&Y is pleased to provide the results of E&Y's analysis of LANL's budget execution processes and internal controls. The E&Y report is comprised of three (3) parts: (I) Overview/Background, (II) Procedures Performed, and (III) Observations and Recommendations.

The E&Y services were performed in accordance with the Statement on Standards for Consulting Services (CS100) of the American Institute of Certified Public Accountants (AICPA) as stated in the Engagement Letter. The Standards for Consulting Services (CS100) do not result in issuance of an opinion and do not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards, the objective of which is the expression of an opinion on the elements, accounts, or items of a financial statement. As a result, E&Y does not express an opinion on LANL's budget execution processes and internal controls. The procedures performed by E&Y did not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards.

A. Background

The University of California is the designated operating contractor under a prime contract (W-7405-ENG-36) awarded by the Department of Energy (DOE) for operation of the LANL. A description of the overall duties of the operating contractor is contained in Paragraph C.001 of Modification Number M552, entitled Statement of Work. Paragraph I.096 of the aforementioned contract modification requires that:

> "The contractor shall maintain and administer a financial management system that is suitable to provide proper accounting in accordance with DOE requirements for assets, liabilities, collections accruing to the Contractor in connection with the work under this contract, expenditures, costs, and encumbrances; permits the preparation of accounts and accurate, reliable financial and statistical reports;

> and assures that accountability for the assets can be maintained."

The governing regulations for the operating contract are the Department of Energy Acquisition Regulation Supplement (DEARS). The DEARS implements and supplements the Federal Acquisition Regulation (FAR).

To fulfill LANL's financial management responsibility, LANL utilizes two handbooks: (1) The DOE Accounting Handbook and (2) an internally developed LANL Financial Management Handbook based, in large part, on the DOE Accounting Handbook. The DOE Accounting Handbook presents the DOE's standards, procedures, and operational requirements in support of accounting policies, principles, and applicable legal requirements for DOE operations. The LANL Financial Management Handbook describes the principle accounting, planning, and reporting requirements. The LANL Financial Management Handbook consists of six major topics: "Indirect Budget", "Data Warehouse", "Time & Effort", "Accounting", "Formal Budgeting", and "Related Resources".

Accounting policies that supplement the guidance contained in the Financial Management Handbook are contained in LANL's Accounting Resource Manual. LANL accounting policies are implemented by specific desk instructions.

Each year, LANL submits a budget in accordance with applicable DOE, Office of Management and Budget, and other federal regulations. LANL's total budget for FY 2003 is approximately $2.7 billion that includes monies for operating, capital construction, and general plant projects.

With input from LANL, DOE develops an initial budget for Office of Management and Budget review. Ultimately, the DOE input becomes part of the President's Budget which is addressed by Congress as part of the Energy and Water Development Appropriations Bill. Once the appropriations bill is signed by the President, DOE receives its portion and provides LANL an initial Approved Financial Plan (AFP), which allocates funds at the Estimated Cost & Obligation Reporting (ECOR) level.

At LANL, the Business Operations Division within the Administration Directorate performs budget planning and execution functions. BUS-3 (Budget and Planning) is responsible for the "core" budget development and execution, as well as development of LANL business policies and practices. As such, BUS-3 oversees the LANL wide budget process, including preparation of indirect budgets/rates. BUS-2 (Distributed Budget) budget analysts are assigned directly to assist program managers in administering the program managers' budgets. The Program Integration Office (PIO) provides a link between the various program (BUS-2) and core (BUS-3) functions. Currently, there are 205 personnel authorized to perform

budget functions; 155 employees were assigned to BUS-2, 25 employees were assigned to BUS-3, and 25 employees were assigned to PIO.

B. Summary of Observations

As a result of our analysis, we identified eight (8) observations related to the strengthening of budget execution processes and internal controls. The observations related to budget adjustments, charging incurred costs to project codes, G&A rates, budget analysis, budget software, budget processes, manual budget operations, and budget reconciliation.

II. Procedures Performed

A. Scope of Analysis

The scope of the compliance and operational analysis of budget execution processes and internal controls, included the following:

- Understand the process for LANL's budget execution activities.
- Assess written policies, procedures, and internal controls related to budget execution functions for compliance with DOE and contract requirements.
- Perform interviews of key personnel.
- Analyze and understand the results of prior reviews on policies, procedures, systems, and practices.
- Sample selected transactions to determine if actual practices are in compliance with written policies, procedures, contractual and DOE requirements.

B. Objectives of Analysis

The objectives of the budget execution processes and internal controls were to:

- Document the LANL's key internal controls including the LANL's stated policies, procedures, systems, and forms.
- Analyze the consistency of application and adequacy of LANL's policies, procedures, systems, and forms to assess compliance with applicable contractual provisions.
- Determine whether sampled items, in accordance with relevant contract and operational requirements were properly reviewed, approved, and appeared appropriate in the circumstances.

III. Observations and Recommendations

Based upon the procedures performed, we identified eight (8) items/control enhancement opportunities in the budget execution internal control processes. Management should address the control opportunities identified from our procedures to further strengthen internal controls in the budget execution processes. In our view, the observations and recommendations are presented in the order of their importance. The items identified and the recommendations resulting from our procedures follow:

A. Budget Execution Process Observations

1. Budget Adjustments

a. Observation

Budget adjustments are periodically made for some programs, excluding all WFO's programs, to prevent actual costs from exceeding the budgeted amounts. Other reasons budgets may be adjusted include: (1) the identification of additional work scope, (2) identification of additional costs and, (3) a sponsor sends additional funding or cuts funding. A changing budget baseline precludes meaningful variance analysis to determine the nature and significance of deviations from budget. As a result, the budgeting function becomes a reactive tool to account for costs rather than a proactive tool to improve the overall planning and control process.

b. Recommendation

LANL should maintain the integrity of initially established budgets as a control and evaluation baseline for variance analyses. Adjustments to the original budget should be limited to changes in the scope of planned work authorized and documented by management.

2. Charging Incurred Costs to Project Codes

a. Observation

Charging of incurred costs to project codes is suspended when incurred costs reach 95 or 99 percent of budget authorization for "regular" and Work For Others (WFO), respectively. Nevertheless, actual costs will, on occasion, exceed the budget authority. When actual costs incurred exceed budgeted/authorized amounts, the excess costs are charged to a suspense account. Costs are analyzed pending receipt of additional budget to determine whether or not the excess costs are potentially

beneficial/assignable to another program. If neither result occurs, the amounts remain as a suspense and are ultimately charged against the UC Management fee.

b. Recommendation

Costs should be charged to the project for which they are incurred irrespective of the funding status. Costs exceeding budgets should not be: (1) suspensed pending possible reclassification; or (2) left in a suspense account. LANL should consider developing a system generated warning report that would be sent to the responsible Budget Analyst informing the Budget Analyst that the project order is approaching 75 percent of the obligation threshold.

3. G&A Rates

a. Observation

LANL has five different General and Administrative (G&A) rates that are applied to: (1) on-site, (2) off-site program, (3) capital and construction program, (4) construction (over $50 million), and (5) commercial work. LANL uses a modified total cost input base that excludes procurement costs over $100 thousand, as well as costs for student and post-doctoral status workers, and university contracts. (LANL's Disclosure Statement only describes three major rates--on-site, off-site program, and capital and construction program.) LANL also uses numerous indirect rates (approximately 400). Although DOE has approved LANL's Disclosure Statement, the practice of using multiple G&A rates may not meet the intent of FAR 31.203(c) or Cost Accounting Standard (CAS) 410.

b. Recommendation

LANL should consider implementing a single G&A rate. LANL should consider simplifying the overall indirect rate structure to reduce the cost and effort associated with budgeting, tracking, and adjusting numerous individual rates. Simplification would also enhance control by focusing management attention on fewer areas of greater significance.

4. **Budget Analysis**

   a. **Observation**

   Budget analysts from both the program and Division levels perform periodic analyses to assist technical program managers in tracking program progress. The program and Divisional personnel use financial reports based on data recorded in the Financial Management Information System (FMIS). Technical program management however, (whether from the Program Management Division or "in-house") use the data recorded in FMIS adjusted for unrecorded transactions (e.g., material accruals and outstanding commitments). Consequently, there are often multiple measures of "actual" costs at any point in time.

   b. **Recommendation**

   LANL should implement a standard reporting format depicting the reconciliation for authorized adjustments to raw financial data. All parties should provide management analyses based on a single measure of cost/schedule control information through use of a standard reporting format completed on a periodic basis.

5. **Budget Software**

   a. **Observation**

   LANL employees use several different types of computer software for budget estimating, monitoring, and project management. Reasons for the variations include customer and user preferences, program functionality, and lack of prescribed standards. These differences result in reduced systems compatibility, increased system/software maintenance, and variability in management reports.

   b. **Recommendation**

   LANL should prescribe the use of standardized, preferably off-the-shelf, computer software to reduce maintenance cost and increase consistency in performance and control activities. All activities should use the same application software for a given function.

6. Budget Processes

a. Observation

A number of LANL budget processes have not been documented either formally or informally by way of flowcharts and/or desktop procedures. To assist in achieving consistency with management direction and policy requirements, all significant processes (and particularly the control features of those processes) should be documented.

b. Recommendation

LANL should provide the resources to institutionalize standard operating practices within the budget function through proper documentation. Desk instructions should include cross-references to policies and other desk instructions, author, origination and effective dates, approvals and date, revision date, and log of revisions in a standard format.

7. Manual Budget Operations

a. Observation

There are a number of manual operations within the budget function that could be automated. For example, due to system limitations, budget personnel generate a budget allocation matrix in EXCEL format for each program. The matrix must then be manually input into FMIS by program. BUS-3 personnel also perform several time-consuming reconciliations on EXCEL spreadsheets (e.g., calculating organizational support on capital and construction, Work for Others, LANL Directed Research and Development adjustment, and Central Maintenance Management System G&A rebate).

b. Recommendation

LANL should provide the resources to automate manual processes to the maximum extent possible. Through increased automation, LANL can improve operating efficiency and decrease the potential for human error.

8. Budget Reconciliation

a. Observation

Approved Funding Plans should be reconciled with Work Authorization Statements before funds are allocated to provide assurance that LANL has the approval to spend monies received. BUS-3 has recognized this as an

important control function as part of their control risk self-assessment and is implementing a reconciliation procedure.

b. Recommendation

LANL should include validation of the reconciliation control procedure in the current validation cycle.

Tab 9

University of California
Los Alamos National Laboratory

Compliance and Operational Analysis
LANL Accounts Payable Processes and Internal Controls

April 15, 2003

ERNST & YOUNG LLP

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April 15, 2003

Ms. Anne C. Broome
Vice President-Financial Management
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Oakland, California 94607-5200

Subject: Report of Compliance and Operational Analysis re: Accounts Payable Processes and Internal Controls

Dear Ms. Broome:

Ernst & Young (E&Y) has completed a compliance and operational analysis of the Los Alamos National Laboratory (LANL) Accounts Payable processes and internal controls, and our Report is attached. This report is intended solely for the information and use of the University of California Management.

Implementation of the recommendations contained in the attached Report will provide for an enhanced control environment for the accounts payable processes. We recommend periodic follow-up to determine accomplishment of the recommended actions.

We appreciate the cooperation and assistance provided to us during the course of our work. If you have any questions, please contact Mr. Brian F. Simmons at 214.969.8629.

Sincerely,

Brian F. Simmons
Central Region Director
Government Contract Services

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I. Overview

The University of California, Vice President - Financial Management retained Ernst & Young LLP (E&Y) to conduct an independent compliance and operational analysis of the Los Alamos National Laboratory (LANL) Accounts Payable processes and internal controls.

In accordance with E&Y's Engagement Letter dated February 4, 2003, E&Y is pleased to provide the results of E&Y's analysis of LANL's accounts payable processes and internal controls. The E&Y report is comprised of three (3) parts: (I) an Overview/Background, (II) Procedures Performed, and (III) Observations and Recommendations.

The E&Y services were performed in accordance with the Statement on Standards for Consulting Services (CS100) of the American Institute of Certified Public Accountants (AICPA) as stated in the Engagement Letter. The Standards for Consulting Services (CS100) do not result in issuance of an opinion and does not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards, the objective of which is the expression of an opinion on the elements, accounts, or items of a financial statement. As a result, E&Y does not express an opinion on LANL's banking processes and internal controls, including DOE funding. The procedures performed by E&Y did not constitute an audit or an examination made in accordance with generally accepted auditing or attestation standards.

A. Background

The University of California is the designated operating contractor under a prime contract (W-7405-ENG-36) awarded by the Department of Energy (DOE) for operation of the LANL. A description of the overall duties of the operating contractor is contained in Paragraph C.001 of Modification Number M552, entitled Statement of Work. Paragraph I.096 of the aforementioned contract modification requires that:

> "The contractor shall maintain and administer a financial management system that is suitable to provide proper accounting in accordance with DOE requirements for assets, liabilities, collections accruing to the Contractor in connection with the work under this contract, expenditures, costs, and encumbrances; permits the preparation of accounts and accurate, reliable financial and statistical reports; and assures that accountability for the assets can be maintained."

The governing regulations for the operating contract are the Department of Energy Acquisition Regulation (DEAR). The DEAR implements and supplements the Federal Acquisition Regulation (FAR).

To fulfill LANL's financial management responsibility, LANL utilizes two handbooks: (1) The DOE Accounting Handbook and (2) an internally developed LANL Financial Management Handbook based, in large part, on the DOE Accounting Handbook. The DOE Accounting Handbook presents the DOE's standards, procedures, and operational requirements in support of accounting policies, principles, and applicable legal requirements for DOE operations. The LANL Financial Management Handbook describes the principle accounting, planning, and reporting requirements. The LANL Financial Management Handbook consists of six major topics: "Indirect Budget", "Data Warehouse", "Time & Effort", "Accounting", "Formal Budgeting", and "Related Resources."

Accounting policies that supplement the guidance contained in the Financial Management Handbook are contained in LANL's Accounting Resource Manual. LANL accounting policies are implemented by specific desk procedures.

The E&Y analysis of the Accounts Payable processes and internal controls focused on specific accounting functions that are performed in LANL's Accounting organization (BUS-1). The Accounting organization consists of approximately 100 employees. The Accounting organization is further subdivided into smaller functional units: Travel, Accounts Payable and Contract Accounting, General Accounting and Work for Others (WFO), Property Accounting, Payroll, and support related functions. The Accounts Payable department consists of 27 employees.

The department is divided into three distinct teams with the following responsibilities:

- General Payables (7 employees) – Process standard invoices.
- Contract Accounting (10 employees) – Process complex and contract-related invoices.
- Process Support (7 employees) – Receive and scan invoices, generate checks, and perform daily batch balancing and edit checks.

Each team reports directly to the Accounts Payable Team Leader. There are two additional employees in Accounts Payable – one employee is dedicated to resolving system barriers and interface occurrences, the other employee performs non-routine "special projects."

DOE's, as well as LANL's, Financial Stewardship Objective for Accounts Payable is that "all goods and services are accurately received, recorded, and paid in a timely efficient manner with adequate safeguarding of records."

During FY 2002, there were approximately 37,700 checks for approximately $1.3 billion that cleared the LANL Accounts Payable bank account. As of January 2003, there were approximately 14,000 checks for approximately $510.2 million that have cleared the LANL Accounts Payable bank account.

The Accounts Payable department uses the following systems to support its business processes:

- PAID (Purchasing, Accepting, Invoicing and Disbursing System) – Matches invoices to purchase orders. Schedules and makes payments. Updates Financial Management Information System (FMIS) with financial accounting and reporting data.
- IAS (Invoice Approval System) – Workflow system for approving invoices.
- Documentum – Electronic document repository for invoices, credit memos, etc.
- PayBase – Check generation software package.
- TIPS – Procurement's Purchase Order system that processes information to the PAID system.

B. Summary of Observations

As a result of our analysis, we identified nineteen (19) observations related to the strengthening of accounts payable processes and internal controls. These observations related to IRS 1099 forms, check runs, check security, non-taxable transaction certificates, purchase order approval codes, PAID system updates, cost corrections, aged credits, aged payables, cash advances, business continuity plan, invoice approvals, manual checks, PAID system voids, duplicate orders, purchase card accounts payable, segregation of duties, Treasury Department discount interest rate, and accounts payable desk instructions.

II. Procedures Performed

A. Scope of Analysis

The scope of compliance and operational analysis of Accounts Payable processes and internal controls included the following:

- Understand the process for LANL's Accounts Payable activities.
- Assess written policies, procedures, and internal controls related to Accounts Payable functions for compliance with DOE and contract requirements.
- Perform interviews of key personnel.
- Sample selected transactions to determine if actual practices are in compliance with written policies, procedures, contractual, and DOE requirements.

B. Objectives of Analysis

The objectives of the Accounts Payable processes and internal controls were to:

- Document LANL's key internal controls including LANL's stated policies, procedures, systems, and forms.
- Analyze the consistency of application and adequacy of LANL's policies, procedures, systems, and forms to assess compliance with applicable contractual provisions.
- Determine whether sampled items, in accordance with relevant contract and operational requirements, were properly reviewed, approved, and appeared appropriate in the circumstances.

III. Observations and Recommendations

A. Accounts Payable Process Observations

Based upon the procedures performed, we identified nineteen (19) items/control enhancement opportunities in the Accounts Payable internal control processes. Management should address the control opportunities identified from our procedures to further strengthen internal controls in the Accounts Payable processes. In our view, the observations and recommendations are presented in the order of their importance. The items identified and the recommendations resulting from our procedures follow:

1. IRS 1099 Forms

a. Observation

During 2002, two Service Contractors who should have received an Internal Revenue Service (IRS) 1099 Form notified Accounts Payable that they had not. Accounts Payable is responsible for issuing IRS Forms 1099 to Service Contractors. Individuals in BUS-7 (System Support for Lab-wide Systems) classify vendors in the Vendor Master File as either a Corporation or Sole Proprietorship based on whether the contractor provides an Employer Identification Number or Social Security Number. Incorrect classification may result in failure to issue IRS 1099 Forms to some non-corporation service contractors. Management has advised that IRS 1099 Forms have been issued for the two service contractors identified above.

Failure to properly issue IRS 1099 Forms to all non-corporation service contractors may result in IRS fines and penalties.

This item was contained in LANL's "Sub-objective #8" in the Accounts Payable Control Risk Self-Assessment performed in January 2003.

b. Recommendation

LANL should establish procedures to properly code all vendors in the Vendor Master File. IRS W-9 Forms should be obtained from all new vendors providing services to LANL. IRS 1099 Forms should then be issued for all non-Corporations.

LANL should perform periodic testing of the Vendor Master File to determine whether vendors are properly coded and take corrective actions as required.

2. Check Run(s)

a. Observation

Accounts Payable generates checks on a daily basis for invoices approved for payment. Although multiple invoices processed on a given day for a single vendor are generally batched and paid on one check, there is no control on the overall number of checks a vendor receives during a month. During the month of January 2003, we noted the following:

- 534 vendors received 2 or more checks.
- Of these, 78 vendors received 5 or more checks
- One vendor received 69 checks.

b. Recommendation

In accordance with best practices, the Accounts Payable department should reduce the number of check runs processed to no more than twice a week. Ideally, LANL should strive to process checks only once a week. This should result in increased efficiency, fewer errors and cost savings.

3. Check Security

a. Observation

Accounts Payable checks are not secured in a sealed envelope or locked drawer prior to mailing. Accounts Payable checks are kept in the Process Support supervisor's office. Checks for vendor pickup are stored in a 3-ring binder. The binder is not secured in a central location and numerous individuals have authority to distribute checks to vendors. Improper

handling of signed checks increases the risk of misappropriation of funds and is not consistent with the internal control for safeguarding of assets.

This item was contained in LANL's "Sub-objective #4" in the Accounts Payable Control Risk Self-Assessment performed in January 2003.

b. Recommendation

To increase the safeguarding of assets, all signed Accounts Payable checks should be secured in a locking drawer or safe prior to distribution.

Responsibility for safeguarding and distributing "pick-up" checks should be assigned to a specific individual.

Alternatively, LANL should consider eliminating the practice of allowing vendors to "pick up" checks; either mail all checks or develop a direct deposit capability.

4. Nontaxable Transaction Certificates

a. Observation

The contract between the University of California and the DOE requires that Nontaxable Transaction Certificates (NTTCs) be provided to each vendor in New Mexico that sells tangible personal property to LANL for use on the contract. Vendor gross receipts taxes are specifically unallowable per the Contract Clause, I.030, that incorporates FAR 52.229-10, "State of New Mexico Gross Receipts and Compensating Tax (Oct 1988)." Currently, LANL issues NTTCs only to vendors who request the certificates. LANL does not track whether or not vendors that have received certificates charge LANL the gross receipts tax or not.

b. Recommendation

LANL should institute a practice of issuing NTTC's to each New Mexico vendor that sells tangible personal property to LANL.

LANL should perform periodic test procedures for the absence of the New Mexico Gross Receipts Tax on vendor invoices for vendors that have been issued NTTC's.

5. Purchase Order Approval Codes

a. Observation

As part of E&Y procedures performed, we noted one "Not-to-Exceed" PO coded as 2A (no approval required). According to the TIPS (purchase order

system) reference library, Not-to-Exceed orders should be coded 2C, 2D, or 2E (approval required). Although the Accounts Payable department is responsible for obtaining invoice approvals through the Invoice Approval System (IAS), buyers determine and code new POs for the required approvals as required. Improper coding increases the risk that payments are made for unapproved transactions or for goods that have not been received.

This item was contained in LANL's "Sub-objective #2" in the Accounts Payable Control Risk Self-Assessment performed in January 2003.

b. Recommendation

Accounts Payable management should develop system edit checks and system exception reporting for proper coding, as appropriate. System edits over PO approval coding, based on the item/service being purchased, should be developed.

As an interim measure, Accounts Payable management should coordinate with Procurement to provide buyers with additional training on approvals required for different types of purchases.

6. PAID System Updates

a. Observation

Although new PO's processed in TIPS update the PAID system, change orders and contract modifications entered in TIPS do not. These changes must be manually entered a second time, after initially being entered to the TIPS System, into the PAID system. The PAID system automatically closes a PO line item whenever a credit memo is entered against that line item so that POs must be manually reopened in the PAID system. In order to re-open a closed PO in PAID, an item must be "received" in the system.

b. Recommendation

Automated processing of changes made in TIPS should be developed to increase efficiency and decrease the possibility of errors. Revisions to the PAID system to eliminate premature closing should be developed to enhance efficiency and reduce potential for error.

7. Cost Corrections

a. Observation

During Fiscal Year 2002, Accounts Payable received 1,334 requests for cost corrections that required the manual adjustment of 10,653 line items of cost.

The large number of cost corrections is due mainly to incomplete or incorrect PO information from the buyer.

This item was contained in LANL's "Sub-objective #1" in the Accounts Payable Control Risk Self-Assessment performed in January 2003.

b. Recommendation

Additional training on proper account coding procedures should reduce the volume of cost corrections. Tracking cost corrections by requesting individual can identify the need for individual attention.

8. Aged Credits

a. Observation

We obtained a report from PAID of items aged greater than 90 days and noted 43 negative amounts (unapplied credits) totaling approximately $146,000 dating back to 1998. Twenty-four (24) items totaling approximately $48,000 were dated prior to 2002.

b. Recommendation

Accounts Payable should establish standard procedures for researching outstanding credits greater than 90 days and writing off uncollectable items.

Management should review the outstanding items to determine applicability or collectability. Items that cannot be matched to invoices or collected should be written off as appropriate.

9. Aged Payables

a. Observation

We obtained a report from the PAID system of items aged greater than 90 days. There were 168 invoices aged greater than 90 days totaling approximately $1,043,000 dating back to 1988. Of those, 68 items totaling approximately $124,000 were dated prior to 2002.

b. Recommendation

Accounts Payable should develop standard procedures for researching outstanding invoices aged over 90 days and writing off items as appropriate.

Management should review the outstanding items to determine whether they are valid payables. Non-valid items should be written off as appropriate.

10. Cash Advances

a. Observation

Accounts Payable permits cash disbursement in advance of expenditures for employee morale related transactions. Accounts Payable does not have a procedure to net actual expenses against cash advances.

b. Recommendation

Accounts Payable should consider eliminating the use of cash advances and only make payment upon the submission of properly approved requests and supporting receipts.

Alternatively, Accounts Payable should develop procedures for netting cash advances against expenses incurred.

11. Business Continuity Plan

a. Observation

A comprehensive business continuity plan has not been developed for the Accounts Payable department.

The lack of a comprehensive business continuity plan increases the risk that vendors may not receive timely payment in the event of a disaster.

b. Recommendation

A formal business continuity plan should be developed for Accounts Payable.

12. Invoice Approvals

a. Observation

When invoices are matched to POs in the PAID system, the default setting is to schedule payment within the terms of the PO. Unless the Invoice Processor manually places a hold on payment by changing the payment field from "P" (pay) to "H" (hold), the invoice will be paid regardless of whether required approvals have been obtained.

This item was contained in LANL's "Sub-objective #2" in the Accounts Payable Control Risk Self-Assessment performed in January 2003.

b. Recommendation

The default setting in the PAID system should be changed to "H" so that processed invoices requiring approval(s) are automatically placed on hold until the required approval(s) are obtained.

13. Manual Checks

a. Observation

Manual checks are currently not processed through the PayBase system. Manual checks are typewritten on separate check stock, which are signed by the BUS-1 Group Leader. The PAID system must be manually updated for all typewritten checks. Manual processing increases the risk of misappropriation of funds and duplicate payment to vendors.

This item was contained in LANL's "Sub-objective #2" in the Accounts Payable Control Risk Self-Assessment performed in January 2003.

b. Recommendation

Manual checks should be eliminated, except for extraordinary circumstances to increase efficiency and to provide for enhanced internal controls.

14. PAID System Voids

a. Observation

The number of system voids from the PAID system appears excessive. During January 2003, there were 423 system voids (or 12 percent) out of 3,656 checks. For example, the standard of five check voids generated on continuous feed forms was acceptable for line-up purposes. LANL no longer uses continuous feed forms, but rather a laser printer that requires no line up check voids. LANL is still generating line-up check voids when not required. The PAID computer software was not updated when the department transitioned to printing checks on the laser printer. Excessive system voids complicates the check generation process, increases processing costs, and complicates the check reconciliation process.

b. Recommendation

LANL should update system software to eliminate unnecessary system voids. Updating the system software should increase efficiency and eliminate unnecessary and costly system line-up check voids.

15. Duplicate Orders

a. Observation

During our walkthrough procedures, we noted that two orders had been generated for the same purchase. The vendor submitted the same invoice twice and received payment twice. Although the PAID system will prevent payment on an exact duplicate vendor invoice number, the same vendor invoice number was entered with a "-I" suffix to enable payment on the invoice. (In this case, the buyer noted the error and notified Accounts Payable to process a credit, and the vendor issued LANL a check for the amount of the duplicate payment.)

b. Recommendation

To prevent duplicate payments, Accounts Payable should develop procedures requiring supervisor-level approval on non-standard invoice numbers (suffix or prefix added, etc.).

In the interim, Accounts Payable should provide training on and notice of the correct procedures for handling duplicate invoice numbers.

16. Purchase Card Accounts Payable

a. Observation

Currently, Accounts Payable has not been able to reconcile the Purchasing Card AP Account (430P0). Year-to-date through March 5th 2003, six debit entries totaling $7,069,980 and 85 credit entries totaling $6,975,648 were posted to Account 430P0 for an account balance of $94,333. Purchasing (BUS-5) approves the amount to be paid to the credit card company, and executes the files that distribute charges. However, when BUS-5 approves for payment an amount different than the amount billed, it does not adjust the distributed charges (to the cost centers). As a result, the amounts paid and the amounts distributed may not be equal. Failure to perform timely account reconciliations makes it more difficult to determine root causes of differences, which may lead to unnecessary write-offs.

b. Recommendation

The Purchase Card AP Account should be reconciled on a monthly basis. Amounts paid to the credit card company (debit entries) should match the recharges to the cost centers (credit entries). Any adjustments for differences should be tested for validity and proper approvals.

17. Segregation of Duties

a. Observation

There are four employees that have individual access to the PayBase system to generate check runs, and have access to the blank check stock. Lack of separate control over the blank check stock and the signing/ generation equipment increases the risk of misappropriation of funds.

b. Recommendation

Access to check stock and signing/ generation equipment should be maintained under dual control (i.e., two individuals should be required in order to print checks).

18. Treasury Department Discount Interest Rate

a. Observation

The US Department of Treasury's cash management requirements (I TFM 6-8000) prescribe the interest rate to be used by agencies in evaluating the cost effectiveness of cash discounts. Notice was given in the Federal Register: October 23, 2002 (Volume 67, Number 205) that the applicable rate is 2 percent for the 2003 calendar year. Currently, the rate in the PAID system is set at 5 percent, and the responsibility for updating the rate is not within the Accounts Payable function.

b. Recommendation

The interest rate used in the PAID system should be updated to reflect the current rate as prescribed by the Department of Treasury.

The responsibility for updating the rate in the PAID system should be transitioned to the Accounts Payable department.

Accounts Payable management should develop procedures to ensure the rate is updated as prescribed by the Department of Treasury.

19. Accounts Payable Desk Instructions

a. Observation

Standardized desk instructions for Accounts Payable are not available through the online Accounting Resource Manual homepage. Existing hardcopies of the instructions do not contain the names of the author or approver, nor do they document the origin, effective, and revision dates. A standard coding system is not employed and instructions are not cross-referenced. Without the above information, there is a lack of accountability for desk instructions, difficulty in referencing items, and an inability to determine whether or not instructions are current.

b. Recommendation

LANL desk instructions should be incorporated online as a living document. The instructions should contain the necessary date and authorship elements.

Tab 10

Los Alamos National Laboratory

External Review of The Procurement Program
Report of Findings

April 7, 2003

LANL 45256

Los Alamos National Laboratory
External Review of The Procurement Program
Report of Findings

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I. Overview

The University of California (UC) Vice-President - Financial Management retained the External Review Team to conduct an administrative review of the Los Alamos National Laboratory (LANL) Procurement Program (the Program). Specifically, the External Review Team was tasked to:

- Evaluate policies and procedures;
- Evaluate current and past practices;
- Analyze identified purchase transactions and/or subcontracts;
- Identify apparent control weakness and/or vulnerabilities;
- Provide relevant observations and conclusions; and
- Recommend corrective actions for strengthening the Program.

The focus of our review was the 24-month period beginning October 1, 2000 and ending September 30, 2002 (the Review Period).

A. Review Team Organization

The External Review Team (the Review Team) is comprised of three members, Mr. John C. Layton (chair), Mr. Charles C. Masten and Mr. James W. Culpepper, and is assisted by a forensic accounting team, led by Mr. Donald J. Kintzer, from the University of California's audit firm, PricewaterhouseCoopers LLP (PwC).

B. Background

LANL's total procurement activity in FY01 was $989.7 million. In FY02, procurement activity increased to $1,271.3 million.[1] LANL's procurement activity may be divided into three broad categories: Institutional Subcontracts, Purchase Orders (i.e., traditional procurement) and Streamlined Purchasing. Streamlined Purchasing is comprised primarily of Just-In-Time (JIT), Local Vendor Agreements (LVA), Requester Release Blankets and Purchase Card transactions.[2] The following table is a summary of procurement activity during the Review Period:

[1] Procurement activity is generally calculated as the change in commitment amount on new and existing subcontracts during the period. For some subcontracts, procurement activity is calculated as the actual amount invoiced or paid during the period. Procurement activity excludes non-purchase order related expenditures such as payroll.

[2] Streamlined Purchasing also includes a customer service function called Express Purchasing.

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TABLE 1: Summary of Procurement Activity During Review Period (in millions)

Procurement Activity Type	FY01	FY02	Total
Institutional Subcontracts[3]	$268.0	$306.9	$574.9
Purchase Orders[4]	604.2	825.0	1,429.2
Streamlined Purchasing			
JIT[5]	75.4	87.0	162.4
LVA[6]	4.2	4.7	8.9
Purchase Cards	33.8	40.7	74.5
RRB[7]	4.1	7.0	11.1
Total	**$989.7**	**$1,271.3**	**$2,261.0**

1. Business Operations (BUS)

The procurement function resides in LANL's Business Operations (BUS) division. Within BUS there are seven groups each reporting to a group leader who, in turn, reports to the CFO and the Associate Director of Administration. The BUS teams are as follows:

- BUS-1: Accounting
- BUS-2: Distributed Finance
- BUS-3: Budget
- BUS-4: Shipping and Receiving
- BUS-5: Procurement
- BUS-6: Property Management
- BUS-7: Systems Management

BUS-5 (Procurement) was recently divided into four functional areas: Procurement, Quality and Assurance, Small Business Office and the Purchase Card Office. Presently, there are approximately 170 BUS-5 employees and contractors.

2. Audits and Reviews

We reviewed reports of audits and reviews conducted on the procurement function during the past ten years, including two external reviews.[8] We were also provided twelve

[3] Institutional Subcontracts include the following contracts: Body Shops (Contract Labor), Fire Department, JCNNM (Johnson Controls Northern New Mexico), PTLA (Security Guard Contract) and Telecommunications.
[4] Purchase Orders include Blanket Purchase Agreements (BPA).
[5] JIT Procurement Activity Detail data available for the Review Period totaled $152.8 million ($75.3 million in FY01 and $77.6 in FY02).
[6] Includes LVA Gas; LVA Procurement Activity Detail data available for the Review Period totaled $6.5 million ($3.0 million in FY01 and $3.5 million in FY02).
[7] RRB Procurement Activity Detail data for the Review Period totaled $12.1 million ($5.5 million in FY01 and $6.6 million in FY02).

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internal reports prepared between FY93 and FY01, primarily by LANL's Audits and Assessments (AA) group. Finally, we were provided LANL's Procurement Self-Assessments for FY95 to FY02. The following are examples of findings we noted in these reports:

- Contract award problems including failure to select appropriate contract mechanisms, failure to use standard contract language, and failure to obtain proper approvals;
- Contract administration issues, including inadequate documentation, failure to perform timely reviews, improper contract modification and failure to perform appropriate cost price analyses; and
- Procurement management breakdowns, including failure to maintain appropriate policies and procedures, inadequate staffing and failure to maintain accurate, verifiable procurement activity data.

3. Procurement Vehicles

a. Institutional Subcontracts

Institutional Subcontracts are major agreements, negotiated with involvement from LANL personnel both inside and outside of procurement, for the provision of facility management, security, fire, contract labor and telecommunications services. LANL's Institutional Subcontracts are outside the scope of this review. However, the Institutional Subcontractors, including LANL's facilities manager, utilize LANL's procurement function to secure goods and services necessary to perform their contractual obligations. As a result, many goods and services procured by LANL's institutional subcontractors were subject to our review.

b. Purchase Orders

A purchase order (PO) is a contractual agreement between LANL and a vendor to buy supplies or services upon specified terms and conditions. Purchase orders formalize agreements on the price of goods or services to be provided; quantity; payment terms; delivery schedule; points of contact; and any other pertinent agreements. Depending on the complexity of the good or service purchased, a contract or addendum is issued in addition to the purchase order. The contract may provide further specific information regarding the terms and conditions including technical specifications and/or more detailed instructions.

A PO is initiated when a requester identifies the need for a good or service and submits a purchase requisition to BUS-5 (Procurement). All LANL employees and contractors are authorized to prepare and submit purchase requisitions.

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[8] External reports reviewed include a General Accounting Office (GAO) report from FY01 and a Department of Energy (DOE) report from FY93.

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c. Streamlined Purchasing

Streamlined procurement is a means to reduce cost, stock requirements, purchasing cycle time and to encourage requesters to take ownership of their own low-value procurements. In its FY02 Self Assessment prepared for the DOE, LANL reported that 98.7% of transactions were processed using rapid or alternative procurement methods.[9] This earned LANL a score of "Outstanding Plus" based on the DOE benchmark statistics. LANL's rapid and alternative procurement methods are managed by BUS-5 Team 1, Streamlined Purchasing, and include Just-In-Time, Local Vendor Agreements, Purchase Cards and Requester Release Blankets.

i. Just-In-Time

The Just-In-Time (JIT) Program was introduced in 1989 as an instrument for streamlining purchasing and decreasing overhead costs associated with warehousing supplies. JIT vendors furnish LANL with commodities such as computer equipment, tools, chemicals and office products on an as needed and timely basis. Items may be ordered by LANL employees and contractors on-line or directly from the vendor (via phone or in person).

ii. Local Vendor Agreements

Local Vendor Agreements (LVA) are subcontracts with Los Alamos area vendors for the provision of low-value, in-stock items such as safety shoes, protective clothing, office supplies and protective eyewear. Items procured from LVA vendors should be less than $500 and should not be readily available from JIT vendors.

iii. Purchase Cards

Purchase Cards are charge cards issued to selected LANL employees for the procurement of low-value goods and services. LANL's Purchase Card Program was subject to a previous External Review and is therefore, excluded from this report.[10]

iv. Requester Release Blankets

Requester Release Blankets (RRBs) are similar to LVA subcontracts and are for the procurement of mechanical and printed circuit board fabrications.

C. Summary of Findings

We observed internal control weaknesses and deficiencies, including the insufficiency of policies and procedures, lack of timely and reliable data and inadequate management of the Program. These weaknesses, individually and in the aggregate, increase the vulnerability of LANL to potential fraud, waste and abuse. While UC and LANL management have taken a number of steps to improve the Procurement Program, we have recommended additional corrective actions to further reduce the exposure to these vulnerabilities. In addition, LANL management must ensure that quality procurement is recognized as essential to the accomplishment of LANL's mission.

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[9] During our Review Period, streamlined purchasing accounted for 11% of LANL's total dollars procured.
[10] See report entitled Report of Findings: External Review of the Purchase Card Program dated December 12, 2002.

During the performance of our review, we noted the following control weaknesses that are more fully explained in our report:

- Policies and procedures are insufficiently detailed to ensure that all aspects of quality procurement are considered;
- Procurement Program data is inadequate for management decision-making and control;
- Contract file maintenance is incomplete and inconsistent;
- Inadequate management of contract administration and the various procurement vehicles;
- JIT and LVA procurements require additional controls to reduce inherent vulnerabilities;
- Controls over the recordation of acquired property are inadequate;
- Blanket Purchase Agreements without adequate controls provide a substantial risk;
- Management should assess the allowability of procurements with questionable business necessity; and
- LANL senior management should provide guidance concerning the purchase of consumer commodities to ensure that items procured meet a test of business necessity.

In connection with our procedures, we identified a number of potentially inappropriate JIT transactions. We referred these transactions to UC and LANL management and recommended that the transactions be brought to the attention of the DOE Office of Inspector General. The value of these transactions is estimated at $14,530.

II. Procedures Performed

In conducting our review of the LANL Procurement Program, we reviewed policies and procedures in existence during the Review Period. We also conducted interviews of LANL personnel, analyzed electronic procurement data, and reviewed procurement subcontracts and supporting documentation for selected transactions. Further details on the procedures we performed are outlined below.

A. Review of Policies and Procedures

We reviewed various sources of procurement guidance, all of which are available on LANL's intranet. In particular, we reviewed the "Requester's Guide to Purchasing", which instructs requesters on how to navigate the procurement process. We also reviewed the "Buyer's Toolbox" which includes a link to LANL's Standard Practices (SP), a menu of standard contract terms and conditions, commonly used forms for

buyers[11] and an overview of procurement training. Finally, we reviewed program-specific guidance for the JIT and LVA programs.

B. Interviews

We conducted interviews of 63 individual employees including LANL procurement management, Contract Administrators (CA), Procurement Contract Administrators (PCA) and technical requesters.[12] We also met with individuals from other Business Operations groups, including BUS-1 (Accounting), BUS-2 (Distributed Finance), BUS-4 (Shipping and Receiving), BUS-6 (Property Management) and BUS-7 (Systems Management) and members of the Information Management group.

C. Analytical Procedures

We obtained and analyzed electronic procurement activity data for the Review Period. Specifically, we analyzed procurement activity data by purchase order as developed by BUS-7 (Systems Management).[13] We also analyzed procurement activity detail data for the JIT and LVA programs and reviewed payment data. In addition, we reviewed data from other subsidiary sources including property, receiving, personnel (Z-numbers) and the JIT catalog. Finally, we verified that all paid invoices were included in the procurement activity data.

Based on the information obtained, we performed various analyses, including:

- Review of procurement data for completeness;
- Limited manual reconciliations between procurement data and accounts payable data;
- Data mining procedures including key word searches and criteria queries (i.e., purchases greater than $500);
- Manual review of data mining results; and
- Stratification of the purchase order population.

D. Contract Reviews

Based on our stratification of procurement activity, we selected a sample of purchase orders and performed a contract file review for the selected transactions. In making our selection, we targeted subcontracts with higher perceived risk to LANL. For example, we considered cost-type subcontracts that were not competed to be a higher risk than a

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[11] Technically, the designation "buyer" applies exclusively to Contract Administrators (CAs). In recent years, however, LANL has informally extended the buyer designation to administrative-level Procurement Contract Assistants (PCAs).
[12] Interviews were conducted with members of all six teams within BUS-5.
[13] Procurement activity data is summarized by PO line item and is an output of a derivative system of PAID. See Section III. A. 1. a.

competitively bid fixed price subcontract. Following is a summary of the results of our stratification and contract selection:

TABLE 2: Summary of Purchase Orders Reviewed

Original Contract Type	PO Activity		Sample Reviewed	
	# of Pos	Procurement Activity (in millions)	# of POs	Procurement Activity (in millions)
Competitive	3,737	$693.8	7	$16.4
Non-Competitive[14]	31,901	628.2	41	27.4
BPA[15]	2,226	107.2	27	4.7
Total	**37,864**	**$1,429.2**	**75**	**$48.5**

For the 75 selected purchase orders, we obtained the contract file from the appropriate buyer. We reviewed the files for content, specifically looking for evidence of documentation required in accordance with SP 4.3 ("Document Requirements"). In addition, we looked for documentation to support assertions made by buyers during our interviews.

In addition to our purchase order contract file reviews, we also reviewed eleven JIT subcontracts, 31[16] LVA subcontracts and two RRB subcontracts.

E. Transaction Reviews

Based on the results of our data analyses, we targeted a selection of PO, JIT and LVA purchases and requested supporting documentation and/or confirmation from the requester. In total, the sampled items represent 291 purchases for 229 different requesters. Documentation supporting the selected purchases was requested directly from the BUS-7 (Systems Management), who retrieved the information from Documentum.[17] The following table summarizes our sample selection:

[14] Includes sole source contracts.
[15] BPA sample population includes a non-negotiated, firm-fixed price contract incorrectly coded as a blanket contract.
[16] Includes one LVA Gas subcontract.
[17] Documentum is a document management software that is used by LANL to store scanned copies of supporting documentation for procurements.

TABLE 3: Transactions Selected (Number of Transactions)[18]

Procurement Program	FY01	FY02	Total
Purchase Order	31	37	68
JIT	48	40	88
LVA	85	50	135
Total	**164**	**127**	**291**

In addition, we selected 51 JIT items that reflected price changes during our Review Period. For each selected item we asked the responsible buyer to request from the vendor support for each price change. We then reviewed the provided documentation to determine if the price changes were appropriate.

F. Review of Property Recordation Procedures

We reviewed LANL's procurement activity data to identify items, which appear to be subject to property control, including items with a purchase or manufacture cost greater than $5,000 or items on LANL's sensitive property listing. We then compared these items to LANL's property management system (Sunflower) and selected a sample of 50 items that could not readily be identified. We provided this sample to LANL's Property Management Group (BUS-6) to determine if these items are bar-coded and in LANL's property control system.[19]

III. Findings, Observations and Corrective Actions

Based on the procedures described above, including the review of policies and procedures, interviews, analysis of data and review of specific transactions, we formulated a number of observations with respect to the LANL Procurement Program. Some observations are relevant to LANL's overall procurement function, while others are specific to each of the reviewed procurement programs. For each observation, we considered corrective actions taken by LANL and assessed whether these changes were sufficient to rectify the observed issue.

[18] We received a response rate of 90% on sampled transactions. On March 21, 2003 we provided a list of non-responses to LANL management.

[19] Because LANL is in the process of conducting a wall-to-wall physical inventory of property-controlled items, we did not physically verify items that were located in Sunflower.

LANL 45265

A. Procurement Program Observations

1. Information Management (Data)

a. Observation

LANL has several front-end procurement data systems,[20] which feed into the core procurement and accounts payable system (PAID).[21] PAID tracks cumulative obligations, invoice and payment amounts and feeds this information (in a summarized format) into LANL's Financial Management Information System (FMIS).[22] Financial reports, including outstanding obligations, are generated in FMIS and transmitted to the UC and the DOE.

The PAID system is a cumulative rather than a transaction based system. It tracks only cumulative balances on purchase orders and does not record or maintain transactional detail. In addition, PAID is an overwrite system and can only provide cumulative data at the moment the system is queried; historical data is not available in the PAID system.

The above limitations impact LANL's ability to generate procurement statistics that are necessary for management decision-making and external reporting. For example, PAID cannot provide historical information nor can it report on procurement activity during a specified period of time.

Business Operations (BUS) has attempted to compensate for the shortcomings of the PAID system by developing a number of workarounds. In order to capture procurement activity, for example, LANL has created a derivative system. This system, created and maintained by BUS-7 (Systems Management), takes month-end "snapshots" of PAID and calculates the difference between periods in order to determine procurement activity in that month. BUS-7 personnel then make a series of electronic and manual adjustments to this data in order to more accurately reflect procurement activity.

Procurement activity data, as calculated by the derivative system, is reported to procurement management on a monthly basis.[23] In addition, this data is used to generate socioeconomic procurement statistics as required by the DOE. Finally, procurement activity data is used to assess LANL's performance with respect to Appendix F: Objective Standards of Performance.[24] Procurement activity data is used, among other things, to calculate the cost-to-spend ratio, a statistic designed to provide assurance to the DOE regarding the effectiveness and efficiency of the procurement organization. In its Appendix F assessments, LANL reported $989.7 million of procurement activity in FY01 and $1,271.3 million in FY02 based on numbers generated by the above-described derivative system.

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[20] These systems include Procurement Desktop, PD Web, STORES and the Invoice Approval System.
[21] PAID is an acronym for "Purchasing, Accepting, Invoicing, Disbursing".
[22] We did not perform detailed system assessments of PAID or FMIS.
[23] This derivative data does not flow into the FMIS system.
[24] The Prime Contract between the DOE and the UC sets forth performance measures for various LANL functions including procurement. LANL's specific performance objectives are defined in Appendix F of the contract.

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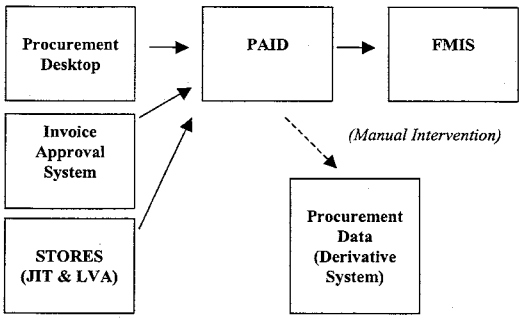
The limitations of the PAID system also impact the availability of data for procurement management decision-making. Procurement managers must rely on programmers to extract simple reports.

We reviewed the current processes in place to generate procurement activity data and identified a lack of internal controls. Specifically, we noted that supporting documentation is not retained. We further noted that there is a lack of knowledge and involvement of other LANL employees in this process, other than the individual responsible for generating the data. We noted a lack of understanding at any level within the procurement organization regarding how this data is created and what it, in fact, represents.

In light of the derived nature of this data, we attempted to validate the LANL procurement activity data. Because of the overwrite nature of the PAID system and because LANL's BUS-7 team does not retain its PAID snapshots for more than a few months, we were unable to confirm the accuracy of LANL's total procurement activity data. The following chart illustrates the flow of procurement data through these data systems:

TABLE 4: Procurement Activity Data Flowchart



b. Corrective Actions Taken

We understand that LANL is in the process of implementing an Oracle enterprise system that will replace several of LANL's current data systems, including PAID. We believe that a transaction-based system will eliminate the need to calculate procurement activity in a derivative system.

In addition, LANL recently initiated a Group Leader Business Stewardship Reporting program, which provides group managers with monthly reports of procurements and other data. Managers are required to review and confirm that resources used were for the

benefit of the LANL mission, allowable under the terms of the Prime Contract and reasonable.

c. Recommendations for Further Corrective Action

Until Oracle is implemented, we recommend that LANL implement a number of internal controls over the creation of procurement activity data, including:

- Formally document procedures used to develop procurement activity data and disseminate information to procurement management;
- Create an audit trail by retaining PAID snapshots at quarter and year end as well as documentation in support of data manually entered by BUS-7;
- Develop formal procedures for reviewing and updating automated functions annually; and
- Incorporate quarterly reviews of the data processes and output.

2. Organizational Structure

a. Observation

BUS-5 (Procurement) is comprised of six teams. With the exception of Team 1, Streamlined Purchasing, the teams are divided by the group or directorate served as illustrated in the table below:

TABLE 5: Procurement Teams

Team	Directorates Served	Distributed
1	All	No
2	Directors Office and Administration	No
3	Threat Reduction and Strategic Research	Non-Proliferation & National Security (NIS)
4	Nuclear Weapons	Nuclear Material Technology (NMT), Weapons (ESA), Dynamic Experiments (DX)
5	Associate Director of Operations Division, Facility Waste Operations, JCNNM, PTLA	Facilities Waste Operations, Cerro Grande Fire Team
6[25]	Laser Facility, Risk Reduction & Environmental Stewardship, Health & Safety	LANSCE

[25] Team 6 was formed in January 2002. Prior to this date, Teams 2 through 5 served these directorates.

Distributed teams physically reside with the technical group they serve (i.e., the customer). LANL moved to a distributed procurement model approximately two years ago. Previously, teams were divided by the commodity procured (e.g., construction, technology equipment, services, etc.). During the transition, buyers specializing in the procurement of a specific commodity were asked to become generalists.[26] A member of the BUS-5 leadership indicated that the pendulum has swung too far in favor of customer service and that procurement quality has suffered as a result. Buyers also indicated that in some specific areas, LANL is migrating back to a commodity-based structure (i.e., University Subcontracts, Research and Development, etc.). Until April 2002, buyers on distributed teams reported to and were evaluated by their customer rather than by a procurement team leader. This created an environment in which buyers may have been incentivized to place the needs/desires of the customer above other aspects of quality procurement.

Responsibility for the contract audit function is split between BUS-5 and LANL's Audits and Assessments (AA) group. BUS-5 performs routine contract reviews but relies upon AA to perform cost and pricing functions including pre-award audits, interim audits and closeout audits. AA, subject to its own staffing constraints, has struggled to keep up with these functions. For example, in FY00, LANL had a backlog of 1,007 contracts requiring closeout. While this backlog was reduced to 59 in FY01, we understand it has subsequently increased. BUS-5's reliance on AA for these key procurement functions has resulted in tension between the groups. As a result, the Procurement Quality Assurance Project Leader has submitted a position paper proposing that the cost and pricing function be transitioned out of AA to his team.

During interviews, we consistently heard that LANL's procurement function is substantially understaffed. Buyers report heavy workloads and a lack of senior personnel to provide technical guidance. LANL buyers stated that because the award of new subcontracts is more urgent and time sensitive than many contract administration functions, they give contract award a higher priority than contract administration. Often, this means that contract administration functions are repeatedly overlooked.

In accomplishing the DOE procurement benchmarks, LANL has succeeded in reducing its cost to spend ratio, which is approximately 50% less than the benchmark for an outstanding rating. In achieving this rating, it appears LANL has compromised key contract administration functions. Furthermore, LANL's low cost to spend ratio indicates that the procurement organization could increase resources, improve contract administration and still meet the DOE's benchmark.

b. Corrective Actions Taken

In April 2002, LANL changed the distributed procurement reporting structure, making distributed buyers report directly to a BUS-5 Team Leader. Buyers we interviewed indicated that their respective BUS-5 Team Leader now prepares their performance evaluations.

[26] Some of these commodity specialists have been designated as "subject matter experts". In addition to their regular job responsibilities, they are available to provide guidance to other Buyers.

In addition, LANL recently created a Procurement Quality Assurance function, reporting directly to the Procurement Functions leader rather than the BUS-5 Group Leader. When fully staffed this team is expected to have sixteen full-time members and be comprised of four teams as follows:

- **Self-Assessment and Procurement Review Team**- responsible for conducting on-going reviews of the procurement organization to assess compliance with stated policies and procedures and to evaluate the overall "effectiveness, efficiency, health and contractual compliance of the procurement operation";[27]
- **Policies and Procedures Team**- responsible for maintaining and/or developing policies and procedures that are useful to both requesters and buyers;
- **Training Team**- responsible for developing and maintaining a comprehensive training program; and
- **Customer Service Team**- responsible for interfacing with buyers and requesters to ensure that these constituencies have the necessary resources to make quality procurements.

c. Recommendations for Corrective Action

In addition to the creation on the Procurement Quality Assurance Group, we recommend that LANL:

- Evaluate staffing needs across all procurement functions;
- Consider creating a hybrid organization in which distributed buyers remain as generalists and core procurement staff return to the commodity-based specialist model; and
- Reclaim ownership over the routine contract audit functions and/or develop better relationships between BUS-5 and Audits and Assessments.

3. Performance Measurement

Appendix F of the Prime Contract delineates specific performance objectives relative to various business functions, including procurement. Specifically, Appendix F defines the procurement performance objectives in four categories. The following table summarizes LANL's ratings with respect its procurement performance objectives:

[27] Per the Procurement Quality and Assurance Project Team overview.

TABLE 6: Summary of Performance Objective Ratings

Performance Objective	FY01 Weight	FY01 Rating[28]	FY02 Weight	FY02 Rating
Management of Internal Business Processes	65%	O	70%	O
Customer Satisfaction	10%	O	10%	O
Learning and Growth	15%	O	10%	O
Managing Financial Aspects	10%	O	10%	O
Total	**100%**	**O**	**100%**	**O**

LANL's compliance with Appendix F is measured largely through a self-assessment process. Each quarter, members of the procurement team gather data necessary to measure LANL's performance relative to the above objectives. At the conclusion of the fiscal year, the procurement group prepares a Final Self-Assessment Report, which is submitted to the DOE.

There are several characteristics of a procurement that should be considered:

- Price/value;
- Quality;
- Timing;
- Delivery; and
- Socioeconomic Impact.

We noted that the performance objectives established by the DOE focus largely on the characteristics of quality, timing and socioeconomic impact and less on the price of goods and services procured. This focus may foster an environment in which accommodation and expediency are valued above other aspects of quality procurement.

We noted one vehicle used by LANL to achieve an outstanding rating from the DOE is its reliance on streamlined purchasing, which accounted for 98% of total procurement transactions and 11% of the total dollar amount procured. Additional resources spent on managing these programs would not adversely affect the cost to spend ratio.

In recent testimony before the House Committee on Government Reform, DOE Inspector General Gregory H. Friedman stated that LANL's "excellent rating in both personal property management and procurement management" raised concern about the meaningfulness of the DOE's evaluation process.

[28] "O" indicates outstanding performance.

4. Contract Award

a. Observation

Contract award is the process by which an organization determines with whom funds will be spent and under what conditions including tasks such as vendor selection, contract writing and negotiation. Contract administration is an ongoing function, which includes managing vendor relationships, approving invoices for payment, monitoring spending against the total subcontract value, issuing modifications as necessary and performing routine reviews of vendor performance.

With respect to contract award, we noted that LANL does not have a definitive listing of required Terms and Conditions (T&C) that must be included in subcontracts. Buyers are responsible for selecting the T&Cs that are applicable to the subcontract from an overall listing of contract clauses that are maintained in Forms 7500 and 765 on LANL's intranet. This process may result in the exclusion of required T&Cs from the subcontracts, and inconsistency in the T&Cs across teams and buyers. We further noted instances of modifications that were issued to incorporate T&Cs that were excluded from the original contract language.

We noted that the majority of LANL's new contract awards are for sole source or non-competitive subcontracts. During our Review Period, 53% of dollar amounts committed on new subcontracts related to non-competitive awards. When calculated on the number of subcontracts awarded, the percentage of non-competitive subcontracts is 87%.

b. Recommendations for Further Corrective Action

We recommend that LANL develop a template of all required terms and conditions. Buyers should have to elect to exclude T&Cs that are not applicable to the subcontract, rather than to include all T&Cs that are applicable. In addition, we recommend that procurement management scrutinize new awards of non-competitive subcontracts to ensure that subcontracts are competitively awarded when necessary and appropriate.

5. Accounting for Property-Controlled Items

a. Observation

LANL policy requires that items with a purchase or manufacture cost of greater than $5,000 as well as items defined as "sensitive" and "attractive" be property-controlled.[29] The DOE approves LANL's sensitive items list. Property control procedures include the assignment of a barcode and property custodian to every controlled item. Furthermore, all controlled property is to be entered and tracked in LANL's property management system (Sunflower).

The procedures by which property-controlled items are captured in Sunflower differ by procurement method. For purchase orders, BUS-1 (Accounting) reviews all purchase orders that are issued and identifies property-controlled items based on description information entered by the buyer. If the item is determined to be subject to property

[29] Sensitive items are defined in SP 45 and the Property Management Manual and include computers, recording devices and cameras among other items.

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control, BUS-1 creates a property control tag number within Sunflower. When BUS-4 (Shipping and Receiving) receives the incoming shipment and creates a receiving report, a barcode sticker is created and applied to the item. For JIT purchases, the vendor is responsible for identifying property-controlled items in the JIT catalog. The JIT system requires that for all items that are flagged as property-controlled, a barcode number be entered before the order may be finalized.[30] The LVA policies and procedures do not specifically prohibit the procurement of property-controlled items, however there are no defined procedures for the accounting for property items purchased through LVAs.

We learned that several controls designed to ensure that items subject to property control are bar-coded and entered into Sunflower were not functioning. For example, the JIT catalog contains a field designed to alert vendors that a particular item requires a property barcode. Because LANL relies on vendors to maintain the JIT catalog, this fundamental control may be circumvented. We reviewed the JIT catalog and identified 985 items that should have been flagged as requiring a property barcode but were not so identified.

We assessed compliance with LANL's property accounting policy by querying LANL's FY01 and FY02 procurement data for items that appear to be sensitive or items with a purchase price of greater than $5,000. We then compared these items to the Sunflower system[31] to determine if the items were included. We identified 2,485 items that we could not readily identify in the property management system.[32] Of this population, we selected a sample of 50 items and requested the assistance of LANL's Property Management Group (BUS-6) to determine if the items are property controlled. After consultation with BUS-6 personnel, we determined that of the 50 items selected, 24 (48%) are not subject to property control.[33] Of the remaining 26 items, which are subject to property control, we confirmed that 22 items (85%) are included in LANL's property management system (Sunflower). Four items were not found in the LANL property control system, including one that carried a barcode sticker but was never entered in Sunflower. All four items were physically validated by BUS-6 personnel and were subsequently added to the property management system.

b. Corrective Actions Taken

In January 2003, LANL's Director of Administration commissioned a cross-functional team to document the property management process from "cradle to grave" and to identify and remedy system failures by April 30, 2003. This team is lead by the BUS-4 (Shipping and Receiving) Group Leader and includes members from the accounting, receiving, property procurement, property management and systems management groups.

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[30] Vendors are responsible for flagging property-controlled items and entering the assigned property number into the "Special Instructions" portion of the Materials Requisition (MR).

[31] We matched items based on the procurement document number (invoice or MR number) and acquisition date.

[32] The complete list of items subject to property control that could not be readily located in the Sunflower system was provided to LANL on March 27, 2003 for resolution in the wall-to-wall inventory.

[33] Four of the sample items not subject to property control are label-maker printers. Contrary to LANL's sensitive items list (which implies that all printers are sensitive), BUS-6 stated that label-maker printers are not property-controlled.

c. Recommendations for Further Corrective Action

We understand that LANL has made significant progress with respect to identifying and eliminating long-standing control weaknesses and process breakdowns. We recommend that these cross-functional meetings continue after the team's assigned mission has been accomplished. In addition, we recommend that LANL perform monthly data mining of new JIT catalog additions to ensure that items are properly flagged as requiring property barcodes. We further recommend that LANL revise its sensitive items list to specify the types of printers subject to property control.

6. Business Necessity

a. Observation

We observed that employees and contractors are often provided items including shoes, clothing, hand lotion, eyeglasses and outerwear. In some cases, we question whether the items purchased meet the test of business necessity. For example, we identified that LANL procured 2,461 pairs of street shoes (brands include Nike, Doc Martens and Skechers) from LVA vendors during our Review Period. The contracts with safety shoe vendors specify that certain LANL divisions are authorized to purchase these types of shoes and states that these "street shoes" are for workers in divisions requiring electrostatic discharge shoes. In addition, 1,410 outerwear jackets were procured through LVA and JIT during the Review Period.[34] In some cases, we contacted the requester to inquire about the business purpose for the purchase and several requesters replied that they perform outdoor work (roof repairs, snow removal, etc.) and testing in outdoor Technical Areas (TA). Finally, we determined that 6,899 bottles of hand lotion (totaling approximately $60,000) were procured from JIT vendors during our Review Period.

While we are aware that situations exist in which it may be appropriate for an employer to procure such items for an employee (e.g., safety garments required by OSHA), the volume of these purchases suggests that there may not exist adequate guidance to ensure that such items are only purchased by LANL when they are specifically required to perform the job.

We identified a number of purchases that, based on the abbreviated description available from the PAID system, did not appear to meet the test of business necessity but which we ultimately determined to be appropriate purchases. These examples solidify our opinion that data analysis without follow-up and understanding can result in inaccurate conclusions.

b. Recommendations for Corrective Action

We recommend that LANL review and assess the procurement of clothing, shoes, lotion, eyewear and other personal items that may not meet an obvious test of business necessity and establish policies and procedures that may be warranted for these types of procurements.

[34] Excludes outerwear identified as fire retardant.

B. Program-Specific Observations

1. Purchase Orders

a. Program Overview

Purchases Orders (PO) are the prime vehicle used to procure goods and services. A purchase order is issued to the vendor and represents a binding contractual agreement between the vendor and LANL.

A comprehensive purchase order, detailing the specifications of the procurement, is issued for commodity procurements and other straightforward transactions. A formalized subcontract is issued, in addition to the purchase order, for services, transactions with technical specifications, and other procurements requiring detailed specifications. The buyer is responsible for processing the procurement requisition,[35] issuing the purchase order and subcontract, administering the subcontract, including processing modifications, change orders, and task orders, and closeout procedures.

In addition to standard purchase orders, buyers may also enter into blanket purchase contracts, referred to as Blanket Purchase Agreements (BPA). The primary purposes of a BPA are to avoid the administrative cost of issuing multiple POs and subcontracts and to obtain quantity discounts when a recurring need for goods or services is anticipated.

When a PO is created, a ceiling is established, which represents the estimated total value of the procurement. The accounting department commits an amount equal to the contract ceiling. This funding is known as the cumulative commitment. Payments are made against the cumulative commitment amount up to the contract ceiling and as a result, invoices cannot be paid if the value of the invoice exceeds the contract ceiling.

The following is a summary of purchase order procurement activity by fiscal year during the Review Period:

TABLE 7: Summary of Purchase Order Procurement Activity

Fiscal Year	Number of POs	Commitment Amount (in millions)	Payment Amount (in millions)
FY01	17,776	$604.2	$434.3
FY02	20,088	825.0	686.3
Total	**37,864**	**$1,429.2**	**$1,120.6**

The buyer, with assistance from the technical requester, determines whether the procurement will be negotiated competitively, non-competitively or awarded as a sole source contract. A competitive award is sent out for bid to two or more potential vendors, and the subcontract is awarded to the vendor who is most responsive to the bid requirements. A non-competitive or sole source award is not competed due to limited

[35] A division technical requester, via the LANL Total Integrated Procurement System (TIPS), generally initiates procurement requisitions.

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sources or exemption from competition, such as published pricing, small business set asides, etc.

b. Observations

i. Policies and Procedures

LANL's Procurement Standard Practices (SP) include Department of Energy approved policies and procedures and are designed to ensure compliance with Prime Contract requirements and University of California policies and requirements. The SPs are developed and maintained by the Procurement Manager and address operational aspects that are tied to specific business planning, organization, and program execution requirements. In some cases, more specific guidance is available in the form of Supplemental Instructions (SI). The SPs and SIs can be found on the LANL's intranet and are intended to be a reference guide for conducting business at LANL.

During the course of our interviews, numerous buyers expressed that some procurement SPs are overly broad and often do not address specific procedural practices. In general, LANL does not maintain detailed procedures buyers can consult when they are navigating the procurement process. As a result, some LANL buyers do not have confidence in the applicability of the SPs and are developing independent operating procedures. We observed that buyers do not consistently apply guidance provided in the SPs or waive guidance without sufficient justification. We also noted that non-authoritative procurement procedures in use by procurement personnel deviate from the SPs and there is the perception among buyers that SPs are out of date.

One buyer with more than ten years of LANL procurement experience indicated that she recently referred to personal notes from 1997 to obtain information on how to complete a procurement transaction because the relevant SP did not adequately address the buyers' questions.

During our contract file review, we identified an instance in which a procedurally required Contract Review Board approval (required for contracts exceeding $5 million) was waived because the transaction "was an urgent requirement." We also noted an instance in which the BUS-5 Group Leader increased the signature authority of a CA for the specific purpose of allowing this individual to process a transaction without additional review. This purchase order was originally issued for three years and had a contract ceiling of $8.4 million. Within the first two years of the contract, the ceiling has been increased by $10 million.

According to the SPs, Buyers are responsible for competing procurement requisitions to ensure that LANL is getting the best value for the goods and services acquired. If a technical requester elects a non-competitive/sole source procurement, and the estimated requisition value exceeds $100,000, the requester must provide a Sole Source Justification indicating the reasons the subcontract need not be competed. Approximately 87% of new subcontracts awarded during the Review Period were issued as non-competitive or sole source contracts. Buyers indicated that they are overworked and understaffed and often accept the sole source justification provided by requesters even if the justification is, in the buyer's opinion, unconvincing or if they know of other sources where the bid could generally be competed. Although buyers indicated that urgent time

requirements are not appropriate justification for a sole-source procurement, we identified instances in which "urgent time constraints" were cited as sole-source justification. In three cases, the sole-source award was approved. Additionally, buyers indicated that many of the goods and services procured by LANL are highly technical and specialized, thereby increasing the number of non-competitive/sole source contracts that are issued.

We observed that buyers do not adhere to the SPs and can potentially develop operating procedures that best suit their needs. Without detailed procedures to which buyers may be held accountable, is difficult to develop and implement an effective review program.

ii. Contract Administration

Our findings indicated that LANL's contract administration is deficient in many respects. LANL uses a modified three-way matching process in order to approve invoices for payment. In most cases where the invoice, PO, and receiving report can be electronically matched, the buyer need not approve the invoice.

During our interviews buyers explained that contract administration is limited to the review and approval of the on-line invoices as received from Accounts Payable and the suppliers. If the invoice is for services (i.e., no receiving report exists) the invoice is routed to the technical requester and buyer for approval. The technical requester is responsible for approving that the services were rendered while the buyer is responsible for verifying that the amount invoiced is in compliance with the terms of the contract. This invoice approval process does not provide for segregation of duties with respect to ordering and payment and exposes LANL to the potential risk that LANL employees have the opportunity to verify receipt and authorize payment for services that were never rendered.

Buyers stated that they do not have sufficient time or resources to dedicate to subcontract administration and consistently indicated that they perform the "bare minimum". During our contract reviews we noted the following:

- Procurement contract files are not standardized and are maintained in accordance with the CA's personal style. Files do not contain the same information, as buyers do not adhere to file checklists. This lack of consistency makes procurement contract file reviews difficult and time consuming;
- Procurement contract files are frequently incomplete. SP 4.3 provides guidance on the documentation that is required to be included in the procurement file. Many of these required items, including progress reports, contract procurement checklists, complete invoice listing, etc., are not included in the contract files. For the subcontracts reviewed we noted 95%(70 of 74) of the files reviewed did not contain contractor progress reports, 61% (45 of 74) did not contain the contract procurement checklist and 58% (43 of 74) did not contain the required table of contents;
- A lack of evidence of approved invoices within the contract files. In general, invoice logs and/or hard copies of invoices are not maintained

within the contract file, as required by SP 4.3. When invoices are included in the file there is not adequate evidence of approval or review; and

- Minimal correspondence is maintained between the buyer, technical requester and/or the vendor. We noted seven contract files that did not contain any correspondence between the buyer, technical requester and/or vendor. One contract, with a value of $1.7 million, contained only a single piece of correspondence.

In addition, we noted that subcontracts are often entered into for low dollar amounts and subsequently modified to raise the contract ceiling. Of the contracts reviewed, 95% contained contractual modifications. Of the modifications reviewed, we noted that 53 were due to funding changes and 51% of these were increased more than 100% above the original contract ceiling. Modifications may also be used to make non-monetary changes to a subcontract such as to change the responsible CA. Modifications are often issued as a result of poor initial contract estimates by the technical requesters. We identified examples of significant contract modifications, which the buyer attributed to poor initial planning on the part of the technical requester. Specifically, we noted that:

- The buyer and/or contractor did not sign subcontract modifications maintained in the procurement files. The contract review noted approximately 20% of the files contained unsigned modifications; and
- Internal change orders are sometimes issued in place of modifications. Changes which address changes in the subcontract's funding level, period of performance, or other changes that affect LANL and the vendor should be incorporated into a formal modification; failure to do so exposes LANL to the risk that the vendor will not adhere to these changes.

An increase in a subcontract's funding value, which is processed after the expense is incurred, is to be processed via contractual ratification. Based on our contract reviews, we noted two instances where modifications were issued in lieu of processing a ratification. In those instances, a modification was processed to increase funding after invoices were received which exceeded the current contract funding values. In one instance, the buyer was instructed by the technical requester to "shake the bushes" to find available funds to cover the subcontract overrun. The contract ceiling represents the best estimate of the total cost of the contract. Exceeding the contract ceiling value, without prior contract modification, illustrates the lack of contractual planning and contract administration.

Buyers commented during our interviews that a culture exists at LANL whereby technical requesters believe the procurement organization will accommodate all commitments, whether authorized or unauthorized. In email correspondence, a buyer expressed concern that a particular technical requester has a "history of exceeding subcontract amounts".

iii. Blanket Purchase Agreements

LANL procured goods and services aggregating $30.1 million in FY01 and $77.1 million in FY02 through the use of Blanket Purchase Agreements (BPA). In the fourth quarter of FY02, LANL learned that several employees had taken advantage of BPA vulnerabilities by purchasing hunting supplies, camping equipment, and other consumer commodities not appropriate in accordance with the terms of the subcontracts. We reviewed the contract file for this vendor in order to identify risk factors, which may exist in other subcontracts and noted the following characteristics:

- The goods sold by the vendor and procured under the BPA included consumer commodities;
- All LANL employees were authorized to make purchases under the BPA;
- The vendor was responsible for notifying the requester if items were purchased that were not covered under the blanket; and
- The subcontract was modified several times in a short time frame, each time increasing the contract ceiling.

We then considered these characteristics in reviewing other Blanket Purchase Agreements. We found that approximately 39% of the 27 BPAs reviewed indicated that all LANL employees were authorized releasers against the subcontract. In addition, we noted that contractual language in BPA contracts often puts the onus on vendors, versus requesters, to identify items not included under the blanket order.

SP 16.2, Blanket Subcontracts, states "all blanket subcontracts should contain the following elements: A listing of LANL personnel authorized to make releases..." Nonetheless, we observed that many BPA contracts are written without this specific designation (i.e., all LANL badge holders are authorized releasers). Such contracts expose LANL to the risk that personnel who do not need to make purchases against the BPA may do so. This factor, coupled with a BPA vendor who sells consumer commodities, increases the likelihood that LANL employees could fraudulently purchase items for personal use.

LANL should develop more robust controls to ensure that items purchased against the BPA are allowable per the terms of the contract. BPAs without a formalized control structure are more vulnerable to fraud and abuse than other contract mechanisms.

iv. Staff Augmentation

To alleviate staff shortages, LANL often issues separate staff augmentation contracts via a purchase order. LANL also secures the services of people via contract labor agreements, which LANL has negotiated with specific staffing sources. These contract labor agreements provide specific parameters regarding the pay scale, which are established by the Human Resource department.

Under staff augmentation contracts, contractors are often paid at hourly rates that exceed their earnings as an employee of LANL and the rates that could be obtained through the

contract labor agreements. Additionally, these arrangements often last several years and are extended without recompetition.

We reviewed a staff augmentation agreement with an outside consultant that had been in effect for six years. The correspondence indicates that the consultant was reimbursed for travel and that the consultant had been offered employment at LANL, but had refused. File correspondence indicates that the consultant was paid at a higher rate than an equivalent internal employee in the same position. Members of the procurement group questioned the reasonableness of this agreement, however the consultant's contract was extended without recompetition. We noted a second example in which a consultant firm, comprised of former LANL employees was retained to perform the same job functions as when the individuals were LANL employees. The subcontract has been modified numerous times since 1997 and the funding value has been increased from $1.1 million to an aggregated commitment amount of $5.7 million.

c. Corrective Actions Taken

BUS is in the process of establishing a Procurement Quality Assurance Team, which will provide valuable support to the procurement and requesting organizations as well as the suppliers to LANL. The organization includes a Policies and Procedures Team whose primary responsibilities are to maintain LANL's policies and procedures, terms and conditions, and contract templates. Additionally, the team is responsible for reviewing, revising and developing tools, guidance, formats and checklists to support both the requesters and the buyers, and conducting studies to install improved procurement practices. LANL is anticipating that five full time employees will comprise the Policies and Procedures Team.

In December 2002, the BUS-5 Procurement Group Leader issued an email memorandum which sets forth a new review policy for modifications exceeding 50% of the original contract value. The memorandum states, "where the aggregate value of the contract is (or will become) greater than $550,000 AND where the modification increases the cumulative scope by 50% or more, then that modification must be reviewed and approved by the BUS-5 Group Office before issuance or execution of that modification."

In addition to addressing the modification review process, the memorandum addresses the issue of bi-lateral signatures on executed modifications. The memorandum provides guidance to buyers stating, "the vendor will sign two copies of the contract, PO or modification first – and then the [buyer] will sign". The guidance continues, "it is always a [buyer's] responsibility to ensure that all of [the] official contract files have originals of the contract and all modifications with bilateral signatures".

In January of 2003, the BUS-5 Procurement Group Leader issued an email memorandum addressing the subject of contract administration. The memorandum states in part, "In the interest of establishing consistency in the organization of written subcontract files exceeding $100,000, I am instituting the use of a Subcontract File Contents checklist that is applicable for all written subcontract files other than for construction. The directions contained in this memorandum shall be followed instead of the procedures stated in LANL SP 4.3b effective immediately for all new subcontract files".

d. Recommendations for Further Corrective Action

In addition to the changes noted, we further recommend that LANL consider the following:

- Review and update the SPs on an ongoing basis to reflect changes in the Prime Contract, changes in regulatory law, and to reflect changes in current procedures performed by procurement personnel;
- Develop more detailed guidance (i.e., desk procedures) for buyers. The detailed guidance will promote consistency in the organization and provide the buyers with the tools for handling all facets of the procurement process;
- Develop standards for contract file format and content, and enforce this format through the contract file review process;
- Conduct quarterly reviews of contract files to ensure that the SPs are followed and that all necessary documentation is contained within;
- Require matching of invoices to receiving reports and/or receipts for BPA procurements; and
- Limit the use and access of Blanket Purchase Agreements. BPAs should only be used when appropriate controls are in place. For example, authorized releasers should be specifically identified within the contract, and the use of "All LANL employees" as authorized releasers should be prohibited. Furthermore, LANL should not rely upon vendors to identify items not included in the BPA.

2. Just-In-Time (JIT)

a. Program Overview

The Just-In-Time (JIT) Program was introduced in 1989 as an instrument for procuring "general purpose, low-value items". The program was designed to streamline the purchasing process and to transfer the burden of warehousing supplies from LANL to the vendor, thereby decreasing costs. JIT vendors provide commodities such as computer equipment, tools, chemicals and office products. During our Review Period, there were 30 vendors contracted under the JIT system with a total of 44 unique subcontracts.[36]

LANL's procurement SPs do not provide guidance with respect to the JIT program or its specific rules. Rather, JIT guidelines are located in the "Requester's Guide to Purchasing," which provides information on the purpose of the JIT system, as well as the various mechanisms for procuring JIT items. The JIT home page also provides relevant information such as Frequently Asked Questions, JIT vendors and ordering instructions. The following table summarizes JIT procurement detail activity in FY01 and FY02:

[36] Some vendors have more than one subcontract. Each contract is specific to the types of goods to be procured. For example Frank's Supply has two subcontracts; one for tools and another for welding supplies.

TABLE 8: Summary of JIT Procurement Detail Activity

Description	FY01	FY02
JIT Procurement Detail Activity	$75.3 million	$77.6 million
Number of JIT Transactions	391,921	406,840
Average Dollar Amount per Transaction	$192	$190
Number of JIT Requesters	5,881	6,250
Number of JIT Vendors	27	30

There are four ways to create a JIT order: by completing an on-line requester order entry; calling the JIT customer service group; phoning the vendor and placing a direct order; and placing an order in person at the vendor. Vendors are assigned LANL Cryptocards[37] and have the ability to enter orders into the JIT system. Deliveries are tracked by scanning the JIT barcode, which is affixed to each package by the vendor. Upon receipt at LANL, an additional scan indicates receipt and initiates the payment process. The JIT system automatically generates weekly invoices and triggers payment on these invoices.

b. Observations

i. Program Management

The JIT program team lacks a single program manager and is administered by three CAs, with the assistance of seven PCAs.[38] We observed that the Streamlined Purchasing Team Leader has not been involved in the daily management of the program. Having a designated leader would enhance supervision, provide greater accountability and foster better controls.

The current management structure and the absence of appropriate policies and procedures may explain the lack of standardization and consistency among buyers with respect to JIT contract administration. Specifically, we noted that each CA treats the issue of vendor rebates differently and that there are different methods for resolving vendor disputes of LANL generated invoices.

Furthermore, the lack of a single program manager hampers communication within the JIT group as well as with others outside of BUS-5. For example, we learned that several years ago, members of the JIT team met regularly with representatives of BUS-1 (Accounting), BUS-4 (Shipping and Receiving), BUS-6 (Property Management) and BUS-7 (Systems Management) to discuss matters pertinent to JIT. Without a program leader, this crucial communication ceased.

Finally, all members of the Streamlined Purchasing Team (with the exception of the Purchase Card team) are responsible for both JIT and LVA vendor subcontracts. These

[37]Cryptocards are an electronic system for assigning passwords and controlling access to LANL's business computer systems.
[38] For three JIT vendors, the contract administrator is a PCA rather than a CA.

dual responsibilities add to team members' workload. CAs cite heavy workloads as the reason they have been unable to re-compete expired JIT subcontracts and the reason LANL gave vendors the responsibility for on-line catalog maintenance.

ii. Contract Administration

Many rudiments of JIT contract administration have been abandoned as JIT team members struggle to keep up with routine customer inquiries and daily contract maintenance. Specifically, we noted that although PCAs prepare quarterly performance reports for JIT vendors, CAs do not consistently follow through by seeking rebate payments from vendors who fail to meet their performance targets. Furthermore, vendor performance statistics are not used to evaluate the vendor's performance over time and we found no evidence that these statistics are relied upon when deciding whether to extend or re-compete a JIT vendor's subcontract.

As part of contract maintenance, PCAs are required to conduct vendor compliance reviews. These reviews were designed to assess the integrity of the catalog maintenance function performed by JIT vendors. Specifically, PCAs are required to perform both vendor price reviews (i.e., cost compliance reviews) and catalog item reviews on a regular basis.

We noted that these required reviews are not routinely performed or are performed inefficiently. For example, instead of targeting manufacturing part numbers that reflect price changes, PCAs randomly select Material Requisitions (MR). This random sampling process makes it difficult to focus on items with frequent or large price fluctuations. PCAs are also required to examine monthly product changes to the on-line catalog in order to verify if added items are allowable, restricted, and/or within vendor contract terms.

According to an internal assessment of the JIT Program, 20 JIT subcontracts (74%) have either expired or are within months of expiration and should either be re-competed or terminated. This failure to compete JIT subcontracts violates the intent of the program, which states "JIT procurements are implemented primarily through competitively awarded system contracts. This competition is designed to ensure that, given contractually mandated performance requirements, LANL can obtain the best value and receive these items at a reduced net cost".[39] In lieu of recompeting subcontracts, CAs frequently issue contract modifications to extend the contract term. This practice is a poor substitute for recompetition or renegotiation.

iii. Catalog Management

The on-line JIT catalog is extensive and requires constant attention in order to maintain its integrity and accuracy. It is imperative that prices quoted on the on-line catalog are current since this price is used to generate JIT vendor invoices. Due to reduced staffing after the 1996 reduction in force, LANL delegated the catalog maintenance function to JIT vendors. Vendors have been granted full access to add, change, or delete catalog items, including the ability to change item status[40] and product pricing. In addition, vendors are responsible for identifying items that are subject to property control and

[39] Per the Requester's Guide to Purchasing.
[40] Stock and Non-stock items.

flagging these items in the catalog. Allowing vendors to make the aforementioned catalog changes creates a high risk for system misuse and/or abuse. Currently, LANL is required to perform catalog reviews. However, PCAs responsible for these reviews do not perform them on a consistent basis.

Although vendors are subject to contractual restrictions with respect to catalog additions,[41] each vendor has complete access to add new catalog items or change product pricing at any time. As a result, there are no controls in place to prevent vendors from adding contractually restricted or unallowable items to the JIT catalog.

Our analysis of JIT data indicated that 25%[42] of the items purchased through JIT had price changes during our Review Period. We selected a sample of 51 JIT catalog items with two or more price changes during our Review Period and requested documentation from the vendor to support the price change. Based on documentation received, we recalculated prices and determined that 58% of the items exhibited unit price variances. Of the transactions with price variances, we determined that 59% of the variance is due to overcharges and the remaining 41% are due to undercharges. In conducting this price review, we noted that some vendors bundle multiple items into one MR, which circumvents key program controls and makes pricing analysis difficult.

Delivery performance statistics are based largely on a vendor's ability to deliver stock items with a contractually specified time frame (usually one day). As a result, vendors could be motivated to alter MRs in order to inflate their on-time delivery performance, thereby avoiding rebate payments to LANL. Until recently, vendors also had the ability to cancel MRs and to reopen new orders when out of stock items became available. Approximately one year ago, LANL revoked vendor's capability to cancel orders. However, vendors still have the ability to change the status of items from stock to non-stock. Changing the item status is yet another mechanism by which vendors may manipulate performance statistics in the absence of internal controls.

iv. Pick-Up Orders

When placing a JIT order, requesters have the option of picking the item up from the vendor or requesting that the item be shipped to a designated drop point at LANL. When items are shipped, the vendor scans the package to indicate that they have released the item. The package is first routed to BUS-4 (Shipping and Receiving) where the item is scanned a second time to indicate receipt in LANL's receiving system and then routes the package to the identified drop point. Here it is scanned for a third time to indicate delivery. The final scan signifies that the item has been received by LANL and releases the MR for payment. This three scan process matches the order to the receiving record and is, therefore, a key internal control of the JIT program.

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[41] Most vendors may only process price increases semi-annually and are prohibited from adding new catalog items without the approval of LANL. Technology equipment vendors are permitted to adjust prices monthly.

[42] Out of 127,931 manufacturing part numbers, 31,677 had two or more price changes over the course of our Review Period.

The majority of JIT orders are shipped to LANL. Occasionally, however, a requester opts to pick-up an item directly from the vendor.[43] In these cases, the receiving process described above is circumvented. Until July 2002, pick-up orders were processed using a two-scan process. First, the vendor scans the item to indicate the item was released. Then the requester is required to sign a form certifying that the item was received.[44] Next, the vendor prints the MR and sends the document to BUS-4 where the document is scanned to indicate that the item was picked up at the vendor site. This second and final scan initiates the payment process.

Beginning in July 2002, the pick-up process was further simplified to eliminate the requirement to send MR forms to BUS-4 for scanning. At this time, the two-scan process was reduced to a single scan, which is performed by the vendor. This means that JIT vendors are now authorized to initiate the payment process on JIT orders without any intervention by LANL. This control weakness is further compounded by the fact that JIT vendors have always had the ability to initiate orders in the JIT system.

We found evidence of the risks inherent in the JIT system. We identified 164 purchases of apparel totaling $14,530 from LANL's JIT tool supplier.[45] The sale of such items is prohibited in accordance with the vendor's contract and the vendor had been specifically instructed not to sell these items. We inquired as to the receipt of the purchase items with twelve individual requesters. Responses received from nine requesters indicated that the merchandise was received but not from the specified vendor. Two requesters indicated that they did not receive the merchandise from any vendor. Only one requester recalled making the purchase as recorded in the JIT system. UC has brought this matter to the attention of the DOE Office of Inspector General.

v. Restricted Purchases

The JIT program was conceived as a vehicle for the procurement of low-value commercially available goods. There are two general categories of restriction placed on the types of items that may be procured through the JIT system:

- Unallowable items as specified in the Prime Contract and in Standard Practice 31.3, and
- Items restricted in accordance with the vendor's subcontract.

Unallowable purchases include items such as awards, gifts, advertising, and memberships and are disallowed in accordance with the Federal Acquisition Regulations (FAR) as well as the Prime Contract between the UC and the DOE. Based on key word searches of item descriptions in the JIT data, we identified 53 items, which could be unallowable depending on prior approval and appropriate cost coding.[46] We also reviewed JIT procurements of consumer commodities that may not meet a test of business necessity. We sampled 88 items and asked each requester to provide an explanation of the business

[43] Vendor pick-up is permitted for time critical procurements or for procurements requiring sizing (e.g., clothing).
[44] Signed pick-up certificates should be maintained by the vendor, although this is not contractually required.
[45] A list of these items was provided to LANL management on March 19, 2003.
[46] On March 19, 2003, we provided a list of these items to LANL management.

purpose as well as written detail of approvals and/or authorizations received prior to the purchase. With the exception of lotion, clothing and eyewear, the responses seemed to meet a test of business necessity.

Each JIT subcontract specifies the types of items that may be procured from the vendor. By contractually limiting a vendor's product offering, LANL is attempting to prevent duplication between vendors as well as to prevent vendors from offering items outside of their contract. Nonetheless, we found evidence of vendors selling items that are prohibited in accordance with their contracts. For example, LANL's JIT supplier of chemicals also sold Gatorade sports drink. This is in addition to the tools vendor who sold apparel and outerwear to LANL employees. These items may have been added to the JIT catalog by the vendor without the knowledge of the CA.

Transportation charges are generally included in JIT item pricing. As a result, separate billing for general transportation charges is not permitted in accordance with JIT subcontracts.[47] Nonetheless, the Procurement Quality Assurance team recently reported that some JIT vendors were inappropriately billing LANL for transportation costs. We reviewed the JIT data for transportation changes and identified 14,550 transactions totaling more than $500,000.

Services are not currently restricted in accordance with JIT policies and procedures and several JIT contracts specifically allow for services. We determined that the JIT system is ill equipped to capture services, especially those billed on a time-and-materials basis. Because the JIT is a catalog-based system and because the vendors are not required to submit documentation, the current system does not allow LANL to verify that the vendor has appropriately billed time-and-materials services.

c. Corrective Actions Taken

We are informed that BUS-5 Team 1 has submitted a staffing plan to increase the number of JIT resources. In the interim, Team 1 is seeking assistance from the Quality and Assurance team to work through the team's backlog of vendor price reviews. In addition, we understand that LANL is in the process of revamping JIT desktop policies and procedures that are currently obsolete. Furthermore, LANL has committed to developing a re-compete strategy for JIT subcontracts. All of the above corrective actions are scheduled for completion by April 30, 2003.

d. Recommendations for Further Corrective Action

In addition to the corrective actions noted above, we recommend that LANL consider implementing the following:

- Appoint a JIT program manager, akin to the Purchase Card Administrator;
- Consider prohibiting pick-up orders from JIT vendors. If LANL elects to continue allowing pick-up orders through JIT, require vendors to send signed pick-up forms to BUS-4 for scanning;

[47] Premium transportation are permitted with prior approval.

- Hold quarterly meetings between all BUS personnel involved in the JIT process;
- Consider separating JIT and LVA into two distinct teams;
- Require CAs to seek rebates from JIT vendors. Consider automating this process so that rebates are automatically deducted from vendor payments;
- Evaluate existing JIT contracts, re-compete expired subcontracts, utilizing past vendor performance statistics in determining whether renewal is warranted;
- Perform routine contract file reviews to ensure that contract administration procedures are performed;
- Reclaim the catalog maintenance function. Consider revoking vendor authority to make catalog changes (with the possible exception of price decreases). If LANL elects to continue delegating catalog maintenance to vendors, create a full-time position for the real-time monitoring of vendor changes;
- Consider prohibiting the use of the JIT system to procure services;
- Make vendors accountable for failure to adhere property labels by adding property control as a vendor performance metric.

3. Local Vendor Agreements (LVA)

a. Program Overview

LVAs are purchasing agreements with local area vendors for the procurement of in-stock items. The LVA procurement program is to be used for items needed immediately by requesters that are not available from the Just-In-Time (JIT) procurement system in the time frame needed by the requester. LANL requesters purchase items at the vendor's location by presenting their LANL identification badge. The LANL Badge provides the requester's Z-number, which is used to record the purchase. The requester also provides other information to the vendor at the time of purchase, which is used by LANL to record the purchase in its financial system.

Items available for purchase from LVA vendors include: audio and video supplies, books and publications, computer supplies, floor coverings, hardware supplies, office supplies, photographic supplies, roofing material, safety and computer glasses, safety shoes and protective clothing.

At the time of purchase, requesters supply information to the vendor including name, Z-number, phone number, group, cost center, program code, cost account, work package code, and mail stop. This information is noted on the transaction receipt by either the vendor or the requester. The receipts are typically in triplicate with one copy given to the

requester, one copy kept by the vendor, and one copy sent to LANL with the invoice for processing.[48]

LVA vendors submit their invoices directly to LANL for payment. Vendors submit invoices weekly or monthly depending on the amount of transactions that the vendor has during that period. The process for LVA vendor payment requires vendors to submit a disk with their transaction detail,[49] a copy of the transaction receipts, and a summary report to BUS-7 (Systems Management). Data is loaded into STORES and hard copy reports transaction receipts are sent to BUS-1 (Accounting) for scanning into Documentum. BUS-1 enters the invoice information into the PAID System, which generates an on-line invoice approval notice that is sent to the PCA who reviews the invoice on-line and approves for payment. Vendors are paid the full amount of the invoice within ten days. Despite the complexity of this process and the number of groups involved, we determined that transaction receipts are not necessarily reviewed. Furthermore, when review of receipts does occur, it is often after the invoice has already been paid.

The following table summarizes LVA procurement detail activity in FY01 and FY02:

TABLE 9: Summary of LVA Procurement Detail Activity

Description	FY01	FY02
LVA Procurement Detail Activity	$3.0 million	$3.5 million
Number of LVA Transactions	58,646	63,212
Average Dollar Amount per Transaction	$51	$55
Number of LVA Requesters[50]	8,624	9,244
Number of LVA Vendors[51]	31	34

LVA activity appeared to be consistent when compared month to month with the exception of some increase in activity at fiscal year end.

Included in our LVA data are three subcontracts with vendors who provide specialty gases and cryogenic liquids. These subcontracts are Blanket Purchase Agreements (BPA) that utilize the LVA payment mechanism. While BUS-5 Team 2 administers these subcontracts, BUS-4 (Materials and Management) Gas Facility oversees all purchases made under these subcontracts. LVA-Gas procurements during our Review Period totaled $529,447.

[48] During our review, we noted that at least one LVA vendor produces receipts only in duplicate form with one copy maintained by the vendor and one copy given to the requester. A copy of the vendor's receipts is sent to LANL with the invoice for processing.
[49] Level of transaction activity determines how often LVA vendors submit their data to LANL, which is no less than monthly.
[50] Calculated by employee Z-numbers.
[51] Calculated by vendor name.

b. Observations

i. Program Management

Like JIT, the LVA procurement program lacks a single program manager as three CAs and seven PCAs responsible for JIT are responsible for the LVA subcontracts. This organization may contribute to the observed control weaknesses in the LVA program.

The LVA program lacks defined guidelines, policies or procedures. At its inception in the late 1980's, the LVA program was intended to be used on a limited basis for urgently needed items only and since its inception, the vendors and types of items available for purchase via LVA have expanded significantly.

Existing LVA guidance simply states that there is a $500 limit per transaction limit and that items purchased via LVA should not be available within the needed timeframe from JIT.[52] There are no standardized desktop procedures followed by PCAs or training programs required for PCAs. For example, we reviewed the current process for invoice review and approval and noted that different procedures are used by PCAs in order to complete this process.

ii. Contract Administration

Due to the lack of formalized policies and procedures, inconsistencies were noted in the administration of LVA subcontracts, including:

- Subcontracts were repeatedly renewed and/or modified to extend the termination period of the subcontract;
- Clauses included in the subcontracts were not standardized;
- Subcontract values were increased significantly via modifications;
- Vendor performance measures were not included in subcontracts; and
- No indication of CA approval of modifications.

With the exception of two LVA subcontracts, all administrative responsibilities and daily procedures are performed by the PCAs. Responsible CAs provide limited mentoring to PCAs when performing tasks related to subcontract administration including preparing modifications to the subcontracts. According to interviewed PCAs, none have received formalized training on the administration of subcontracts and some are not comfortable with this responsibility. In addition, there are no procedures in place for routine subcontract review.

As noted above, due to the lack of defined guidelines, different procedures are used by PCAs to review LVA invoices. Review procedures vary by PCA and may include verifying the following when reviewing invoices:

- Item descriptions;
- Amounts billed including discounts;

[52] See the Requester's Guide to Purchasing on the Procurement home page.

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- Billing for out-of-pocket expenses (for purchases of safety and computer glasses);
- Receipts signed by the requesters;
- Authorized employee groups;
- Correct Z-numbers; and
- Correct cost codes.

Supporting documentation maintained by PCAs is inconsistent and there is no indication of review of the supporting documentation that is maintained by the PCAs. One PCA we interviewed indicated that they perform no review of invoices whatsoever and simply files the invoices when received. The same PCA also noted that documentation is sometimes received up to four months after the invoice is paid. In addition, almost all PCAs stated that they were behind in their review of LVA invoices. The timely review of LVA invoices is crucial to maintaining proper control over the program. Errors that are caught timely by PCAs can be corrected directly with the vendor and/or the requester to eliminate repeat occurrences.

Furthermore, the process that is currently used for LVA invoice review is deficient. There is no three-way matching process, which is typical of more traditional procurement programs. Currently, PCAs receive only the vendor's invoice and transaction receipts. Receiving reports are not generated in the LVA process. Therefore, only vendor receipts are reviewed and compared to vendor invoices. There is no policy that requires requesters to retain and submit their invoices for review. Requester receipts are not reviewed and compared to vendor receipts to ensure that items reported on vendor invoices were actually purchased by the requester.

In addition, when making LVA purchases, LANL employees purchase items directly from authorized LVA vendors. LVA-purchased items are picked up by the requester from the vendor at the time of purchase and therefore, do not pass through LANL BUS-4 (Shipping and Receiving). Thus, the receipt of these items is also not verified by LANL.

iii. Control Over Requesters

There is limited control over requesters making purchases via Local Vendor Agreements. Any LANL badge-holder is authorized to make purchases from LVA vendors and no approval is required prior to making an LVA purchase. Our review of LVA purchases indicated that vendors and visitors made LVA purchases during our Review Period. [53]

In total, approximately 12,000 individuals made LVA purchases during our Review Period. Based upon our review of LVA data, we determined that Z-numbers and requester names do not always match. We performed an additional analysis of requester Z-numbers to determine that the Z-numbers used to make LVA purchases were valid at the time of purchase. Based on our analysis, we determined that 25 purchases totaling

[53] The program does not specifically prohibit LANL visitors, vendors or contractors from making LVA purchases.

$1,412 were made on invalid Z-numbers. An additional 15 transactions totaling $3,414 were made on Z-numbers that were expired on the date of purchase.[54]

iv. Restricted Purchases

The LVA program was conceived as a vehicle for the procurement of low-value commercially available goods. There are three general types of restrictions placed on the types of items that may be procured from LVA vendors:

- Unallowable items as specified in the Prime Contract (SP 31.3);
- Items restricted in accordance with LVA program guidance; and
- Items restricted in accordance with the vendor's subcontract.

Based upon our review of LVA transactions in FY01 and FY02, we identified possible restricted purchases in each of the above categories. A summary of our findings is as follows:

TABLE 10: Summary of Restricted Purchases

Restricted Purchases	Number of Transactions	Dollar Amount
Restricted Per Prime Contract		
Possible Unallowable Transactions[55]	15	$2,094
Restricted Per LVA Program Guidance		
Transactions greater than $500	390	$842,000
Split Transactions	21	$3,324
Contractually-Restricted Transactions	2,654	$311,229

Unallowable transactions are disallowed in accordance with the Federal Acquisition Regulations (FAR) as well as the Prime Contract between the UC and the DOE. Examples of potentially unallowable purchases made from LVA vendors include plaques and gift certificates.

The LVA program guidelines provide for a $500 transaction limit. Some LVA subcontracts state that it is inappropriate to split a transaction in order to circumvent the $500 threshold. We were informed that buyers sometimes gave special approval to waive the LVA transaction limit. As illustrated in the above table, we found instances of transactions exceeding the $500 limit as well as possible split transactions.

Although the LVA program guidelines do not specifically prohibit the purchase of property-controlled items, the program does not have any mechanism to ensure that items procured are entered into the property management system (Sunflower). We identified

[54] A list of invalid or expired Z-numbers was provided to LANL management on March 19, 2003.
[55] Allowability of these items is dependant upon prior approval and appropriate cost coding. A list of these items was provided to LANL management on March 19, 2003.

65 items subject to property control that were procured from LVA vendors, none of which were readily identifiable in Sunflower.[56]

Each LVA subcontract incorporates either an inclusion list of items that may be purchased from that vendor or an exclusion list of items that may not be purchased from that vendor. These lists are specific to each LVA vendor and each subcontract.

Of the listed restricted purchases above, we selected a sample of 135 transactions and requested confirmation from the requesters that these items were ordered. We also asked the requester to confirm that the items were received and that the vendor provided satisfactory service. Finally, we asked the requester to provide an explanation of business purpose and if any prior authorizations or approvals were made before making the purchase. We received responses on 92% of the sampled transactions.[57] In 114 instances, the requester's provided reasonable explanations of the business purpose that met a test of business necessity. Responses for which the business purpose was uncertain were included in our list of possible unallowable items, and included items procured for which the business necessity is unclear such as a coffeemaker, radio, tent stakes and potting soil.[58]

c. Corrective Actions Taken

On March 5, 2003 LANL announced its intention to reduce the number of individuals allowed to make LVA purchases. A memorandum from LANL's Associate Director of Administration, dated March 5, 2003, asks each LANL Division to identify a discrete number of individuals who will be authorized to make purchases under LVA subcontracts. The memorandum asked that these designations be made by March 14, 2003.

On March 24, 2003, the Procurement Quality Assurance Team made a presentation to LANL's Business, Policies, Procedures and Practices Committee. They proposed to continue the LVA Program in the interim period but proposed the following changes:

- For the procurement of safety shoes, safety and/or computer glasses, and other personal equipment, requesters must complete a pre-authorization form prior to making the purchase and obtain approval on the form from their Group Leader or Team Leader. When making the purchase, the requester submits the approved form to the vendor. After the purchase is made, the requester submits their copy of the transaction receipt to their Group or Team Leader and they validate that the requester has purchased and received the items. The Group or Team Leader maintains the pre-authorization form and the transaction receipt on file. For payment processing, the vendor submits their copy of the transaction receipt, the pre-authorization form, and the invoice

[56] These items were included in the list of 2,485 items referred to management for resolution during LANL's wall-to-wall inventory on March 27, 2003.
[57] A list of sample items for which no response was received was provided to LANL management on March 19, 2003.
[58] A list of these items was provided to LANL management on March 19, 2003.

to LANL. Invoices are forwarded to the PCAs for review and approval.

- For the procurement of other commodities via LVA, the requester is to complete a LVA Request Form that is to be signed by the designated buyer for that requester's division. The designated buyer keeps a copy of the LVA Request Form and upon making a purchase; the requester presents a copy of the approved form to the vendor. After making the purchase, the requester gives a copy of the transaction receipt to the designated buyer. The designated buyer maintains the LVA Request Form and the transaction receipt on file. The vendor submits their copy of the transaction receipt, the LVA Request Form, and the invoice to LANL for payment. Then, these items are reviewed by the PCAs in their invoice review process.

Previously, LANL implemented a new procedure for gathering information at the point of purchase. Each vendor was provided an Employee Certification Stamp and required to stamp every LVA transaction receipt. The requester is then required to fill in information such as name, Z-number and cost codes. Finally, the requester is required to sign the document certifying that the items purchased are for official purposes and necessary for the performance of work at LANL.

d. Recommendations for Further Corrective Action

We agree with the corrective actions that LANL has announced to-date and intend to make in the near future. Additionally, we recommend the following:

- Review current LVA processes and procedures performed by PCAs and formalize policies and desktop procedures including guidelines for maintaining standardized supporting documentation. Also incorporate detailed procedures for PCAs to follow when restricted purchases are made by vendors and requesters;
- Develop procedures for the electronic validation of LVA requester Z-numbers and names. This validation should be performed before the vendor-submitted invoice data is imported into the STORES system;
- In conjunction with formalizing policies and procedures, develop training programs and implementation schedules for PCAs, LVA vendors and requesters. Also provide resources to reference when encountering questions or issues when making LVA purchases;
- Perform complete review of all LVA subcontracts to determine if the LVA procurement program is the appropriate procurement mechanism to use for the specific type of purchases made and evaluate each LVA subcontract to determine if subcontract renewal is needed;
- Revise subcontracts during re-compete/renewal process to cite inclusive lists of allowable items rather than exclusive lists of restricted items;

- Perform routine LVA subcontract reviews and monitor subcontracts to ensure that proper documentation is maintained and contract terms do not expire.

4. Requester Release Blankets (RRB)

a. Program Overview

Requester Release Blankets (RRB) are contracts for the procurement of mechanical and printed circuit board fabrications (i.e., machine shop services). While RRB and LVA subcontracts are often confused because their detail data is commingled in Data Warehouse, they are two distinct programs.

Fabrications are highly specialized items built to specifications defined by the requester. RRB items are not property-controlled. The following table summarizes activity during the Review Period:

TABLE 11: Summary of RRB Procurement Detail Activity

Description	FY01	FY02
RRB Procurement Detail Activity	$5.5 million	$6.6 million
Number of Transactions	2,588	3,084
Number of Requesters[59]	131	176
Number of Vendors	23	25

All authorized RRB requesters have a $10,000 signature limit, although four individuals have signature authority limits of $25,000.[60] When an authorized requester requires a fabrication, they complete a request form, discuss their specifications with the vendor and place the order. After a fabrication is complete, the requester either picks-up the product from the vendor or has it delivered directly to them. BUS-4 (Shipping and Receiving) is not involved in the RRB procurement process and as a result, there are no receiving reports for RRB fabrications. Invoice terms for RRB subcontracts are net 30 days. The same payment process for LVA vendors is used for the RRB vendors.

b. Observations

Unlike the JIT and LVA procurement programs, the RRB program has a dedicated CA and PCA responsible for the administration of all RRB subcontracts, the review and approval of invoices, and developing and providing training for vendors and requesters. The centralization of these duties allows for enhanced controls over the RRB Program. In addition, there are authorized requesters for RRB items and there is a defined process

[59] All LANL employees may make an RRB purchase by making a request directly with BUS-5, Team 4. BUS-5, Team 4 will approve the transaction and place the order with the vendor for the requester.
[60] The "Elite Four" were given these higher signature authority limits as they have expertise in these types of fabrications. These employees were formerly members of an internal LANL fabrication shop that no longer exists as fabrications were outsourced via RRB's.

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for the approval of new RRB requesters and there are required forms for RRB requesters to use when making a purchase.

However, like the LVA program, there is no three-way matching process to confirm that goods and services were received. RRB items are usually picked-up directly from the vendor and therefore, no receiving reports are generated. The only matching process that is performed is to agree the invoice to the requester forms. The signature of the requester is the only validation that these items were received.

c. Corrective Actions Taken

All authorized RRB requesters are required to participate in a training course administered by BUS-5, Team 4 prior to making an RRB purchase. As of February 2003, RRB requesters are required to sign that they understand the rules and regulations to the RRB program and certify that they have completed the course.

In addition, an internal committee has been established to revise the RRB policies and procedures. The Deputy Group Leader of the Institutional Quality Management division chairs the committee. The revised RRB policies and procedures are scheduled for release in April 2003.

IV. Limitation of Procedures Performed and Resultant Findings

The observations and findings outlined in this report are based on the procedures performed. During the process of performing our work, we were not able to independently verify all events or data. Our procedures were designed to fulfill the tasks outlined above in Section I and were not specifically designed to detect fraud. Further, we do not make any representation as to the adequacy or sufficiency of our procedures for UC's purposes.

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Tab 11

U.S. Department of Energy
Office of Inspector General
Office of Inspections

Interim Inspection Report

Inspection of Internal Controls Over Personal Computers at Los Alamos National Laboratory

Department of Energy
Washington, DC 20585

April 24, 2003

MEMORANDUM FOR THE SECRETARY

FROM: Gregory H. Friedman
Inspector General

SUBJECT: INFORMATION: Interim Report on "Inspection of Internal Controls Over Personal Computers at Los Alamos National Laboratory"

BACKGROUND

The Department of Energy's (DOE) Los Alamos National Laboratory (Los Alamos) maintains approximately 5,000 laptop and 30,000 desktop computers for processing a broad range of classified and unclassified information. These computers are considered "sensitive property" due in part to their susceptibility to theft. It is an expected practice that management controls over computers throughout the DOE complex remain robust and consistent.

The purpose of this inspection was to determine the adequacy of internal controls over laptop and desktop computers at Los Alamos. The primary focus of this interim report is on accountability of laptop computers. A broader assessment of controls over laptop and desktop computers will be included in a subsequent report.

RESULTS OF INSPECTION

Through our fieldwork to date, we determined that controls over classified and unclassified laptop computers at Los Alamos were inadequate. We identified control weaknesses that undermined confidence in the Laboratory's ability to assure that laptop computers were appropriately controlled; were adequately safeguarded from loss or theft; and, that laptop computers used to process and store classified information were controlled in accordance with existing security requirements. Specifically, we found that:

- Los Alamos could not accurately account for its single user, stand-alone, classified laptop computers;
- Laptop computers reported as "unlocated" were written-off of the Laboratory's Property Inventory without a formal inquiry;
- Thefts of laptop computers were sometimes not reported to the Laboratory's Office of Security Inquiries, as required;

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- The "purchase card process" did not assure that required inventory controls were followed when new computers were purchased;

- Laptop and desktop computers were acquired using purchase cards after the Laboratory prohibited such purchases without special authorization; and,

- Employees were not held financially liable for the loss of their assigned Government computer(s) in accordance with Laboratory requirements.

MANAGEMENT REACTION

Management, while not formally concurring, expressed general agreement with the report. Management stated that the issues presented in the report would be factored into the corrective action efforts currently underway by the University of California, Los Alamos National Laboratory, Los Alamos Site Office, and appropriate National Nuclear Security Administration (NNSA) Headquarters staff offices.

Because of the weaknesses identified, specifically those relating to computers used for processing classified data, we do not believe that Los Alamos can provide adequate assurance that classified, sensitive, or proprietary information is appropriately protected. As a consequence, we have referred our findings and recommendations to the Department's Offices of Counterintelligence and Independent Oversight and Performance Assurance and the NNSA Office of Defense Nuclear Counterintelligence for review and appropriate action.

Attachment

cc: Deputy Secretary
Acting Administrator, National Nuclear Security Administration
Under Secretary for Energy, Science and Environment
Director, Office of Counterintelligence
Director, Office of Independent Oversight and Performance Assurance
Chief, Office of Defense Nuclear Counterintelligence
Director, Policy and Internal Controls Management (NA-66)

INSPECTION OF INTERNAL CONTROLS OVER PERSONAL COMPUTERS AT LOS ALAMOS NATIONAL LABORATORY

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Overview

INTRODUCTION AND OBJECTIVE

Computers are used extensively in the full range of operations at the Los Alamos National Laboratory (LANL), including processing classified national security information. LANL reported an inventory of approximately 5,000 laptop and 30,000 desktop computers at the end of Fiscal Year (FY) 2002. Department of Energy (DOE) and LANL property policies identify computers as "sensitive property," due in part to their susceptibility to theft and potential for conversion to cash. It is an expected practice that management controls over computers throughout the DOE complex remain robust and consistent.

The Office of Inspector General's recent *Special Inquiry on Operations at Los Alamos National Laboratory (DOE/IG-0584, January 2003)* reported inadequate or untimely analysis of, and inquiry into, property loss or theft and security issues; a lack of personal accountability for property; and inadequate controls over property systems.

The objective of this inspection is to determine the adequacy of internal controls over laptop and desktop computers at LANL. While this interim report addresses some concerns relevant to desktop computers, its primary focus is on accountability of laptop computers. A broader assessment of controls over desktop and laptop computers will be included in a subsequent report.

OBSERVATIONS AND CONCLUSIONS

We have determined through our field work to date, that internal controls over classified and unclassified laptop computers at LANL are inadequate. We identified control weaknesses that undermine confidence in LANL's ability to assure that laptop computers are appropriately controlled; are adequately safeguarded from loss or theft; and that laptop computers used to process and store classified information are controlled in accordance with existing security requirements.

Specifically, we found that:

- The "purchase card process" did not assure that required inventory controls were followed when new computers were purchased;
- Laptop and desktop computers were acquired using purchase cards after LANL prohibited such purchases without special authorization;
- LANL could not accurately account for its single user, stand-alone, classified laptop computers;
- Laptop computers reported as "unlocated" were written-off of the LANL Property Inventory without a formal inquiry;
- Thefts of laptop computers were sometimes not reported to the Office of Security Inquiries, as required; and,
- Employees were not held financially liable for the loss of their assigned Government computer(s) in accordance with LANL requirements.

Additionally, there were indicators of similar problems regarding desktop computers.

Details of Findings

PURCHASE CARD ACQUISITIONS OF COMPUTERS

LANL's purchase card process[1] did not assure that required inventory controls were followed when new computers were purchased.

Property Numbers

We identified new computers that had not been assigned property numbers within the LANL Property Inventory System and instances where computer property numbers were not entered into the LANL Purchase Card Database, as required. During FYs 2001 and 2002, LANL acquired approximately 1,093 new computers, including laptops and desktops, using purchase cards. LANL's property management policy identifies computers as "sensitive items." As such, a property number must be assigned so that the item can be tracked through LANL's Property Inventory System. The property number assigned to all sensitive items acquired using a purchase card must be entered into the Purchase Card Database.

The purchase card process requires all cardholders to inform the appropriate Property Administrator when a sensitive item is ordered. There are many Property Administrators at LANL. The Property Administrator assigns a property number and provides a bar-coded property tag. The Administrator then requests that the Property Accounting Office activate the number within the LANL Property Inventory System. The purchase card holder is responsible for entering the assigned property number for the acquired sensitive item into the Purchase Card Database.

We found instances where no property numbers were assigned to computers. In other instances, we discovered that property numbers were not assigned for more than a year after the computer was acquired. We determined that the reason for these oversights was that purchase card holders had not informed Property Administrators of the computer purchases or that they had received the shipment of computers. Property numbers were not assigned at a central receiving point.

The Purchase Card Database did not contain a property number for approximately 762 (70%) computers purchased during FYs 2001 and 2002. The requirement to include the property number in the database serves to ensure that purchases of sensitive items and equipment are subject to appropriate property controls.

[1] In December 2002, an External Review Team retained by LANL concluded that LANL's Purchase Card Program had internal control weaknesses that left LANL vulnerable to fraud and abuse. The Team noted that there was a failure in the Purchase Card Program to properly account for sensitive controlled property, which includes computers.

Inventory Reconciliation

Computer purchases listed in LANL's Purchase Card Database could not be reconciled with computers listed in LANL's Property Inventory System, due to:

- Inaccurate or incomplete descriptions of the computers;
- Differences in cost entries for the same items listed in the Purchase Card Database and the Property Inventory System;
- Purchase transactions of multiple computers with only one assigned property number; and,
- No property numbers or incorrect property numbers entered into the Purchase Card Database.

Using a small sample of computers that were listed in the Purchase Card Database without property numbers, we determined that 23 of 26 computers, in fact, had property numbers that had been entered into the LANL Property Inventory System. However, obtaining this information was accomplished with difficulty, requiring interviews of purchase card holders, requesters, and Property Custodians[2].

CONTINUED USE OF PURCHASE CARDS

Laptop and desktop computers were acquired using purchase cards after LANL prohibited such purchases without special authorization. This occurred following a change in LANL policy requiring such authorizations. A LANL memorandum changing LANL purchase card use procedures, effective August 26, 2002, states that all property-controlled items, which include sensitive items such as laptop and desktop computers, may not be purchased with purchase cards unless authorized and approved by the LANL Property Manager or Deputy Property Manager.

Los Alamos officials asserted that purchase card holders were not notified by management of these changes until September 11, 2002. During the period August 26 to September 11, 2002, cardholders purchased 20 laptop and desktop computers. We found that one laptop and one desktop computer were purchased after September 11, 2002. The Deputy Property Manager advised that no LANL employee had requested nor was granted approval

[2] At the request of the Office of Inspector General, LANL is currently attempting to reconcile computers acquired by Purchase Cards with the LANL Property Inventory.

for the acquisition of a laptop computer using a purchase card after August 26, 2002.

DISCREPANCIES IN LIST OF CLASSIFIED COMPUTERS

LANL could not accurately account for its single user, stand-alone classified laptop computers. At our request, LANL's Office of Cyber Security provided a list of classified single user, stand-alone laptop computers that we subsequently found was inaccurate. We were told that the primary purpose of the Office of Cyber Security's list was to identify the laptop computers that were accredited for processing classified information. Accreditation is the authorization by a designated approval authority that a computer can be used to process classified information in a specific environment, based on the computer meeting pre-specified technical requirements for achieving adequate data security[3]. Accreditation is required in accordance with DOE M 471.2-2. During our inspection fieldwork, we identified laptop computers that were not on the Office of Cyber Security's list, were not accredited, and were being used to process classified information. The use of a laptop computer to process classified information before it is accredited circumvents the controls in place to ensure that national security interests are protected.

We found the following discrepancies:

- Four laptop computers being used for classified processing were not on the Office of Cyber Security's list;
- Two of the five laptop computers were not accredited;
- One of those two unaccredited computers had been used to process classified information for at least 1 ½ years prior to our fieldwork and identification of the problem (NOTE: Upon learning of the accreditation issue regarding the laptop computers, LANL officials took corrective action);
- Four laptop computers on the Office of Cyber Security's list were not on LANL's property inventory;
- One laptop computer on the Office of Cyber Security's list did not have a valid property number;

[3] Accreditation of a laptop computer requires that it be operated under a current Classified Information Systems Security Plan within the responsibility of a Classified Information Systems Security Officer, or an Organizational Computer Security Representative.

- Three laptop computers had been excessed, but were still on the Office of Cyber Security's list; and

- Two laptop computers on the Office of Cyber Security's list were no longer being used for classified processing. We learned that they should have been excessed.

We observed that these discrepancies could have been identified by the Office of Cyber Security through a physical inventory of classified laptop computers. LANL's Property Management Manual requires that a physical inventory and reconciliation of "sensitive property numbered Government items" be conducted annually. Office of Cyber Security officials advised us that inventories are conducted using a self-assessment process, whereby each division self-reports on its inventory of classified media, including classified laptop computers. In view of the discrepancies we identified, the self-assessment process for conducting inventories of classified computers was not sufficient to assure strict accountability for classified laptop computers.

UNLOCATED COMPUTERS

Laptop computers reported as "unlocated" were written-off of the LANL Property Inventory without a formal inquiry. Unlocated computers, while not specifically defined in LANL's property policy, are defined by LANL as those that cannot be found following a property inventory at the end of the fiscal year. For FYs 2001 and 2002, LANL reported 22 laptop computers as unlocated[4]. These computers were purchased at a cost of $80,778. Although LANL's Office of Security Inquiries (OSI) conducted inquiries into "lost" and "stolen" items[5], including laptop computers, no formal inquiry was conducted on these "unlocated" laptop computers.

For example, at the end of its FY 2002 inventory, Protection Technology Los Alamos (PTLA), the physical security subcontractor at LANL, identified four laptop computers as unlocated. PTLA took action to have the four laptop computers, which were purchased at a cost of $17,705, written-off of the property inventory and no OSI inquiry was conducted. Aspects of PTLA's mission are classified and highly sensitive. PTLA

[4] The January 2003 Office of Inspector General Special Inquiry reported that during FYs 2000, 2001, and 2002, 42 laptop computers purchased at a cost of $151,821 were lost, stolen, or unlocated.
[5] Prior to January 2002, OSI conducted inquiries of stolen items only.

officials advised that the computers were not used for classified work.

REPORTING OF STOLEN LAPTOP COMPUTERS

Thefts of laptop computers were sometimes not reported to LANL OSI, as required[6].

We determined that three stolen laptop computers at LANL were not reported to OSI. The computers disappeared from a "drop-point" at Technical Area 54 in June 2001. OSI officials advised that they had no record of this incident and had not conducted an inquiry.

As early as November 1998, LANL's policy disallowed the use of drop-points for delivery of laptop computers. Instead, policy required that laptop computers be picked-up by the customer at the Customer Service Center. We learned that this policy stemmed from an understanding that the use of drop-points increased the potential for theft.

FINANCIAL LIABILITY

LANL employees were not held financially liable for the loss of their assigned Government computers. In addition to the 22 unlocated laptop computers reported for FYs 2001 and 2002, LANL reported 16 laptop computers, purchased at a cost of $53,267, as lost; 10 laptop computers, purchased at a cost of $32,899, as stolen; and 4 laptop computers, purchased at a cost of $11,589, as possible theft.

The LANL Property Management Manual states that when equipment is lost, damaged, destroyed, or stolen, the Government may hold the property custodian financially liable for repair or replacement if it is proven that the cause resulted from willful misconduct or gross negligence. LANL's Property Manager, Deputy Property Manager, and former Purchase Card Administrator advised that for the past two fiscal years no one has been held financially liable for any unlocated, lost, or stolen computers.

SUMMARY

In our judgment, this review identified significant weaknesses in LANL management controls over laptop computers. Laptop computers have been acquired using purchase cards and were not assigned property numbers or bar-code tags, or were delayed in receiving such control numbers. Laptop computers not accredited

[6] The January 2003 OIG Special Inquiry found that LANL had a substantial degree of dysfunction in its communication and assignment of responsibilities for the handling of property loss and theft concerns.

to process classified information were, in fact, used to do so. Stolen laptop computers were not reported to appropriate authorities and computers reported as unlocated were written-off of the LANL property inventory without a formal inquiry.

Because of these weaknesses, we were especially concerned about the control over classified, sensitive, and proprietary information. As a consequence, our findings and recommendations were referred to the Department's Offices of Counterintelligence and Independent Oversight and Performance Assurance and to the National Nuclear Security Administration's (NNSA's) Office of Defense Nuclear Counterintelligence for review and appropriate action.

RECOMMENDATIONS

We recommend that the Manager, Los Alamos Site Office, take appropriate action to ensure that LANL:

1. Officials take prompt action to ensure that all property and security policies regarding computers are fully implemented;

2. Conduct a full and complete accounting of laptop computers at LANL and strengthen security controls over laptop computers used to process classified information;

3. Purchase card holders adhere to LANL policies regarding the use of purchase cards for the acquisition of sensitive items, and that an appropriate system of checks and balances is implemented to ensure compliance;

4. Officials initiate a formal inquiry when computers are reported as unlocated;

5. Officials report all lost and stolen computers to the appropriate Laboratory organization; and

6. Employees are held financially liable for lost, stolen, and unlocated computers, in accordance with the Laboratory's Property Management Manual.

MANAGEMENT COMMENTS

Management, while not formally concurring, expressed general agreement with the report. Management stated that the issues presented in the report would be factored into the corrective action efforts currently underway by the University of California, Los

Alamos National Laboratory, Los Alamos Site Office, and appropriate NNSA Headquarters staff offices.

INSPECTOR COMMENTS

Management has acknowledged the existence of internal control weaknesses at LANL. During recent discussions with University of California, LANL, and NNSA officials, management described corrective actions being implemented to address the recommendations in our report.

Appendix A

SCOPE AND METHODOLOGY

The fieldwork portion for this interim report was conducted during the period December 2002 to March 2003. This review included interviews with DOE officials from the Albuquerque Service Center and officials from LANL, PTLA and other LANL subcontractors. We reviewed applicable policies and procedures pertaining to sensitive property and property management, including:

- Department of Energy Property Management Regulations, Title 41 Code of Federal Regulations, Chapter 109.
- "LANL Property Management Manual."

In addition, we conducted inventory verification of a judgmental sample of laptop and desktop computers.

This inspection was conducted in accordance with the "Quality Standards for Inspections" issued by the President's Council on Integrity and Efficiency.

Appendix B

Department of Energy
National Nuclear Security Administration
Washington, DC 20585

APR 21 2003

MEMORANDUM FOR Christopher R. Sharpley
Acting Assistant Inspector General
for Inspections

FROM: Anthony R. Lane
Associate Administrator
for Management and Administration

SUBJECT: Comments to LANL Computer Controls Draft Inspection Report

The Office of Inspections conducted an inspection to determine the adequacy of internal controls over laptop and desktop computers at Los Alamos National Laboratory. NNSA has reviewed the draft report and will have the facts, as presented, factored into the corrective action efforts currently underway by the University of California, Los Alamos National Laboratory, Los Alamos Site Office, and appropriate NNSA Headquarters staff offices. Additionally, NNSA will factor the corrective actions associated with the draft report's recommendations into the ongoing efforts. NNSA appreciates all of the work that the Inspector General has accomplished through their Audit, Investigations, Inspections, Special Inquiry, and Management Referral functions related to the Internal Controls problems the Laboratory.

Should you have any questions, please contact Richard Speidel, Director for Policy and Internal Controls Management. He may be reached at 202-586-5009.

cc: Ralph Erickson, Manager, Los Alamos Site Office
Robert Braden, Senior Procurement Executive, NA-63
David Marks, Director, Field Financial Management, SvcCen/NV

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IG Report No. DOE/IG-0597

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3. What format, stylistic, or organizational changes might have made this report's overall message more clear to the reader?

4. What additional actions could the Office of Inspector General have taken on the issues discussed in this report which would have been helpful?

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Tab 12

U.S. Department of Energy
Office of Inspector General

Special Inquiry

Operations at Los Alamos National Laboratory

DOE/IG-0584 January 2003

Department of Energy
Washington, DC 20585

January 28, 2003

MEMORANDUM FOR THE SECRETARY

FROM: Gregory H. Friedman
Inspector General

SUBJECT: Special Inquiry Regarding Operations at Los Alamos National Laboratory

BACKGROUND

On November 18, 2002, the Office of Inspector General began a fact finding inquiry into allegations that senior management of the Los Alamos National Laboratory engaged in a deliberate cover-up of security breaches and illegal activities, in particular, with respect to reported instances of property loss and theft. The Acting Administrator of the National Nuclear Security Administration requested this inquiry based, in part, on media reports that Los Alamos employees had misused the Government purchase order system to buy millions of dollars worth of goods for personal use and that Los Alamos management had attempted to hide these events from the Department of Energy and the public.

Shortly after our review began, Los Alamos terminated the employment of two security officials who had been vocal in criticizing Los Alamos management's handling of property loss and theft issues. We expanded our review to evaluate the circumstances surrounding those terminations.

This inquiry did not include a case-by-case validation of whether individual items of property had been lost or stolen. Ongoing reviews by the Office of Inspector General, the Federal Bureau of Investigation, and others will address a number of those reported instances.

RESULTS OF INQUIRY

Our inquiry disclosed a series of actions by Laboratory officials that had the effect of obscuring serious property and procurement management problems and weakened or overrode relevant internal controls. These actions created an atmosphere in which Los Alamos employees were discouraged from, or had reason to believe they were discouraged from, raising concerns to appropriate authorities. In short, management's actions – whether intended as a cover-up or not – resulted in delayed identification and resolution of the underlying property and procurement weaknesses, and related security concerns. Although our inquiry did not substantiate the allegation that Laboratory management deliberately hid criminal activity, we found that Laboratory management:

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- Failed to take appropriate or timely action with respect to a number of identified property control weaknesses, and related security concerns. There was: (1) inadequate or untimely analysis of, and inquiry into, property loss or theft and security issues; (2) lack of personal accountability for property; (3) a substantial degree of dysfunction in the Laboratory's communication and assignment of responsibilities for the handling of property loss and theft concerns; and (4) inadequate controls over procurement and property systems.

- Had inadequate Laboratory policies that governed when and under what circumstances Laboratory activities must be reported to law enforcement.

- Issued, then immediately rescinded without adequate explanation, a memorandum requiring corrective actions to address "disturbing negative trends regarding Laboratory management of Government property."

- Published certain materials emphasizing loyalty to the Laboratory at the possible expense of full disclosure of identified problems. This included materials distributed to Laboratory employees, in advance of a November-December 2002, Department cyber security review, containing such guidance as "Resist the temptation to 'spill your guts'"; "Handwritten notes can be especially damaging....They are not easily disavowed"; and "Finger pointing will just make the program look bad."

Our inquiry corroborated a number of the concerns expressed by the terminated security officials related to weak internal controls and other property management issues. The Laboratory's decision to terminate the two security officials during ongoing external reviews that were addressing some of the very same issues raised by these officials, and which were later corroborated, was, in our judgment, incomprehensible. These events raise doubt about Los Alamos' commitment to solving noted problems, had the potential to have a chilling effect on employees who may have been willing to speak out on matters of concern, and were inconsistent with Laboratory and University of California obligations under its contract with the Department of Energy. As you know, the University recently announced that the two security officials had been re-hired.

Our report of inquiry contains recommendations for corrective action. In particular, responsible Department officials must ensure that the University of California and the Laboratory's management is held accountable for implementing and executing corrective actions resulting from the current situation at the Laboratory.

Attachment

cc: Deputy Secretary
Acting Administrator, National Nuclear Security Administration

SPECIAL INQUIRY REGARDING OPERATIONS AT LOS ALAMOS NATIONAL LABORATORY

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BACKGROUND

For 60 years, the University of California (University) has operated the Los Alamos National Laboratory for the Department of Energy and its predecessor agencies. Among its many important missions and functions, Los Alamos has critical national security responsibilities, including helping to ensure the safety, security, and reliability of the nation's nuclear weapons stockpile.

In recent years, Los Alamos has been the subject of intense scrutiny during a number of controversies regarding allegations of espionage, lax security, and related internal control failures. The Department and Los Alamos initiated actions intended to ensure that the Laboratory was carrying out its missions with a heightened emphasis on protecting national security interests. Realignment of Los Alamos' security function, or "S" Division, was one such action. On a broader scale, Congress and the President created the National Nuclear Security Administration (NNSA) as a semi-autonomous agency within the Department.

In 2001, Los Alamos undertook a nationwide search to recruit an experienced leader for the Office of Security Inquiries within the "S" Division. In addition to various security responsibilities, the job announcement for this position provided, in part, that the person hired would conduct investigations into theft and property protection. Given the sensitive nature of much of the work at Los Alamos, imbuing this position with a sense of urgency for the protection of property – especially computers and other technology that may store classified and other national security information – was consistent with the Laboratory's stated goal to heighten national security awareness. The nationwide search culminated with the hiring of a new Security Inquiries Team Leader (Security Inquiries Leader) who took office in January 2002.

On November 5, 2002, anonymous sources were quoted in the news media alleging that Los Alamos leadership was attempting to deliberately hide major criminal activity, administrative mismanagement, and high-level corruption from the public, the Department, law enforcement agencies and others. On November 6, 2002, NNSA's Acting Administrator requested that the Office of Inspector General conduct an inquiry into the anonymous allegations.

We commenced this inquiry on November 18, 2002. On November 25, 2002, Los Alamos terminated the employment of the Security Inquiries Leader and another security official. The timing of this action raised the specter that the terminations could be retaliatory in nature. We, therefore, incorporated an examination of the terminations into our inquiry.

During the course of the inquiry, we interviewed over 60 Laboratory officials and other parties, including the two terminated security officials. We also reviewed thousands of pages of pertinent records. We did not validate, on a case-by-case basis, whether individual items of property had been lost or stolen. Other ongoing Office of Inspector

General reviews and investigations, further requests for follow up actions, Department initiatives, as well as matters under the purview of the Federal Bureau of Investigation (FBI), are continuing to address a number of those reported instances.

In light of the serious nature of these charges, the personal attention and concern the Secretary has brought to bear on these matters, and the substantial and understandable public concern that the Laboratory's actions have generated, we provided the Secretary with a memorandum on December 24, 2002. That memorandum contained our preliminary observations.

RESULTS OF INQUIRY

A. Allegations of Cover-up/Questionable Management Actions

Laboratory officials took a number of actions that, in our judgment, obscured serious property management and security problems. These actions contributed to an atmosphere where Los Alamos employees were discouraged from, or had reason to believe they were discouraged from, raising concerns about property loss and theft, or other concerns, to appropriate authorities. Our inquiry, however, did not substantiate the anonymous allegations, reported in the media on November 5, 2002, that Laboratory management deliberately hid criminal activity.

Management's actions – whether intended as a cover-up or not – made successful identification and resolution of the underlying property, procurement, and security weaknesses problematic. The most overt action Los Alamos took was firing the security officials. This action, taken amidst ongoing reviews of allegations of lax security controls, was clearly and predictably controversial. Moreover, the officials were fired soon after they spoke with the Office of Inspector General. It is impossible to imagine that this action would not have had a chilling effect on other employees who might have contemplated speaking out about problems at the Laboratory. In our judgment, the terminations undermined management's actions to address the core issue: identifying and correcting weaknesses in controls over national security assets.

In addition to the firings, our inquiry disclosed that Laboratory management:

- Issued, then immediately rescinded, a memorandum requiring corrective actions to address problems regarding the management of Government property.

- Published Laboratory documents that could be interpreted as discouraging Los Alamos employees from reporting on the extent or severity of control weaknesses.

Rescinded Memorandum

In an April 2002, memorandum, addressed to all Laboratory "Leaders," the Laboratory's Office of the Chief Financial Officer (CFO Office) cited the need to "call your attention to disturbing negative trends regarding Laboratory management of Government property

and to engage your support in taking corrective action." According to the CFO Office, the concerns were that the amount of property missing during the Fiscal Year 2001 inventory had nearly tripled from the previous year, to $723,000; and, that substantial amounts of property, valued at $533,000, had been reported lost or stolen during Fiscal Year 2001.

The CFO Office's memorandum further stated that neither Los Alamos nor the Department could accept $1.3 million (the total of the two categories listed previously) in unaccounted property. The CFO Office noted that the issue would negatively impact the Laboratory's rating in property management. Attached to this memorandum was organization-specific listings reflecting property losses.

To address these concerns, the CFO Office described four new quarterly tracking and trend reports that this office would be responsible for issuing. The memorandum requested that each Los Alamos division develop a corrective action plan to raise awareness of property accountability and safeguards. The memorandum also suggested the initiation of a root cause analysis and planned training, and recommended review of instances of multiple losses or lack of accountability by the same individual. On December 18, 2002, we asked the CFO Office to provide us copies of each of these reports, including copies of each division's corrective action plan.

In a memorandum dated December 19, 2002, we were informed that the April 10, 2002, memorandum had actually been rescinded the day after it was distributed. Los Alamos management decided that it would be more appropriate to provide each division leader only the information relevant to his or her division and that it served no purpose and was insensitive to people's privacy to publish the entire list. Thus, an e-mail was sent asking division leaders to disregard the memo of the previous day. Given that the guidance was rescinded, there was no requirement to provide the corrective action plans, and a number of the other new reporting mandates were never fully effectuated.

This chain of events raised doubts as to management's commitment to address identified control weaknesses.

Laboratory Documents

During our inquiry, two other significant documents came to our attention that could be interpreted as discouraging Los Alamos employees from reporting on the extent or severity of control weaknesses.

We reviewed briefing materials for a training course to be attended by Los Alamos employees in anticipation of a November/December 2002 Department of Energy Inspection & Evaluation (I&E) review on Laboratory cyber security. The briefing materials, which were prepared by the Laboratory's Office of Chief Information Officer (CIO Office), were titled, "Surviving the [I&E] Audit," and included the following suggestions:

- "Resist the temptation to 'spill your guts'."
- "Handwritten notes can be especially damaging....They are not easily disavowed."
- "Finger pointing will just make the program look bad."

When shown these materials, a senior Los Alamos management official said that he had not previously seen them and that they were "stupid." Subsequently, on December 16, 2002, a memorandum was sent to certain employees clarifying the purpose of these materials in light of their "potential for misinterpretation." Nevertheless, it was difficult to conceive of any legitimate purpose for such guidance in anticipation of a routine Department of Energy review of security issues.

A second document, which Los Alamos internal auditors have been required to sign, was titled a Code of Ethical Conduct statement. This document was based on the Institute of Internal Auditors (IIA) Code of Ethics, but departed from the IIA code by requiring auditors not to use information in a manner that could be perceived as "...detrimental to the University of California, the Los Alamos National Laboratory, or the Audits and Assessments Office." While it may not have been the intent of the document, reporting erroneous payments or surfacing other internal control weaknesses – traditional responsibilities of internal auditors – could be perceived as "detrimental" to Los Alamos. Los Alamos auditors were also asked to "exhibit loyalty in all matters pertaining to the affairs of the University of California, the Los Alamos National Laboratory, and the Audits and Assessments Office...." The document in question created, in our opinion, the appearance of a lack of independence for Los Alamos auditors.

B. Security Officials' Terminations

We endeavored to evaluate the Laboratory's decision to terminate the two security officials consistent with the Department's standards for protecting contractor employees from retaliatory termination. Based on our evaluation, we believe it will be difficult for the University of California to sustain its burden under the prevailing standard for adjudicating these matters.

Specifically, under the Department's procedures, once an initial case of retaliatory termination is established, the burden shifts to the contractor entity to demonstrate, by clear and convincing evidence, that the contractor entity would have taken the same action without the contractor employee's disclosure or other protected activity.

In this regard, our inquiry disclosed that:

- The two terminated security officials were vocal in their criticisms of the Laboratory's management of property loss and theft concerns.

- Laboratory management acknowledged that prior to the arrival of the Security Inquiries Leader, Laboratory efforts to inquire into these matters were inadequate.

- Recent external reviews, including this inquiry, corroborated a number of the fundamental concerns previously expressed by the two terminated security officials relating to property and management systems.

- As late as October 2002, the Security Inquiries Leader had received a favorable performance evaluation.

The timing of the terminations was, itself, suspect. A memorandum documenting the Laboratory's stated rationale for the terminations is dated the same day (November 20, 2002) as the Office of Inspector General's interview of one of the two security officials. We were advised by the Security Inquiries Leader, and Laboratory documentation confirmed, that he had informed his management, in advance, that he and his staff were to be interviewed by the Office of Inspector General inquiry team.

In the November 20, 2002, memorandum cited above, a senior Los Alamos official documented what he believed to be valid reasons for the terminations. We evaluated these reasons, and concluded that a substantial number of them do not withstand scrutiny.

C. Internal Control Weaknesses

In a March 26, 2002, memorandum to Los Alamos management, the Security Inquiries Leader expressed significant concern with the manner in which Los Alamos addressed property loss and potential theft. Our inquiry corroborated a number of those concerns. Specifically, we found: (1) inadequate or untimely analysis of, and inquiry into, property loss or theft and security issues; (2) lack of personal accountability for property; (3) a substantial degree of dysfunction in the Laboratory's communication and assignment of responsibilities for the handling of property loss and theft concerns; and (4) inadequate controls over procurement and property systems.

Property and Security Issues

We noted that property loss and theft issues, and related security considerations, were not subject to thorough and consistent analysis. For example, in 2001, the report documenting the loss of a security radio was inadequate. It did not provide information concerning what frequencies might have been compromised.

The Security Inquiries Leader expressed this and related concerns in his March 2002 memorandum, including those with respect to the entry into a law enforcement tracking system of Laboratory property theft reports. Although he noted that such reports were being provided to the Los Alamos Police Department and the FBI, the Security Inquiries Leader asserted that those agencies were not entering the property information into the National Crime Information Center records because the reports were of poor quality.

As noted by a counterintelligence official, the theft of Laboratory property can have national security implications. In this vein, with respect to previous Laboratory property reports he reviewed, the Security Inquiries Leader observed:

> The reports indicate that no questions were asked pertaining to the type of data that may have been on stolen computers, laptops, PDAs[1], and digital cameras. It is possible that they may have had sensitive or proprietary materials on those systems, but inquiry personnel failed to explore that potential; at least one can assume this view based on the data contained in the inquiry reports.

Based on these concerns, we requested that Los Alamos explain the steps taken to account for lost computers and other sensitive equipment. We also inquired as to any efforts made to evaluate whether classified or other protected information had been compromised as a result. The Laboratory produced a draft memorandum, dated December 18, 2002, in which the CIO Office concluded that none of the lost, stolen, or unlocated computers identified by Los Alamos contained classified information. The CIO's memorandum also concluded that there were at least 258 computers lost, 44 computers stolen, and 61 computers unlocated for the Fiscal Years 1999, 2000, 2001, and 2002[2]. We did not validate these numbers, or the CIO's conclusion concerning the non-compromise of classified information. In fact, a CIO official told us that there were inconsistencies between these numbers and previous reports provided by the CFO and the Office of Security Inquiries.

A CIO official acknowledged that the Laboratory's processes for reporting lost, stolen, and unlocated computers are "fragmented." He noted inconsistencies between computers reported lost and stolen to the Office of Security Inquiries and data available to property management officials. Another Laboratory official confirmed that these reporting mechanisms are not integrated throughout the Laboratory, and both of these key officials asserted that they have recently recommended corrective action to ensure that appropriate systems are integrated.

The timing of the Laboratory's effort to reconcile these important questions is, in and of itself, troubling. It was not until the November-December 2002 timeframe that there was intensive effort in this regard.

Property Accountability

According to a Los Alamos official, Laboratory employees have not been routinely held liable or accountable for lost property under their control. This official explained that when an employee first takes custody of an item of property, the employee signs an "accountability" statement. However, Los Alamos management generally chose not to enforce the statements, according to this official, but rather chose to "write off" the missing property at the end of an inventory cycle. An accounts receivable official could not recall ever receiving any restitution from any Los Alamos employee for a lost or stolen item for which he or she was responsible. The Security Inquiries Leader made a similar point in his March 2002 memorandum.

---

[1] "Personal Digital Assistants."

[2] The CIO's memorandum identified an additional 75 computers requiring follow up and resolution as to their status.

Based on these assertions, we reviewed electronic records of "Unlocated," "Lost," and "Stolen" property for Fiscal Years 2000, 2001, and 2002. A judgmental selection disclosed the following types of property categorized as "Lost," "Stolen," or "Unlocated":

Item	Quantity	Acquisition Value
Desktop Computers	204	$694,938
Laptop Computers	42	$151,821
Analyzers	8	$ 99,225
Cameras	12	$ 11,318
Computer Printers	127	$177,141
Oscilloscopes	17	$207,620
Power Supplies	5	$ 51,843
Radio Transceivers	27	$ 35,596
Video Recorders	18	$ 47,293
Telephones (including cell phones)	80	$ 27,208
Scanners	12	$ 10,475

These records did not contain sufficient information to fully assess the nature and extent of property losses. Nevertheless, the results of our judgmental selection raise additional questions about the Laboratory's property controls and accountability.

Another issue we identified relates to Los Alamos' use of "drop points" for the delivery of new equipment. Under the drop point system, Laboratory property is not delivered, uniformly, to a central, secure location. At such a secure central location, the equipment can be tagged, inventoried, and consistently tracked. We were told that many of these Laboratory drop points are in open spaces with little or no security. A number of key officials advised that there have been insufficient Laboratory efforts to ensure that equipment delivered to Laboratory drop points is safeguarded. We were also told that property would be left at these locations for inordinate amounts of time, without being checked by property administrators.

Communication and Responsibilities

Our inquiry disclosed a substantial degree of dysfunction in Los Alamos' communication and assignment of responsibilities and authorities for the handling of property loss and theft concerns. For example, there was organizational inconsistency between the roles of

[3] The "Acquisition" value of these sampled items amounts to $1,514,478.

the Office of Audits and Assessments and the Office of Security Inquiries. The Office of Audits and Assessments was tasked with the internal review of Laboratory "waste, fraud, and abuse" concerns, whereas the Office of Security Inquiries was responsible for reviewing alleged "theft." This left not only the potential for "overlap" in responsibilities, but "underlap," as one senior security official characterized this condition to our inquiry team.

There were also mixed messages sent to the two former security officials with respect to the scope of their authorities and responsibilities. For example, Security Inquiries officials were told that they were not "investigators." At the same time, our inquiry disclosed that one of the terminated security officials was directed by a senior Los Alamos official to travel off site, to another state to interview a private citizen, to obtain information concerning a matter (the alleged improper purchase of a Mustang automobile), which included the possibility that it was criminal in nature. This appeared inconsistent with previous direction, and other management communications to these officials, about the scope of their responsibilities and authorities.

Further, Laboratory management acknowledged that there were inadequate Laboratory policies that governed when and under what circumstances Laboratory activities must be reported to law enforcement. Laboratory officials had been drafting such a policy since the spring of 2002, but the policy remained in draft at the time of our inquiry.

Procurement and Property Systems

As we completed our inquiry fieldwork, the final report of the Laboratory's external review team was completed. That report noted a number of Laboratory "programmatic weaknesses" with respect to Los Alamos' controls over purchase cards, including:

- Failure to reconcile and approve monthly statements;
- Failure to resolve disputed transactions;
- Failure to properly account for controlled property;
- Purchase of restricted items in violation of Laboratory policies;
- Insufficient documentation of items purchased;
- Inadequate or ineffective sanctions for non-compliance;
- Insufficient training, especially for approvers;
- Insufficient program audit and review procedures;
- Failure to properly manage cardholder spending limits; and,

- Failure to safeguard card information.

The external review team recommended a number of corrective actions, and noted that they had not validated the Laboratory's implementation of recent corrective actions.

We also noted during our inquiry that NNSA had completed an assessment of the Laboratory's "Personal Property Management" and "Procurement Management," in December 2002, and rated the Laboratory as "excellent" in both categories. Although we did not evaluate the process by which these or earlier ratings were issued, the facts disclosed during our inquiry suggest that the Department's process for arriving at such ratings warrants review by appropriate Department officials.

RECOMMENDATIONS

In light of these facts, we are making the following recommendations for corrective action. Specifically, it is incumbent upon responsible Department officials to ensure that:

1. Recently announced corrective actions are fully implemented and executed;

2. Additional follow-up and corrective action is taken with respect to the matters disclosed in this report, including:

   (i) inadequate or untimely analysis of, and inquiry into, property loss or theft and security issues;

   (ii) lack of personal accountability for property;

   (iii) substantial degree of dysfunction in the Laboratory's communication and assignment of responsibilities for the handling of property loss and theft concerns; and,

   (iv) inadequate controls over procurement and property systems;

3. The Department processes to evaluate the Laboratory's procurement and property accountability systems for fee purposes are reviewed and improved based on the current experience at the Laboratory;

4. Concrete steps are taken to communicate to Laboratory employees that they are encouraged to identify and disclose waste, vulnerabilities, and other concerns in an atmosphere free of reprisal; and,

5. The Department does not bear the costs incurred by the University in conducting its own inquiries into these matters, or in otherwise effectuating remedial action, including the costs associated with any monetary settlements deemed just and proper, and which may be extended to the two terminated security officials.

IG Report No.: DOE/IG-0584

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PREAMBLE

The following Standards of Performance consist of Strategic Performance Objectives and supporting Performance Measures and are the primary components of the performance-based management system described in Section H clause entitled, Performance-Based Management.

Implementation of this Appendix is supported by the Contractor's Evaluation Plan (CEP) that includes implementation guidelines for each Performance Measure. Those guidelines establish points of accountability and include procedures for addressing Level 2 budget planning milestones consistent with Item #8 in the Basis for Budget Planning as agreed at the NNSA Navigators' meeting on August 2, 2002.Where appropriate, they contain performance targets and related dates for each measure.

The Parties agree that the NNSA Site Office Managers, UCOP, and the Laboratory Directors will jointly review the CEP's implementation guidelines for the purpose of obtaining NNSA comment and input. The Site Office Managers will collect and summarize input from NNSA offices on the Contractor's CEP implementation guidelines and communicate the input to the Contractor as appropriate. It is the intent of the Parties that issues involving the CEP implementation guidelines will be resolved to the maximum possible extent and that unresolved issues, if any, will be included in NNSA's annual Performance Evaluation Report.

Performance Area: Mission

Performance Objective # 1: Develop and Implement a Common UC Design Laboratory Certification Strategy

Performance Measures:

1. Develop an integrated, scientifically based, quantitative certification methodology that has been externally reviewed for use in future warhead certification and to support the Annual Certification Process.

2. Demonstrate application of a common assessment methodology using Quantification of Margins and Uncertainty (QMU) in major warhead assessments.

3. Demonstrate progress toward quantifying margins and reducing uncertainties relevant to primary and secondary performance.

Performance Objective # 2: Develop with NNSA and implement long-term balanced, integrated stewardship

Performance Measures:

1. Support the needs of warhead assessment and certification by coordinated programs of targeted small- and large-scale experiments and mining of archival UGT data to improve predictive capability.

2. Demonstrate advances in radiography technology and develop joint options and recommendations for future x-ray and proton radiographic capability that support the quantitative certification methodology.

3. Demonstrate ASC simulation and modeling capabilities that support the ongoing needs of stockpile assessment and certification.

4. Improve and apply tools and models for prediction of systems and/or component lifetimes.

5. Develop and implement a collaborative and complementary program of experiments at High Energy Density (HED) facilities that supports the quantitative certification methodology.
6. Develop an integrated program for plutonium capabilities of LANL and LLNL to support the overall NNSA strategic requirements.

Performance Objective # 3: Develop with NNSA and implement near-term balanced weapon program plans

Performance Measures:

1. As part of the Annual Certification Process, the laboratory directors will complete the annual assessments of the continued safety, reliability and performance of all warhead types in the stockpile including whether nuclear testing is required for resolution of any issue; and support DOE as required during interagency and community coordination of the Annual Certification Process.

2. Provide technical support to production complex operations, including the Integrated Weapons Activity Plan (IWAP).

3. Deliver on W88 Pit Manufacturing and Certification Project major milestones.

4. Deliver on the major milestones for the Life Extension Programs for the W76, the B61-7/11, and the W80-2/3 in accordance with the Phase 6.X process.

5. Conduct stockpile surveillance and assessment activities, including investigation and subsequent resolution of significant findings on a priority basis, and issues identified in technical assessment reports.

6. Support directive schedule requirements.

Performance Objective # 4: Develop and implement sound non-proliferation/counter terrorism program basis

Performance Measures:

1. Sustain and expand intelligence and counterintelligence programs and analysis and analytical data systems for detecting and thwarting Proliferation and Terrorism.

2. Sustain and expand international cooperative programs to reduce the threat of nuclear proliferation.

3. Develop and expand complex systems modeling to enhance prediction and identification of threats, prioritization and integration of counter-terrorism efforts, and effectiveness of response systems for terror events.

4. Develop and transition technologies for large-scale deployment for civilian preparedness against terrorist biological, chemical and other attacks.

5. Develop and demonstrate nuclear detection and monitoring technologies; provide technologies and expertise to enhance protection of nuclear materials in, at, and outside of US borders; and maintain the capability to deploy a nuclear emergency response team for protecting US assets from radiological and nuclear threats.

6. Develop global situational awareness with the defense and intelligence communities and enable the necessary technical underpinnings to monitor and track facilities, people, and situations worldwide in real-time.

Performance Objective # 5: Enhance and nurture a strong science base in support of NNSA strategic objectives

Performance Measures:

1. Develop and implement an integrated and balanced strategy for investing LDRD, programmatic, and institutional resources to ensure the long-term vitality of the laboratory science and technology base to support the NNSA mission and emerging national needs.

2. Nurture and maintain the Laboratories' signature capabilities including unique experimental facilities and competencies in support of Laboratory and external users and sponsors.

3. Strategically pursue and successfully execute a portfolio of non-NNSA sponsored research that builds on unique Laboratory capabilities and enhances the Laboratories' competencies to meet current and future national security needs.

4. Foster active participation in the broad scientific community and leverage unique Laboratory expertise and capabilities to develop strategic collaborations with other national laboratories, industry, and academia.

Performance Objective # 6: Achieve successful completion of projects and development of user facilities

Performance Measures:

1. Execute significant construction projects as identified and agreed to between the Site Offices and laboratories within budget, scope, and schedule.

2. Develop with NNSA and implement a National Hydrotest Plan that addresses mutual utilization of hydrotest facilities, including containment and materials availability.

3. Develop and implement with NNSA and other appropriate DOE programs plans to support optimal use of scientific, research and test facilities and capabilities (e.g., NIF, DARHT, Terascale Computing Facilities, LANSCE) at both Laboratories.

Performance Area: Operations

Performance Objective # 7: Maintain a secure, safe, environmentally sound, effective and efficient operations and infrastructure basis in support of mission objectives

Performance Measures:

1. Meet facility short and long term needs to support mission requirements; critical facilities, including nuclear facilities, will meet operational needs for programmatic work requirements by minimizing unplanned system outages and downtime. Achieve the objectives in the approved FY03 Ten-Year Comprehensive Site Plan.

2. Achieve continual improvement in ISM:

   •Develop and implement simplified facility safety basis and related operational requirements for non-nuclear facilities based on benchmarking of best practices.
   •Assure consistent application of ISM principles across all organization levels and across all Laboratory facilities.

3. Comply with 10 CFR 830 subpart B for the operations of the Laboratories' category 2 and 3 nuclear facilities by completing the required Documented Safety Analysis and Technical Safety Requirements according to the Master Schedule (LANL) or Approved Submission Plan (LLNL).

4. Complete the NNSA-approved action plans and UC-approved project plans for implementing Integrated Safeguards and Security Management and after that, achieve continuous improvements by providing consistency throughout the Laboratory.

5. Develop with NNSA a long-term plan to reduce inventories of surplus and excess SNM and onsite waste.

6. Develop and execute an Environmental Management Program consistent with regulatory and mission requirements. (LANL) Maintain an Environmental Management Program consistent with DOE negotiated regulatory requirements and funding levels. (LLNL)

7. Implement an Emergency Management Program within NNSA approved schedules. (LLNL Only)

8. Implement effective controls in business systems by assessing existing controls and, where needed, strengthening controls to ensure effective stewardship of public assets.

Performance Objective # 8: Utilize UC strengths to recruit, retain and develop the workforce basis

Performance Measures:

1. Provide skills necessary to enhance the science base by implementing integrated recruiting and retention strategies to meet the Laboratories' long-range skills requirements.

2. Implement leadership and management development programs aligned with workforce planning and diversity objectives.

Performance Objective # 9: Sustain effective Community Initiatives

Performance Measures:

1. Leveraging the UC expertise and mission in science education, the laboratories will establish and maintain science education outreach programs with the joint goals of community outreach and substantive contribution to science education.

2. Support community and tribal initiatives that leverage community and corporate UC resources in order to foster economic development and corporate citizenship, including educational activities, regional procurement, and workforce development. (LANL Only)

3. The Laboratory will develop local community initiatives to include those programs or responses addressing mutual goals and concerns. (LLNL Only)

The Secretary of Energy
Washington, DC 20585

December 24, 2002

Tab 14

Dr. Richard C. Atkinson
President
University of California
1111 Franklin Street
Oakland, California 94607-5200

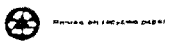
Dear President Atkinson:

Since our December 12, 2002, meeting with you, your senior staff, and the Los Alamos National Laboratory leadership to review the ongoing issues with management and security at Los Alamos, we have reviewed both the material you presented then and in subsequent conversations with Deputy Secretary McSlarrow and Acting National Nuclear Security Administrator Brooks as well as actions taken by the University of California.

To date, much of our discussion has concerned the status of corrective action on the misuse of procurement cards, theft through purchase orders, and property accountability. These are matters on which investigation began in April 2002, with an inquiry by the Inspector General (IG) of the Department of Energy into abuse of purchase cards. While I recognize that the Laboratory is making a number of significant efforts to address these problems, we remain deeply concerned about them as we have previously indicated to the University and the Laboratory. I expect to be kept informed of your progress through Ambassador Brooks.

Of most immediate concern, however, are the events surrounding the dismissal of Mr. Walp and Mr. Doran, their allegations of cover-up concerning matters that they were investigating, and their allegations that their dismissal has precluded investigation of additional matters that are, therefore, going unaddressed.

As Deputy Secretary McSlarrow relayed to you, the inescapable conclusion is that the actions relating to Mr. Walp and Mr. Doran reflect a systemic management failure, one for which the Laboratory management must be held accountable. I understand that you are addressing this issue now, and I expect the University to continue its efforts to ensure that these failures are corrected.



Nor have I been satisfied by the fact that no effort or thought seems to have been given to either appointing new personnel empowered to investigate the areas of concern Mr. Walp and Mr. Doran identified, whether before or after their dismissal, or to ensuring all possible lines of inquiry are pursued otherwise.

Consequently, I have now asked the Inspector General to investigate such allegations and any others he deems appropriate. Given the nature of some of the allegations, it is important that any investigation be independent of the University of California. Taken together, these problems have called into question the University of California's ability to run the Los Alamos National Laboratory (LANL). This, I know you will agree, is an untenable situation given the critical role that the Los Alamos National Laboratory serves in protecting our Nation's security and must be remedied to ensure we return Los Alamos to its preeminent position in science and national security.

Thus, in addition to any management changes, I intend to fully evaluate the University's capacity to operate LANL notwithstanding the 5-year contract extension that was signed on January 19, 2001. I have directed Deputy Secretary McSlarrow and Ambassador Brooks to conduct such an evaluation to be completed by April 30, 2003, or as soon as possible thereafter, when the IG's investigations are concluded. This evaluation will be based on:

- The IG's investigation and findings;
- The results of the University's reviews;
- The University's corrective actions with respect to lab management and personnel; and
- Any other relevant issues.

Ambassador Brooks and Deputy Secretary McSlarrow will provide a recommendation to me at the end of the evaluation process.

For 60 years, the University and the Federal Government have been partners in operating our nuclear design laboratories. The scientists and engineers of Los Alamos play a vital role in the security of the United States. Regardless of the specific conclusions reached during that evaluation, I am firmly committed to ensuring that the Laboratory continues to attract and retain the world-class scientists on whom our nuclear deterrent depends and intend to see to it that any changes that may result enhance rather than detract from the accomplishment of that objective.

As I indicated to you last month, your personal attention to these matters is important to ensure the necessary changes and corrective measures. I appreciate your doing so because, though there is still much to do, it is clear that your direct participation has already resulted in some progress in a very short time.

Sincerely,

Spencer Abraham

cc: Deputy Secretary McSlarrow
Acting Administrator Brooks
Inspector General Friedman
Bruce Darling, Senior Vice President, University of California

Tab 15

December 12, 2002

Dr. John C. Browne
Director, Los Alamos National Laboratory
Los Alamos National Laboratory
Los Alamos, NM 87545

Subject: Report of Findings re: External Review of The Purchase Card Program

The External Review Team has completed an administrative review of the Los Alamos National Laboratory (LANL) Purchase Card Program and the Report of Findings is attached. I was assisted in this review by Mr. Charles C. Masten, Vice Chair, along with a team of forensic accountants from PricewaterhouseCoopers.

We reviewed documentation and data for the period October 1, 1998 through June 30, 2002 and conducted interviews of cardholders, requesters, approvers and managers. Several areas have been identified for improvement in the management and application of the Purchase Card Program. We have concluded that internal control weaknesses existed in the program, which left LANL vulnerable to fraud and abuse. Numerous cardholders failed to reconcile monthly purchase card statements and managers did not ensure that these statements were appropriately reviewed. Purchases were made in violation of LANL policies and procedures. Disputed items were neither credited by the bank nor followed-up by the cardholders in numerous instances. We provided your management team with lists of transactions requiring additional explanation and for the purpose of determining the appropriateness of specific costs.

The corrective actions recently announced by LANL, along with implementation of the recommendations contained in the attached Report of Findings should provide for an enhanced control environment for the Purchase Card Program. Further, we recommend periodic follow-up on these corrective actions.

If you should have any questions regarding our administrative review or the Report of Findings, please do not hesitate to contact me

Sincerely,

John C Layton

John C. Layton
Chair, External Review Committee

Attachment

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Los Alamos National Laboratory

External Review of The Purchase Card Program
Report of Findings

December 12, 2002

PWC000079

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Los Alamos National Laboratory
External Review of The Purchase Card Program
Report of Findings

I. Overview

We were retained by the Director's Office of Los Alamos National Laboratory (LANL) to conduct an independent administrative review of the LANL Purchase Card Program (the "Program"). Specifically, we were tasked to:

- Evaluate current policies and procedures;
- Evaluate current practices;
- Identify control weaknesses or vulnerabilities;
- Investigate suspect or abnormal purchase transactions, trends or patterns;
- Provide relevant observations and conclusions; and
- Recommend corrective actions for strengthening the Program.

The focus of our review was the 45-month period beginning October 1, 1998 and ending June 30, 2002 (the "Review Period"). In conjunction with this review, we were asked to further analyze the purchase card procurement activity of a particular LANL buyer.

A. Review Team Organization

The External Review Team (the "Review Team") is comprised of two External Review Committee members, Mr. John C. Layton and Mr. Charles C. Masten, assisted by a forensic accounting team, lead by Mr. Donald J. Kintzer, from the University of California's audit firm, PricewaterhouseCoopers (PwC). The Review Team's fieldwork was initiated on August 26, 2002 and concluded on November 8, 2002.

B. Background

The LANL Pilot Credit Card Procurement Program was founded in February 1993. The LANL Purchase Card Program was fully implemented by December 1994 and was conceived as a component of the Total Integrated Procurement System (TIPS) to streamline procurement activities and reduce costs.

Purchase cards are credit cards issued to LANL employees for the procurement of low-value goods and services. LANL purchase cards are currently issued by BankOne and bear the MasterCard logo. LANL cardholders include procurement specialists (buyers), whose primary job responsibility is to procure goods and services on behalf of LANL, as well as administrative, managerial and technical personnel.

All cardholders are permitted to procure items for themselves or for others, referred to as requestors. Cardholders are required to enter purchase card purchases in an on-line system called the LANL Purchase Card System. At month end, cardholders electronically reconcile their detailed procurement activity with statements provided by the bank. The Purchase Card Program is not a reimbursement-based program; LANL pays directly for cardholder purchases and cardholders are required to verify purchases and reconcile their credit card statements.

The Purchase Card Program is managed by the LANL Procurement group, part of the Business Operations (BUS) division. A Purchase Card Administrator, reporting to the Team Leader of Streamlined Procurements, is responsible for day-to-day operations of the Program. The Administrator's job responsibilities include developing and conducting training, planning and supervising quarterly audits and reviews, interacting with BankOne and responding to cardholder inquiries. Since inception, there have been five Program Administrators with the current administrator in place since August 2001. Currently, the Purchase Card Office is staffed with five full-time employees.

According a former Purchase Card Administrator, there was a reduction in force at LANL in 1996. The Purchase Card Program was viewed as a cost-saving mechanism by which work could be transferred from buyers to technical requestors, thereby allowing LANL to reduce the size of its procurement staff. As a result, LANL management placed strong emphasis on the Purchase Card Program and encouraged cardholders to make small procurements themselves instead of seeking the assistance of a buyer. Simultaneously, management encouraged buyers to increase their utilization of purchase cards. To this end, all buyers were required to become cardholders and were granted limits of $25,000 per transaction or more. In addition, buyers were permitted to self-approve purchase card transactions. According to a former Purchase Card Administrator, the rationale behind higher limits and self-approval rights for buyers was that these individuals, as procurement specialists, are authorized by their signing authority to make purchases of up to $100,000 or more without additional approval.

1. Use of Purchase Cards at LANL

Total purchases made with the purchase card during the Review Period amounted to $120 million for approximately 170,907 separate transactions[1], an average of approximately $700 per transaction. The use of LANL purchase cards has remained relatively constant since fiscal 1999. However, the average transaction has increased from $661 in fiscal 1999 to $766 in fiscal 2002. The following is a summary of purchase card activity during the Review Period:

[1] A distinct reference number defines a transaction.

TABLE 1: Summary of Purchase Card Activity[2]

Fiscal Year	Active Cardholders	Amount Procured	Number of Transactions	Average Transaction
1999	887	$32,322,507	48,881	$661
2000	874	27,547,563	41,321	667
2001	881	34,243,084	46,492	737
2002	799	35,814,065	46,773	766

Of the total amount purchased during the Review Period, buyers were responsible for over $40.8 million (approximately 34%) of total purchase card procurements.[3] Buyers' spending limits were significantly higher than non-buyer cardholders (generally $25,000 per transaction), although these higher limits were not documented in LANL's policies and procedures. The dollar value of purchases made by buyers' were, on average, 68% greater than the purchases of non-buyer cardholders ($1,661 per transaction for buyers compared to $534 for other cardholders). Until August 26, 2002, buyers were permitted to self-approve their purchase card statements (i.e., no review by a supervisor or other third party was required).

We determined that the Engineering Sciences and Applications, Nonproliferation and International Security divisions as well as Johnson Controls Northern New Mexico were the major requestors of items purchased using LANL purchase cards during our Review Period (see Table 2).

[2] FY02 data provided by LANL Purchase Card Office. Data for July through September 2002 was not available when the External Review commenced and was therefore not reviewed by the External Review Team but is included in the FY02 data provided above.

[3] Due to personnel turnover and lack of historical data, we were unable to associate $11.8 million of purchases with a specific group.

TABLE 2: Top Five Divisions Using Purchase Cards

Title	Division	Amount Procured	Number of Transactions	Average Transaction
ESA	Engineering Sciences and Applications	$18,928,568	12,925	$1,464
JCNNM	Johnson Controls Northern New Mexico	9,980,832	23,754	420
NIS	Nonproliferation and International Security	8,922,490	12,662	705
MST	Materials Science and Technology	7,391,686	9,767	757
DX	Dynamic Experimentation	7,387,834	8050	918

The majority of cardholders contributed to 2% or less of total purchase card purchases. However, one cardholder was responsible for 13% of total purchase card procurements during the Review Period. Together, the top five cardholders were responsible for 22% of all purchase card activity (see Table 3).

TABLE 3: Top Five Cardholders Purchasing with the Purchase Card

Cardholder	Number of Items	Amount Procured	% Of Total Purchases
Cardholder A	11,462	$15,078,110	13%
Cardholder B	2,215	3,273,688	3%
Cardholder C	2,572	2,386,550	2%
Cardholder D	2,504	2,308,982	2%
Cardholder E	951	2,177,448	2%

In contrast, no single requestor was responsible for more than 2% of total purchase card activity (see Table 4).

TABLE 4: Top Five Requestors of Purchase Card Purchases

Requestor	Number of Items	Amount Procured	% Of Total Purchases
Requestor A	4,063	$2,671,470	2%
Requestor B	3,068	1,829,874	2%
Requestor C	4,415	911,070	1%
Requestor D	4,868	875,071	1%
Requestor E	410	860,478	1%

2. Summary of Prior Audit Findings

In fiscal 1996, LANL's Audits and Assessments division conducted a review of the LANL Purchase Card Procurement Program. A follow-up audit of the Purchase Card Program was conducted in fiscal 1997. Both audits were designed to identify internal control weaknesses. The findings of these reviews are summarized below:

TABLE 5: Summary of Prior Audit Findings

Finding	FY96	FY97
Purchase of Restricted Item		X
Improper Source/Vendor		X
Insufficient Documentation/ Description	X	X
Unauthorized Users/ Safeguarding Card Information	X	X
Inadequate Reconciliation Procedures		X
Inadequate Approval Procedures		X
Insufficient Proof of Delivery/Receipt		X
Failure to Properly Record Fixed Assets	X	X
Failure to Properly Account for Purchases	X	X
Failure to Utilize Enhanced Reporting Capabilities	.	X
Duplicate Payments on Purchase Orders	X	
Failure to Track Resolution of Disputed Purchases	X	
Failure to Ensure Funds are Budgeted	X	

The above findings are similar to those reported by the General Accounting Office regarding reviews of the Departments of the Army and Navy purchase card programs. The Department of Energy also reported similar findings in report dated February 2, 2002, which summarized findings from twenty purchase card reviews conducted since 1998.

3. Mustang Transaction

On July 18, 2002, Bank of America (LANL's then purchase card provider) notified the Purchase Card Administrator that an automobile was charged to a LANL purchase card. The Administrator was further informed that the cardholder disputed the charges and that Bank of America reversed the charges.[4]

4. Other Activities

Subsequent to notification of the above transaction, LANL commenced an internal review of the Purchase Card Program and assessed programmatic control weaknesses. The internal review team identified a number of control vulnerabilities and proposed corrective actions. Based in part on these findings, LANL took the following actions:

- Announced modifications and changes to the Purchase Card Program, to be effective August 26, 2002; and
- Retained this External Review Team to conduct an independent review of the Program.

C. Summary of Findings

LANL's Purchase Card Program was established as an instrument for expediting procurement. We observed programmatic control weaknesses, which we believe made LANL vulnerable to fraud and/or abuse. LANL took steps to improve the internal control environment on August 26, 2002, when a series of initiatives designed to improve the internal controls of the Purchase Card Program were announced.

As a result of our review procedures, we made a number of observations regarding the LANL Purchase Card Program. For each observation, we considered the appropriateness of corrective actions announced on August 26, 2002 and if necessary, formulated recommendations for further corrective action.[5]

1. Program Observations

We observed a number of programmatic weaknesses, including:

- Extensive use of purchase cards by procurement specialists (buyers) without programmatic modifications;
- Failure to reconcile and approve monthly statements;

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[4] The Cardholder is presently on administrative (investigative) leave.

[5] Because the Review Period concluded on June 30, 2002, we did not test implementation of the August 26, 2002 corrective actions.

- Failure to resolve disputed transactions;
- Failure to properly account for controlled property;
- Purchase of restricted items in violation of LANL policies;[6]
- Insufficient documentation of items purchased;
- Inadequate or ineffective sanctions for non-compliance;
- Insufficient training, especially for approvers;
- Insufficient program audit and review procedures;
- Failure to properly manage cardholder spending limits; and
- Failure to safeguard card information.

2. Matters Referred to Appropriate Authorities

In connection with our procedures, we reviewed several inappropriate transactions. The following transactions, some of which were identified by LANL prior to our review, have been referred to the appropriate authorities.[7]

- Mustang Transaction;
- Casino cash advances;
- Retail department store charges; and
- Jewelry purchase.

The potential loss to LANL stemming from these transactions is presently estimated at approximately $2,800.

3. Corrective Actions

On August 26, 2002, LANL management announced changes in the Purchase Card Program, which we believe substantially address many of the observed control weaknesses. Nonetheless, during the course of our review we identified additional areas for improvement. Therefore, in addition to the above changes, we recommend the following additional corrective actions:

- Require approvers to take a more active role in the compliance process by notifying them of violations (including failure to reconcile) and requiring approvers to ensure resolution;

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[6] Restricted items include products available through the Just In Time system, unallowable expenditures including items that do not meet the test of business necessity, and other purchases not authorized for procurement on a LANL purchase card.

[7] Recent press articles suggest that two LANL employees illegally used Purchase Cards to procure $50,000 in unauthorized merchandise including gas grills, hunting knives and camping equipment. Although both are cardholders, the alleged purchases were not made on LANL purchase cards and were, therefore, not within the scope of this review.

- Follow-up on all unreconciled accounts and implement sanctions for cardholders who fail to reconcile on a timely basis;
- Establish policies and procedures governing the use of purchase cards by buyers;
- Implement sanctions for inappropriate card usage; and
- Perform routine data mining to diagnose trends and to identify possible improper or fraudulent transactions.

II. Procedures Performed

In conducting our review of the LANL Purchase Card Program, we reviewed policies and procedures in existence during the Review Period. We also conducted interviews of LANL personnel and analyzed purchase card data and supporting documentation for selected transactions. This approach was designed to provide perspective on the intended uses of the Program as well as the ways in which the Program is actually used in practice. Further details on the procedures we performed are outlined below.

A. Review of Policies and Procedures

We obtained the policies and procedures governing the Purchase Card Program in effect immediately prior to the changes adopted on August 26, 2002. Through inquiries and interviews with former Purchase Card Administrators and cardholders, we obtained prior versions of the policies and procedures from 1998, 1999 and early 2002. These earlier versions of the purchase card policies and procedures allowed us to obtain an understanding and perspective of the policies and procedures during the Review Period. The policies and procedures generally address the following areas:

- General purchasing guidelines including unauthorized purchases;
- Cardholder and approving official responsibilities;
- How to enter information in the electronic Purchase Card System;
- Documentation and reconciliation procedures;
- General shipping guidelines;
- Procedures for processing disputes; and
- Procedures for reporting lost or stolen purchase cards.

Other than periodic updates to the unauthorized items list, there have been five significant changes to the policies and procedures from 1998 until the changes adopted on August 26, 2002. These changes include:

- Addition of language allowing the $2,500 single transaction purchasing limit to be increased after the cardholder has established a sustained record of purchasing;

- Change in documentation retention from 3 years to 6 years;
- Changes to requirements regarding who should maintain records when a cardholder transfers groups;
- Revision of the sensitive items list[9]; and
- Addition of a new requirement that cardholders document the reason for not purchasing through JIT.[10]

A number of significant changes were recently made to the policies and procedures. These changes were made in response to an internal review of the Purchase Card Program, following the discovery of the Mustang Transaction in July 2002. The following are highlights of the more recent changes:

- Implemented refresher training for all cardholders and required approvers to attend Purchase Card Program training;
- Established 5:1 maximum ratio of cardholders to approver;
- Prohibited cardholders from approving their own purchase card statements;
- Changed approving officials (responsible for approving reconciled purchase card statements) from group to team leader;
- Decreased cardholder spending limits to $2,500 per transaction and $25,000 per month. Limit may be increased to a maximum of $5,000 and $50,000 per month when justified and with written approval of the Division Leader;
- Prohibited the purchase of property-controlled items (including sensitive items such as VCR's and palm pilots) without authorization by Property Manager;
- Permitted cardholders to delegate their statement reconciliation responsibility only when on leave of absence (reconciliation may not be delegated to the cardholder's approving official);
- Prohibited cardholders from providing purchase card number to requestors;
- Notified cardholders that purchase cards may be suspended if the purchase card statement is not reconciled within two statement cycles;
- Required all over-the-counter purchases greater than $500 must be processed by the approving official;

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[9] Removed the following items from the list: electronic balances, bicycles, external CD ROM drives, fax machines, microwave ovens, typewriters and televisions

[10] Just-in-time subcontractors are pre-established LANL vendors for selected high-volume, low-value items.

- Required all phone and internet orders be shipped to the LANL warehouse (exceptions require written approval by the cardholder's division leader); and
- Prohibited cardholders from shipping items directly to themselves (exceptions require written approval from the cardholder's division leader).

B. Interviews

We conducted 41 interviews of 36 individual employees including LANL management, cardholders, requestors and approvers. The purpose of our interviews was as follows:

- Obtain an understanding of actual purchase card practices;
- Assess cardholder, requestor and approvers' familiarity with Purchase Card Program policies and procedures; and
- Request information on specific targeted transactions.

Based on an agreement between the Federal Bureau of Investigation and LANL management, the Review Team did not interview three LANL employees whose insights may have been relevant to our findings. In addition, based upon a similar understanding, we did not interview individuals outside of the LANL facility.

C. Analytical Review

We obtained and analyzed electronic purchase card data for the Review Period. To gain an understanding of how purchase cards were used in practice during the Review Period, we performed three separate procedures. First, we performed data mining procedures, including key word searches and criteria queries (i.e., no description, not reconciled, etc.), on the complete population of purchases. Second, we selected a random sample of purchases and requested supporting documentation. Finally, based on the results of our data mining procedures and analyses, we targeted a selection of purchases and requested supporting documentation.

1. Data Mining

Data mining is a process by which historical data is extracted and analyzed to obtain an understanding of trends, patterns and other relevant information. During our data mining procedures, we specifically:

- Tested the completeness of purchase card data by reconciling electronic purchase card totals to a summary statement provided by the banks issuing LANL purchase cards;
- Developed a list of risk factors based on the results of prior Purchase Card Program audits as well as LANL policies and procedures for the Purchase Card Program;

- Queried the purchase card data for occurrences of these risk factors in the population; and
- Compiled the results of these queries.

Through review of prior audits and policies and procedures, we developed a refined list of factors to apply in our analysis of the purchase card data. These risk factors and an explanation for each are listed in Table 6 below:

TABLE 6: Data Mining Risk Factors

Risk Factor	Explanation
Purchases for Potential Personal Use	Item description suggests item could be for personal item and/ or vendor is likely to sell items for personal use items
Unauthorized or Unallowable Costs	Items included on the Unauthorized[11] or Unallowable[12] Lists
Split Transactions	Vendor divided purchase into two or more transactions, possibly to avoid cardholder single transaction limits
Self Approved	Cardholder is also approver of own purchases
Not Approved	Purchase card reconciliation was not approved electronically within required number of days[13]
Not Reconciled	Cardholder did not complete purchase card reconciliation electronically within required number of days
No Description	Cardholder did not enter a description of the item that was purchased
Potential Improper Source/Vendor	Cardholder purchased an item that was available through JIT from a non-JIT vendor

[11] List is included in the Purchase Card Program policies and procedures. These items cannot be purchased using the purchase card as the procurement method.
[12] Sourced from LANL Procurement Standard Practices Section 31, Subject 31.3 Unallowable Costs. These items are unallowable under LANL's Prime Contract.
[13] Approver may have submitted approval manually. The Purchase Card Office did not track manual reconciliations electronically.

TABLE 6: Data Mining Risk Factors (Continued)

Risk Factor	Explanation
Charge Exceeds Cardholder's Transaction or Monthly Limit	Purchase exceeds cardholder's approved single transaction or monthly purchasing limit
Property Controlled Item	Equipment with an initial acquisition or fabrication cost of $5,000 or greater or a sensitive item[14]

2. Random Sample Selection

A random sample of 300 purchase card items was selected for testing from items procured during the Review Period. The sampled items represent purchases from 177 different cardholders. Documentation supporting the selected purchases was requested directly from the cardholders.

The criteria we used to assess this random sample were designed to test the accuracy of data entered into the purchase card system by the cardholders and to test cardholder compliance with established policies and procedures. Our review assessed compliance with LANL policies and procedures including:

- Was the purchase card statement reconciled within 21 days;
- Is the requestor properly identified;
- Was appropriate documentation maintained;
- If the item was disputed, was the dispute properly resolved;
- Is the item available through JIT;
- If the item is shipped to an off-site location, is there a signature of someone other than the cardholder verifying receipt of item; and
- Does the charge meet the test of business necessity?

3. Targeted Sample Selection

We selected four targeted samples from the remaining population of purchase card data. These samples were specifically designed to include items most at risk of being non-compliant with LANL policies and procedures.

First, a targeted sample was judgmentally selected based on our data mining procedures and includes 205 items. To select this sample, we prepared a listing of all items flagged through our data mining procedures with three or more risk factors. We then reviewed this list and judgmentally selected items that appeared unusual or non-compliant.

[14] The sensitive item list has changed slightly over the review period. As of 10/02, the sensitive item list was comprised of: cameras, firearms, personal computers, printers, recorders, scanners & telephones.

Finally, we performed a cursory review of items flagged with three or fewer risk factors and added several of these items to the targeted sample.

Second, a sample consisting of disputed items[15] not credited as of June 30, 2002 was selected. Of the 513 disputed items that do not appear to have been credited, 45 items were selected for review.

Third, a sample was selected from the purchase card activity of a targeted cardholder and a targeted requestor and consisted of 100 items.

Fourth, a sample consisting of property-controlled items and items attractive for personal use was selected. Of the 86 items in this sample, 34 items are also included in the previously selected samples. For the items in this sample, the Review Team and LANL property management personnel jointly performed physical observations of the items and determined if property-controlled items were bar-coded.

III. Findings, Observations and Corrective Actions

Based on the procedures described above, including the review of policies and procedures, interviews, and analysis of specific transactions, we formulated a number of observations with respect to the LANL Purchase Card Program. For each of the identified observations, we considered LANL's recent corrective actions to determine if the changes were sufficient to rectify the observed issue. In addition, during the course of our review, we identified improper transactions, which we understand LANL has referred to the appropriate authorities.

A. Program Observations

1. Use of Purchase Cards by Buyers

a. Observation

Approximately 8% of cardholders are procurement specialists (buyers) who use purchase cards to fulfill purchase requests that would otherwise be placed on purchase orders. Because buyers have procurement authority averaging more than $25,000 per transaction, they were granted higher spending limits than ordinary cardholders. Furthermore, since buyers do not require approval for purchases within their procurement authority, they were permitted to self-approve their purchase card statements.

In most cases, buyers purchase on behalf of others, although some buyers also purchased items for themselves. We found that approximately 10% of procurements made by buyers did not involve a separate requestor. This, in combination with high spending limits and the lack of third-party approvers for buyers, created an environment conducive to misuse.

[15] During data entry of a purchase, a cardholder can click on a "dispute" button that automatically enters the word "dispute" in the description text field. The cardholder is responsible for then submitting a dispute form, explaining the dispute, to the bank.

During our review period, we noted that the policies and procedures as written did not address this large contingent of cardholders. As a result, in many respects, buyers operated outside the parameters of the written policies and procedures.

b. Corrective Actions Taken

Revisions to policies and procedures effective August 26, 2002 attempt to bring buyers' use of purchase cards back in line with existing policies and procedures. Currently, single transaction limits are capped at $2,500 for all cardholders and $5,000 for cardholders with special approval. Self-approval of purchase card statements is now strictly prohibited.[16]

c. Recommendations for Further Corrective Action

We believe LANL's corrective actions to date will effectively minimize control deficiencies related to use of purchase cards by buyers. If LANL management determines that use of the purchase card as a procurement tool by buyers is desirable, we would recommend that LANL draft a Standard Practice to specifically address the use of purchase cards by buyers. The general policies and procedures should also be updated to reference the buyer guidance.

2. Reconciliation and Approval Procedures

a. Observation

The reconciliation and approval process is the most important internal control governing the Purchase Card Program. During the reconciliation process, cardholders are required to provide a detailed description of items purchased, the name of the requestor and the cost account to which the transaction should be charged. Once the reconciliation is complete, the statement is automatically forwarded to the cardholders' approver for on-line approval. Prior to 1999, approvers were required to review supporting documentation as part of the approval process. Since that time, approvers have only been required to perform "periodic" reviews of supporting documentation.

LANL's policies and procedures requires the cardholder, or individual who was delegated reconciling responsibility[17], to reconcile the purchase card statement within 21 days of system notification. If a cardholder fails to reconcile within this timeframe, unreconciled charges were automatically posted to a designated overhead account, which could result in inappropriate or unallowable costs being inadvertently charged.[18] The

[16] An August 26, 2002 communication distributed to management and administrative support reinforced the existing policy that cardholders cannot approve their own monthly statements.

[17] In past policy and procedure manuals, a cardholder could delegate this responsibility to another person in the cardholder's group. This provision has currently been revised to permit delegation of reconciliation only in a leave of absence situation.

reconciliation process provides information necessary to allow approvers and the Purchase Card Office to understand the nature of items purchased and also acts as a control mechanism for a cardholder to identify inappropriate or duplicate vendor charges.

We determined that approximately 7,000 items or $3.8 million in purchases were not reconciled electronically within the allotted time. This correlates to approximately 1,600 statements that were not reconciled electronically during our review period. According to cardholders and former Purchase Card Administrators we interviewed, the Purchase Card Office actively sought manual reconciliations during much of the Review Period. The present Purchase Card Administrator, however, was unable to provide us with evidence of past manual reconciliations.

We determined that buyers were permitted to self approve their purchase card statements during the Review Period. Through our data mining procedures, we determined that more than $43 million in purchases were subject to self-approval by the buyer cardholder and not by a group leader.[19]

We further determined that 45,000 items or $16 million in purchases were not electronically approved within the allotted time frame. We believe many of these transactions were manually approved although we were unable to determine which statements were manually approved.

b. Corrective Actions Taken

Recent changes to the LANL Purchase Card Program policies and procedures added language stating that failure to reconcile within two statement cycles may result in suspension of the purchase card. The revised policies also prohibit buyers from self-approving purchase card activity. In addition, LANL implemented a cap on the number of cardholders assigned to a single approver (the maximum ratio is now five cardholders per approver). To facilitate these shifts in practice, LANL decreased the mandatory approval level from Group Leader to Team Leader. Finally, approvers are required to attend purchase card training. The training course, conducted by the Purchase Card Office, provides step-by-step reconciliation procedures and includes guidance on the responsibilities of the purchase card approving official.

c. Recommendations for Further Corrective Action

In addition to the above corrective actions, we recommend that LANL make a number of additional changes to the reconciliation and approval process. First, we recommend that approvers be required to review the actual support documentation compiled by the cardholder. Approval should be noted electronically as well as by signing the printed Statement of Account form. Second, we recommend that the Purchase Card Office track

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[18] According to the present Purchase Card Administrator, if a cardholder initiates a reconciliation, but does not complete the process and submit the statement for approval, the cost accounts identified by the cardholder will be charged (not the overhead account).

[19] Many of the unreconciled statements were also not approved.

unreconciled or unapproved purchase card statements on a monthly basis and report these statistics to appropriate individuals within division management. Third, we recommend that LANL implement appropriate sanctions for cardholders who fail to comply with reconciliation procedures. Fourth, we recommend that manual reconciliations require the signature of the cardholder's group budget analyst before submission to the Purchase Card Office. The finance manager's signature indicates that charges posted to the default overhead account have been reversed and charged to the cost accounts designated by the cardholder. Finally, we recommend that LANL consider sanctions for approvers who fail to approve purchase card statements on a timely basis.

On November 21, 2002, the Review Team provided LANL management with a list of transactions totaling $3.8 million that were not reconciled within 21 days according to the Purchase Card System. Management is currently researching these items to ensure that all items are properly reconciled, approved and charged to the appropriate cost account.

3. Dispute Resolution

a. Observation

In accordance with LANL's purchase card policy, cardholders are responsible for disputing duplicate, inaccurate or fraudulent charges and tracking these disputes to resolution. We determined that 513 charges made by 193 cardholders and totaling $316,648 were disputed in the LANL Purchase Card System, but were never credited by the vendor or bank.

We selected a sample of 45 items (representing 21 cardholders) of the 513 disputed items and requested supporting documentation from the cardholder. We received and reviewed documentation for 29 of these items. Of the items reviewed, we found 10 items that were erroneously identified by the cardholder as a dispute and were, in fact, accurate charges. We identified 15 items for which credit was not issued because the cardholder failed to notify the bank of the dispute or failed to complete the necessary paperwork. The remaining items were partially credited or were credited in multiple installments.

According to present and former Purchase Card Administrators, the Purchase Card Office has never followed up on disputed items to determine if credit was issued. Because disputed charges were not tracked, inappropriate charges may have gone undetected.

b. Corrective Actions Taken

Our sample indicated that at least 3 cardholders do not understand or failed to properly execute the dispute process. This problem is being addressed in mandatory refresher training for all cardholders.

c. Recommendations for Further Corrective Action

We recommend that the LANL Purchase Card Office perform data mining procedures on a monthly basis to identify disputed items for which credit has not been issued. While

we believe that cardholders should retain the primary responsibility for ensuring that disputes are resolved, we further recommend that the Purchase Card Office take responsibility for monitoring disputes and following-up with cardholders. To ensure that disputed transactions are not overlooked, LANL should consider posting disputes to a suspense account managed by the Purchase Card Office rather than the cardholder's designated overhead account. In addition, we recommend that LANL consider appropriate actions concerning the purchase cards of cardholders who fail to resolve disputes on a timely basis.

In addition, cardholders should be trained on the proper procedures for disputing charges. We recommend that cardholders be trained to make one attempt to resolve the charge with the vendor. If this is not successful, the cardholder should dispute the charge directly with BankOne. All erroneous charges that cannot be easily resolved with the vendor should be disputed.

We noted that the current policy with respect to disputes is confusing and in some cases, misleading. For example, we noted that the dispute form available on the LANL intranet is for Nations Bank, a vendor LANL has not used for several years. As a result, we recommend that the policies and procedures regarding disputes be carefully reviewed and updated as necessary.

On December 2, 2002, we provided a listing of the 513 transactions noted above to LANL management for review and resolution.

4. Accounting for Property-Controlled Items

a. Observation

LANL policy requires items with a purchase or manufacture cost of $5,000 or more as well as items deemed "sensitive" by LANL management be property-controlled. Property control procedures require the assignment of a barcode and property custodian to every controlled item. Custodians are required to account for all assets under their care by completing annual accountability statements. The Purchase Card Program policies and procedures required cardholders to notify the Property Manager once property-controlled items have been procured using a LANL purchase card.

We assessed cardholders' compliance with property-control policies and procedures by selecting a sample of 59 property-controlled items procured on LANL purchase cards. LANL's property management personnel were able to physically locate or account for 53 of these items. Of the 53 items accounted for, 31 were bar-coded in accordance with LANL policy (one additional item was returned to the vendor and therefore did not require a barcode). Of the remaining six items, one was allegedly at the residence of the property custodian, another was reported as lost or stolen, a third was believed to have been destroyed and the fourth was not located because the requestor is no longer employed by LANL and the remaining two have not been located. We also physically validated 27 additional items that were attractive for personal use but not subject to

property control. Of these items, we were able to physically observe or otherwise account for all 27 items.

It is the cardholder's responsibility to notify property management when a property-controlled item is procured using a purchase card. Furthermore, the property accounting group does not act upon a flag in the Purchase Card System, designed to notify accounting and/or property management that a property-controlled item was purchased.

According to a former Purchase Card Administrator, monthly desk reviews were once performed to identify property-controlled items procured on purchase cards that had not been bar-coded. According to the current Purchase Card Administrator, this procedure is no longer performed.

b. Corrective Actions Taken

Recent changes to the policies and procedures prohibit the procurement of property-controlled items unless advance authorization is obtained from the Property Manager. The policy also provides an electronic link to LANL's list of sensitive, property-controlled items.

c. Recommendations for Further Corrective Action

We concur with LANL management's decision to prohibit the procurement of property-controlled items using LANL purchase cards without prior approval. The revised policy does not, however, provide guidance regarding how to obtain authorization from the Property Manager or the procedures necessary to ensure that the asset receives a bar code. We recommend that LANL clarify this policy and ensure that the Property Manager is prepared to respond to cardholder's seeking exemptions from this policy.

We recommend that the LANL Purchase Card Office perform monthly data mining of purchase card data to identify possible procurements of property-controlled items. The Purchase Card Office should then refer these items to the cardholder for resolution. We further recommend that the approver be notified of the policy violation.

5. Purchase of Restricted Items

a. Observation

In performing our review, we identified a number of restricted items purchased on LANL purchase cards. Restricted items are those identified in the policies and procedures, which may not be procured using a LANL purchase card. Items are included on the list for a number of reasons, including:

- Health or safety regulations governing purchase, storage and/or use of specified items;
- Unallowable in accordance with government regulations;
- Available through Just In Time (JIT) vendors; and
- Subject to dye marking or other property-control procedures (such as tools).

In accordance with the policies and procedures, all cardholders (including buyers) are prohibited from procuring restricted items using a LANL purchase card. In specific instances, however, the Purchase Card Office granted exemptions to this policy. For example, cardholders who could demonstrate justification (such as lower price or faster delivery) were permitted to purchase JIT items using a purchase card. In another example, LANL granted exemptions to the tool policy providing the cardholders take personal responsibility for ensuring that all tools procured on a purchase card were dye marked. Other items, such as those that are unallowable in accordance with LANL and University of California policy, should not be procured using a purchase card. Examples of unallowable costs include awards, gift, memorabilia, advertising, entertainment costs and personal or luxury items that do not meet the test of business necessity.

Through our transaction testing, we found 264 purchases of items that that appear to have been restricted for purchase on LANL purchase cards, totaling $526,861. These restricted purchases were comprised of one or more of the following categories:

- Items which appear to be available on JIT (130 items totaling $298,516);
- Possible unallowable expenditures (15 items totaling $68,210);
- Items for which the business purpose was not clearly documented in the supporting documentation provided (53 items totaling $68,673);[20] and
- Other purchases not authorized for procurement using a LANL purchase card (125 items totaling $269,356).

b. Corrective Actions Taken

Our review indicated that many cardholders do not understand what can and cannot be procured using a purchase card. This problem is being addressed in mandatory refresher training for all cardholders. The fact that many restricted purchases were approved indicates that approvers are also unaware of LANL's policy regarding restricted items. The recent implementation of modified approver policies and related training should be effective in addressing this issue.

Finally, LANL is in the process of combining all lists of restricted items (JIT, unallowable, unauthorized and sensitive property) in a central location on the LANL intranet. A centralized list will make it easier for cardholders to determine if an item may be procured on a purchase card before the order is placed.

c. Recommendations for Further Corrective Action

In addition to the corrective actions implemented to date, we recommend that LANL consider updating the on-line Purchase Card System to include fields for purchase category and the business purpose. These additional fields will permit approvers as well

[20] We performed a preliminary analysis of items, which may have been for the personal use of the cardholder or requestor. Upon reviewing a sample of these items, we determined that most had reasonable business purposes.

as the Purchase Card Office to more effectively assess the appropriateness of purchase card purchases.

We recommend that the LANL Purchase Card Office perform routine data mining of purchase card transactions to identify possible purchases of restricted items. We provided the Purchase Card Administrator with a list of key words LANL can use to identify possible restricted items. Once identified, the Purchase Card Office should refer these transactions to the cardholder and approver for resolution. We recommend that the Purchase Card Administrator consider appropriate action to address cardholders who continue to procure restricted items after receiving appropriate warnings.

On November 21, 2002, we provided LANL management with a list of purchases aggregating $766,722 that may have been unauthorized in accordance with LANL's policies and procedures. Such items were identified as a result of our data mining procedures. Management is currently researching these items to determine if the costs are appropriate, allowable and charged to the correct cost account.

6. Purchase Card Documentation and Support

a. Observation

LANL policies and procedures identify general categories of documentation that must be retained in support of purchase card transactions. Cardholders are required to complete an on-line PC Form noting descriptions of items purchased and the name of the requestor. In addition, they are also required to retain invoices, shipping documents, dispute forms and other relevant documents and are required to obtain special signatures when items are shipped off-site. We examined the documentation provided by cardholders in response to our sample requests to determine if cardholders are following these procedures in practice. We determined that descriptions, when provided, were generally accurate. In addition, we noted that cardholders often enter themselves as the requestor rather than the actual individual requesting the purchase. This practice allows for potential concealment of relationships between cardholders and requestors and also makes it difficult to locate the custodian of assets procured using a purchase card. We observed that items shipped off-site did not comply with the proof-of-delivery requirement.

b. Corrective Actions Taken

Our review of purchase card documentation indicated that some cardholders, particularly non-buyers, do not fully understand LANL's document retention requirements for purchase card transactions. This issue is being addressed in mandatory refresher training for all cardholders. Approvers are also being trained on documentation requirements so that they are able to assess the completeness of a cardholder's files.

LANL recently updated the shipping policy to require phone or Internet orders to be shipped to the LANL receiving facility. Orders are also required to include the

requestor's name and the word "PCARD" in the shipping address. The revised policy also prohibits purchase card orders from being shipped directly to the cardholder. Orders must now be shipped to a third party (the requestor, approver, another cardholder or co-worker). The revised policy does not prohibit cardholders from picking items up from the vendor.

In most recent revision of the policies and procedures, LANL changed the requirement for record retention when a cardholder transfers between divisions. Historically, cardholders were required to leave their documentation with the division they were employed by when the purchases were made. The revised policy requires cardholders to take documentation with them.

c. Recommendations for Further Corrective Action

We believe LANL's new policy prohibiting items from being shipped to the cardholder creates unnecessary opportunity for items to be misappropriated or lost. In lieu of this requirement, we recommend that whenever the cardholder and requestor are the same person, the cardholder should be required to document receipt by obtaining the signature of his or her approver on the invoice.

7. Sanctions for Non-Compliance

a. Observation

Cardholders and approvers must be held responsible for failure to comply with documented policies and procedures governing the Purchase Card Program. Historically, the policies and procedures have been silent on the issue of sanctions for non-compliance. As a result, the task of establishing and implementing appropriate sanctions was left to the discretion of the Purchase Card Administrator. This placed the Administrator in the difficult position of sanctioning cardholders without the ability to reference clear guidelines or rules. Furthermore, the current Purchase Card Administrator's authority to suspend or cancel cards is limited, making the implementation of effective sanctions impossible.

b. Corrective Actions Taken

The policies and procedures were recently updated to include warnings that failure to reconcile or approve within two statement cycles may result in suspension of the card.

c. Recommendations for Further Corrective Action

We believe the above changes to the policies and procedures regarding sanctions for failure to approve and/or reconcile are appropriate. In addition, we recommend that LANL establish firm guidelines for warnings and sanctions regarding non-compliance and include these guidelines in the policies and procedures and that the Purchase Card Administrator be given broader authority to implement sanctions in accordance with the established guidelines.

8. Training

a. Observation

Historically, cardholders received purchase card training when they first received a purchase card. Approvers have not historically been required to attend training. Refresher training was not required, although remedial instruction was occasionally provided when routine audits identified cardholders who were not in compliance. While interviewing cardholders, we determined that cardholders and approvers were unclear on some of the key policies and procedures. One experienced buyer was unaware that policies and procedures exist for the Purchase Card Program.

b. Corrective Actions Taken

LANL recently implemented mandatory refresher training for cardholders as well as mandatory training for approvers.

c. Recommendations for Further Corrective Action

We believe that the implementation of refresher training will be effective in improving overall compliance by cardholders and approvers. To underscore the importance of this training, we recommend that LANL establish a date by which all cardholders and approvers must complete this training. We further recommend that the Purchase Card Office take appropriate action with respect to individuals who fail to attend training by the established deadline.

We further recommend that LANL institute a requirement for periodic refresher training for cardholders and requestors. The Purchase Card Office should also continually update the training materials to ensure that all policy and procedure changes are addressed.

9. Purchase Card Office Audits and Reviews

a. Observation

A Purchase Card Office audit and review program, while not a substitute for compliance on the part of cardholders and approvers, is an effective means to maintain compliance with program policies and procedures. Historically, the Purchase Card Office conducted a number of audits and reviews designed to assess cardholder compliance. According to a former Purchase Card Administrator, the following procedures were routinely performed:

- Quarterly random audits;
- Monthly "desk review" of vendor names and descriptions for purpose of identifying unallowable, unauthorized or otherwise inappropriate transactions;
- Monthly or bi-monthly review of all items purchased for more than $5,000. The intent of this review was to identify property-controlled items and to ensure that the items have been properly bar-coded; and

- Audits of new cardholders, conducted approximately three months after a new LANL purchase card was issued, in order to provide constructive feedback to the cardholder and to prevent improper practices from becoming habitual.

As staffing levels in the Purchase Card Office fluctuated over time, the audit and review program outlined above was altered. Only the random quarterly audit was consistently performed. According to the present Purchase Card Administrator, the office has been as much as one year behind on quarterly audits but is presently up-to-date.

b. Recommendations for Corrective Action

The audit and review program should not be the primary internal control. Rather, it should augment key controls including reconciliation, approval and training. To accomplish this goal, we recommend that the LANL Purchase Card Office expand its current audit program by adding new cardholder audits and routine data mining procedures. We also suggest that the Purchase Card Administrator meet at least annually with a representative from LANL's Audits and Assessments division to review audit procedures and findings. When appropriate, we recommend that LANL report findings to the cardholder and approver for appropriate correction and modification. We recommend that LANL perform routine data mining procedures to address the following areas:

- Failure to reconcile or approve;
- Split transactions;
- Possible purchases of unallowable or unauthorized items;
- New and/or unusual vendors;
- Possible purchases of property-controlled items; and
- Disputes not credited by the vendor or bank on a timely basis.

10. Management of Cardholder Spending Limits

a. Observation

New cardholders are granted an initial transaction limit of $2,500 per transaction. Historically, the policies and procedures did not specify guidelines for maximum monthly credit limits, although $25,000 was common for new cardholders. Sometime between 1999 and June 2002, language was added to the policies and procedures permitting a cardholder's limit to be increased once a cardholder has "established a sustained record of purchases". No ceiling was established for such limit increases.

We reviewed cardholder limits as of June 30, 2002 for 876 LANL cardholders. We found that 427 cardholders had single transaction limits of more than $2,500; 141 cardholders had limits in excess of $5,000; and 15 cardholders had limits of $25,000 or more per transaction. Six cardholders (all buyers) had single-transaction limits of $100,000 and two cardholders (buyers) had a monthly limit of $900,000.

High transaction limits were not limited to buyers. Other cardholders were granted single transaction limits as high as $25,000 and monthly credit limits up to $500,000.

Despite the relatively high credit limits, we found evidence that some cardholders attempted to circumvent transaction limits by splitting purchases into two or more separate orders. The policies and procedures forbid cardholders from splitting transactions in order to avoid exceeding their maximum per transaction spending limits. In our transaction review, we identified 15 instances in which transactions appear to have been split.

Through our data mining efforts, we identified instances in which cardholders were permitted to spend beyond their single purchase or monthly credit limit. While, the bank administering the Purchase Card Program is responsible for denying purchases that exceed the cardholder's established limit, we not able to determine how the limits were allowed to be exceeded.

b. Corrective Actions Taken

Recent revisions to the policies and procedures instituted a maximum per transaction limit at $5,000 and $50,000 per month. Any increase to a higher limit must be justified in writing and approved by the approving official and division office.

c. Recommendations for Further Corrective Action

We believe LANL's recent actions to reduce cardholder spending limits are appropriate and increases to such limits should be made on a selective basis. In addition, we recommend that LANL perform regular data mining to identify possible split transactions and modifications to cardholder limits. Identified transactions should be referred to the cardholder and approver for resolution. The Purchase Card Office should take appropriate action when cardholders are determined to have split transactions

11. Safeguarding Card Information

a. Observation

Historically, cardholders have been instructed to safeguard purchase card information and to inform the bank immediately when a card has been lost or stolen. We assessed compliance with this policy by reviewing our transaction review sample. We identified at least two instances in which a cardholder appears to have shared his/her card number with a requestor or the requestor obtained the card number without the cardholder's knowledge. We also found instances in which other individuals in a cardholder's group used the purchase card without authorization.

b. Corrective Actions Taken

The revised policies and procedures clarify a cardholder's responsibility when a card is believed to have been compromised. In such instances, the new policy requires a cardholder to notify the bank, the approving official and the Purchase Card Office of the compromise within one day.

The most recent version of the policies and procedures includes a new clause, prohibiting cardholders from providing purchase card information to requestors.

Finally, mandatory refresher training for cardholders will function to remind cardholders about the importance of not sharing purchase card information with anyone. Approvers will also be reminded that purchase cards are the property of a cardholder, not the group, and cannot be used by anyone other than the cardholder.

c. Recommendations for Further Corrective Action

We believe the corrective actions implemented by LANL will be effective in addressing this control weakness. We have no further recommendations for corrective action.

B. Matters Referred to Appropriate Authorities

In conducting our review, the following transactions came to our attention and we understand they have been referred to appropriate authorities by LANL management.

1. Mustang Transaction

On May 1, 2002 a Mustang automobile was ordered and charged to a LANL purchase card. During May 2002, various charges from this vendor, totaling $29,920, were posted to the cardholder's account. The cardholder disputed the charges and denied purchasing the automobile. Telephone records indicate a series of telephonic communications between the cardholder's office and the automobile vendor on May 1, 2002 and subsequent dates. As of this writing, the cardholder is on investigative leave from LANL.

2. Casino Cash Advances

Eleven cash withdrawals at three New Mexico casinos on a LANL purchase card were posted to between March 19, 2002 and April 26, 2002. The charges totaled $1,417. A review of the cardholder's purchase card activity indicates that between March and May 2002, other questionable charges were posted to the purchase card account including charges from gas stations, a grocery store, LANL's cafeteria, and a discount retail store. The cardholder admitted making some of these charges but claimed they were for business purposes.

The cardholder was placed on investigative leave on August 19, 2002 and was subsequently terminated.

3. Retail Department Store Purchases

Data mining procedures identified two charges from a retail department store totaling $1,045 posted to a LANL purchase card account on February 21, 1999 and April 16, 1999. We interviewed the cardholder with respect to these transactions. Initially, the cardholder admitted making the charges. When the charges appear to have been disputed, the the cardholder provided a different explanation, stating the charges were fraudulent and that dispute procedures had been initiated with the bank. No credit was ever issued by the bank nor was the cardholder able to provide evidence that the charges were in fact disputed.

We also requested supporting documentation for a charge posted to a LANL purchase card by a retail department store on June 11, 2000 in the amount of $232. The cardholder reconciled the statement, which was subsequently approved. When the External Review Team requested supporting documentation for the transaction, the cardholder stated that the LANL card was erroneously used in place of a personal credit card and the vendor had reversed the charge. The cardholder was not able to provide supporting documentation nor was evidence of the charge reversal identified.

4. Jewelry

Our data mining procedures identified three transactions, which appear to be purchases of jewelry. On September 22, 1998 and November 17, 1998, two charges identified as cubic zirconium jewelry were posted to a LANL purchase card. The charges totaled approximately $80. The cardholder denied making the charges to the approving official. The cardholder states that several unsuccessful attempts were made to dispute the charges with the vendor. We found no evidence that the charges were disputed with the bank and the charges were never credited or reversed by the vendor or the bank.

On July 22, 1999, another LANL cardholder made a purchase from a jewelry store in the amount of $158.87. On September 9, 1999 the cardholder reimbursed LANL for the purchase, stating that she had inadvertently used her LANL card to make a personal purchase. As the cardholder reimbursed LANL shortly after receipt of the statement, this transaction was not referred to authorities.

IV. Limitation of Procedures Performed and Resultant Findings

The observations and findings outlined in this letter are based on the procedures performed through November 8, 2002. During the process of performing our work, we were not able to independently verify all events. At the request of LANL management and as coordinated with law enforcement authorities, we did not interview several LANL employees or individuals outside of LANL, whose insights may have been relevant to our findings. Finally, our procedures were designed to fulfill the tasks outlined above in Section I and were not specifically designed to detect fraud. We do not make any representation as to the adequacy or sufficiency of our procedures for LANL's purposes

Tab 16

U.S. Department of Energy
Office of Inspector General

Special Report

Management Challenges at the Department of Energy

DOE/IG-0580 December 2002

U. S. DEPARTMENT OF ENERGY
Washington, DC 20585

December 31, 2002

MEMORANDUM FOR THE SECRETARY

FROM: Gregory H. Friedman (Signed)
Inspector General

SUBJECT: INFORMATION: Special Report on "Management Challenges at the Department of Energy"

BACKGROUND

At the request of Congressional leadership, the Office of Inspector General has, for the past several years, identified what it considers to be the most significant management and performance challenges facing the Department of Energy. This effort, which was codified as part of the Reports Consolidation Act of 2000, is now done on an annual basis and includes an assessment of the agency's progress in addressing each challenge area. As in the past, the methodology employed by my office relies on recent and on-going audit, inspection, and investigation work. The process places great emphasis on the identification of those programs and operations with demonstrated performance problems and those which are, in our judgment, inherently the most difficult to manage. While any analysis of this sort is somewhat subjective, we believe that the result is a balanced, comprehensive depiction of Departmentwide challenges.

The Office of Management and Budget, in 2001, issued the *President's Management Agenda.* The Agenda included five government-wide initiatives for improving management and performance that all federal agencies were to address: strategic management of human capital; competitive sourcing; improved financial performance; expanded electronic government; and, budget and performance integration. The Department of Energy was also assigned responsibility for a specific initiative, to develop and implement better research and development investment criteria. Where appropriate, this report identifies the relationship between the Office of Inspector General's list of management challenges and the initiatives in the *President's Management Agenda.*

RESULTS

In our judgment, the following are the most serious challenges that the Department needs to address in 2003 and beyond:

- Contract Administration
- Environmental Cleanup
- Information Technology Management
- National Security

- Performance Management
- Stockpile Stewardship
- Worker/Community Safety

Since our last report, the Department's senior management has taken positive steps to address a number of previously reported challenges. While these issues have been deleted from the management challenge list, they are, nonetheless, complex subject areas that will continue to require management's attention and periodic assessment.

It should be noted that the Department, in its FY 2002 Performance and Accountability Report, identifies a similar set of issues that impact the Department's ability to fulfill its critical missions. In this regard, the Department and the Office of Inspector General will continue to evaluate agency performance in an effort to improve programs and operations, particularly as they relate to the management challenge areas identified in this report.

Attachment

cc: Deputy Secretary
Under Secretary for Energy, Science and Environment
Acting Administrator, National Nuclear Security Administration
Director, Office of Management, Budget and Evaluation/Chief Financial Officer
Chief of Staff

MANAGEMENT CHALLENGES AT THE DEPARTMENT OF ENERGY

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OVERVIEW

INTRODUCTION

The Department of Energy (Department) is a multi-faceted agency encompassing a broad range of national security and scientific activities with an annual appropriation of about $21 billion. In conducting these endeavors, the Department employs more than 115,000 federal and contractor staff in 35 states and is organized into four business lines: National Nuclear Security, Environmental Quality, Energy Resources, and Science. Specific missions include ensuring that the Nation's nuclear weapons stockpile is safe and reliable; environmental clean-up at Department facilities and surrounding areas; fostering a secure and reliable energy system; and, conducting world-class scientific research. In the wake of the events of September 11, 2001, the Secretary has charged each programmatic office with more sharply focusing its efforts and activities on the Department's overarching mission to protect and enhance national security.

In accordance with the Reports Consolidation Act of 2000, this report sets forth the Office of Inspector General's (OIG) conclusions on the most serious management challenges facing the Department. Our conclusions are based on knowledge gained through the performance of audits, inspections, and investigations of the Department and its operations.

CONCLUSIONS AND OBSERVATIONS

As of the end of Calendar Year 2002, the OIG had identified seven key management challenge areas facing the Department. These represent the most serious management and performance challenges that are impacting the agency's ability to carry out its critical missions. Each of these areas is briefly discussed in the body of the report:

- Contract Administration
- Environmental Cleanup
- Information Technology Management
- National Security
- Performance Management
- Stockpile Stewardship
- Worker/Community Safety

Recently-issued OIG reports are used to illustrate key aspects of the challenges. We have also included, as appropriate, areas of progress in each area and briefly assessed the Department's actions in addressing

those challenges. Appendix 1 lists key OIG reports issued during the past year that are associated with each of the challenge areas.
The list of challenges, which is presented alphabetically, differs somewhat from our previous lists. Some challenges have shifted focus due to the changing situations worldwide. The prevention of terrorism, for example, has brought a significant focus not only to the protection of nuclear weapons but also to the protection of materials that could be used to produce weapons of mass destruction. In addition, the report has combined and re-titled some areas to better capture the essence of the challenge. For example, Infrastructure and Asset Management and Security and Safety from last year's list were reorganized and re-named. Appendix 2 presents a crosswalk between the current list and the list we provided last year. In addition, Appendix 3 discusses the status of three management challenges reported in 2001, which are not a part of our 2002 report.

As we have stated in the past, many of the challenges represent difficult, and in some cases intractable, problems that will require a concerted effort over a long period of time. Others, such as Performance Management and Information Technology Management can be addressed more quickly through the implementation of effective administrative processes and systems.

Signed
Office of Inspector General

MANAGEMENT CHALLENGES AT THE DEPARTMENT OF ENERGY

Challenge Summaries

The following sections detail our observations regarding each challenge area, including, where appropriate, Departmental efforts or accomplishments that have come to our attention. In addition, we have identified the relationship between these areas and those Departmental initiatives that relate directly to *The President's Management Agenda.*

Contract Administration

A significant portion of the Department's mission is accomplished through contracts, with industrial, academic, and nonprofit institutions operating the government-owned plants and laboratories under a "management and operating" contractor relationship. These contracts, with an annual value of about $14.8 billion, represent the largest share of the Department's budget. Contract administration, which includes project management, has been a longstanding challenge. Although the Department has changed its contract management approach with respect to its major facility contracts, as well as the overall management of its procurement system, the Department continues to have problems with contract management practices and difficulties in managing some of its major projects, as illustrated below.

Concerns about the Department's ability to build new facilities or upgrade existing systems have arisen due to cost overruns, schedule slippages, and other project management problems. As reported in *Cost-Sharing at the Ashtabula Environmental Management Project* (DOE/IG-0558, June 2002), the Department did not evaluate cost-sharing arrangements when entering into a remediation contract for the Ashtabula Environmental Management Project. Had cost-sharing provisions been included in the current contract, the Department could have avoided about $25 million in unnecessary costs and fees. Additionally, the Department could avoid about $34 million on future contracts by requiring the contractor to pay its fair share of the cost to clean up its plant and eliminating all fees.

During the past year, OIG reports have also disclosed challenges in the use of procurement cards. Our report on the *U.S. Department of Energy's Purchase Card Program – Lessons Learned* (IO1OP001, February 26, 2002), disclosed a number of complex schemes by contractor employees devised to facilitate the misuse of purchase cards. Even when existing policies and procedures were present, they were not always adequately enforced. For example; our report on the *Sandia*

National Laboratories Procurement Card Program (WR-B-02-03, August 6, 2002), showed that Sandia had not enforced its existing policies and procedures nor did it have adequate controls over the approval of transactions. There were instances where Sandia procurement cardholders purchased restricted items, split purchases to avoid transaction limits, and allowed unauthorized users to make purchases. Sandia's internal auditors had identified problems with internal controls for administering the procurement card contract and program in 1998, but problems still remained in 2002.

Based on ongoing work at Los Alamos National Laboratory, the OIG has observed a substantial degree of dysfunction in the Laboratory's handling of property loss and theft. In fact, the OIG and other reviewers have identified significant weaknesses in internal controls over property and the use of purchase cards. We expect to issue reports on these matters in the near future.

The Office of Management, Budget and Evaluation has an ongoing review of 32 of the Department's 67 locations that operated purchase card programs. The review has identified no instances of fraud, waste, or abuse. However, it did disclose areas where control procedures need to be strengthened or clarified to ensure that Departmental purchase card programs operate in a strong environment and to further limit our vulnerability to misuse.

The Department reported it has initiated several actions to improve contract administration in 2002, such as:

- Reviewing its science laboratory management and operating contracts to develop innovative approaches and techniques for improving contractor performance and contract administration;

- Developing a model for improving the management and performance of its National Nuclear Security Administration (NNSA) contractors that identified key concepts like strengthening of performance-based management, attainment of fiscal efficiency, and restructuring of federal and contractor oversight and functions;

- Completing several assessments of its major site environmental management contracts that identified issues that contracting officers need to focus on to improve performance; and,

- Implementing recommendations made by the National Research Council of the National Academy of Sciences on Departmentwide policies and procedures to improve project management deficiencies.

In Fiscal Year (FY) 2003, the Department plans to conduct a benchmarking study of projects focusing on factors for success, and to establish a risk-based assessment process to review and approve projects in their conceptual design phase.

Environmental Cleanup

During the Cold War, the nuclear weapons complex generated large amounts of hazardous and radioactive wastes. The Department has the daunting task of clean-up at numerous contaminated facilities that supported nuclear weapons production activities. This effort is complicated by the fact that the clean-up processes it employs must protect the health of its workforce and citizens in the communities surrounding Department sites.

The Department has made some significant strides in its remediation efforts. For example, it has put in place accelerated clean-up contracts for many of its sites. In addition, in 2002, the President recommended, and the Senate approved, Yucca Mountain as the site to establish a safe repository in which to store the nation's nuclear waste. The Administration asserts that the successful completion of the Yucca Mountain project will ensure that the United States has a safe and secure underground facility that will store nuclear waste in a manner that is protective of the environment and American citizens.

However, the Department is at risk of not meeting its long-term cleanup objectives if it does not clearly define needs to meet mission requirements and develop comprehensive plans for each site. In an effort to make the program more effective and efficient, the Office of Environmental Management (EM) completed a "top-to-bottom" assessment of all aspects of its EM program. In the resulting report, *A Review of the Environmental Management Program* (February 4, 2002), EM concluded that there was a systemic problem with the way it has conducted its activities. The underlying theme in the report was that the EM program has not been driven as a project with a completion mindset along with an appropriate sense of urgency. The emphasis was on managing risk rather than actually reducing risk to workers, the public, and the environment.

During the year, the OIG continued to identify problems with the way the EM program was implemented. For example, in October 2001, the Department changed its original plan for processing salt waste and announced that solvent extraction was the preferred treatment technology. Our report on *Salt Processing Project at the Savannah River Site* (DOE/IG-0565, August 27, 2002) found that direct disposal in grout technology posed less risk to on-site workers, the general public, and the environment than solvent extraction. The direct disposal alternative is also the least costly of the evaluated alternatives for treating salt waste.

At the Ashtabula Environmental Project, we found that cleanup would not be completed as originally planned and that questionable costs of about $4.9 million had been billed by and reimbursed to the contractor. Specifically, our report on *Remediation and Closure of the Ashtabula Environmental Management Project* (DOE/IG-0541, January 15, 2002) disclosed that the cleanup effort might not be completed until 2012 instead of 2003, extending the 10-year expected life of the project to 19 years, resulting in a likely increase in project costs of over $60 million.

Infrastructure issues also continue to present challenges to the Department as well as the EM program. During the years of nuclear weapons production, over 20,000 facilities were constructed that no longer serve a mission and have been identified as excess to the Department's needs. The cost of performing surveillance and maintenance on these facilities was estimated to exceed about $70 million annually in FY 2001. Over time, these costs and the potential for negative impacts to worker safety and the environment will increase. In our report, *Disposition of the Department's Excess Facilities* (DOE/IG-0550, April 3, 2002), we found that the Department did not fully consider mission requirements, risk reduction, and costs when prioritizing facility disposition activities. The OIG also has an ongoing audit regarding the adequacy of EM's planning for its infrastructure needs.

Information Technology Management

Congress passed the Clinger-Cohen Act of 1996 and the Government Management Information Security Act of 2000 (GISRA) to enhance the management and control of information technology (IT). Further, the

President's Management Agenda encourages the use of electronic commerce to make it simpler for citizens to receive high-quality services from the Federal government while reducing the cost of delivering those services.

With an estimated $1.4 billion annual expenditure for IT, it is essential that the Department develop and implement an effective IT management investment and control process. Although the Department continues to integrate IT into all aspects of its management and administration of various missions, it has experienced problems in fully implementing the requirements of the Clinger-Cohen Act and GISRA.

Information technology investment and development and cyber protection have suffered in the past from program management planning and execution weaknesses. For example, we found that the planned and ongoing nuclear materials accounting systems development activity was not always consistent with the Department's Corporate Systems Information Architecture. The Department maintains the Nuclear Materials Management Safeguards System (NMMSS), which comprises a major component of the Government's nuclear materials inventory accounting system, but also has over 50 separate nuclear material tracking systems. Many of these systems are duplicative and inefficient. Our report, *Nuclear Materials Accounting Systems Modernization Initiative* (DOE/IG-0556, June 6, 2002), concluded that the Department had not adequately managed its activities to redesign or modernize its nuclear materials accounting systems.

Similarly, we found that while the Department had taken a number of positive steps to improve its unclassified cyber security program, many of its critical information systems remained at risk. For example, we noted that the Department had not (1) consistently implemented a risk-based cyber security approach, (2) assured continuity of operations through adequate contingency and disaster recovery planning, (3) strengthened its incident response capability by reporting all computer incidents, (4) ensured that employees with significant security responsibilities had received adequate training, and (5) adequately addressed configuration management and access control problems. Our report, *The Department's Unclassified Cyber Security Program 2002* (DOE/IG-0567, September 9, 2002), concluded additional work in policy development and implementation is necessary to ensure that critical information technology resources are adequately protected.

Like most private sector and government organizations, the Department has an aggressive program to provide its Federal and contractor personnel with the ability to remotely access a number of unclassified information systems. While the benefits of such access are clear, there is a corresponding increase in certain risks, most importantly, the potential for unauthorized access to the Department's information systems. Our report on *Remote Access to Unclassified Information System* (DOE/IG-0568, September 13, 2002) pointed out that the majority of offices reviewed had not adequately protected information systems from unauthorized remote access. For example, over half of the offices had not: (1) considered the risk associated with remote access when developing cyber security protection plans; (2) developed specific guidance addressing remote access security requirements; and, (3) required the use of protective measures such as personal firewalls, up-to-date virus protection, and current systems software. The Department reported it has made some progress in the area of Information Technology. For example:

- The Chief Information Officer now directly reports to the Deputy Secretary and is the primary official for Departmentwide information management issues.

- The Department developed the Information Resources Management Strategic Plan that includes specific goals and performance measures targeted at the reform of IT management processes associated with the Clinger-Cohen Act.

- The Department is progressing in developing an Enterprise Architecture that will serve as a roadmap for guiding investment decisions and achieving systems integration throughout the Department.

- The Department instituted a Capital Planning and Investment Control to address previous deficiencies in IT investment and management.

- The Department upgraded its site cyber security protection through the expanded use of firewalls and intrusion detection software and stronger passwords.

In FY 2003, the Department plans to publish the *Cyber Security Performance Program* that implements risk-based policies for the protection of cyber assets. The Department also plans to promulgate a set of cyber security manuals, which will lead to the establishment of Risk Management and Certification & Accreditation processes to support the Department's Cyber Security Management Program. In addition, future plans include issuing internal policy that will establish requirements for IT management throughout the Department and completing an acquisition framework. Plans also include issuing internal policy that will establish requirements for IT management throughout the Department and completing an acquisition framework.

Although progress has been made in establishing management processes to control IT planning and investment, and cyber security, the Department's IT management challenge remains to effectively implement these processes to, among other things, avoid system duplication and to minimize system vulnerabilities.

National Security

While the deterrent provided by nuclear weapons has been, and continues to be, a key component of the Nation's security posture, the Department now faces a complex set of challenges related to defending against worldwide threats. These challenges, brought to the forefront by the events of September 11, 2001, now require the Department to consider evolving security threats and the need to identify and implement new security measures. The Department has been instrumental in the development of technologies designed to counter future terrorist acts, including systems to detect airborne biological agents, sensors to track missile launchers or other weaponry in a desert environment, and chemicals to decontaminate buildings, such as the anthrax-infected Hart Senate Office Building. However, audits and inspections conducted over the last year have shown that improvements can be made to better control foreign access to valuable material and information.

Specifically, our audit on *Accounting for Sealed Sources of Nuclear Material Provided to Foreign Countries* (DOE/IG-0546, March 20, 2002), determined that the Department and its predecessor agencies did not enforce requirements for reporting sealed source information and could not fully account for the sealed sources of nuclear material lent to

foreign countries. Because of concerns regarding the possible misuse of these radioactive sources, including the potential for the development of radiological dispersal weapons, recommendations were made to improve the reporting system and identify the location of the material in cooperation with the International Atomic Energy Agency.

In addition to protecting sensitive materials, access to Department sites is critical to the security of the Nation. The Department has three nuclear weapons laboratories and many other multi-program laboratories that perform sensitive work on preserving the stockpile and countering terrorism at home and abroad. Our report, *Personnel Security Clearances and Badge Access Controls at Department Headquarters* (DOE/IG-0548, March 26, 2002), disclosed that process problems with the Department's clearance and badging controls could allow unauthorized individuals access to Department Headquarters. Personnel who had discontinued their employment with the Department had either not had their clearance terminated or had not returned their badges to the Department. While we found no instances of inappropriate access, these situations could have allowed unauthorized individuals easy entry to Department facilities. A similar audit is ongoing at selected Department field locations.

In a similar vein, the OIG issued a report on the foreign visits and assignment program at two national laboratories. We found that the Department had not adequately controlled unclassified visits and assignments by foreign nationals. Each year the Department's national laboratories host thousands of visitors from around the world. These visits benefit both the Department and its international partners by providing a forum for the exchange of information, a path for open communications and the stimulation of ideas, and an opportunity for the enhancement of research. These visits, however, pose certain security risks. Specifically, as noted by the *2002 Hamre Commission Report*, our adversaries might use unclassified activities – such as those taken by visitors and assignees – to gain access to classified activities.

The creation of the Department of Homeland Security (DHS) also poses additional challenges to the Department. For example, several Department activities and organizations will become part of the new agency. The Department will need to plan for this transition in sufficient detail to ensure an uninterrupted focus on national security. Furthermore, the Department will need to establish and maintain

efficient, well-coordinated mechanisms for interacting with DHS on issues relating to terrorism and homeland security. We note, for example, that at least two national laboratories have already established homeland security organizations. It is not yet clear to us how these and other Departmental organizational components will interact with DHS. The Department must work to ensure that where its mission and capabilities intersect the mission and needs of DHS, bureaucratic inefficiencies are minimized and national security is not compromised.

Performance Management

The President's Management Agenda identified Budget and Performance Integration as a government-wide initiative and outlined a plan to provide a results-oriented management process for the Federal government. A primary focus of the President's plan is that funding allocations are based on the achievement of goals. In the past, the Department has been criticized for deficiencies that include: (1) performance measures that are not quantifiable, (2) performance measures that do not support key goals, and (3) underlying processes that are not results oriented. In response to this criticism, the Department created the Office of Program Analysis and Evaluation and is moving toward a five-year planning, programming budget and evaluation system, which is intended to better integrate improved performance measures with the budget. In addressing this issue, the Department needs to ensure that comprehensive metrics are in place and are used to manage ongoing programs and activities effectively. To illustrate, our report on *Environmental Management Performance Measures* (DOE/IG-0561, June 27, 2002) noted that although the Office of Environmental Management had developed a number of corporate and project-specific performance measures, these measures did not capture overall program results. Specifically, the measures did not cover the majority of cleanup projects or budgets, capture overall program performance, or address risk reduction attributes.

In another report on the *Synchrotron Radiation Light Sources at Lawrence Berkeley National Laboratory and Stanford Linear Accelerator Center* (DOE/IG-0562, July 22, 2002), we found that the Office of Basic Energy Sciences had not established performance measures to evaluate the use of beam lines at its user facilities. Specifically, while beam lines at the Stanford facility were being fully used, those at Berkeley were not even though researchers with valid scientific projects had requested time to use the lines.

A recent report, *Remote Treatment Facility* (DOE/IG-0573, November 5, 2002), disclosed that the Department had not taken a corporate approach and integrated all mission needs in the Remote Treatment Facility planning and design process. While the Department had established performance measures as required by the *Government Performance and Results Act of 1993*, such measures were not sufficient in scope and did not address the ultimate disposition of all site remote-handled solid waste.

In FY 2002, the Department reported that it completed the following efforts:

- Issued new policy to provide consistent application of performance measurement principles;
- Established a formal training program to facilitate the development and reporting of quantifiable performance goals and measures in conjunction with the budget process;
- Implemented new performance tracking software to improve reporting and analysis capabilities and facilitate more useful information for decision making; and,
- Integrated performance plans with FY 2003 and FY 2004 budgets and utilized performance information to support its budget decisions.

In FY 2003, the Department plans to issue an Annual Performance Plan that will show its progress in developing better goals and targets that are more results driven and outcome oriented. In addition, internal assessments will be conducted to identify ways to improve performance management practices. These actions are encouraging and responsive to establishing more meaningful performance metrics and better integrating performance results into budget decisions. The OIG will continue to monitor the Department's performance in this critically important area.

Stockpile Stewardship

The Department's plan for stockpile stewardship is one of the most complex, scientifically technical programs ever undertaken. The

Department is responsible for maintaining the safety, reliability, and performance of the aging nuclear weapons in the Nation's stockpile. Since the moratorium on underground testing of nuclear weapons, the Department has accomplished this responsibility through its Stockpile Stewardship Program. The Department is required to annually certify to the President that the nuclear weapons stockpile is, in fact, safe and reliable and that underground nuclear testing does not need to be resumed. Ultimately, the program's success is dependent upon developing an unprecedented set of scientific tools to better understand nuclear weapons, enhancing stockpile surveillance capabilities, and, in the process, extending the life of the weapons that comprise the stockpile.

Deficiencies have been identified in surveillance tests of stockpiled nuclear weapons, a key component of the Stockpile Stewardship Program. Since 1996, the Department has not met certain milestones for surveillance testing and, in some cases, now faces a significant backlog. This backlog puts the Department at risk for not having critical information on the reliability of these weapons. Deficiencies have also been identified in conducting significant finding investigations to determine the cause and impact of problems identified by surveillance tests, and to recommend corrective actions.

As part of the *Strom Thurmond National Defense Authorization Act of 1999*, Congress created *The Panel to Assess the Reliability, Safety, and Security of the United States Nuclear Stockpile* to review and assess the Stockpile Stewardship Program and related activities. The Panel's FY 2001 report addressed five major areas that needed attention during FY 2002, and beyond. These were (1) new presidential guidance; (2) a capable and flexible weapons complex; (3) rigorous surveillance, assessment and certification processes; (4) test readiness; and, (5) decisive NNSA leadership and management. The Panel's March 2002 report provided specific details in each of these areas. Some involve action beyond the direct control of the Department, but many can be addressed from within.

During the past year, OIG reports have addressed difficulties that the Department has had in meeting this critical mission. For example, our audit of *National Nuclear Security Administration's Test Readiness Program* (DOE/IG-0566, September 9, 2002) disclosed that, based on the current status of available human and physical resources, the

Department's ability to conduct an underground nuclear test within established parameters was problematic. In addition, a report issued by the Nevada Operations Office, *Enhanced Test Readiness Cost Study*, concluded that the Department's ability to maintain a test readiness posture of 24 to 36 months is "at risk" at the currently planned funding level of $10 million per year. The conclusions in this report were consistent with the OIG's findings.

In a similar vein, an audit of *The Department of Energy's Pit Production Project* (DOE/IG-0551, April 12, 2002) disclosed that the Department's ability to produce a certifiable pit in accordance with its performance plans is at risk. As of December 2001, over half of the approximately 40 nuclear manufacturing processes that will be used to produce pits were behind schedule or had been delayed. While Los Alamos asserted that the delays occurred because the original schedule was too aggressive, we identified deficiencies in the management control process that make the on-time delivery of a certifiable pit questionable.

Last year, we reported on problems with the Department's stockpile surveillance testing and related significant finding investigations. This year, our audit on the *Resolution of Significant Finding Investigation Recommendations* (DOE/IG-0575, November 18, 2002) disclosed that while NNSA could account for the resolution of the 26 most serious significant finding investigation (SFI) recommendations related to problems affecting weapon safety, reliability, or performance, the status of 74 additional recommendations, each with a potential consequence for the surveillance program's operations and processes, was not tracked. We found that no action had been taken on 23 of the recommendations and that most were not assigned to any specific individual or organization for follow-up. NNSA did not have controls in place to ensure that such assignments were made and that follow-up actions were completed. In our view, the failure to track and resolve SFI recommendations, admittedly those that may have been determined to be of a lower risk and/or priority, has the potential to undermine the effectiveness of the Department's testing regime.

In addition, our review on the *Depleted Uranium Operations at the Y-12 National Security Complex* (DOE/IG-0570, September 25, 2002) pointed out that although the Y-12 depleted uranium facility is currently able to manufacture components, NNSA cannot ensure the continued

reliability of national security processes at the site. Production equipment, in many cases, is outdated, damaged, or beyond repair.

Finally, as is the case with most major Department programs, NNSA faces challenges with regard to repairing and replacing its deteriorating infrastructure. Although Congress has committed substantial funds to infrastructure improvements over the next 10 years, our work has led us to conclude that NNSA needs better planning and prioritization of its requirements to ensure that the additional funds, which may approach $2 billion, are used as effectively as possible.

Worker/Community Safety

The Department performs a wide variety of work to carry out the many missions of the Department. With thousands of employees and the local communities to consider, safety is a key concern to the Department. Other agencies and or groups, such as State regulators, the Environmental Protection Agency, the Defense Nuclear Facilities Safety Board, and the Office of Independent Oversight and Performance Assurance also help the Department stay focused on the safety of its operations and facilities. OIG reports have identified problems with safety operations or plans at several of the Department's facilities.

Our report on *National Nuclear Security Administration's Test Readiness Program* (DOE/IG-0566, September 9, 2002) disclosed Nevada had not fully updated its nuclear explosives procedures and activities to incorporate enhanced nuclear safety requirements issued in fiscal year 2001. According to Nevada, it could take from 12 months to 18 months to complete the remaining six areas master studies. Without these studies completed, it could affect the ability to resume underground testing should the President determine that such tests are needed.

Likewise, the ongoing review of the *National Nuclear Security Administration's Nuclear Explosive Safety Study Program* disclosed that required comprehensive Nuclear Explosive Safety studies at Pantex have been delayed for a majority of active nuclear weapons types in the Nation's stockpile. While revalidation studies have been conducted for these weapon types, most were late, causing, in some cases, work delays.

A priority of the Defense Nuclear Facilities Safety Board (Board) has been safety at the Department's Pantex site. For example, in 2000, the Board reported a problem with the Department's software quality assurance standards and the Department was to prepare a corrective action plan to address the deficiencies. In 2002, the Board sent the Department a number of recommendations focusing on shoring up the level and availability of safety expertise made available to the Pantex Plant. The Board also issued a recommendation on the quality assurance for safety-related software because after two years of effort to produce a corrective action plan, the Department's attempts now appear to be stalled.

Our report on *Nuclear Safety Rules at Ashtabula* (DOE/IG-0576, November 29, 2002), identified issues relating to nuclear safety. Specifically, that radiological work at the Metals Plant and commercial work with Department equipment were not covered by a license of nuclear safety procedures. In addition, during our ongoing *Inspection of Explosives Safety at Selected Department Sites,* we concluded that improvements could be made in the areas of explosives, fire, and lighting safety.

Appendix 1

Calendar Year 2002 Reports and Ongoing Reviews

Contract Administration

Issued Reports:

Audit Report on "Procurement Administration at Brookhaven National Laboratory" (CR-B-02-02, August 22, 2002)

Audit Report on "Sandia National Laboratories Procurement Card Program" (WR-B-02-03, August 6, 2002)

Audit Report on "Privatization of Safety Management Services at the Savannah River Site" (DOE/IG-0559, June 18, 2002)

Audit Report on "Cost Sharing at the Ashtabula Environmental Management Project" (DOE/IG-0558, June 7, 2002)

Audit Report on "Alternative Fuels Use at the Department of Energy" (DOE/IG-0553, May 2, 2002)

Audit Report on "Funds Received from Termination of the Silo 3 Subcontract at the Fernald Environmental Management Project" (ER-L-02-02, April 15, 2002)

Inspection Report on "Inspection of Licensing of Trade Secrets by Sandia National Laboratories" (DOE/IG-0547, March 22, 2002)

Inspection Report on "Department of Energy's Purchase Card Programs – Lessons Learned" (IO1OP001, February 26, 2002)

Audit Report on "Grant Administration at the Oakland Operations Office" (WR-B-02-02, January 15, 2002)

Audit Report on "Advanced Radioisotope Power Systems Program" (DOE/IG-0540, January 14, 2002)

Audit Report on "Passive Magnetic Resonance Anomaly Mapping at Environmental Management Sites" (DOE/IG-0539, January 11, 2002)

Appendix 1 (Continued)

Ongoing Reviews:

- Sensitive Equipment Accountability
- Local Government Use of Nuclear Waste Funds
- Administration of Financial Instruments by Laboratories
- Research and Development Investment Criteria for Fossil Energy
- Weatherization Assistance Program
- Department's Agreement for Utility Services at East Tennessee Technology Park
- Reindustrialization at the East Tennessee Technology Park
- Facility Maintenance at the Hanford Site
- Disposal of Surplus/Excess Personal Property at the Nevada Test Site
- Beryllium Operations at Y-12
- Albuquerque Operations Office Transportation Procurement
- Oak Ridge National Laboratory Subcontracting
- NNSA Funding and Leasing Issues
- Savannah River Operations Office Emergency Response and Law Enforcement Related Grants
- Bonneville Power Marketing Administration's Kaiser Remarketing Funds

Information Technology Management

Issued Reports

Audit Report on "Business Management Information System" (DOE/IG-0572, November 4, 2002)

Evaluation Report on "The Federal Energy Regulatory Commission's Unclassified Cyber Security Program 2002" (DOE/IG-0569, September 13, 2002)

Audit Report on "Remote Access to Unclassified Information Systems" (DOE/IG-0568, September 13, 2002)

Evaluation Report on "The Department's Unclassified Cyber Security Program 2002" (DOE/IG-0567, September 9, 2002)

Audit Report on "Nuclear Materials Accounting Systems Modernization Initiative" (DOE/IG-0556, June 6, 2002)

Audit Report on "Cyber-Related Critical Infrastructure Identification and Protection Measures" (DOE/IG-0545, March 20, 2002)

Appendix 1 (Continued)

Ongoing Reviews

- Information Systems Planning, Implementation, and Security Practices at the Power Marketing Administrations
- Wireless Communications

Environmental Stewardship

Issued Reports

Audit Report on "Planned Characterization Capability at the Waste Isolation Pilot Plant" (DOE/IG-0577, December 18, 2002)

Inspection Report on "Inspection of Nuclear Safety Rules at the Ashtabula Environmental Management Project" (DOE/IG-0576, November 26, 2002)

Audit Report on "Remote Treatment Facility" (DOE/IG-0573, November 5, 2002)

Audit Report on "Idaho Settlement Agreement Activities" (DOE/IG-0571, October 9, 2002)

Audit Report on "Salt Processing Project at the Savannah River Site" (DOE/IG-0565, August 27, 2002)

Audit Report on "Advanced Vitrification System" (DOE/IG-0564, August 20, 2002)

Audit Report on "Closure of the Fernald Environmental Management Project" (DOE/IG-0555, June 5, 2002)

Audit Report on "The Plutonium Stabilization and Packaging System at the Rocky Flats Environmental Technology Site" (DOE/IG-0554, May 13, 2002)

Audit Report on "Completion of K Basins Milestones" (DOE/IG-0552, April 15, 2002)

Audit Report on "Disposition of the Department's Excess Facilities" (DOE/IG-0550, April 3, 2002)

Audit Report on "Idaho Operations Office Planned Construction of a Waste Vitrification Facility" (DOE/IG-0549, April 1, 2002)

Appendix 1 (Continued)

Audit Report on "Department of Energy's Strategy for Disposal of Plutonium" (ER-L-02-01, February 7, 2002)

Audit Report on "Soil Washing at the Ashtabula Environmental Management Project" (DOE/IG-0542, January 28, 2002)

Audit Report on "Remediation and Closure of Ashtabula Environmental Management Project" (DOE/IG-0541, January 15, 2002)

Ongoing Reviews

- Advanced Mixed Waste Treatment Project at the Idaho National Engineering and Environmental Laboratory
- Planning for Waste Treatment Plant at Hanford
- Disposal of WIPP's Remote-Handled TRU Waste
- Treatment of Mixed Incinerable Wastes
- Waste Stabilization Facility at Savannah River
- Local Government Use of Nuclear Waste Funds
- In-House Energy Management
- Plutonium Finishing Plant at the Hanford Site

National Security

Issued Reports

Audit Report on "Calutron Isotope Production Capabilities" (DOE/IG-0574, November 14, 2002)

Inspection Report on "Inspection of the Security of Spent Nuclear Fuel at the West Valley Demonstration Project" (DOE/IG-0563, July 23, 2002)

Inspection Report on "Inspection of Department of Energy Fresh Pursuit Policies and Practices" (DOE/IG-0557, June 6, 2002)

Audit Report on "Personnel Security Clearances and Badge Access Controls - Department of Energy Headquarters" (DOE/IG-0548, March 25, 2002)

Audit Report on "Accounting for Sealed Sources of Nuclear Material Provided to Foreign Countries" (DOE/IG-0546, March 20, 2002)

Appendix 1 (Continued)

Inspection Report on "Inspection of the Accountability and Control of Sealed Radioactive Sources at Selected Department of Energy Sites" (DOE/IG-0544, March 12, 2002)

Audit Report on " The Department's Unclassified Foreign Visitor and Assignment Program" (DOE/IG-0579, December 23, 2002)

Ongoing Reviews

- Implementation of the Indications, Warning, Analysis, and Reporting
- Department's Integrated Security System
- Personnel Security Clearances and Badge Access Controls at Selected Field Locations
- Selected Aspects of Security Force Administration at the Department
- Power Marketing Administration's Infrastructure Protection
- Special Nuclear Materials Received from Foreign Countries
- Security Issues
- Force on Force Recommendations
- Transportation Security at the National Nuclear Security Administration – Savannah River Site
- Department of Energy Counterterrorism Coordination
- Hazardous/Toxic Chemical Security
- Firearms Internal Controls
- FY 2002 4th Quarter Intelligence Oversight
- Export Control of Savannah River Operations Office Grant/Work-for-Others Information
- Explosive Security
- Security of Spent Nuclear Fuel Shipments
- Review of International Memorandums of Understanding
- Department of Energy Aircraft Security
- Department of Energy Aircraft Support of Joint Technical Operations Team
- Sensitive Information On Department of Energy Websites
- Safeguards and Security at Los Alamos National Laboratory
- Laptop Internal Controls
- Department Nuclear Weapons Incident Response Program
- Controls Over Expenditures at the Office of Transportation Safety

Appendix 1 (Continued)

Performance Management

Issued Reports

Audit Report on "Implementation of Sound Project Management Practices in the Office of Science" (OAS-L-03-02, November 4, 2002)

Audit of "State of Nevada Yucca Mountain Oversight Funds for Fiscal Year 2001" (CR-C-02-01, August 22, 2002)

Audit Report on "Synchrotron Radiation Light Sources at Lawrence Berkeley National Laboratory and Stanford Linear Accelerator Center" (DOE/IG-0562, July 22, 2002)

Audit Report on "Environmental Management Performance Measures" (DOE/IG-0561, June 27, 2002)

Inspection Report on "Inspection of Training Issues at the Rocky Flats Field Office" (SO2IS020, March 22, 2002)

Audit Report on "Relativistic Heavy Ion Collider Project" (DOE/IG-0543, March 6, 2002)

Ongoing Reviews

- Science Infrastructure
- Funding Mission Development Activity at Idaho National Engineering and Environmental Laboratory
- Waste Receiving and Processing Facility at Hanford
- Department of Energy's Spent Nuclear Fuel Lead Laboratory
- Planning and Budgeting for NNSA Infrastructure

Stockpile Stewardship

Issued Reports

Audit Report on "Resolution of Significant Finding Investigation Recommendations" (DOE/IG-0575, November 18, 2002)

Audit Report on "Depleted Uranium Operations at the Y-12 National Security Complex" (DOE/IG-0570, September 25, 2002)

Appendix 1 (Continued)

Audit Report on "National Nuclear Security Administration's Test Readiness Program" (DOE/IG-0566, September 9, 2002)

Audit Report on "The Department of Energy's Tritium Extraction Facility" (DOE/IG-0560, June 24, 2002)

Audit Report on "The Department of Energy's Pit Production Project" (DOE/IG-0551, April 12, 2002)

Ongoing Reviews

- Initiatives for Nuclear Nonproliferation
- NNSA's Planning, Programming, and Budgeting System Process and Structure
- Dual Axis Radiographic Hydrodynamic Test Facility
- Dual Axis Radiographic Hydrodynamic Test Facility Commissioning
- National Ignition Facility
- Kansas City Plant Operations
- Nuclear Facilities
- W80 Refurbishment
- Department of Energy's Safety Analysis Requirements
- Department's Management of Beryllium Inventories
- Plutonium-238 Production Capabilities

Worker/Community Safety

Ongoing Reviews

- National Nuclear Security Administration's Nuclear Explosives Safety Study Program
- Memorandums of Agreements at Selected Department of Energy Facilities
- Nuclear Safety Rules at Ashtabula
- Los Alamos National Laboratory Reportable Incident Reports
- Explosives Safety
- Memorandums of Agreement at Brookhaven National Laboratory

Appendix 2

Crosswalk of Management Challenges

Continuing Challenges

Contract Administration
Information Technology Management
Performance Management
Stockpile Stewardship

Restated Challenges

FY 2002	FY 2003
Environmental Standards and Stewardship	Environmental Stewardship
Infrastructure and Asset Management *	Stockpile Stewardship/Contract Administration
Security and Safety **	National Security and Worker/Community Safety

* Infrastructure and Asset Management was split and restated in Stockpile Stewardship and Contract Administration, respectively.
** Security and Safety was split and restated in National Security and Worker/Community Safety, respectively.

Previous Challenges

Energy Supply
Human Capital
Research and Development Investment

Appendix 3

Status of Previously Reported Management Challenges

The Department has taken steps to address three previously reported OIG management challenges and a number of the President's management initiatives. These actions came about as a result of strategic planning and goal setting, management commitment, and concentrated efforts by many Department and contractor personnel. Through these efforts, progress has been made in the areas of Human Capital, Better Research and Development Investment Criteria, and Energy Supply. While these areas still represent daunting issues that the Department must plan for and deal with on a continual basis, we noted that management had put into place a number of initiatives designed to address problematic aspects of these challenge areas. We recognize, however, that these areas will continue to challenge the Department for many years to come and plan to revisit these areas in the future.

Human Capital

Since 1995, the Department has experienced a 27 percent reduction in its workforce. To address the impacts of this dramatic downsizing, a comprehensive human capital management strategy, *Human Capital Update: Accelerating Workforce Restructuring and Addressing Skill Gaps in Mission Critical Positions,* was developed to serve as a baseline for workforce demographics for future change. In addition, several other initiatives have been implemented, such as revitalizing Senior Executive Service mentoring and candidate development programs; expanding use of automated human resource systems; implementing new intern and leadership programs; and, using available personnel tools and flexibilities (including buyouts and early retirement) to rebuild its workforce.

Ongoing OIG work has reinforced the conclusion that progress is being made. For example, our review of *Recruitment and Retention Efforts for Federal Employees* has shown that the Department has initiated programs to attract prospective employees and develop current staff. We did note, however, that corrective actions from prior reports are still not complete. Our audit of *Recruitment and Retention at the Los Alamos and Lawrence Livermore National Laboratories* has found that both laboratories have addressed NNSA's recruitment and retention program objectives to develop and deploy an aggressive, multi-laboratory strategy and a comprehensive plan to ensure that critical skills, knowledge, and technical capabilities were available to the Nuclear Weapons Program. It is still too early, however, to measure the strategy's effectiveness.

While progress is being made, we have also noted that human capital issues still represent hurdles that management must successfully negotiate to meet mission requirements. For example, our audit of *Management of the Stockpile Surveillance Program's Significant Finding Investigations* (DOE/IG-0535, December 18, 2001), cited a shortage of personnel that could affect the ability of the NNSA to resume underground testing within specified timeframes. Personnel shortages were also identified in our report of *National Nuclear Security Administration's Test Readiness Program*

Appendix 3 (Continued)

(DOE/IG-0566, September 9, 2002). The Department agreed with the recommendations made in both reports and noted it was already working on initiatives or actions to mitigate the effect of resource shortages.

Better Research and Development Investment Criteria

Given the magnitude of the Department's research and development activities, which are funded at approximately $3.3 billion annually, the Administration has noted that significant care needs to be taken in the prioritization and management of these activities. In the last year, as directed in the *President's Management Agenda*, the Department and the Office of Management and Budget (OMB) developed, then worked to refine, investment criteria to assist in allocation decisions for applied research and development investments. This criteria was then used as the basis for the Department's FY 2003 budget request for energy technology programs.

Once the criteria has been further refined, OMB plans to apply it to all federal departments and applicable agencies with applied research and development programs in time for the formulation of the FY 2004 budget. There are also plans to develop separate criteria for evaluating basic research in the near future.

Energy Supply

The Department is taking action to shift its energy research work toward high-risk, longer-range activities with the potential for large payoffs, including energy science research in the physical, biological, and environmental areas. In this regard, the National Energy Policy established five key national goals: modernizing conservation efforts; modernizing our energy infrastructure; increasing energy supplies; accelerating the protection and improvement of the environment; and, increasing our Nation's energy security. To address these goals, resources have been increased to develop technology to make electricity generation and energy use more efficient. Another Departmental program is working to develop more energy efficient and alternatively fueled vehicles capable of reducing or eliminating the Nation's dependence on foreign oil. The Department also supports wind, solar, biomass, hydropower, and geothermal energy research and development projects to find ways to increase domestic energy supplies. Further, the Congress is working on national energy legislation that could affect energy supplies of the future.

The Office of Inspector General believes that the Department cannot unilaterally improve the energy supply situation. Consequently, we are not separately reporting this challenge for FY 2003. Factors that could affect the Department in achieving its goals in the Energy Supply area include the market and consumer adoption of new technologies developed, environmental technologies, the energy industry's profitability, access to capital, and the undertaking of steps necessary to make the energy system less vulnerable.

IG Report No.: DOE/IG-0580

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PROGRAM PERFORMANCE IMPROVEMENT INITIATIVES

The Contractor made proposals dated August 21, 2000, September 19, 2000, and October 2, 2000 (LANL only) to improve program performance at Los Alamos National Laboratory (LANL) and Lawrence Livermore National Laboratory (LLNL). Specific milestones and other requirements implementing the proposed Program Performance Improvement Initiatives are contained in Appendix O and other terms of the Prime Contract.

The Contractor will strengthen its management and performance at LANL and LLNL by implementing the above proposals (to the extent not inconsistent with the prime contract including Appendices) and Appendix O, which includes the following:

1. Establish a Vice President for Laboratory Management (VPLM) Position, single point of contact for LANL and LLNL within the University of California's (UC) Office of the President, reporting to the President. The UC President and VPLM are accountable for verification of implementation of Appendix O, including DOE requirements at LANL and LLNL; DOE has approval authority over selection of the VPLM.

2. Establish a Laboratory Senior Management Council (LSMC), reporting to the UC President, for the VPLM, Senior Vice Presidents and Laboratory Directors to review progress, discuss key and future initiatives. The LSMC will establish routine communications to inform and solicit feedback from DOE management on issues/actions.

3. Obtain subcontractor expertise to assist LANL, LLNL, and the VPLM as described in Appendix O.

4. Institutionalize best practices in operational, safety and security management in nuclear facility operations.

Appendix O includes more detailed milestones and measures of program performance improvement initiatives that will be implemented as described in Appendix O. The costs associated with these initiatives are allowable in accordance with the terms and conditions of the Section H Clause entitled, Advanced Understanding of Costs and Expenses.

PROGRAM PERFORMANCE INITIATIVES

Tab 18

This Appendix implements Appendix L and describes Program Performance Initiatives committed to by the University of California (UC) in managing and operating the Los Alamos National Laboratory (LANL) and the Lawrence Livermore National Laboratory (LLNL). UC's success in performing against initiatives in management accountability; safeguards and security management; facilities safety (including nuclear facility operations); critical skills, knowledge and technical capabilities; and project management and construction project management will be assessed based upon the expectations and methodology set forth in this Appendix.

The President of the University of California, the Vice President for Laboratory Management (VPLM), and the Directors of LANL and LLNL are responsible and accountable for the successful implementation and accomplishment of these Program Performance Initiatives, and improved performance at LANL and LLNL.

DOE will evaluate the performance results under this Appendix using the expectations and methodology in this Appendix. This Appendix will be effective from the date of contract modification until September 30, 2002.

Appendix O - Program Performance Initiatives

1. **Management Accountability Improvements Initiative**

This initiative is intended to strengthen UC management of and accountability for LANL and LLNL, including successful accomplishment of Appendices L and O commitments and overall performance in Appendix F. The President of UC, through the VPLM, will be accountable for successfully implementing all initiatives in those Appendices. It is intended that the VPLM provide leadership, management, and integration of the initiatives for LANL and LLNL. The VPLM will be cognizant of issues and information from each Laboratory, or external sources that affect either Laboratory. The VPLM will ensure adequate integration between LANL and LLNL to avoid duplication of problems and to provide for learning. The VPLM will be accountable for institutionalizing the changes, improvements, and the benefits gained from the infusion of industry expertise provided for under this Appendix O into LANL and LLNL.

1.1 The President of UC shall be accountable for overall UC management and operating performance at LANL and LLNL, and specifically for the accomplishment of commitments in Appendices L and O and overall performance in Appendix F. To assist the President of UC, a VPLM will be established. UC shall have selected, gained DOE approval and hired the VPLM within 7 months of execution of modification M507 (LANL) and A390 (LLNL).

1.2 Upon execution of the modification M507 (LANL) and A390 (LLNL), the President of UC will establish and implement the Laboratory Senior Management Council (LSMC), chaired by the VPLM, who with the Senior Vice Presidents and Laboratory Directors will use the LSMC as a forum to review issues, progress on key initiatives and future requirements. The VPLM will ensure that LSMC is an effective forum.

1.3 Within five (5) days of execution of the UC extension modification M507 (LANL) and A390 (LLNL) the VPLM shall develop and submit to DOE, for review and comment, subcontract Statements of Work (SOWs) for appropriate subject matter experts (SMEs) for operational improvements in safeguards and security, project management and construction management. The SOWs will describe how the SMEs will advise the VPLM, and require the SME's primary work to be on-site at LANL and LLNL, with direct involvement of LANL and LLNL staff. The VPLM will demonstrate the effectiveness of the SMEs and the use of the subcontract expertise by LANL and LLNL.

1.4 The VPLM will establish routine communications to ensure greater participation and feedback from DOE management on actions and issues and to advise DOE concerning improvements to LANL and LLNL performance. UC will demonstrate the effectiveness of such communications as part of the annual UC self-assessment under this appendix.

1.5 The President of UC and VPLM are expected to demonstrate commitments, reflected in Appendix L and reference letters, have been met in accomplishing Appendix O initiatives. UC will address VPLM success in accomplishing the following specific commitments as part of the Appendix O annual self-assessment described in Paragraph 6.4 of this appendix:

1.5.1 Setting expectations for the VPLM

1.5.2 Setting expectations for Laboratory Directors

1.5.3 VPLM verifying implementation and adherence to DOE requirements

1.5.4 VPLM communicating and facilitating implementation of LANL and LLNL Directors' efforts to:

1.5.4.1 Integrate operational practices and processes

1.5.4.2 Integrate accepted SME recommendations into overall operations at LANL and LLNL

1.5.4.3 Implement best business practices in support of core mission requirements

1.5.4.4 Ensure institutionalization and long term benefit of improvement and integration actions

1.5.4.5 Oversee and rate annual performance at LANL and LLNL

1.5.4.6 VPLM provide an effective UC presence at LANL and LLNL to support the accomplishment of facility operations in accordance with disciplined procedures established through applicable directives.

The President of UC and VPLM will include discussions of progress, issues and changes associated with meeting the above commitments as part of quarterly reviews identified in Paragraph 6.3 of this appendix.

2. <u>Safeguards and Security Management Improvements Initiative</u>

This initiative is intended to: ensure that each employee is directly responsible for performing work safely and securely; improve safeguards and security management; and, instill public confidence in safeguards and security at LANL and LLNL. The VPLM will ensure that LANL and LLNL accomplish actions associated with this initiative and facilitate communication and coordination between LANL and LLNL.

2.1 UC will subcontract for the expertise and services needed to strengthen oversight of safeguards and security at LANL and LLNL, including identification of industry best practices. Within five days after execution of modification M507 (LANL) and A390 (LLNL), UC will provide the Statement of Work to DOE. Within 90 days of DOE's review and comment

on the Statement of Work, UC will have safeguards and security expertise in place.

2.2 In performing work under this contract, the VPLM shall ensure that management of safeguards and security functions and activities become an integral and visible part of LANL and LLNL's work planning and execution processes. The Directors for LANL/LLNL shall put in place by December 31, 2002, an integrated safeguards and security management system to ensure the following:

2.2.1 Each employee is directly responsible for performing work securely and contributing to a secure workplace in meeting National Security requirements.

2.2.2 Line management is directly responsible for the protection of the DOE assets, the worker, the public, and the environment.

2.2.3 Clear and unambiguous lines of authority and responsibility for ensuring safeguards and security shall be established and maintained at all organizational levels.

2.2.4 Employees shall possess the experience, knowledge, skills, and abilities that are necessary to discharge their responsibilities in a secure manner.

2.2.5 Resources shall be effectively allocated to address safeguards and security, programmatic, and operational considerations in protecting the DOE assets, the worker, the public, and the environment whenever activities are planned and performed.

2.2.6 Before work is performed, the associated threats shall be evaluated and an agreed-upon set of safeguards and security standards and requirements shall be established which, if properly implemented, will provide adequate assurance that DOE assets, the worker, the public, and the environment are protected from adverse consequences.

2.2.7 Administrative and engineering controls to prevent and mitigate threats shall be tailored to the work being performed and associated threats.

2.2.8 The conditions and requirements to be satisfied for operations to be initiated and conducted shall be clearly established and agreed upon by DOE and UC; the extent of documentation and level of authority for agreement shall be tailored to the complexity and threats associated with the work and shall be established in a safeguards and security management system.

2.3 Within 90 days of execution of modification M507 (LANL) and A390 (LLNL), the VPLM shall ensure that LANL and LLNL develop an integrated safeguards and security communication plan to promote awareness and to solicit employee feedback.

2.4 By August 23, 2001, LANL and LLNL shall conduct an assessment (gap analysis) comparing the existing system to the safeguards and security management system required in 2.2 above. The analysis shall incorporate all actions necessary to ensure implementation of a safeguards and security management system by December 31, 2002.

2.5 By September 28, 2001, LANL and LLNL shall develop an action plan for DOE approval based on the gap analysis (ref. 2.4) that specifies actions necessary to demonstrate adequate progress will be made toward December 31, 2002 implementation of the system described in 2.2.

2.6 By September 30, 2002, the VPLM will demonstrate integration of safeguards and security into LANL and LLNL activities by assessing implementation

progress in comparison to the elements of 2.2 above and meeting milestones in the action plan described in 2.5 above.

Should DOE establish a Directive for safeguards and security management or change requirements for safeguards and security management systems after the effective date of modification M507 (LANL) and A390 (LLNL), then such Directive or applicable changes will be incorporated into this Appendix using the change control process described herein.

3. **Facility Safety (Including Nuclear Facility Operations) Improvements Initiative**

This initiative is intended to institutionalize best practices in facility operations and safety at LANL and LLNL for both nuclear and non-nuclear facility operations. The VPLM will ensure LANL and LLNL accomplish actions associated with this initiative and facilitate communication and coordination between LANL and LLNL.

The VPLM will also ensure that, over the long term, LANL and LLNL will sustain nuclear operations either by training employees, hiring or obtaining expertise through subcontract.

3.1 Nuclear Facilities Operations

3.1.1 LANL will use a subcontract for commercial expertise to assess current practices and will plan and execute operational improvements for nuclear facilities operations. LANL will ensure continuous operational improvements for nuclear facilities, consistent with the principles of Integrated Safety Management. LLNL will also make

use of this additional expertise, as needed, in accordance with 3.1.5. below.

3.1.2 LANL will subcontract for extensive experience in nuclear facility operations within ninety (90) days of execution of modification M507 (LANL) and A390 (LLNL), for the purpose of providing advice and assistance to LANL management.

3.1.3 Within thirty (30) days of execution of the nuclear operations support subcontract, UC will initiate, through the subcontract, assessment of existing nuclear facility operations at LANL.

3.1.4 UC will require the subcontractor, within 120 days of execution of the nuclear operation support subcontract, to provide a report with recommendations (including opportunities to apply "best practices") for nuclear facility operational improvements.

3.1.5 For both LANL and LLNL, the VPLM will ensure that plans, processes, and expertise are in place to sustain and continue operational improvements. The VPLM will ensure that incidents, assessments, SME recommendations, improvements, best practices, and other information regarding nuclear facility operations are effectively shared between LANL and LLNL.

3.1.5.1 The VPLM Appendix O annual self-assessment of LANL and LLNL under 6.4 below will demonstrate improved performance in nuclear facility operations through improvements in nuclear facility operations down time and improved performance (from the FY 2000 baseline) against nuclear facility operations measures in Appendix F, which are designed to improve protection of the workers, the public, and the environment.

Appendix O - Program Performance Initiatives

3.2 Nuclear and Non-Nuclear Facilities Initiatives, including 10 C.F.R. 830, Defense Nuclear Facilities Safety Board (DNFSB) Recommendation 2000-2, and Authorization Basis (AB)

3.2.1 10 CFR 830 Initiatives: LANL and LLNL will be accountable for ensuring implementation of the quality assurance criteria and the unreviewed safety question requirements in accordance with 10 CFR 830.

3.2.2. DNFSB Recommendation 2000-2:

3.2.2.1 LANL and DOE will develop a schedule for meeting DOE's Implementation Plan for DNFSB Recommendations 2000-2; LANL will complete the required documentation for identified nuclear facilities per the agreed-upon schedule.

3.2.2.2 For LLNL

3.2.2.2.1 By February 28, 2001, complete the Phase I assessment for Building 332 safety class, confinement ventilation, and fire protection systems from Commitment #3 of the DOE 2000-2 Implementation Plan.

3.2.2.2.2 By May 31, 2001, complete the Phase I assessment for B-231 Vault, B-334, B-331, and B-233 CSU applicable safety class, confinement ventilation, and fire protection systems from Commitment #4 of the DOE 2000-2 Implementation Plan.

3.2.2.2.3 By June 30, 2001, complete the Phase I assessment of Building 231 Vault, B-233 CSU, B-331, B-332, and B-334 CSU remaining safety significant systems.

3.2.3 AB Initiatives for LANL

3.2.3.1 Nuclear Facilities: LANL will submit the following Nuclear Facility AB Documents by the following dates:

Facility	AB Document	Due Date
WETF	SAR	May 15, 2001
TA-18	BIO	May 30, 2001
TA-55	SAR Update	June 30, 2001

3.2.3.2 By September 30, 2001, a new list will be developed for specific AB document deliverables in FY 2002.

3.2.3.3 By September 30, 2001, LANL will ensure that it identifies all radiological facilities and begins an annual inventory report to DOE.

3.2.3.4 By February 28, 2001, LANL will approve Laboratory Implementing Requirements (LIR) for nuclear facilities. Also, by February 28, 2001, LANL will develop and submit for DOE comment, draft LIRs for non-nuclear facilities and categorization of facilities. By April 30, 2001, these LIRs will be approved by LANL.

3.2.3.5 By September 30, 2001, LANL will develop a "Facilities Safety Deliverables Master Schedule." The Master Schedule shall include a risk-based facility-specific schedule (including nuclear and non-nuclear facilities) that is approved by the LANL Director. The Master Schedule will be updated periodically and will be the basis for establishing priorities for AB efforts; and, include schedules; as follows:

3.2.3.5.1 By September 30, 2001, complete AB documents for all Category 2 and 3 nuclear facilities currently operating without DOE-approved AB documents.

3.2.3.5.2 By September 30, 2002, submit for DOE approval upgrade of three ABs (TA-8, Transportation, and Radiological Liquid Waste); remaining SAR upgrades for Category 2 and 3 facilities (for SARs not currently meeting existing requirements) will be submitted for DOE approval, in accordance with 10 CFR 830 schedules.

3.2.3.6 Non-nuclear Facilities:

3.2.3.6.1 By September 30, 2001, complete safety surveys for moderate hazard facilities.

3.2.3.6.2 By September 30, 2001, based on the safety surveys, LANL and DOE will establish a list of facilities for which AB documents will be completed. LANL will complete AB documents per the Master Schedule.

3.2.4 AB Initiatives for LLNL

3.2.4.1 LLNL will complete implementation of the nuclear facility AB corrective action plan according to the following milestones:

3.2.4.1.1 By May 31, 2001, complete the baseline review of nuclear facilities AB to define any issues.

3.2.4.1.2 By May 31, 2001, establish AB due dates.

3.2.4.1.3 By June 1, 2001, define a graded approach for nuclear safety AB that will be submitted to DOE.

3.2.4.1.4 By June 1, 2001, develop a schedule for completing safety basis documents for nuclear facilities.

3.2.4.1.5 By August 30, 2001, develop internal procedures for nuclear facility managers and AB experts to meet AB requirements

3.2.4.2 By September 30, 2001, LLNL will complete the appropriate AB documents for non-nuclear facilities.

3.2.4.3 By June 1, 2001, LLNL will prepare the emergency hazard assessments, in accordance with DOE Directive 151.1 and DOEG 151.1, Volume 2 and submission of the assessments to DOE.

4. **Critical Skills, Knowledge and Technical Capabilities Initiative**

This initiative is intended to ensure that workforce critical skill replenishment is managed in a sound and systematic manner to assure that future mission needs of the Nuclear Weapons Program are effectively met. One of the goals of this initiative is to develop and deploy an aggressive, multi-laboratory strategy and comprehensive plan that ensures critical skills, knowledge, and technical capabilities are available to the Nuclear Weapons Program. The VPLM is accountable for integrating and leveraging the resources and recruitment programs of UC, LANL and LLNL to address all of these expectations below:

4.1. Building upon the October 2000 Critical Skills Workshop and the critical skills list and performance metrics due to DOE by January 12, 2001, the VPLM will demonstrate effective workforce management to assure the availability of critical skills, including:

4.1.1 By March 31, 2001, UC shall have finalized at LANL and LLNL consistent definitions for ensuring that critical skills, knowledge and technical capabilities are available.

4.1.2 By March 31, 2001, designate agreed-upon indicators to track progress in recruiting and retaining critical skills. By June 30, 2001, designate agreed-upon indicators for training.

4.1.3 By June 30, 2001, complete an assessment of the current workforce and the development of projections over five years to determine any gaps in critical skills at LANL and LLNL.

4.1.4 By September 30, 2001, complete a consolidated LANL and LLNL plan for recruiting, training, and retaining critical skills to address projected gaps over the next five years.

4.1.5 Beginning September 30, 2001Conduct quarterly assessments of results using the agreed-upon indicators.

5. **Project Management and Construction Project Management Improvement Initiative**

This initiative is intended to strengthen project management and to institutionalize and standardize processes. The VPLM will ensure that LANL and LLNL accomplish actions associated with this initiative and facilitate communication and coordination between LANL and LLNL. Projects will be executed in accordance with the principles of DOE Directive 413, in accordance with good business practices, and within scope, schedule, and cost. The VPLM will also ensure that, over the long term, LANL and LLNL will sustain project management expertise either by training employees, hiring or obtaining expertise via subcontract.

5.1 The University of California will provide for the expertise and services needed to strengthen oversight of line item Construction Project Management (CPM) at LANL and LLNL. Within five days after execution of modification M507 (LANL) and A390 (LLNL), UC will provide the Statement of Work to DOE. Within 90 days of agreement between DOE and UC on the Statement

of Work, UC will have the SME project management expertise in place. The subcontractor will provide recommendations regarding the implementation of CPM systems at LANL and LLNL, perform analyses of proposed and existing projects, and provide consultation and advice on improving construction project management at LANL and LLNL.

5.2. For mutually agreed program elements (that are not primarily R&D), the VPLM will ensure that the agreed-to program elements are planned and executed (using project management principles, tools and best practices), based upon clear work scope, milestones, costs and deliverables as approved by DOE. It is agreed that the following program elements will be projectized:

5.2.1 Pit Manufacturing and Certification: Upon DOE approval of an integrated scope, schedule, and cost baseline, LANL will execute this project in accordance with the DOE-approved baseline and in accordance with established change control and project management reporting processes.

5.2.2 National Ignition Facility Related Cryogenics and Core Diagnostics Systems: Within 9 months of receiving written confirmation from DOE of LLNL's responsibilities for the cryogenics and core diagnostics, LLNL will prepare a detailed projectization plan, including scope of work for these program elements.

5.3 The Contractor agrees to engage in discussions with DOE, by March 31, 2001, to understand both the desire for and the extent of projectization in the national weapons program, and to define an envelop of appropriate future directions. On or prior to September 30, 2001, the VPLM will provide to DOE a written summary of agreed-to results of discussions with DOE and a plan for proceeding with at least two additional projects consistent with those agreed-to results.

5.4 For the National Ignition Facility Project, the Nuclear Materials Safeguards and Security Upgrades Project, and the Isotope Production Facility Project, the VPLM will ensure that project management performance is "good" or better in accordance with the Appendix F criteria;

5.5 For line item construction projects, the Directors for LANL/LLNL shall have developed an implementation plan for each project to meet the following expectations:

5.5.1 LANL and LLNL project personnel will be qualified commensurate with project, scope and dollar value.

5.5.1.1 Within 150 days after award of the subcontract, under 5.1 above, a formal program for qualifying and training personnel in key project positions, will be in place.

5.5.1.2 Within 180 days after award of the subcontract, under 5.1 above, using the formal program in 5.5.1.1 above, ensure that key project personnel are qualified and possess the skills, knowledge, and ability to perform their assignments before being assigned to a project.

5.5.1.3 Within 180 days after award of the subcontract, under 5.1 above, ensure that LANL and LLNL have training programs in place that enable appropriate personnel to become familiar with and use construction management tools and methods.

5.5.2 Multi-disciplinary teams will be assigned to integrate the areas of program, business, and operations to meet, as appropriate, program needs, safety, security, and operations are fully integrated from project inception through completion.

5.5.3 By June 30, 2001, UC will ensure that LANL and LLNL have requirements to establish a multidisciplinary team for each project that integrates 5.5.2 functions.

5.5.4 Principles of DOE Directive 413 and good business practices are incorporated in project activities.

5.6 For those projects included in this initiative, project management improvements will be measured by assessing projects quarterly as to cost, schedule, and technical scope compliance measured against the DOE-approved baseline.

6. **Evaluation Methodology**

UC performance against this Appendix will be assessed annually beginning in Fiscal Year 2001 and ending in Fiscal Year 2002. Evaluation of the degree to which the Contractor has met the above expectations is addressed below.

6.1 DOE assessment of UC performance against expectations for each initiative in this appendix will be based on quantity, quality, and timeliness in meeting the expectations. Each initiative will be assessed based on the expectations for the initiative. DOE's assessment of performance will consider information provided in UC's Appendix O annual self-assessment report under paragraph 6.4 below. Performance on each initiative will be assessed as either "pass" or "fail." DOE assessment will focus on determining if UC met the overall expectation for each initiative.

6.2 While DOE expects UC to meet all expectations under the initiatives in this Appendix, there may be instances where quantity, quality, and timeliness of products or actions may be less than required by the expectation. In such cases, assessment of UC performance, against overall initiative, will take into consideration the nature and impact of such instances and UC efforts to self-

identify, recover and maintain continued progress toward realizing meaningful program performance improvements.

6.3 Quarterly meetings between the VPLM and DOE will be conducted to review progress under the initiatives in Appendix O.

6.4 The VPLM will annually self-assess UC performance against Appendix O initiatives. The VPLM self-assessment will address, from a quantity, quality, timeliness perspective, the accomplishment of all expectations in each of the initiatives in Appendix O. The self-assessment will be documented in a report to be provided to DOE not later than December 1, 2001, for FY 2001, and December 2, 2002, for FY 2002. The self-assessment and report shall as a minimum:

6.4.1 Separately address each initiative;

6.4.2 Discuss internal and external events, factors, etc. which influenced performance;

6.4.3 Discuss recovery plans, where applicable, to resolve less than expected performance; and

6.4.4 Include an overall Appendix O performance summary.

6.5 Final assessment of UC performance against Appendix O will be determined by DOE and documented in a letter to UC from the Contracting Officer.

7. Change Control Process for Appendix O

7.1 Change control boards (CCB) for LANL and LLNL will be used to manage changes to Appendix O. CCBs will consist of DOE, UC, and LANL / LLNL representatives, and will be chaired by DOE.

7.2 Change requests may be initiated by any of the parties. Proposed changes due to matters outside the contractor's control (e.g., programmatic direction and changed priorities and security requirements) will be considered. Proposed changes resulting from matters within the direct control of the contractor should be the exception rather than the rule.

7.3 Change requests will be submitted in writing and should describe the change, the revised completion date, and a justification for the requested change; the implementing assumptions, and impacts if the change is not approved.

7.4 If the requested change is approved by the CCB Chair, DOE, UC, and the LANL and LLNL representatives will be notified in writing of the decision. Approved changes will be incorporated into this Appendix O by appropriate modification to the contract.

7.5 In the event that the CCB members do not agree on a proposed change, the issue will be elevated to the associated DOE Operations Office Manager for discussion with the LANL / LLNL Director and UC, as appropriate, prior to final decision by the DOE Operations Office Manager.

4. Critical Skills, Knowledge and Technical Capabilities Initiative										
Par#	Summary Requirement	UC Champion	FY01 2nd Qrtr	FY01 3RD Qrtr	FY01 4TH Qrtr	FY02 1st Qrtr	FY02 2nd Qrtr	FY02 3rd Qrtr	FY02 4thQrtr	Status
4	Critical Skills, Knowledge and Technical Capabilities (overall assessment)	VPLM								
4.1.1	Shall have finalized at LANL and LLNL consistent definitions for ensuring critical skills, knowledge, and technical capabilities are available.	UCOP	3/31/01							
4.1.2	Designate agreed-upon indicators to track progress in recruiting and retaining critical skills.	UCOP	3/31/01							
4.1.2	Designate agreed-upon indicators for training.	UCOP		6/30/01						
4.1.3	Complete assessment of current workforce and development of projections over five years to determine any gaps in critical skills at LANL and LLNL.	UCOP		6/30/01						
4.1.4	Complete consolidated LANL and LLNL plan for recruiting, training, and retaining critical skills to address projected gaps over next five years.	UCOP			9/30/01					
4.1.5	Conduct quarterly assessments of results using the agreed-upon indicators.	UCOP			Start 9/30/01	12/31/01	3/31/02	6/30/02	9/30/02	

Tab 19

The Secretary of Energy
Washington, DC 20585

April 29, 2003

MEMORANDUM FOR KYLE MC SLARROW
DEPUTY SECRETARY

LINTON F. BROOKS
ACTING ADMINISTRATOR
NATIONAL NUCLEAR SECURITY
ADMINISTRATION

FROM SPENCER ABRAHAM

SUBJECT: Los Alamos National Laboratory

I have reviewed your report of April 26, 2003, on the future relationship between the University of California and the Los Alamos National Laboratory. I agree with your conclusions and approve your recommendations.

In particular, I agree that the vigorous action the University is taking to correct the problems uncovered at Los Alamos, the significant value the University brings in the area of science, and the significant disruption to the mission of the Laboratory and the morale of the employees from early termination all make retaining the University through the end of the current contract in September 2005 the most appropriate course.

At the same time, the University bears responsibility for the systemic management failures that came to light in 2002. Given that responsibility and the widespread nature of the problems uncovered at Los Alamos, I intend to open the management of Los Alamos to full competition when the current contract expires. The University of California will, of course, be eligible to take part in that competition and I strongly agree that it should be urged to do so. I categorically reject the notion that competition is a repudiation of an incumbent contractor or that an incumbent contractor is inherently incapable of prevailing in a competition.

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In implementing your recommendations, I direct that any future competition include provisions to retain the existing Los Alamos workforce and to preserve the culture of scientific skepticism and peer review. I also agree with your recommendation to devise a mechanism to ensure that, if the University does not continue to operate Los Alamos following the 2005 competition, the pension benefits of current Los Alamos employees are fully protected. We must do everything we can to retain the vital national asset that the Los Alamos workforce represents.

The management of the nuclear weapons complex is my most important responsibility as Secretary of Energy. Under the University's stewardship, the science at Los Alamos has consistently been of the highest caliber. But it is important that business services be as good as the science. In approving your recommendations, it is my intention to make it clear that, in dealing with nuclear weapons and materials, only the highest standards of performance are acceptable.

The Administrator, National Nuclear Security Administration, is directed to carry out the recommendations of your report, taking into account the recommendations of the *Blue Ribbon Commission on Use of Competitive Procedures at the Department of Energy Laboratories* when available. The Administrator is further directed to report progress to the Deputy Secretary and me on a regular basis.

Department of Energy
Washington, DC 20585

April 26, 2003

Tab 20

MEMORANDUM FOR THE SECRETARY

FROM: Kyle McSlarrow
Deputy Secretary

Linton F. Brooks
Acting Administrator
National Nuclear Security Administration

SUBJECT: Los Alamos National Laboratory

On December 24, 2002, you concluded that events at Los Alamos National Laboratory reflected a "systemic management failure." Although this conclusion was primarily aimed at the management at Los Alamos itself, you also directed us to conduct an examination of the relationship between the University of California, as the responsible contractor, and the Los Alamos National Laboratory. We have also explored the relationship among the University of California, Los Alamos, and the National Nuclear Security Administration, Department of Energy.

The University and the National Nuclear Security Administration share responsibility for allowing these problems to develop. Prior to November 2002, the University's supervision of Los Alamos was ineffective in the area of business processes. The Federal oversight role was limited to a mechanistic review of performance as set forth in the contract when, in fact, a broader, more aggressive role was called for, particularly in light of the problems that developed at Los Alamos in the late 1990s.

Although the University was slow to take action to correct these failures, once it became engaged its actions were broad, forceful, and effective. It is difficult to see how any organization could have done more to deal with the problem than the University of California has since December 2002. Further, the University brings substantial value to the mission of Los Alamos, in science, recruiting, retention and fostering a culture of scientific skepticism and peer review. Therefore, given the extraordinary disruption that would flow from an immediate termination, we do not believe contract termination is in the best interests of the national security missions conducted at Los Alamos.

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We recommend:

- That the University of California continue to manage Los Alamos through the end of the current contract in September 2005.
- That you direct the NNSA Administrator to examine the utility of a contract modification institutionalizing some of the reforms made by the University over the last few months.
- That the Department announce its intent to compete the Los Alamos contract when it expires in September 2005.
- That we urge the University of California to compete for the contract in 2005, perhaps in association with another entity with business and project management experience.
- That you direct the NNSA Administrator to begin now to develop appropriate criteria for evaluating a future competition, taking into account the results of the Blue Ribbon Panel when available.
- That you further direct the NNSA Administrator to ensure that any future competition includes provisions for retaining the current Los Alamos workforce following September 2005.
- That you reject in advance any notion of split responsibility for Laboratory operations in which different contractors would perform the science and business operations functions.
- That you direct the NNSA Administrator to devise a mechanism to ensure that, if the University does not continue to operate Los Alamos following the 2005 competition, the pension benefits of all Los Alamos employees on the rolls as of September 30, 2005, or previously retired, are fully protected.
- That in dealing with future competitions, the Department explore ways in which to not only take into account truly outstanding performance but also to encourage contractors who might fall short during a contract term to strive to develop plans to correct problems so that they may compete and succeed.
- That you direct that all current and future contracts be reviewed in order to ensure that performance reviews capture the crosscutting information necessary to form a complete picture of performance.
- That you direct us to continue to monitor progress and subsequent information from either internal or external reviews in order to provide additional recommendations as facts and circumstances develop that warrant additional action.

Attachment
Complete report

Report by the Deputy Secretary of Energy and the Acting Administrator of the National Nuclear Security Administration on the future relationship between Los Alamos National Laboratory and the University of California

April 26, 2003

Introduction. In accordance with your direction in your letter of December 24, 2002, we have conducted an examination of the relationship between the University of California and the Los Alamos National Laboratory. Our examination included the following:

- Review of briefings to the University Regents, internal University of California reports, and similar documents between 2001 and the time of the relief of the Los Alamos National Laboratory Director in 2003.
- Review of all relevant Inspector General and Office of Independent Assessment and Oversight reports covering Los Alamos. We paid particular attention to those Inspector General reports covering the period since the problems at Los Alamos surfaced; a list is attached.
- Review of the Appendix O process and material (Appendix O was put in place during contract renewal in 2001 to correct perceived security problems; it is further discussed below).
- Review of testimony given by witnesses to the Subcommittee on Oversight and Investigations of the House Energy and Commerce Committee.
- Interviews with former Vice President for Laboratory Management, John McTague, former National Nuclear Security Administration (NNSA) Administrator, General John A. Gordon, and the Los Alamos Site Manager, Ralph Erickson.
- A daylong meeting with senior Los Alamos and University officials at Los Alamos, including a separate meeting with Federal site office management officials who have contract oversight responsibilities.
- A number of meetings with Senior Vice President for University Affairs Dr. Bruce Darling, who also serves as Interim Vice President for Laboratory Management, along with phone calls with Dr. Darling several times a week.
- A similar set of meetings and phone calls with Interim Laboratory Director, Dr. George "Pete" Nanos, and his senior staff.
- Conversations with various Regents of the University of California to review our conclusions.

This memorandum reports the results of our assessment and our recommendations for the future Los Alamos – University of California relationship.

Background. The University of California has operated the Los Alamos National Laboratory since 1943 under contract with the Department of Energy and its predecessors. The contract has routinely been extended without competition, most recently in January 2001 just 2 days before the Bush Administration took office. The

University also operates Lawrence Livermore National Laboratory under an identical, but separate contract, as well as the Lawrence Berkeley National Laboratory. The University has traditionally regarded its management of the laboratories as a public service to the nation. As one indication of this, the University has taken the position that its operation of the laboratories should be revenue neutral. That is, the University retains no fee for operating the laboratories and seeks to use no University of California funding to do so. The fee paid by the Government is returned to the laboratories for additional laboratory-directed research and development, after deducting the costs of that portion of the University Office of the President involved with overseeing the laboratories, paying expenses not otherwise reimbursable, and establishing a reserve to cover significant losses.

During the late 1990's two major concerns arose with Los Alamos National Laboratory, both involving security. The first was the case of Dr. Wen Ho Lee, a Los Alamos scientist who was ultimately convicted of mishandling classified material. This case raised extensive questions about the adequacy of security at the Laboratory. These concerns were reinforced in May 2000 when two hard drives containing Restricted Data could not be located for an extended period of time. The hard drives were ultimately located in a secure area within Los Alamos, but the Laboratory's inability to locate them, coming on top of the concern raised by the Wen Ho Lee case, further exacerbated security concerns.

Security concerns were among the reasons that Congress created the National Nuclear Security Administration. Despite this, no senior Los Alamos manager was terminated, reassigned, or demoted as a result of either of these incidents, although some formal reprimands were issued and two lower-level employees were reassigned.

Notwithstanding these security concerns, the University's contract to manage Los Alamos was extended non-competitively in January 2001. The current contract expires on September 30, 2005. In extending the contract, the Department imposed a number of requirements to correct the perceived problems with the management of Los Alamos. The new requirements were codified in a separate appendix to the Los Alamos contract called Appendix O. An identical appendix was included in the contract for Lawrence Livermore National Laboratory.

Appendix O committed the University to establish a position of Vice President for Laboratory Management and made the first incumbent of that position subject to departmental approval. It also committed the University to take a series of discrete steps to improve management. To enforce these commitments, Appendix O established a series of quarterly reviews between the Department, the University, Los Alamos, and Livermore. By its own terms, Appendix O expired on September 30, 2002. At that time, the NNSA, on behalf of the Department, concluded that all the requirements of the Appendix had been met. None of these requirements related to business services.

The precipitating incidents. Beginning in the summer of 2002, a series of problems with business services at Los Alamos came to light. The problems themselves originated

several months earlier, but were not widely recognized outside the Laboratory until the summer of 2002. These problems included:

- Questions concerning the effectiveness of controls over Government purchase cards (credit cards). Several laboratory employees (all now terminated except one, where disciplinary action is pending) used a laboratory-issued purchase card to make fraudulent purchases, including an attempt to purchase an automobile. Actual loss to the Government was only about $3000, but the massive audit conducted by the University in response to the issue revealed an additional $195,246 worth of purchases where documentation was inadequate or missing (some documentation was destroyed in the Cerro Grande fire) along with $125,000 in employee recognition awards that exceed the approved DOE threshold. Although no additional cases of fraud were uncovered, the University chose to reimburse the Government the entire sum of both questionable items for a total of about $320,000.

- A scheme by two employees (both now terminated) apparently used doctored purchase orders to order material for their personal use. The incident is still under investigation by the FBI. The amount of the apparent theft exceeded $300,000, but all but about $50,000 has been recovered. The University has reimbursed the Government for the loss.

- Questions concerning the adequacy of property controls. Newspaper revelations indicated that the laboratory was unable to account for $1.3 million worth of controlled property, including such pilferable items as computers. Although the most spectacular allegations (a missing fork lift, for example) were ultimately resolved, substantial amounts of property remained un-located.

- The Laboratory's action in firing two investigators within a few days of those same investigators raising concerns with the Inspector General. You, the University and the Inspector General have all stated that the Laboratory's action in firing the inspectors was 'incomprehensible." We share that assessment. While the Inspector General's investigation did not substantiate the allegation that Laboratory management deliberately hid criminal activity, this incident (in which the University played no role) demonstrated the degree to which the Laboratory's management was out of touch and ineffective.

Taken individually, it is possible that none of these incidents would call into question the adequacy of Laboratory management. Taken in the aggregate, however, they revealed systemic weaknesses in business practices at Los Alamos. These weaknesses were further confirmed by additional Inspector General audits in unrelated areas, including:

- An audit of firearms control that revealed significant weaknesses in procedures and accountability, although all firearms were ultimately located.

- An interim audit that determined that control over laptop computers was inadequate. Computers were not properly controlled, not adequately safeguarded against theft, and not always acquired in accordance with approved procedures. Computers that could not be located were written off without a formal inquiry and theft of laptop computers was not always reported to the appropriate office.

- An audit of the allowability of incurred costs that assessed that just over $14 million (about 0.3 percent out of the total of $5.4 billion examined) was improperly charged to the government under existing rules. The three areas of concern were travel and conference costs not adequately documented, provision of business meals, and an audit function evaluated as inadequate.[1]

The fact that there was not greater fraud and theft at Los Alamos is a tribute to the character of the vast majority of men and women working there, and not to the efficacy of the management systems in place. The actual loss to the Government could have been far greater and the business practices in place in 2002 would not have been able to identify and therefore prevent such a loss.

There is no evidence that the lax approach to business processes and business issues extended to science or security. The fear that such practices might spread, however, was—justifiably—a primary motivation for insisting that the University of California move promptly to correct the problems.

University of California response. The University was relatively slow to respond to the public allegations of business practices problems. University response was initially limited to providing assistance as requested by the Laboratory Director and did not include any action to ensure that the Laboratory Director was taking sufficient steps to examine the problem. The University engagement began in earnest in mid-November following the commissioning of an Inspector General investigation (requested by the Laboratory) and a series of increasingly embarrassing press accounts. University engagement increased still further following the intervention of the Secretary of Energy in November and December 2002.

Once the University became engaged its actions were broad, forceful, and effective. The University made significant personnel changes in Laboratory management, including accepting the resignation of the Laboratory Director, terminating the Principal Deputy Director, and transferring, downgrading, or terminating 16 other officials including the Chief Financial Officer, Laboratory Auditor, Security Office Director, and the heads of the procurement and purchase card programs. Given the size of the Los Alamos management team, these represent sweeping changes.

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[1] Although the Laboratory has generally agreed with all the findings of outside audits, it disagrees with this specific audit, contending that virtually all the costs should be allowable. Final determination of allowability will be made by the Contracting Officer in accordance with established DOE procedures.

The University mobilized substantial auditing resources to examine issues in depth. It used teams of extremely senior officials to investigate the issues. University senior officials (for example the University Auditor) essentially devoted full time to Los Alamos issues. The University permanently subordinated the Laboratory auditor to the University Auditor and temporarily subordinated all Laboratory business functions to the University Vice President for Financial Management. It directed a series of external reviews by Ernst and Young, PriceWaterhouseCoopers, and a team headed by a former DOE Inspector General. These were major reviews; the Ernst and Young review, for example, involved 20 people at the Laboratory. It is difficult to see how any organization could have done more to deal with the problem than the University of California did after about mid- December 2002. In particular, we have been impressed with the performance to date of both the Interim Vice President for Laboratory Management, Dr. Bruce Darling, and the Interim Los Alamos Director, Dr. George "Pete" Nanos.

The University's steps were not limited to Los Alamos. Although we did not investigate actions at other laboratories, the University appears to have been vigorous in taking the lessons from Los Alamos and applying them to the Lawrence Livermore and Lawrence Berkeley National Laboratories. The University required these Laboratories, as well as the University auditor, to examine their own internal procedures to ensure similar problems did not arise elsewhere. The University also used senior officials at these Laboratories to assist at Los Alamos.

The University and the new Laboratory leadership are viewing the necessary improvements broadly, not narrowly. Although the specific issues that came to light in late 2002 dealt with business practices, the University and the Interim Laboratory Director are taking the opportunity to look at Laboratory practices in all areas, including project, program, environmental, procurement, and nuclear facilities management. While the responsibility for implementing this broad approach belongs to the Interim Director, the University selected that Director and has been strongly supportive of examining all areas of Los Alamos management. This increases the chance that the changes being made will endure.

Finally, the University is in the process of putting in place a new governance model involving strengthened internal management and oversight and a strong external governing Board with members having strong backgrounds in industry, defense and science. The new Board will have some of the responsibilities of the Regents and will be able to hold both the University administration and Laboratory Management accountable. We are not yet able to evaluate the efficacy of this new governance model, but it is a clear indication that the University sees its task not simply as implementation of a temporary "get well" program but as a transformation of its model of oversight.

The cause of the problems. Our review suggests that there are multiple causes of the failure of business systems at Los Alamos:

- **Prior to November 2002, the University's supervision of Los Alamos was ineffective in the area of business processes.** University supervision was almost

entirely focused on other areas including science, security, environment, and project management. Briefings to the Regents never discussed business practices nor was the subject a focus of the former Vice President for Laboratory Management. Internal documentation relating to University oversight in this period is silent on business practices.

- **The Department of Energy and the NNSA's direct Federal oversight was narrowly focused on specific performance measures called out in the contract, rather than on overall effectiveness.** Appendix O was focused on issues other than business services. Most discussions were in areas of safety or of having Los Alamos and Livermore work together. NNSA's own supervision focused on areas such as safety and security, rather than business services and tended to assess performance within "stovepipes," while many of the actual problems were failures of appropriate connections between stovepipes. A division of responsibility between the Los Alamos Site Office and the former Albuquerque Operations Office further weakened NNSA oversight, with oversight of business practices coming almost exclusively from Albuquerque.[2]

- **In hindsight, warning signs may have been ignored.** Following the Dr. Wen Ho Lee and hard drive incidents, neither the Laboratory, the University, NNSA, nor the Department examined whether broader problems existed at Los Alamos. For years, there has been general acknowledgement of a "Los Alamos way" that was unique and that devalued business practices. Evaluations of Los Alamos in recent years always showed it slightly inferior in overall performance to the other two weapons laboratories, but never by enough to cause strong concern. Because there was no precipitating event, no one at any level acted on these indicators.

- **Cultural problems beyond the control of the University or the Department played an important role.** The Los Alamos culture exalted science and devalued business practices. Changing this culture will be the most difficult long-term challenge facing the Laboratory no matter who manages it.

The value of the University. In evaluating our options, it is important to recognize that the University brings substantial value to the mission of Los Alamos, in both obvious and less obvious ways. Stockpile Stewardship and other Los Alamos missions depend on attracting and retaining world-class scientific talent. The academic prestige of association with a world-class university is of clear benefit in both recruiting and retention.[3] In addition, there are formal agreements for scientific cooperation with four of the component campuses of the University of California. These areas of cooperative research directly advance the scientific mission of the Laboratory.

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[2] The NNSA reorganization implemented in December 2002 is designed to centralize responsibility to the Site Manager and thus avoid this fragmentary oversight in the future.
[3] At least some prospective employees at both Los Alamos and Livermore in recent months have stated that they were uninterested in affiliating with a national laboratory that is not connected with the University. We lack data on how extensive this belief is.

Finally, an important, little-noted benefit of the University is to foster a culture of scientific skepticism and peer review. This attitude, both within the Laboratory and between Los Alamos and Lawrence Livermore National Laboratories, is absolutely crucial to the success of the Stockpile Stewardship Program and to the ability to certify the stockpile. A senior laboratory official at Los Alamos has told us, for example, that the culture of peer review is the only thing that allowed the successful dual revalidation of the W76 warhead conducted a few years ago.

In addition to the actual value that the University brings, an important consideration is the widespread perception among Laboratory employees at both Los Alamos and Lawrence Livermore National Laboratories that the University association is critical to the mission of the Laboratory. Examples of this perception abound and have been a constant theme of our discussions with laboratory employees. We received petitions from 2,500 Los Alamos employees and 3,000 Livermore employees stressing the value of the University association. We received a similar, separate communication from the Los Alamos Fellows, those senior scientists at Los Alamos not part of management. We have reviewed public statements by distinguished figures such as Edward Teller, arguably the most famous living nuclear weapons designer. Even if we disagreed with these assertions of the University's value (which we do not), we need to take account of the widespread perception among the people who actually carry out the important national security mission of the Laboratory that the University association is critical to that mission.

At the same time, the national security missions carried out at Los Alamos require the total confidence of Congress and the public as well as of Los Alamos employees. An erosion of that public trust undermines not only the University but our national security as well. Our recommendations are, therefore, premised on a view that ensuring public confidence is merited is crucial for our country, the University and Los Alamos.

Problems with immediate termination. We are aware of forceful calls that the University contract with Los Alamos be terminated immediately. While the University can be faulted for having allowed the problems to develop, we believe that immediate termination would undermine the national security mission at the lab without measurably addressing the problems that Los Alamos faces today. Further, the Department, and since its creation, the NNSA, share responsibility for lax oversight of business practices. In our view, immediate termination is undesirable for several reasons. Such a step would be highly disruptive to the things that are going well at Los Alamos, especially science. It would also hamper the implementation of the internal reforms the University has put in place. Immediate termination would lose the very real benefits of the University association and, because of this, would be devastating to morale.[4] Finally, any decision for immediate termination would almost certainly have a counterproductive effect on other contractors facing similar problems in the future. If this vigorous get well program

[4] The prospect of termination may already have had an adverse effect. As of April 8, 266 Los Alamos employees (68 with critical skills) have applied for retirement. In contrast, there were only 177 retirements during all of 2002. Retirement requests at Livermore are currently running at roughly twice the 2002 rate.

put in place by the University leads only to termination, no future contractor will have any incentive to put this much of an effort into remediation of major problems.

Recommendations. Based on the above, we recommend:

- **That the University of California continue to manage Los Alamos through the end of the current contract in September 2005.** The vigorous action the University is taking to correct the problems uncovered at Los Alamos, the significant value the University brings in the area of science, and the significant disruption to the mission of the Laboratory and the morale of the employees from early termination all make retaining the University through the end of the current contract the most appropriate course. Termination of the contract would not improve the management of Los Alamos in the near-term; the University appears to be fully engaged in an effective and comprehensive program.

- **That you direct the NNSA Administrator to examine the utility of a contract modification institutionalizing some of the reforms made by the University.** If the University continues to operate Los Alamos through 2005, it will be important to ensure that the current momentum for improvement continues. Some institutionalization of the reforms may assist in this area. We believe that discussions between Los Alamos, the NNSA, Los Alamos Site Office, and the University are necessary before determining exactly what changes require codification.

- **That the Department announce its intent to compete the Los Alamos contract when it expires in September 2005.** Given the Department's and the Administration's strong preference for competition, and the widespread nature of the problems uncovered at Los Alamos, it is difficult to argue for any other course of action. Because the question of competition for National Laboratories is the subject of your recently chartered Blue Ribbon Panel, the mechanics of implementing this decision should take into account the results of the Panel's report.[5]

- **That we urge the University of California to compete for the contract in 2005, perhaps in association with another entity with business and project management experience.** The University has brought immense benefits to the Laboratory and the country over the past 60 years. It is important to note that a decision to compete is not a repudiation of the University, but simply a recognition that the University's performance in the area of business management did not rise to the exceptionally high standards required to override the presumption of competition in Department orders.

[5] The Blue Ribbon Panel, formally the "Blue Ribbon Commission on Use of Competitive Procedures at the Department of Energy Laboratories," was established on January 3, 2003 as a subsidiary body to the Secretary of Energy Advisory Board. It is tasked with examining the Department's policy on competition for management of national laboratories and is expected to make its report by July 2003.

- **That you direct the NNSA Administrator to begin now to develop appropriate criteria for evaluating a future competition, taking into account the results of the Blue Ribbon Panel when available.** The results of the competition in 2005 should preserve the many advantages offered by a world-class academic institution while also ensuring continuation of the reforms now being initiated and strengthening business functions. Devising the proper criteria to achieve these results while avoiding unforeseen consequences will be complicated and should begin at once.

- **That you further direct the NNSA Administrator to ensure that any future competition includes provisions for retaining the current Los Alamos workforce following September 2005.** The staff of Los Alamos is a national treasure that must be preserved. It is important to establish now that a competition in 2005 will not result in a changed workforce. Otherwise we will face both a serious morale problem and the prospects of a significant exodus of staff in the mistaken belief that their jobs are at risk.

- **That you reject in advance any notion of split responsibility for Laboratory operations in which different contractors would perform the science and business operations functions.** Some have argued for having the science and business portions of the Laboratory supervised by different contractors. We urge you to reject this approach. While the University might well benefit from a partnership with industry, the Laboratory Director should not report to two entities. Further, the Interim Laboratory Director believes that a major part of the problem at Los Alamos is fragmentation between the science and business communities within the Laboratory. A dual reporting approach would make this problem worse, not better.

- **That you direct the NNSA Administrator to devise a mechanism to ensure that, if the University does not continue to operate Los Alamos following the 2005 competition, that the pension benefits of all Los Alamos employees on the rolls as of September 30, 2005, or previously retired, are fully protected.** While the Los Alamos employees who have contacted us are generally concerned about the impact on science and mission of losing the association with the University of California, many are also concerned with their benefits under the University's pension system. It is important to reassure employees, that, regardless of the outcome of the future competition, those benefits will be protected. Otherwise, we could face a significant challenge to morale and, potentially, a devastating exodus of the most experienced employees.

- That you direct us to continue to monitor progress and subsequent **information from either internal or external reviews in order to provide additional recommendations as facts and circumstances develop that warrant additional action.**

Lawrence Livermore National Laboratory. The University of California also manages the Lawrence Livermore National Laboratory under a separate, but essentially identical, contract as the contract with Los Alamos. Our review did not explicitly cover Lawrence Livermore National Laboratory and we believe that there is no need to make even a preliminary decision on whether to extend or compete the Lawrence Livermore contract when it expires in September 2005. Such a decision can clearly be deferred and can await, among other things, the results of the recently established Blue Ribbon Panel. There is no legal reason why the Department could not choose to compete the Los Alamos contract and extend the Lawrence Livermore contract, and the Secretary should continue to hold that option open.

Additional issues. An important aspect of the problems of Los Alamos has been the potential loss of Congressional and public trust resulting from the revelations of the serious management deficiencies at the Laboratory. This problem was exacerbated by two factors:

- The current Government rules on property accountability significantly overstate the value of the unaccounted for property. Government rules require that property be carried at its original cost. Thus, for example, an obsolete computer that would not fetch $50 at a yard sale is carried at its original purchase value of several thousand dollars. A 35 year-old forklift, which any business would have written off as an asset through depreciation years ago, is carried at its original cost. As a result, the apparent dollar value of un-located property overstated the actual magnitude of the problem and diverted the attention from the more systemic problems. The Secretary should direct that the Department seek authority to revise government property accounting rules to be more consistent with those used in the private sector.

- The grading system at Los Alamos, adapted from other Government systems, is based on a scale of Outstanding, Excellent, Good, Satisfactory, and Unsatisfactory. This scale suffers from what might be called "rhetorical grade inflation." Thus, a mark of "Excellent" conveys a sense of exceptional performance, when, in fact, it is used for routine performance. The Secretary should direct that in future contracts the NNSA Administrator use a descriptive system that will more accurately reflect the intent of a particular grade.

The grading problem is simply one example of a broader set of concerns raised over the issues relating to competition of Federally Funded Research and Development Centers such as Los Alamos. Although it was not specifically established with any one facility in mind, the Blue Ribbon Panel discussed above was created in part because it became clear that any decision to compete was increasingly perceived as a repudiation of an incumbent contractor. This is a view that has undoubtedly grown over many decades, but it has had unfortunate consequences. Incumbent contractors view their choices as being either a series of contract extensions, or loss of the contract. As a result, incumbent contractors often assert that they will be unwilling to participate in a competition.[6] We recommend

[6] The wide spread perception that no incumbent DOE contractor has ever prevailed in a competition is one manifestation of this attitude. The perception is wrong. There are at least four

that the Department explore ways in which to not only take into account truly outstanding performance but also to encourage contractors who might fall short during a contract term to strive to develop plans to correct problems so that they may compete and succeed.

An equally important concern is the overall "stove piped" nature of the NNSA evaluation system in place at Los Alamos (and elsewhere). The contract entered into in January 2001 established a performance review process that considered individual areas in isolation. By failing to consider relationships between different processes, it failed to detect overall systemic problems and thus failed to capture the type of management failures that we are addressing in this memorandum. As a result, the performance review process assigned an "Excellent" rating to the Laboratory management almost simultaneously with the Secretary of Energy stating publicly that there was a "systemic management failure." We therefore recommend that all current and future contracts be reviewed in order to ensure that performance reviews capture the crosscutting information necessary to form a complete picture of performance.[7]

Concluding observation. We believe it is important to recognize that the overwhelming majority of Los Alamos employees—in all areas, including business services—are honest, dedicated, competent, and hard working. Ultimately, the value of the Laboratory lies not in expensive technology, but in people. The failures at Los Alamos are real, but they are the failures of a few. As we implement changes, we urge that all levels of the Department emphasize this fact at every opportunity.

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instances where incumbents have retained contracts following competition, including one Federally Funded Research and Development Center (National Renewable Energy Laboratory). Still, the perception exists and needs to be dispelled.

[7] Recent changes in NNSA evaluation procedures are designed to ensure a focus on broad management issues. It is important that these changes be pursued vigorously.

Inspector General Reports consulted

Completed reports

Report Number	*Title*	*Date Issued*
OAS-L-03-06	Recruitment and Retention at the Los Alamos and Lawrence Livermore National Laboratories	11/27/2002
S02IS013	Inspection of 2001 Safeguards and Security Survey of Los Alamos National Laboratory	01/12/2003
IG-0584	Special Inquiry: Operations at Los Alamos National Laboratory	01/28/2003
IG-0587	Inspection of Firearms Internal Controls at Los Alamos National Laboratory	02/21/2003
IG-0591	Allegations Concerning the Reporting of a Radiological Incident at LANL	03/20/2003
IG-0596	University of California's Costs Claimed And Related Internal Controls for Operation of Los Alamos National Laboratory	04/16/2003
IG-0597	Inspection of Internal Controls Over Personal Computers at Los Alamos National Laboratory (Interim Report)	04/24/2003

Reports not yet made public but where we have reviewed draft findings

The Dual Axis Radiographic Hydrodynamic Test Facility (Draft Report)

Ongoing reports to which we have not yet had access[8]

LANL's Nuclear Materials Stabilization Program

Various Law Enforcement Sensitive reports on criminal activity

[8] We have no reason to believe that any of the ongoing investigations and audits would change the recommendations of this report.

Office of the President News Room

FOR IMMEDIATE RELEASE
Wednesday, April 30, 2003

Contact: Michael Reese
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Below is a statement from UC President Richard C. Atkinson regarding the decision announced today (Apr. 30) by U.S. Secretary of Energy Spencer Abraham concerning UC's management contract for Los Alamos National Laboratory.

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Tab 21

Richard C. Atkinson
President
University of California

The University of California appreciates the strong statement of support issued today by Secretary of Energy Spencer Abraham. We are grateful that the secretary recognizes the "vigorous action" the University has taken to remedy the business problems at Los Alamos National Laboratory, the "significant value" the University brings to the science, and the "significant disruption" that termination would have caused to the laboratory's mission and to the morale of employees involved in protecting the nation's security.

I also appreciate that the secretary is urging the University of California to compete. My instinct continues to be to compete — and to compete hard — in order to continue the University's stewardship of excellence in science and innovation. We believe, with every fiber of our institutional being, that continued UC management is in the absolute best interests of the nation's security.

However, there is another question at stake — and that is whether the University *should* compete. The answer to that is less clear, and it goes to the fundamental nature of these particular government laboratories and the historical reasons why the University was asked to manage them as a public service. The ultimate decision whether to compete will have to be made by the UC Board of Regents. In making their decision, they will have to grapple with a number of critical issues, including the terms and conditions, the implications that a competition will have on the scientific work and integrity at the laboratory, and whether it would result in any compromise of academic standards. I expect these issues to be addressed in the coming months.

The final paragraph of the report submitted to the secretary includes a very important observation that is worth repeating: "The failures of Los Alamos are real, but they are the failures of a few." We have always believed that the overwhelming number of Los Alamos employees are honest, hardworking, and dedicated to the nation's security. The University of California and Los Alamos continue to work aggressively to ensure that these isolated failures do not deter from the laboratory's excellent scientific contributions. The University and laboratory remain focused on our immediate responsibilities to continue to ensure the safety and reliability of America's nuclear weapons and to respond to the national security and scientific needs of our nation. UC is extremely proud of the contributions to the country and the world that have resulted from our 60 years of managing Los Alamos National Laboratory in partnership with the Department of Energy.

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Statement from George P. (Pete) Nanos, Interim Director, Los Alamos National Laboratory

Tab 22

Contact: Linn Tytler, ltytler@lanl.gov, (505) 667-7000 (03-061)

LOS ALAMOS, N.M., April 30, 2003 -- The following comments from George P. (Pete) Nanos, interim director, Los Alamos National Laboratory, are provided in response to the statement issued by Department of Energy Secretary Abraham concerning the future management contract process for Los Alamos National Laboratory:

"As I told laboratory employees earlier this morning, every employee in this laboratory who has worked extremely hard over the past four months should take heart. Today's announcement by the Department of Energy recognizes the significant improvements that have been made because it allows the University of California to continue in its role as laboratory manager through the end of the current contract. In addition, the Department is urging UC to compete for contract renewal, thus showing they recognize the value of UC to this laboratory's mission.

"We now have an opportunity to build on our successes. We will continue to show the world that we are the premier nuclear weapons laboratory, and that our business processes, program management and other administrative efforts will be the equal of our scientific excellence. We will ensure that our most important job — that of ensuring the capability of the nation's nuclear stockpile — is done to the very best of our collective abilities. And we will continue on the path toward the many important process improvements we have undertaken.

"I am deeply grateful for the tremendous commitment to this laboratory and its mission for

Recent News
- Statement from George P. (Pete) Nanos, Interim Director, Los Alamos National Laboratory
- Homeland security lecture series at Fuller Lodge
- Laboratory's Mee named U.S. Minority Small Business Advocate of Year
- Science Circus April 29 at Laboratory's Bradbury Science Museum
- Los Alamos employees' scholarship fund awards 47 scholarships
- Taylor, Farrar garner Los Alamos leadership prize
- Albuquerque Academy team takes top prize
- Los Alamos restores U.S. ability to make nuclear weapons

the nation's security shown by every laboratory employee. Together, we will continue to fulfill that mission."

Los Alamos National Laboratory is operated by the University of California for the National Nuclear Security Administration (NNSA) of the U.S. Department of Energy and works in partnership with NNSA's Sandia and Lawrence Livermore national laboratories to support NNSA in its mission.

► University of California, Los Alamos announce engineering education initiative

► Public meeting "Water, drought and New Mexico" to focus on how Los Alamos science can aid water policy

Los Alamos enhances global security by ensuring the safety and reliability of the U.S. nuclear stockpile, developing technologies to reduce threats from weapons of mass destruction, and solving problems related to energy, environment, infrastructure, health and national security concerns.

Additional news releases related to Organization/Operations

Additional news releases from the Directors Office(DIR)

Los Alamos

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