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Domestic Policy Subcommittee of the  
Oversight and Government Reform Committee

on

"DoD's experience with Circular A-76 competitions and  
the specific context of the A-76 competition which  
privatized Military Retired and Annuitant Pay functions"

Mr. Chairman and distinguished members of this committee, thank you for the opportunity to appear before you this morning and address our experience with Office of Management and Budget (OMB) Circular No. A-76 competitions and more specifically, our work relating to the competition that privatized Military and Retired and Annuitant Pay functions. This testimony will cover previous audits by the Department of Defense Office of the Inspector General (DoD IG) and analysis by the Center for Naval Analysis (CNA) for the Defense Finance and Accounting Service (DFAS) related to the DFAS Military Retired and Annuitant Pay Functions and associated DoD IG work with A-76 competitions.

### DFAS Military Retired and Annuitant Pay Functions

*Audit of the “Public/Private Competition for the Defense Finance and Accounting Service Military Retired and Annuitant Pay Functions,” March 21, 2003 (D-2003-056).*

In response to a congressional request, we performed an audit of the public/private competition for the Military Retired and Annuitant Pay Functions from December 2001 through November 2002. The audit reviewed selected portions of the OMB Circular A-76 process and the decision to award the military retired and annuitant pay functions to a private contractor, and to assess related performance risks.

The audit found that although the competition process was completed and the 10-year contract was awarded:

- a calculation error of \$31.8 million was identified for the in-house estimate;
- DFAS overhead costs of \$33.7 million used for the in-house estimate, based on the OMB-directed 12-percent cost factor, were not reduced after the functions were awarded to the contractor; and
- the contract had inadequate standards to measure performance (7 out of 10 were inadequate).

DFAS had awarded the Military Retired and Annuitant Pay Functions to the contractor based on a savings of only \$1.9 million (\$366.6 million for in-house performance versus \$364.7 million for contractor performance that included the \$10 million minimum conversion differential).

We found several other issues that also raised concerns. The cost comparison showed that the Government didn't realize any cost savings until year 9 of contract performance, and that the Government Most Efficient Organization (ME0) had proposed 503 full-time equivalents (FTEs) while the contractor staffing profile went from 451 FTEs in contract year 1 to 250 FTEs in contract year 10.

The audit showed that the two customer service performance requirements (call center and resolve pay problems) were not measurable or identified as critical performance requirements in the contract. For the call center, the established performance standard was "80 percent of the customer calls responded to within 20 seconds." DFAS representatives stated they did not have the capability to measure the requirement and chose to measure calls based on whether they were answered. Although the acceptable quality level was 80 percent for the life of the contract, the contractor had received deficiency reports in February, March, and April 2002, for achieving quality levels of only 33.6 percent, 58.3 percent, and 79.2 percent, respectively. The audit recommended that DFAS conduct a benchmarking study to identify appropriate customer service performance standards such as "the ability of a call center to answer callers' questions on the first call with no transfers and no call-backs," and the Director DFAS concurred and stated DFAS would develop the solicitation requirement for a benchmarking study for the call management area by March 31, 2003.

In addition, the general scope of the contract to provide resources to staff the military retired and annuitant pay functions included 120,000 hours or about 68 FTEs at an annual cost ranging from \$6.4 million in year 1 to \$8.8 million in year 10 totaling about \$75.2 million (676 FTEs) for time and materials work. This time and materials work was related to Automated Information System changes that the Government may

request based on new legislation, policy, new or existing requirements, system performance issues, or enhancements.

*The Center for Naval Analysis (CNA) “Analysis of DFAS Military Retired and Annuitant Pay Sourcing Options,” September 2003 (CRM D0008864.A2/Final).* In response to our Report D-2003-056, DFAS contracted with CNA to examine the choices available to address the error found in the A-76 competition of retired and annuitant pay functions. The CNA identified four options, Option 1 – Retain the existing contract; Option 2 – Return to government performance without additional competition; Option – 3 Conduct a new public competition; and Option 4 – Conduct a private-private competition.

The CNA recommended Option 1 – Retain the existing contract. As part of their analysis CNA had determined that DFAS had overestimated “the level of work that is likely to occur” for one-time systems changes in both the contract and MEO. “As a result of this adjustment, the existing contract is estimated to be \$42 million less expensive than the MEO once it has been revised for systems work.” CNA determined that the contractor’s costs for systems changes were included in the time and materials portion of the contract and considered variable while a large portion of the MEO’s costs associated with systems changes were considered “a permanent part of the organization, not a flexible unit whose staffing would fluctuate with changes in demand.” CNA determined that the contractor’s actual costs for systems changes during the year 1 were only \$1.5 million, or 23.8 percent of the costs of the time and materials portion of the contract or about \$5 million less than expected for the first year.

The CNA also determined that current contractor performance was satisfactory using three measures. “All three measures indicate that overall performance is satisfactory and at least as good as the government’s prior to competition.”

*DFAS Decision to Retain Contractor.* On October 20, 2003, the Director, DFAS notified Congressman Kucinich that DFAS “will be retaining the contract and will

evaluate it each year to ensure it continues to provide best value and acceptable performance.”

*Audit of “Analysis of the Defense Finance and Accounting Service Military Retired and Annuitant Pay Sourcing Options,” June 16, 2004 (D-2004-088).* In response to a request from Congressman Kucinich to review the \$42 million cost savings associated with retaining the existing contract, we conducted an audit of the retired and annuitant pay sourcing options. We did not agree that the contract was \$42 million less expensive than the MEO once it has been revised for systems work. CNA chose to reduce only a portion of the MEO’s cost estimate for system work while reducing the contractor’s cost estimate for the full amount extrapolated from only two years of actual cost experience. We believed that since the amount of system work to be performed in the remaining years was unknown, the reduction in systems work should be applied to all portions of the in-house cost estimate to fairly compare the contractor proposal and the MEO offer. Also, DFAS was still only able to evaluate the contractor on 4 of 10 contractual performance requirements; therefore, we were unable to come to a conclusion on the performance of the contractor.

*Current Status for the DFAS Retired and Annuitant Pay Functions (July 2, 2008).* The DoD commercial activities management information system used to track A-76 competition shows a baseline cost for the retired and annuitant pay functions of \$386.3 million based off of the original MEO bid and an estimated savings from the competition of \$31.6 million. The system also shows the following costs associated with contractor performance (\$ million).

<u>Year (CY)</u>	<u>Contract Bid Cost</u>	<u>Contract Actual Cost</u>	<u>Difference</u>
1 (2002)	\$ 39.3	\$ 34.1	\$ (5.2)
2 (2003)	37.2	31.2	(6.0)
3 (2004)	34.5	31.3	(3.2)

4 (2005)	33.2	33.3	0.1
5 (2006)	33.3	30.5	(2.8)
6 (2007)	33.4	35.4	2.0
Total	\$210.9	\$195.8	\$ (15.1)

We also were unable to find any contractor assessment reports in the DoD Past Performance Information Retrieval System (PPIRS) related to the contract for the retired and annuitant pay functions.

Recently Completed A-76 Project

*Audit of “Performance-Based Service Contract for Environmental Services at the Navy Public Works Center, San Diego, California,” April 3, 2007 (D-2007-079).* In response to a congressional request, we reviewed selected portions of the OMB Circular No. A-76 process and the decision to award the environment services function at the Navy Public Works Center, San Diego, California, to a private contractor. The contract awarded in January 2005 was a performance-based, combination firm-fixed-price and indefinite-delivery-indefinite quantity contract valued at \$67.3 million over 5 years.

Our audit report showed that the Navy Public Works Center was not effectively managing the performance-based environmental services contract, was unable to adequately assess contractor performance on all performance requirements, and could not relate workload to payments because actual workload was significantly less than established in the performance work statement but the fixed payment remained the same.

The Public Works Center also was not following sound procurement practices for performance-based indefinite-delivery-indefinite-quantity work valued at \$5.8 million annually. For example,

- there were no means to hold the contractor accountable for measurable performance outcomes on the firm-fixed-price performance-based task orders, and
- the contractor was using higher labor rates on the task orders than those negotiated in the competitive sourced contract. We calculated that during the base and first option period, the Navy paid about \$1.4 million more than negotiated by using higher labor rates and that over the next three option periods the Navy would pay about \$6.6 million more if the Navy continued to accept the contractor's higher labor rates.

Further, the Navy in-house team would have won the competitively sourced environmental services function by about \$7.1 million if the contractor had proposed the higher labor rates.

In response to our report, the Navy took aggressive action. The Navy added additional staff to administer the contract, deleted performance standards that were obsolete or repetitious, and reduced non-critical performance standards from 78 to 38. Contractor performance reported in the Contractor Performance Assessment Reporting System has improved from marginal in FY 2005 to satisfactory in FY 2007. The Navy was able to negotiate a reduced contract price for laboratory services in-line with the workload level and decreased the fixed-price lab costs by about \$3.7 million. The Navy also reached a settlement with the contractor associated with using the higher labor rates for indefinite-delivery-indefinite-quantity work where the contractor agreed to pay \$553,285 for costs associated with the overpayment issues. Finally, the Navy is beginning to develop its acquisition strategy for the follow-on contract and during a recent follow-up meeting Navy representatives expressed concern about potential cost increases on the follow-on contract.

## Ongoing Projects Related to National Defense Authorization Act for FY 2008

*Requirement to Review In-sourcing Guidelines in Section 324 (Project No. D2008-D000CH-0165).* Section 324 of the FY 2008 National Defense Authorization Act requires the Under Secretary of Defense for Personnel and Readiness (USD(P&R)) to develop guidelines and procedures to ensure that consideration is given to using DoD civilian employees to perform new functions or functions that are performed by contractors and required the DoD IG to review the guidelines on in-sourcing. The guidelines should provide that special consideration be given to using DoD civilian employees to perform any new requirement or function that is performed by a contractor and:

- has been performed by DoD civilian employees at any time during the previous 10 years,
- is a function closely associated with the performance of an inherently governmental function,
- has been performed pursuant to a contract awarded on a non-competitive basis, or
- has been performed poorly because of excessive costs or inferior quality.

On April 4, 2008, the Deputy Secretary of Defense implemented Section 324 and issued guidelines and procedures on in-sourcing new and contracted out functions. He stated that the Department should give special consideration to using DoD civilian employees to perform certain categories of functions and to use the inventory of contractors (required by section 807 of the FY 2008 National Defense Authorization Act) to identify those functions. DoD Components can use civilian employees to perform new functions or functions that are performed by a contractor if an economic analysis performed by the activity shows that DoD civilian employees are the low cost provider, or the DoD Component has determined that the function under review is inherently governmental or exempt from private sector performance.



As required by Section 324, we plan to issue a report on the guidelines by July 25, 2008.

*Requirement to Review OMB Influence on DoD A-76 Competition Required by Section 325 (Project No. D2008-D000CH-0166).* Section 325 of the FY 2008 National Defense Authorization Act prohibits the Office of Management and Budget (OMB) from directing or requiring the Secretary of Defense or Secretary of a Military Department to prepare for, undertake, continue, or complete a public-private competition of a DoD function to contractor performance under OMB Circular No. A-76 and required the DoD IG to review OMB influence on A-76 competitions.

As required by Section 325, we issued Report No. D-2008-088, “DoD IG Interim Report to Congress on Section 325 of the National Defense Authorization Act for Fiscal Year 2008, Office of Management and Budget Influence Over DoD Public-Private Competitions,” on April 22, 2008. We plan to issue a final report by December 31, 2008.

On March 20, 2008, the Deputy Under Secretary of Defense for Installations and Environment issued competitive sourcing guidance. He stated that restrictions in the FY 2008 Defense Authorization Act limit, but do not entirely prohibit, the use of the competitive sourcing tool. He stated that DoD independently determines its competitive sourcing program during the normal program and budget review process, and DoD Components are expected to execute these plans. He also encouraged DoD Components to continue to use competitive sourcing to the maximum extent possible to determine the most cost-effective business methods to perform commercial activities.

Competitive sourcing is the second initiative on the President’s Management Agenda. In FY 2002, OMB directed DoD to complete public-private competitions on 50 percent of the DoD Federal Activities Inventory Reform (FAIR) Act inventory (226,404 positions) by FY 2005. OMB informed DoD that DoD’s FAIR inventory was more than half of the Government-wide inventory, and therefore, the DoD share was “critical to the overall success (or failure)” of the competitive sourcing initiative. OMB

rates DoD's competitive sourcing efforts using the Executive Management Branch Scorecard. As of the first quarter FY 2008, OMB rated DoD's competitive sourcing initiative as "yellow" for mixed results, meaning that DoD needed to make adjustments to the program in order to achieve objectives on a timely basis.

The fact that competitive sourcing is a President's Management Agenda item creates pressure on DoD to complete public-private competitions. In addition, Components are expected to execute the President's budget. However, DoD was not close to completing public-private competitions of the 226,404 positions by FY 2005, as OMB originally directed. Additionally, the estimated time frame for completing DoD competitive sourcing efforts continues to move out each year. As of the draft FY 2009 budget estimate, the efforts should be completed by FY 2013.

We held initial meetings to discuss OMB or DoD pressure to conduct competitive sourcing efforts. We received a variety of responses and requested further information for our final report to determine the extent of pressure to complete public-private competitions. The Competitive Sourcing Officials from the Office of the Secretary of Defense, Office of Housing and Competitive Sourcing; the Office of the Assistant Secretary of the Navy for Installations and Environment and Office of the Chief of Naval Operations; and the Air Force Directorate of Manpower, Organization, and Resources stated that they do not feel pressure to conduct public-private competitions. However, the Office of the Assistant Secretary of the Army for Installations and Environment and Office of the Assistant Chief of Staff for Installation Management stated that the Army has had difficulties with implementing the competitive sourcing program and feels extreme pressure from OSD to conduct public-private competitions.

### Closing

Thank you for the opportunity to appear before the committee today to address our work relating to OMB Circular A-76 competitions.

Although we currently have a strategic audit plan to address key competitive sourcing issues in DoD to assess and evaluate the effectiveness and efficiency of the DoD competitive sourcing program and initiatives, other high priority audits frequently require us to use our limited resources elsewhere which prevents us from performing more audit work in the competitive sourcing area.