

September 2006

DEFENSE INFRASTRUCTURE

Actions Taken to Improve the Management of Utility Privatization, but Some Concerns Remain





Highlights of [GAO-06-914](#), a report to congressional committees

Why GAO Did This Study

Department of Defense (DOD) installations have about 2,600 electric, water, wastewater, and natural gas utility systems valued at about \$50 billion. In 1997, DOD decided that privatization was the preferred method for improving utility systems, and Congress approved legislative authority for privatizing DOD's utility systems with Public Law No. 105-85. DOD estimates that some utility privatization contracts will cost over \$100 million. In a May 2005 report, GAO identified several management weaknesses in DOD's implementation of the program.

The Fiscal Year 2006 National Defense Authorization Act required GAO to evaluate and report on changes to the utility privatization program since May 2005.

Accordingly, this report updates the status of the program and discusses the effect of DOD's changes on the concerns noted last year. To conduct this review, GAO summarized program status and costs, assessed DOD's changes to program guidance and in other areas, and reviewed the services' implementation of the changes.

What GAO Recommends

GAO is making seven recommendations to improve the management of the utility privatization program. DOD generally agreed with six and indicated disagreement with one recommendation. Still, GAO believes this recommendation continues to have merit.

www.gao.gov/cgi-bin/getrpt?GAO-06-914.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barry W. Holman at (202) 512-5581 or holmanb@gao.gov.

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Actions Taken to Improve the Management of Utility Privatization, but Some Concerns Remain

What GAO Found

DOD's progress in implementing the utility privatization program has been slower than expected and the estimated completion date has slipped from the department's target of September 2005 to September 2011. DOD attributed the delays to the complexity of the program and to the services' decision to suspend and reassess the management of the program between October 2005 and March 2006. Since May 2005, the services privatized 14 utility systems under the legislative authority for the program, bringing the total number of awarded projects to 81. However, the services have awarded no projects since DOD issued new program guidance in November 2005. Meanwhile, the services' total estimated program implementation costs through fiscal year 2006 have increased to \$285 million, and more funds will be required before the program is completed in 2011.

Since GAO's May 2005 report, DOD has issued new guidance and required changes in procedures. If fully implemented, these changes should result in more reliable economic analyses, improved budgetary consideration of increased utility costs, enhanced oversight of privatization contracts, and reduced instances where contractors recover more than the fair market value paid for system conveyances. However, a number of concerns from the May 2005 report remain. For example:

- Although DOD made changes to improve the reliability of project economic analyses by requiring independent reviews, GAO reviewed 10 economic analyses and found reliability issues that had not been identified during the independent reviews.
- DOD directed the services to adequately consider in their budgets the increased costs resulting from utility privatization. However, questions remain over the availability of the funds needed to complete the program because the services estimate that they will need \$453 million more than is currently programmed to pay costs associated with remaining utility systems that might be privatized.
- Although DOD made many changes to improve contract administration and oversight, it may take some time to fully implement the changes as new privatization contracts are awarded. GAO's review of five projects awarded prior to DOD's changes found continuing questions about the adequacy of resources provided to perform oversight and the lack of required plans for overseeing contractor performance.
- It is too early in the program's implementation to know to what extent DOD's efforts will be successful in ensuring equitable periodic contract price adjustments and limiting long-term cost growth in the utility privatization program. However, GAO found indications that cost growth may become a challenge.
- DOD did not change its guidance to require that project economic analyses depict the actual expected costs of continued government ownership if the systems are not privatized. Therefore, DOD's reported \$650 million in long-term cost reductions is unrealistic.

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United States Government Accountability Office
Washington, DC 20548

September 5, 2006

Congressional Committees

Department of Defense (DOD) installations have about 2,600 electric, water, wastewater, and natural gas utility systems valued at about \$50 billion. These systems consist of the equipment, fixtures, pipes, wires, and other structures used in the distribution of electric power and natural gas, the treatment and distribution of water, and the collection and treatment of wastewater. According to DOD officials, many of these systems have become unreliable and are in need of major improvements. To address this issue, DOD decided in 1997 that utility privatization was the preferred method for improving utility systems and services because privatization would allow installations to benefit from private sector financing and efficiencies. With private sector financing, installations could immediately obtain major upgrades to their utility systems and pay for these improvements over time. Thus, utility improvements could be achieved without going through the traditional budget justification and funding process. Under DOD's program, utility privatization normally involves two transactions with the successful contractor—the conveyance of the utility system infrastructure and the acquisition of utility services for upgrades, operations, and maintenance under a long-term contract of up to 50 years. DOD estimates that some privatization contracts will cost more than \$100 million over the contract time frames.

To institute the program, at DOD's request, Congress approved legislative authority in 1997 for privatizing utility systems at military installations.¹ The authority requires that the military services meet a number of conditions to privatize a system including, in part, the following condition: the services must demonstrate through an economic analysis that privatization of a system would reduce the government's long-term costs for utility services. DOD's program guidance permits the services to exempt systems from privatization when long-term costs will not be reduced or for unique security reasons.

¹National Defense Authorization Act for Fiscal Year 1998, Pub. L. No. 105-85, § 2812 (1997).

In May 2005, we issued a report that identified management weaknesses in DOD's implementation of the utility privatization program.² The report noted a number of concerns, such as the reliability of the economic analyses associated with privatization decisions and the adequacy of contract oversight, and made several recommendations to DOD to improve the guidance and procedures used to implement and oversee the utility privatization program. Although DOD initially disagreed with the report's findings and recommendations, after further review of the report, the department subsequently reported to Congress that it generally agreed with our findings and recommendations and decided to issue new guidance on November 2, 2005, to address the key issues in our prior report.³ Among other things, this guidance required the services to complete remaining evaluations of utility system potential for privatization in a timely and efficient manner, perform an independent review of the economic analyses supporting proposed projects, consider and plan for increased costs for utility services resulting from potential privatization projects, and take steps designed to improve the administration and oversight of awarded privatization projects. Even before DOD issued the new guidance, the services had implemented several program improvements including the requirement for independent reviews of project economic analyses.

In January 2006, the National Defense Authorization Act for Fiscal Year 2006⁴ made several modifications to the legislative authority for the utility privatization program, restricted the number of utility systems that DOD could privatize during fiscal years 2006 and 2007, and required the Secretary of Defense to submit a report to congressional defense committees by April 1, 2006, addressing program issues and many of the concerns noted in our May 2005 report. The act also directed us to evaluate and report on the changes made by DOD to the program since May 2005 and their effects. Accordingly, this report (1) updates the status of the utility privatization program, and (2) discusses the effect of DOD's

²GAO, *Defense Infrastructure: Management Issues Requiring Attention in Utility Privatization*, [GAO-05-433](#) (Washington, D.C.: May 12, 2005).

³DOD, Under Secretary of Defense, *Memorandum for Secretaries of the Military Departments and Director, Defense Logistics Agency, Subject: Supplemental Guidance for the Utilities Privatization Program* (Washington, D.C.: Nov. 2, 2005).

⁴National Defense Authorization Act for Fiscal Year 2006, Pub. L. No. 109-163, § 2823 (2006) (codified as amended at 10 U.S.C. § 2688).

changes on the program management and oversight concerns noted in our May 2005 report.

To address these objectives, we summarized program implementation status and costs and compared the status to DOD's past and current goals and milestones. To determine the effect of DOD's changes on the program management and oversight concerns noted in our prior report, we interviewed DOD and service officials and reviewed pertinent policies, guidance, memorandums, and reports to document the changes made, and we compared those changes with our previously identified concerns to assess whether the issues had been fully addressed. Further, we reviewed the reliability of the economic analyses supporting 10 privatization projects that were awarded after our prior report and had been subjected to the services' new independent review process. We also visited four installations to assess contract administration and oversight issues and reviewed contract price changes in six ongoing utility privatization contracts. Although we generally relied on program status data provided by the services, we confirmed the status data for five utility privatization projects and did not otherwise test the reliability of the data.

We conducted our review from March through July 2006 in accordance with generally accepted government auditing standards. A more detailed description of our scope and methodology is included in appendix I.

Results in Brief

DOD's progress in implementing the utility privatization program has been slower than expected, and implementation costs have continued to climb. Since our previous report, the estimated program completion date has slipped from the department's target of September 2005 to September 2011. DOD officials have attributed delays in program implementation to privatization evaluation, solicitation, and contracting processes that were more complex and time-consuming than originally anticipated. Service officials also stated that additional delays resulted from the services' decision to suspend and reassess the management of the program between October 2005 and March 2006. The officials stated that the suspension allowed DOD and the services time to review concerns noted in our prior report, develop and issue supplemental guidance for the program, and implement program changes necessitated by modifications in the program's legislative authority. Between May 31, 2005, and September 30, 2005, the services privatized 14 utility systems under the legislative authority for the program, bringing the total number of awarded projects to 81. However, the services have awarded no projects since September 2005 and, therefore, no projects have been awarded since DOD issued

supplemental program guidance in November 2005. With program delays, the services' total estimated program implementation costs through fiscal year 2006 have increased from \$268 million to \$285 million and additional amounts will be required before the program is projected to be completed in 2011. Program delays also caused the Defense Energy Support Center to cancel solicitations to privatize 42 Army utility systems in May 2006. These solicitations had been closed from 1 to 4 years with no award decision and there were concerns that conditions, such as the accuracy of the inventory and needed improvements, had changed or might change before an award decision would be made. The Army plans to resolicit these systems over the next few years.

DOD has issued new program guidance and required changes in program procedures to improve the management and oversight of the utility privatization program since our May 2005 report. For example, DOD implemented a requirement for an independent review of economic analyses for proposed privatization projects and has imposed greater emphasis on contract oversight. If fully implemented, the changes should result in more reliable economic analyses supporting proposed privatization projects, improved budgetary consideration of increased utility costs from privatization, enhanced oversight of privatization contracts, and reduced instances where contractors recover more than the amounts they paid as the fair market value for system conveyances. However, we noted a number of limitations in implementation of the new procedures. Moreover, a number of concerns noted in our prior report remain, at least to some degree, because DOD's changes to address some issues were not implemented effectively, some changes were not sufficient to fully eliminate some concerns, and DOD did not make changes to address some concerns. For example:

- First, although DOD made changes to improve the reliability of project economic analyses by requiring independent reviews, we found issues with the implementation of this change. Specifically, we reviewed the economic analyses supporting 10 privatization projects that had been subjected to independent review and found reliability issues that had not been identified during the independent review.
- Second, although DOD directed the services to adequately consider in their budgets the increased costs resulting from utility privatization, questions remain over the availability of the funds needed to complete the program. The services have estimated that they will need \$453 million more than is currently programmed for continuing government utility operations to pay implementation and contract costs associated with the remaining number of utility systems that might be privatized through 2010

for the Air Force and the Navy and Marine Corps and through 2011 for the Army. In view of competing needs and budget priorities, the Air Force stated that it will not solicit additional utility privatization contracts until further resources are identified to cover the potential increase in costs. DOD had not made any decisions on the funding availability issue at the time of our review in June 2006.

- Third, it may take some time to fully implement DOD changes to improve utility privatization contract administration and oversight as new privatization contracts are awarded. Our review of five projects awarded prior to DOD's changes found continued oversight concerns, including questions about the adequacy of resources provided to perform oversight and the lack of required plans for overseeing contractor performance.
- Fourth, DOD reported to Congress in March 2006 that, although privatization may limit the government's options during contract negotiations, the department continues to prefer privatization with permanent conveyance and believes that safeguards are in place to adequately protect the government's interests. It is too early in the program's implementation to know to what extent DOD's efforts will be successful in ensuring equitable periodic contract price adjustments and limiting long-term cost growth in the utility privatization program. However, we found cost growth in three of six privatization projects we reviewed. In one case, the government's annual costs for utility service were expected to increase by 92 percent as a result of the contract's first periodic price adjustment.
- Fifth, DOD did not change its guidance to require that project economic analyses depict the actual expected costs of continued government ownership in the event that the systems are not privatized. Therefore, although DOD reported to Congress that the 81 contracts awarded under the utility privatization authority will result in about \$650 million in long-term cost reductions to the government, the amount is unrealistic because it was not calculated based on the actual expected cost differences between continued government ownership and privatization, and because privatization generally results in increased, not decreased, utility service costs to the government.

We are making a number of recommendations designed to ensure that DOD improves the reliability of the economic analyses for proposed utility privatization projects, addresses potential program funding shortfalls, ensures adequate oversight in utility privatization contracts awarded prior to DOD's program changes, monitors potential contract cost growth, and clearly depicts the increased costs resulting from proposed utility privatization projects. In comments on a draft of this report, DOD generally agreed with six of our seven recommendations and outlined a plan of action to address each recommendation. Where it indicated

disagreement, we continue to believe our recommendation has merit. We discuss DOD's comments in detail later in this report.

Background

At DOD's request, Congress approved legislative authority in 1997 for privatizing utility systems at military installations.⁵ In defining a utility system, the authority included systems for the generation and supply of electric power; the treatment or supply of water; the collection or treatment of wastewater; the generation or supply of steam, hot water, and chilled water; the supply of natural gas; and the transmission of telecommunications. Included in a utility system are the associated equipment, fixtures, structures, and other improvements as well as easements and rights-of-way. The authority stated that the Secretary of a military department may convey a utility system to a municipal, private, regional, district, or cooperative utility company or other entity and the conveyance may consist of all right, title, and interest of the United States in the utility system or such lesser estate as the Secretary considers appropriate to serve the interests of the United States.

Among other things, the 1997 authority also included two requirements for utility privatization. First, DOD was required to submit a report to congressional defense committees and wait 21 days before allowing a conveyance. For each conveyance, the report was to include an economic analysis, based on acceptable life-cycle costing procedures, demonstrating that (1) the long-term economic benefit of the conveyance to the United States exceeds the long-term economic cost of the conveyance to the United States, and (2) the conveyance will reduce the long-term costs of the United States for utility services provided by the utility system concerned. Second, the Secretary was required to receive as consideration for a conveyance an amount equal to the fair market value, as determined by the Secretary, of the right, title, or interest of the United States conveyed. The consideration could take the form of a lump sum payment or a reduction in charges for utility services.

Before and after approval of the specific authority for privatizing utilities, the services have used other authorities for utility privatization. For example, the Army had privatized some systems after obtaining congressional authority for each specific case. Also, the services have privatized systems by modifications to natural gas services agreements

⁵Pub. L. No. 105-85, § 2812 (1997).

administered by the General Services Administration and by conveyances of some systems on the basis of authorities related to base realignment and closure and the military housing privatization program.

DOD's Office of the Deputy Under Secretary of Defense for Installations and Environment provides overall policy and management oversight for the utility privatization program. However, primary management and implementation responsibility for the program is delegated to the individual services, their major commands, and individual installations. In addition, Defense Logistics Agency's Defense Energy Support Center is responsible for providing the military services with utility privatization contracting, technical, and program management support.

DOD Made Utility Privatization a Department Policy

In December 1997, DOD issued Defense Reform Initiative Directive Number 9, which made utility system privatization a DOD policy.⁶ The directive instructed the military departments to develop a plan that would result in privatizing all installation electric, natural gas, water, and wastewater utility systems by January 1, 2000, unless exempted for unique security reasons or if privatization would be uneconomical. Under the program, privatization normally involves two transactions with the successful contractor—the conveyance of the utility system infrastructure and the acquisition of utility services for upgrades, operations, and maintenance under a long-term contract of up to 50 years. Normally, the conveyances do not include title to the land beneath the utility system infrastructures.

A year later, in December 1998, DOD issued another directive to establish program management and oversight responsibilities and provide guidance for performing economic analyses for proposed projects, exempting systems from the program, and using competitive procedures to conduct the program.⁷ The directive also stated that the objective was for DOD to get out of the business of owning, managing, and operating utility systems by privatizing them and that exemptions from privatization should be rare.

⁶DOD, Deputy Secretary of Defense, *Memorandum for Secretaries of the Military Departments and others, Subject: Department of Defense Reform Initiative Directive #9—Privatizing Utility Systems* (Washington, D.C.: Dec. 10, 1997).

⁷DOD, Deputy Secretary of Defense, *Memorandum for Secretaries of the Military Departments and others, Subject: Department of Defense Reform Initiative Directive #49—Privatizing Utility Systems* (Washington, D.C.: Dec. 23, 1998).

The directive reset the privatization implementation goal to September 30, 2003.

Implementation Goals Reset and Program Guidance Revised

In October 2002, DOD issued revised program guidance and again reset implementation goals.⁸ The guidance noted DOD's contention that many installation utility systems had become unreliable and in need of major improvements because the installations historically had been unable to upgrade and maintain reliable utility systems due to inadequate funding caused by the competition for funds and DOD's budget allocation decisions. DOD officials stated that owning, operating, and maintaining utility systems was not a core DOD function and the guidance stated that privatization was the preferred method for improving utility systems and services by allowing military installations to benefit from private sector financing and efficiencies. The revised implementation goals directed the military departments to reach a privatization or exemption decision on all systems available for privatization by September 30, 2005. The October 2002 guidance also reemphasized that utility privatization was contingent upon the services demonstrating through an economic analysis that privatization will reduce the long-term costs to the government for utility services. The guidance included details for conducting the economic analyses, stating that the services' analyses should compare the long-term estimated costs of proposed privatization contracts with the estimated long-term costs of continued government ownership assuming that the systems would be upgraded, operated, and maintained at accepted industry standards, as would be required under privatization.

GAO Report Identified Weaknesses in Program Implementation

In May 2005, we issued a report that identified management weaknesses in DOD's implementation of the utility privatization program.⁹ The report noted that utility privatization implementation had been slower than expected, the services' economic analyses supporting utility privatization decisions provided an unrealistic sense of savings to a program that generally increases government utility costs, DOD's funding obligations would likely increase faster than they would under continued government ownership, DOD did not require that the services' economic analyses be

⁸DOD, Deputy Secretary of Defense, *Memorandum for Secretaries of the Army, Navy, and Air Force and Director, Defense Logistics Agency, Subject: Revised Guidance for the Utilities Privatization Program* (Washington, D.C.: Oct. 9, 2002).

⁹See footnote 2.

subjected to an independent review for accuracy and compliance with guidance, implementation of the fair market value requirement in some cases resulted in higher contract costs for utility services, the services had not issued specific contract administration guidance for the program, and DOD's preferred approach of permanently conveying utility system ownership to contractors may give the contractor an advantage when negotiating service contract changes or renewals. The report made several recommendations for DOD to address these concerns.

Program Legislative Authority Modified

The National Defense Authorization Act for Fiscal Year 2006,¹⁰ enacted in January 2006, made several modifications to the legislative authority for the utility privatization program. The act did the following:

- Reinstated a requirement that the Secretary of Defense must submit to congressional defense committees an economic analysis and wait 21 days after the analysis is received by congressional defense committees, or 14 days if in electronic form, before conveying a utility system.¹¹ The economic analysis must demonstrate among other things that the conveyance will reduce the long-term costs to the United States of utility services provided by the utility system. The report and wait requirement had been replaced with a requirement for a quarterly report of conveyances by the National Defense Authorization Act for Fiscal Year 2004.¹²
- Added a requirement that the economic analyses incorporate margins of error in the estimates, based upon guidance approved by the Secretary of Defense, that minimize any underestimation of the costs resulting from privatization or any overestimation of the costs resulting from continued government ownership.
- Eliminated the requirement that DOD must receive as consideration for a conveyance an amount equal to the system's fair market value.
- Limited contract terms to 10 years, unless the Secretary concerned determines that a longer term contract, not to exceed 50 years, will be cost-effective and provides an explanation of the need for the longer term

¹⁰Pub. L. No. 109-163, § 2823 (2006).

¹¹Prior to November 2003, section 2688 of title 10 stated that the Secretary of Defense was not permitted to make a conveyance until he submitted a report that demonstrated two specific factors and a period of 21 days had elapsed from the date at which the analysis was submitted.

¹²National Defense Authorization Act for Fiscal Year 2004, Pub. L. No. 108-136, § 1031(a)(32)(2003).

contract, along with a comparison of costs between a 10-year contract and the longer term contract.

- Placed a temporary limitation on conveyance authority stating that during each of fiscal years 2006 and 2007, the number of utility systems for which conveyance contracts may be entered into under this authority shall not exceed 25 percent of the total number of utility systems determined to be eligible for privatization under this authority as of January 6, 2006.
- Required DOD to submit, not later than April 1, 2006, to congressional defense committees a report describing the use of section 2688 of title 10, United States Code (10 U.S.C. 2688), to convey utility systems. The report was to address several specified aspects of the utility privatization program.

DOD's Response to GAO's Report and Modifications to the Program's Authority

Although DOD initially disagreed with our May 2005 report, after further review of the report, it subsequently reported to Congress that the report had brought some significant issues to light and that the department had decided to issue new guidance to address the key issues in the report in order to improve program management. On November 2, 2005, DOD issued the new guidance, which among other things required the services to complete the remaining evaluations of utility system potential for privatization in a timely and efficient manner, perform an independent review of the economic analyses supporting proposed projects, consider and plan for increased costs for utility services resulting from potential privatization projects, and take steps to improve the administration and oversight of awarded privatization projects.¹³ DOD issued additional supplemental guidance¹⁴ on March 20, 2006, to implement the modifications to the legislative authority made by the Fiscal Year 2006 National Defense Authorization Act; and on March 31, 2006, DOD submitted to congressional defense committees the utility privatization report required by the act.¹⁵ Even before DOD issued new guidance to improve the program in November 2005, the services had implemented several program improvements, including the requirement for independent reviews of project economic analyses.

¹³See footnote 3.

¹⁴DOD, Under Secretary of Defense, *Memorandum for Secretaries of the Military Departments and Director, Defense Logistics Agency, Subject: Supplemental Guidance for the Utilities Privatization Program* (Washington, D.C.: Mar. 20, 2006).

¹⁵DOD, Deputy Under Secretary of Defense (Installations and Environment), *Report to Congress on Use of Utility System Conveyance Authority and Temporary Suspension of Authority Pending Report* (Washington, D.C.: Mar. 31, 2006).

Utility Privatization Milestones Have Slipped and Implementation Costs Continue to Climb

DOD's progress in implementing the utility privatization program has been slower than expected and implementation costs have continued to climb. None of the services met DOD's September 2005 implementation goal and the program's estimated completion date has now slipped to September 2011. In addition to increasing implementation costs, program delays have also resulted in the cancellation of privatization solicitations because of concern that conditions had changed or might change before a decision would be made whether to privatize.

Services Did Not Meet Program Implementation Milestone

None of the services met DOD's goal of making a privatization or exemption decision on all systems available for privatization by September 30, 2005. Since the program began, DOD officials have attributed delays in program implementation to privatization evaluation, solicitation, and contracting processes that were more complex and time consuming than originally anticipated. Service officials stated that additional delays occurred because the services decided to suspend the program between October 2005 and March 2006. According to the officials, the suspension was provided to allow DOD and the services time to review concerns noted in our May 2005 report, develop and issue supplemental guidance for the program, and implement program changes necessitated by modifications in the program's legislative authority made by the National Defense Authorization Act for Fiscal Year 2006. The services now estimate that their program completion dates—the date when a privatization or exemption decision has been made on all available systems—are October 2007 for the Navy and Marine Corps, December 2008 for the Air Force, and September 2011 for the Army. Among other things, the Army attributed the extension in its completion date to the privatization process being more complicated than envisioned and a recognition that the Army's past estimates for completing the program were unrealistic. Table 1 shows progress as of March 31, 2006, compared to DOD's goal, as well as the current estimated program completion dates.¹⁶

¹⁶Although this report includes Defense Logistics Agency program status information, the report does not include any additional Defense Logistics Agency program information because the agency has few systems available for privatization compared to the military services and has awarded no utility privatization contracts.

Table 1: Percentage of Systems with Privatization or Exemption Decision and Estimated Program Completion Date

Component	Goal for September 30, 2005 (percent)	Actual as of March 31, 2006 (percent)	Estimated completion date
Army	100	75	September 2011
Navy and Marine Corps	100	78	October 2007
Air Force	100	82	December 2008
Defense Logistics Agency	100	86	December 2007

Source: DOD.

Services Have Awarded Contracts for a Fraction of the Total Systems Available for Privatization

After spending about \$268 million on program implementation costs through fiscal year 2005, the services had awarded contracts for a fraction of the 1,496 utility systems available for privatization. Between May 31, 2005, and September 30, 2005, the services privatized 14 utility systems using 10 U.S.C. 2688 authority bringing the total number of awarded projects to 81. However, the services have awarded no projects under this authority since DOD issued supplemental program guidance in November 2005. In addition to the projects awarded under 10 U.S.C. 2688 authority, DOD privatized 36 systems under other programs, such as DOD’s housing privatization program. The services also have exempted 147 additional systems, bringing the total systems exempted from privatization to 458. Table 2 shows program status as of March 31, 2006.

Table 2: Status of the Utility Privatization Program as of March 31, 2006

Component	Systems available for privatization	Systems pending solicitation or under reassessment	Systems in solicitation	Systems exempted	Total contract awards	Contract awards using 10 U.S.C. 2688 authority
Army	320	0	202	38	80	70
Navy and Marine Corps	645	13	411	200	21	1
Air Force	502	4	262	220	16	10
Defense Logistics Agency	29	0	29	0	0	0
Total	1,496	17	904	458	117	81

Source: DOD.

Program Delays Have Resulted in Increased Implementation Costs

With program delays, the services' estimated program implementation costs have increased from about \$268 million through fiscal year 2005 to about \$285 million through fiscal year 2006. Additional implementation funds will be needed before the services complete their programs between October 2007 and September 2011. According to service officials, the funds used to implement the program primarily paid for consultants hired to help the services in conducting an inventory of their utility systems, assessing the systems' condition, preparing economic analyses, and soliciting and contracting for proposed projects. Program implementation costs did not include funds used to pay the costs of awarded privatization contracts. Table 3 shows program implementation costs by service and the Office of the Secretary of Defense.

Table 3: Implementation Costs for the Utility Privatization Program

Dollars in millions			
Component	Implementation costs for fiscal years 1998 through 2005	Estimated implementation costs for fiscal year 2006	Total estimated implementation costs through fiscal year 2006
Army	\$62.5	\$4.0	\$66.5
Navy and Marine Corps	109.7	4.4	114.1
Air Force	92.6	8.0	100.6
Office of the Secretary of Defense	3.6	0.3	3.9
Total	\$268.3	\$16.8	\$285.1

Source: DOD.

Note: Totals may not add due to rounding.

Program delays also caused the Defense Energy Support Center to cancel solicitations to privatize 42 Army utility systems in May 2006. These solicitations had been closed from 1 to 4 years with no award decision and there were concerns that conditions, such as the accuracy of the inventory and needed improvements, had changed or might change before an award decision would be made. The Army plans to resolicit these systems over the next few years. Further, Defense Energy Support Center officials stated that program delays and the resulting decrease in assistance requested by the services have made it difficult to retain qualified staff to support the utility privatization program. Consequently, the center will need to train new staff once the program's pace begins to increase again.

Services Have Estimated the Number and Cost of Potential Privatization Contracts

In addition to revising their program completion dates since our previous report, the services also estimated the additional number of systems that might be privatized by the completion of their programs and the funds needed to pay the costs of these anticipated contracts. The Army estimated that 41 additional systems might be privatized with the associated contract costs totaling about \$212 million; the Navy and the Marine Corps estimated that 40 additional systems might be privatized with the associated contract costs totaling about \$139 million; and the Air Force estimated that 210 additional systems might be privatized with the associated contract costs totaling about \$602 million (see table 4). Air Force officials stated that its estimated 210 additional systems was a “worst case” estimate used to determine the maximum funding needed for possible additional privatization contracts. The officials stated that the more likely number of systems that might be privatized was about 105 systems. However, the officials did not provide an estimate of the contract costs associated with the smaller number of systems.

Table 4: Potential Additional Privatization Contracts and Associated Costs

Dollars in millions

Component	Number of additional systems that potentially could be privatized	Potential program costs if the additional systems are privatized
Army	41	\$212.4
Navy and Marine Corps	40	139.3
Air Force	210	602.0
Total	291	\$953.7

Source: DOD.

DOD’s Changes to Improve Utility Privatization Implementation Have Addressed Many Areas but Have Not Eliminated All Program Concerns

DOD has made many changes to improve the management and oversight of the utility privatization program since our May 2005 report. To improve the reliability of the economic analyses supporting privatization decisions, DOD now requires that the analyses undergo an independent review to assess the inputs and assumptions, ensure that cost estimates for the government-owned and privatization options are treated in a consistent manner, and verify that all relevant guidance has been met. Also, in supplemental program guidance issued in November 2005, DOD reminded the services to consider and plan for increased costs for utility services contracts resulting from potential privatization projects and prepare operation and maintenance budgets based upon the expected costs under privatization. The guidance also emphasized the importance of contract

oversight and directed a number of actions designed to ensure adequate contract administration and oversight. Among other things, the guidance directed the Defense Energy Support Center to develop specific preaward and postaward procurement procedures for the effective management of utilities services contracts, directed contracting agencies to adequately train and prepare personnel involved in the utility privatization contracts, noted that DOD components are responsible for ensuring that the acquisition plan adequately addresses cost growth control, and stated that DOD components are responsible for ensuring that resources required to properly administer the contracts have been identified and provided. In March 2006, DOD also issued guidance implementing modifications in the program's legislative authority made by the Fiscal Year 2006 National Defense Authorization Act, which among other things addresses our concern that some utility privatization contracts had allowed contractors to recover more than they paid as the fair market value for system conveyances. If fully implemented, the changes should result in more reliable economic analyses supporting proposed privatization projects, improved budgetary consideration of increased utility costs from privatization, enhanced oversight of privatization contracts, and reduced instances where contractors recover more than the amounts they paid as the fair market value for system conveyances.

Although DOD has made many changes to improve implementation of the utility privatization program, the changes have addressed some concerns but have not eliminated all concerns noted in our prior report, such as ensuring the reliability of project economic analyses and ensuring effective contract oversight. We found that changes to address some issues have not been effectively implemented, some changes were not sufficient to totally eliminate the concerns, and DOD did not make changes to address some concerns causing continued questions about the reliability of the economic analyses, the availability of funds to pay for the remaining projects that might be privatized, the adequacy of contract oversight in projects awarded prior to DOD's changes, and the control of long-term cost growth in utility privatization contracts. We also have concerns that the program may continue to provide an unrealistic sense of savings and decision makers may have incomplete information on the financial effect of privatization decisions.

DOD Has Taken Steps to Improve the Reliability of Project Economic Analyses but Implementation Is a Concern

Although DOD has made changes to improve the reliability of the analyses supporting proposed utility privatization projects, we found issues with the services' implementation of the changes. In November 2005, DOD issued supplemental program guidance requiring DOD components to ensure that independent reviews were conducted for all economic analyses supporting a proposed conveyance. The guidance stated that the independent review should verify that all relevant guidance has been met and that privatization is in the best interest of the government. In March 2006, DOD reported to Congress that the independent review included procedures to review the general inputs and assumptions, verify that the inventory in the economic analysis is identical to the inventory in the solicitation, and ensure that the government and the contractor treat the renewal and replacement cost estimates in a consistent manner.¹⁷ Even before DOD issued the guidance requiring independent reviews, Army and Air Force officials stated that they had implemented such reviews to help ensure reliability of their project analyses. The officials stated that independent reviews were performed on the analyses supporting 12 utility privatization projects that were awarded in September 2005—after our previous report—but before DOD's issuance of the guidance requiring independent reviews.

As an additional step to help ensure reliable economic analyses, DOD's March 2006 report to Congress stated that the services must conduct postconveyance reviews that compare actual project costs with the estimated costs included in the projects' economic analyses. DOD stated that the postconveyance reviews are conducted 2 to 3 years after contract award, or 1 year after the first periodic price adjustment, whichever is later, and that the results of these reviews will be compiled until such time as the analysis of all conveyances is complete. DOD stated that the reviews are to include an analysis of the system's inventory, changes in requirements and contract costs, and a comparison of actual contract costs with estimates from the economic analyses.

Although DOD's changes are key steps in the right direction to improve the reliability of the economic analyses, we found issues with the implementation of the changes. First, we reviewed the analyses associated with 10 Army and Air Force projects awarded in September 2005.

¹⁷Renewals and replacements is a term used to describe the normal replacement of, or repairs to, a system's components or parts as needed to keep the system functioning in accordance with industry standards.

Although these analyses were prepared prior to the issuance of DOD's supplemental guidance, the services had already implemented an independent review process and these analyses underwent an independent review. Service officials noted that the independent reviews had just begun and expected that the thoroughness of the reviews would improve as experience was gained and DOD's supplemental guidance was implemented. We found that the reviews did identify some questionable items and that some changes were made to improve the reliability of the economic analyses. Yet, we also found questionable items in each analysis that were not identified during the independent review. For example:

- The economic analysis for the natural gas system privatization at Minot Air Force Base did not treat estimates of renewal and replacement costs for the government-owned and privatization options in a consistent manner. The analysis estimated that the Air Force would spend \$7.1 million on renewals and replacements during the first year of continued government ownership. Under the first year of privatization, the analysis estimated that the contractor would spend about \$0.2 million on renewals and replacements. When we asked about this difference, Air Force officials stated that the contractor is not required to perform the same renewals and replacements identified in the government estimate and that the government found the contractor's proposal to be acceptable. Because the analysis was not based on performing the same work, the cost estimates were not consistently developed and resulted in favoring the privatization option. This issue was not identified in the independent review.
- The economic analyses for the water and wastewater privatization projects at Andrews Air Force Base were based on the systems' inventory (i.e., the wells, pumps, water treatment equipment, valves, fire hydrants, water distribution mains, meters, storage tanks, reservoirs, and other components that constitute the systems) and condition 2 years prior to contract award. The Air Force stated that adjustments to the contract could be made after contract award, if needed, to reflect changes in the inventory. However, because the analyses were not updated to reflect inventory changes before contract award, the reliability of the analyses is less certain. This issue was not noted in the independent review.
- The economic analyses for privatization of the electric distribution system at Fort Leavenworth and the water and wastewater systems at three Army installations in the Tidewater Virginia area incorrectly included financing costs under the government option. Although this favored the privatization option, the amount was not enough to change the outcome of the analyses. This issue was not identified in the independent review. However, Army officials told us that they would ensure that this did not occur in future analyses.

Second, although DOD noted in its March 2006 report to Congress the importance of postconveyance reviews as an additional measure to help ensure reliable economic analyses, DOD has not issued guidance that requires the services to perform the reviews. Service officials stated that they had performed only a limited number of postconveyance reviews and do not have plans to perform the reviews in the manner or frequency described in DOD's report to Congress. Also, DOD's report cited seven Army Audit Agency postconveyance reviews, four additional Army postconveyance reviews, and one Air Force postconveyance review. However, only three of the Army Audit Agency reviews included a comparison of actual contract costs with estimates from the economic analyses.

DOD Has Taken Steps to Address Some Funding Issues but Concerns Remain

Although DOD has taken steps to help ensure that the services adequately consider the increased costs from utility privatization projects during budget preparation, questions remain over the availability of the additional funds needed to complete the program. The services estimate that they potentially will need \$453 million more than is currently programmed for continuing government utility operations to pay implementation and contract costs associated with the remaining number of utility systems that might be privatized through 2010 for the Air Force, the Navy, and Marine Corps, and through 2011 for the Army. As a result, in view of competing needs and budget priorities, the Deputy Assistant Secretary of the Air Force (Installations) stated in an April 2006 memorandum that the Air Force could not afford to award further utility privatization contracts unless additional resources are provided.

Utility Costs Increase with Privatization

Our May 2005 report noted that installation utility costs under privatization typically increase significantly above historical levels because the systems are being upgraded and the contractors recoup their investment costs through the utility services contracts. Essentially, under the privatization program, the services leverage private sector capital to achieve utility system improvements that otherwise would not be feasible in the short term because of limited funding caused by the competition for funds and budget allocation decisions. The services pay for the improvements over time through the utility services contracts, which are "must pay" bills. As a result, if an installation's funds were not increased sufficiently, then funds provided for other installation functions where there was more discretion in spending might be used to pay the higher utility bills. This, in turn, could negatively affect those other functions, such as the maintenance of installation facilities. We recommended that DOD provide program guidance emphasizing the need to consider increased utility costs under

privatization as the military services prepare their operation and maintenance budget requests and that DOD direct the service Secretaries to ensure that installation operations and maintenance budgets are adjusted as necessary to reflect increased costs from utility privatization projects.

In November 2005, DOD issued supplemental program guidance that reminded DOD components to consider the increase in utility costs from privatization. Specifically, the guidance directed the components to consider and plan for increased costs for utility services contracts resulting from potential privatization projects and system conveyance and prepare operation and maintenance budgets based upon the expected costs under privatization.

Funds Not Programmed for All
Potential Utility Privatization
Projects

DOD's guidance addresses the recommendations from our May 2005 report and, if implemented, should result in the increased costs from utility privatization projects being adequately considered during budget preparation. However, in view of competing needs and budget priorities, questions remain over availability of the additional funds needed to complete the program. To illustrate, DOD's November 2005 supplemental guidance also directed DOD components to advise the Deputy Under Secretary of Defense (Installations and Environment) if significant shortfalls are anticipated that will affect utilities privatization efforts. In response to that direction, each service estimated the remaining number of utility systems that might be privatized, calculated the associated implementation and contract costs, compared these costs with the funds already programmed for continued government operation of the systems that might be privatized, and determined whether any potential funding shortfalls existed. The Army's estimate was through fiscal year 2011 and the other services' estimates were through fiscal year 2010. As a result of this review, each service determined that funding shortfalls existed to pay for potential future privatization contracts (see table 5).

Table 5: Service Estimates of Potential Utility Privatization Program Funding Shortfall

Dollars in millions

Component	Number of systems that potentially could be privatized	Potential program costs if the systems are privatized	Total funds programmed	Total unfunded requirement (shortfall)
Army	41	\$212.4	\$90.3	\$122.1
Navy and Marine Corps	40	139.3	103.2	36.1
Air Force	210	602.0	306.9	295.1
Total	291	\$953.7	\$500.4	\$453.3

Source: DOD.

Air Force May Not Award Some Additional Privatization Projects Due to Funding Issues

Air Force officials stated that the increased costs from potential future utility privatization contracts had reached a critical point. The officials stated that because funds are limited and funding needs for some Air Force programs are greater than the funding needs for utility upgrades, the Air Force has concluded that it will not solicit new utility privatization contracts until additional resources are identified to specifically cover any potential increase in future costs. Air Force officials further explained that privatization results in improving utility systems to an industry standard level by creating “must pay” contracts. However, without additional resources, funding these contracts must come from other base operating support funds, which would result in diverting critical resources from remaining facilities and infrastructure. Also, the officials noted that the utility privatization program drives system recapitalization to an industry standard level that may be questionable when compared to historical Air Force requirements and, furthermore, reflects a funding level that is not affordable in light of current fiscal constraints and differing Air Force modernization priorities.

When we questioned a cognizant DOD official in June 2006 about the potential funding shortfall, the official stated that each service has competing priorities and the cost of awarding contracts to privatize utility infrastructure is just one of many. However, the official also stated that the funding issue and alternatives were under discussion but conclusions had not yet been reached.

DOD Directed Actions to Improve Utility Privatization Contract Oversight but Some Concerns Remain

DOD has made a number of changes designed to improve utility privatization contract administration and oversight since our May 2005 report. However, it may take some time for the improvements to be fully implemented as the changes are applied to new privatization contract awards and efforts may be needed to ensure that the changes are applied, where needed, to previously awarded contracts.

DOD Has Taken Steps to Address Oversight Concerns

To address privatization contract oversight concerns, DOD issued supplemental program guidance in November 2005 that emphasized to the services the importance of contract oversight and directed a number of actions designed to ensure adequate contract administration and oversight. Among other things, the guidance

- directed the Defense Energy Support Center to develop specific preaward and postaward procurement procedures for the effective management of utilities services contracts resulting from a utility conveyance, and coordinate with the Defense Acquisition University to develop a training program for all contracting officers and DOD components involved in utilities privatization efforts;
- directed contracting agencies to adequately train and prepare personnel involved in the administration of the utilities services contracts resulting from a utilities conveyance;
- stated that contracting officers must be able to use guidance for postaward contract management and contract provisions to ensure that the government's interests are protected in the long-term utility service contracts and associated real estate documents;
- stated that prior to awarding a services contract resulting from a utility conveyance, DOD components are responsible for ensuring, among other things, that resources required to properly administer the contract have been identified; and
- directed that transfers of contract administration responsibilities from the procuring contract office to the contracting administration office should include an on-site transfer briefing with government and contractor personnel that includes, among other things, a clear assignment of responsibilities.

During our visit to the Defense Energy Support Center in April 2006, officials stated that in accordance with the guidance, the center had already issued the preaward and postaward procurement procedures that would help ensure the effective management of utilities services contracts. The officials stated that they had also begun developing a training program for all contracting officers and other DOD personnel involved in utilities privatization efforts and had developed procedures for transferring

Some Contract Oversight
Concerns Identified at the Four
Installations We Visited

contract responsibilities that should help ensure effective contract oversight. During our visits to the services, officials stated that, in addition to working with the Defense Energy Support Center, further efforts were underway to ensure that postaward management is effective. For example, Air Force officials stated that they had developed their own postaward plan, which defines the responsibilities and standards by which the government could ensure that utility services are provided in accordance with requirements. Navy officials stated that the Navy plans to prepare a quality assurance plan for each utility privatization contract awarded.

Although the steps taken by DOD, the Defense Energy Support Center, and the services are significant improvements, implementation will be the key to ensuring effective oversight of all utility privatization contracts, and it may take some time to fully implement improvements as new privatization contracts are awarded. From the time DOD's supplemental guidance was issued and other improvement measures were put into place through the time of our review in June 2006, the services awarded no new utility privatization contracts. Thus, to assess contract oversight, we were unable to visit installations with utility privatization contracts awarded after DOD's changes were implemented. Instead, we assessed contract oversight at four installations with five utility privatization projects that were awarded prior to our May 2005 report. We found continuing concerns about the adequacy of oversight because no additional resources were provided to oversee the contracts at all four installations and mandatory written plans for overseeing contractor performance were not prepared at two installations.

For example, officials at each of the four installations we visited noted that no additional resources were provided at the installation level to perform contract oversight once their utility systems were privatized. The contract officials stated that the extra work associated with the contracts was added to their workload of overseeing other contracts. Some officials stated that they did not have sufficient personnel to perform the level of detailed monitoring of contractor performance that they believed was needed. According to Fort Eustis officials, when the electric system was privatized, they requested three additional people to oversee the contract based on the magnitude of the workload associated with this contract. Yet, no additional people were provided and the extra workload was added to the workload of the staff responsible for overseeing other contracts.

Also, our review of the electric distribution system privatization projects at Fort Eustis and the Army's Military Ocean Terminal Sunny Point found that neither installation had a quality assurance surveillance plan in place

for overseeing contractor performance. Such plans are required by the Federal Acquisition Regulation. Officials at both installations stated that although a formal surveillance plan had not been prepared, they were performing oversight to ensure that the contractors met contract requirements. Nevertheless, formal contractor performance monitoring plans are an important tool for ensuring adequate contract oversight.

Containing Utility Privatization Contract Cost Growth May Be a Challenge

Because contractors own installation utility systems after privatization and, therefore, may have an advantage when negotiating contract changes and renewals, containing utility privatization contract cost growth may become a challenge as contracts go through periodic price adjustments and installations negotiate prices for additional needed capital improvement projects and other changes. In March 2006, DOD stated that although it recognizes that privatization may limit the government's options during contract negotiations, the department continues to prefer privatization with permanent conveyance and believes that safeguards are in place to adequately protect the government's interests. Although it is too early in the program's implementation to know to what extent DOD's efforts will be successful in ensuring equitable contract price adjustments and limiting long-term cost growth in the utility privatization program, our review found indications that containing cost growth may become a concern.

DOD Continues to Prefer Permanent Conveyance but Has Taken Steps to Control Costs

In our prior report, we noted that, according to DOD consultant reports, DOD's approach to utility privatization differs from typical private sector practices in that private sector companies may outsource system operations and maintenance but normally retain system ownership. As a result, the consultant reports note that DOD's preferred approach of permanently conveying utility system ownership to contractors may give the contractor an advantage when negotiating service contract changes or renewals. This occurs because DOD must deal with the contractor or pay significant amounts to construct a new utility distribution system to replace the one conveyed to the contractor, attempt to purchase the system back from the contractor, or institute legal action to reacquire the system through condemnation proceedings. Because of concern that contractors may have an advantage when it comes time to negotiate contract changes and renewals, we recommended that DOD reassess whether permanent conveyance of utility systems should be DOD's preferred approach to obtaining improved utility services.

DOD stated that it has reassessed its position and continues to believe that owning, operating, and maintaining utility systems is not a core mission of

the department and that permanent conveyance of systems under utilities privatization enables the military installations to benefit from private sector innovations, economies of scale, and financing. Although DOD contends that private industry can normally provide more efficient utility service than can the government, DOD has not provided any studies or other documentation to support its contention. Given that the private sector faces higher interest costs than the government and strives to make a profit whereas the government does not, it is not certain that utility services provided by the private sector would be less costly than utility services provided by the government through the use of up-front appropriations.

Although DOD continues to prefer privatization with permanent conveyance of the utility systems, DOD has recognized that privatization may limit the government options during contract renegotiations and has taken steps to help control contract cost growth. First, DOD stated in its March 2006 report to Congress that a contractor also may have limited options under privatization because the contractor typically cannot use the installation's utility system to service other customers. DOD reported that privatization creates a one-to-one relationship between the installation and the contractor. In this relationship, DOD stated that both parties must work together to execute fair and equitable contract changes, both parties have significant vested interests in successful negotiations, and both parties retain substantial negotiation leverage.

Second, DOD noted that service contracts awarded as part of a privatization transaction are contracts subject to the Federal Acquisition Regulation and applicable statutes. Because it is recognized that privatization will as a practical matter limit future opportunities to re compete this service, DOD stated that all contracts will include appropriate provisions to protect the government's interest while allowing the contractor reasonable compensation for the services provided. DOD's report further stated that fixed price contracts with prospective price adjustment provisions have been determined to be the most appropriate contract in most situations and that this type of a contract will mitigate cost risk and hopefully result in a satisfactory long-term relationship for both the contractor and the government.

Third, DOD noted that utility services contracts resulting from a utility conveyance may include a contract clause that provides an option for the government to purchase the system at the end of the contract period. According to Defense Energy Support Center officials, the center has developed language for future Army and Air Force contracts that would

Cost Growth in Utility
Privatization Contracts May
Become a Concern

provide an option for the government to buy back a system at the end of the contract period. Center officials stated that this clause may help the government in negotiations at the end of the contract term. Navy officials stated that the Navy does not plan to include a buy back clause in its future utility contracts because a system could be taken back, if necessary, through condemnation procedures.

Fourth, in its November 2005 supplemental guidance, DOD emphasized the importance of controlling contract cost growth. Specifically, the guidance noted that prior to awarding a services contract resulting from a utility conveyance, DOD components are responsible for ensuring that the acquisition plan adequately addresses cost growth control, which includes specifying the appropriate price adjustment methodology and postaward contract administration.

Although DOD has policies, guidance, and procedures to help control contract costs and ensure that price adjustments are equitable, cost growth may still become a concern as utility privatization contracts go through periodic price adjustments and, in some cases, installations negotiate changes for additional capital improvement projects or other needs. According to DOD, most utility privatization contracts include provisions for periodic price adjustments. The price adjustment process allows contract price changes based on changes in market prices, generally to cover inflation, and changes to the service requirement from system additions or modifications resulting from capital upgrades. Under this process, the contractor is required to submit sufficient data to support the accuracy and reliability of the basis for service charge adjustments. If the contractor's data is determined to be fair and reasonable, the contracting officer negotiates a service charge adjustment. Utility privatization contracts normally provide for price adjustments after an initial 2-year period and every 3 years thereafter. In addition to cost increases from service charge adjustments, contract costs can also increase as a result of contract modifications to pay for additional capital improvement projects not included in the initial contract.

According to the services, utility privatization contracts for 22 systems are currently undergoing, or will be subject to, their first periodic price adjustment before the end of calendar year 2007.¹⁸ Although it is too early

¹⁸Air Force officials stated that four additional utility privatization contracts were previously eligible for periodic price adjustment but no adjustment was made because neither the contractor nor the government requested an adjustment.

to know the extent of cost changes that might occur in these contracts, our review of six contracts—one that completed a periodic price adjustment, one that was undergoing periodic price adjustment, and four that had not yet undergone a periodic price adjustment—found conditions that indicate that cost growth in utility privatization contracts may become a concern. Changes in contract costs could result in privatization costs increasing above the levels estimated in the economic analyses. To illustrate:

- The Fort Rucker natural gas distribution system privatization contract was issued on April 24, 2003. The contract provided for a price adjustment after the initial 2 years of the contract and then every 3 years thereafter. In February 2005, the contractor submitted a proposal for a price adjustment and requested an increase in the price paid to the contractor for operations and maintenance, associated overhead, and renewals and replacements. According to a government memorandum that summarized the results of the price adjustment process, the requested increases were based on the contractor's actual labor hours and material costs and additional overhead costs which resulted from a change in the way the contractor calculated overhead costs. The change in overhead calculations included costs that were not included in the original proposal submission or in the contract. When queried, the contractor responded that the costs were not originally submitted but should have been. After review, the government team responsible for the price adjustment process determined that the requested increases were allowable and reasonable and approved the price increase. The change increased the government's annual utility service charge costs from about \$87,000 to about \$124,000, an increase of about \$36,000, or 41 percent. In approving the increase, the government team noted that although the estimated cost avoidance from privatization would be reduced, the contract was still economical compared to the estimated costs of government ownership.
- The Sunny Point electric distribution system privatization contract was issued on September 30, 2003. In January 2006, the contractor submitted a proposal for a price adjustment and requested an increase in the utility service charge based on the contractor's actual labor hours and material costs associated with operating and maintaining the system, including the installation's emergency generators. According to installation officials, the costs to operate and maintain the system were significantly higher than originally anticipated by the contractor because of errors in the system's inventory used to develop the solicitation, such as not including all of the installation's emergency generators. When queried about the requested price increase, the contractor responded that the initial contract bid would have been higher if the true inventory of the system had been known. Although the price adjustment process was not final at the time of our visit

in June 2006, installation officials stated that the government team responsible for the process had determined that the requested increases were allowable and reasonable and had approved the price increase. As a result of the price adjustment, the government's annual utility service costs are expected to increase from about \$415,000 to \$798,000 in the third year of the contract, an increase of about \$383,000, or 92 percent.

- The Fort Eustis electric distribution system privatization contract was issued on June 24, 2004. While this contract is not scheduled for a periodic price adjustment until December 2006, the contract costs have increased by about \$431,000, or 26 percent, since the contract was signed. The increase is the result of two factors. First, the annual service charge was increased by about \$73,000 as the result of correcting errors to the system's inventory described in the privatization solicitation. Second, the contract's cost was increased by about \$358,000 to pay for capital improvement projects that were added to the original contract. Fort Eustis officials stated that funding for the capital improvement projects added to the contract did not have to compete for funding against other needed installation improvement projects because project costs were added to the privatization contract. The officials stated that it was unclear whether these projects would have been approved for funding had the privatization contract not been in place.

The remaining three contracts we reviewed—the water and wastewater privatization contracts at Bolling Air Force Base and the electric distribution system privatization contract at Dobbins Air Reserve Base—were not yet eligible for, or not subject to, a periodic price adjustment. At the time of our visits in May 2006, actual contract costs in these cases approximated the estimates in the projects' economic analyses.

DOD Has Not Made Changes to Provide More Realistic Savings Estimates from Utility Privatization

Because DOD has not changed the guidance for performing the economic analyses or taken any other steps to change the perception that the utility privatization program results in reduced costs to the government, the program may continue to provide an unrealistic sense of savings for a program that generally increases annual government utility costs in order to pay contractors for enhanced utility services and capital improvements. The concern was caused by the methodology DOD uses to determine whether a proposed privatization contract would meet the statutory requirement for reduced long-term costs. In our previous report, we noted that DOD's guidance directs the services to compare the estimated long-term costs of the contract with the estimated long-term "should costs" of continued government ownership assuming that the service would upgrade, operate, and maintain the system in accordance with accepted

industry standards as called for in the proposed contract. This estimating method would be appropriate, if in the event the system is not privatized, the service proceeded to upgrade, operate, and maintain the system as called for in the estimate. However, this generally is not the case. According to DOD and service officials, if a system is not privatized, then the anticipated system improvements would probably be delayed because of DOD's budget allocation decisions, which have limited funds for utility improvements. Because of the time value of money, a future expense of a given amount is equivalent to a smaller amount in today's dollars. Thus, if reduced costs to the government are expected to be a key factor in utility privatization decision making, then it would appear more appropriate for the services to compare the cost of a proposed privatization contract with the cost of continued government ownership on the basis of the actual planned expenditures and timing of these expenditures.

Since May 2005, DOD has not changed the guidance for performing the economic analyses nor has DOD taken other steps, such as showing current utility system costs in the economic analyses, to change the perception that the utility privatization program results in reduced costs to the government. DOD's November 2005 supplemental program guidance directed the services to continue to prepare economic analyses based on the "should costs," which is defined as an independent government estimate of the costs required to bring the system up to and maintain it at current industry standards. Further, DOD's March 2006 report to Congress stated that the "should cost" estimate is the government's best tool for predicting the future requirement for individual systems and is the most realistic methodology. Yet, the report also acknowledged that the department had done an inadequate job of defining industry standards and then subsequently programming, budgeting, and executing to that requirement. Because DOD has not programmed funds to do the work described in the "should cost" estimate if the system is not privatized, DOD's estimates of the reduced costs to the government that would result from privatization are not based on realistic cost differences.

Information that DOD reported to Congress in March 2006 illustrates our concern. DOD's report stated that the department's total cost avoidance from utility conveyances is expected to exceed \$1 billion in today's dollars and, as shown in table 6, the report included information showing that the 81 contracts awarded under 10 U.S.C. 2688 will result in about \$650 million in reduced costs to the government in today's dollars compared to DOD's "should cost" estimate.

Table 6: DOD’s Estimated Cost Avoidance from Utility Privatization

Dollars in millions

Component	Number of systems privatized	Estimated costs under government ownership	Estimated costs under privatization	Estimated cost avoidance with privatization
Army	70	\$2,377.0	\$1,867.5	\$509.5
Navy and Marine Corps	1	308.1	215.4	92.7
Air Force	10	220.5	173.0	47.5
Total	81	\$2,905.6	\$2,255.9	\$649.7

Source: DOD.

Note: Estimates are totals in today’s dollars over the contract terms (50 years for most projects).

DOD’s reported cost avoidance amounts provide an unrealistic sense of savings for several reasons:

- First, as previously stated, the estimated costs under government ownership are not based on the actual expected costs if the system is not privatized but rather on a higher “should cost” amount. As a result, estimated costs under government ownership are overstated and, therefore, DOD’s estimated cost avoidance is overstated, at least in the short term.
- Second, the government’s costs for utility services increase with privatization. Army officials estimated that average annual cost increase for each privatized Army system was \$1.3 million. Also, the services estimate that they will need \$453 million more than is currently programmed for continuing government ownership to pay for the contract and other costs associated with the remaining number of utility systems that might be privatized through 2010 for the Air Force and the Navy and Marine Corps, and through 2011 for the Army.
- Third, DOD’s reported cost avoidance does not consider the program’s one-time implementation costs. Through fiscal year 2005, about \$268 million was spent to implement the program.
- Fourth, the economic analyses used to estimate the cost avoidance between the government-owned and privatization options for several of the 81 projects included in DOD’s report to Congress are unreliable. As noted in our previous report, our review of seven project analyses identified inaccuracies, unsupported cost estimates, and noncompliance with guidance for performing the analyses. The cost estimates in the analyses generally favored the privatization option by understating long-term privatization costs or overstating long-term government ownership costs. When we made adjustments to address the issues in these analyses,

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- the estimated cost avoidance with privatization was reduced or eliminated. Also, as discussed in another section of this report, although DOD has taken steps to improve reliability, we found questionable items in 10 economic analyses supporting projects awarded after our May 2005 report.
- Fifth, cost growth in privatization contracts might reduce or eliminate the amount of the estimated cost avoidance from privatization. We reviewed the analysis supporting the Navy's one privatization project under 10 U.S.C. 2688, awarded in 1999, and compared actual contract costs to the estimated contract costs included in the analysis. The analysis showed that if contract costs continue to increase at the same rate experienced since the contract was awarded, then the project's estimated cost avoidance would be reduced from about \$92.7 million to about \$18 million. This analysis also did not include consideration of privatization contract oversight costs. Consideration of these costs would further reduce the estimated cost avoidance to about \$4 million. As discussed in another section of this report, we found contract cost growth concerns in 3 of 6 additional utility privatization projects we reviewed, which will reduce the estimated cost avoidance for those projects.

In addition to providing an unrealistic sense of savings by providing only the "should cost" estimates, the economic analyses do not include other information that would provide decision makers with a clearer picture of the financial effect of privatization decisions. If the analyses included information showing the amount that the government currently spends on operating, maintaining, and upgrading the utility systems being evaluated for privatization, decision makers could better consider the increase in costs that will result from privatization as they assess the merits of proposed projects. However, DOD's guidance does not require that the services' economic analyses include current utility system cost information.

The National Defense Authorization Act for Fiscal Year 2006 modified the program's legislative authority by requiring that project economic analyses incorporate margins of error in the estimates that minimize any underestimation of the costs resulting from privatization of the utility system or any overestimation of the costs resulting from continued government ownership and management of the utility system. This step could help improve the reliability of the cost differences between the government-owned and privatization options. The modified authority stated that incorporating margins of error in the estimates was to be based upon guidance approved by the Secretary of Defense. However, as of June 2006, DOD had only issued general guidance in this area with no details on how the services were to comply with the new requirement. Specifically,

on March 20, 2006, DOD issued guidance directing the services to include in the economic analysis an explanation as to how margin of error considerations were addressed in developing the independent government cost estimate and carried forward in the price analysis report and cost realism report. Although the guidance referenced Office of Management and Budget Circular A-94, dated October 29, 1992; DOD Instruction 7041.3, dated November 7, 1995; and Deputy Secretary of Defense memorandum and guidance dated October 9, 2002; none of these documents provide details on how margins of error should be incorporated into the economic analyses. At the time of our review in June 2006, Army and Navy officials stated that they were evaluating how to include margins of error into future economic analyses. Air Force officials stated that their economic analyses already included margins of error calculations but that no formal rules existed on how to use the results of the calculations. Without detailed DOD guidance, there is little assurance that the services will include margins of error considerations in an appropriate and consistent manner in future project economic analyses.

Changes in Legislative Authority and DOD's Implementation of the Change Address Fair Market Value Concerns

DOD's changes to implement a modification to the legislative authority for the utility privatization program have addressed the fair market value concerns discussed in our May 2005 report. Our report noted that in some cases implementation of a previous legislative requirement that the government receive fair market value for systems conveyed to privatization contractors had resulted in higher contract costs for utility services. To address this concern, we recommended that DOD place greater scrutiny on the implementation of the fair market value requirement in proposed contracts to minimize cases where contractors recover more than the amounts they paid for system conveyances. Subsequent to our report, in January 2006, the National Defense Authorization Act for Fiscal Year 2006 was enacted.¹⁹ The act changed the legislative language from stating that fair market value from a conveyance must be received to stating that fair market value from a conveyance may be received.

In March 2006, DOD issued guidance to implement modifications in the legislative authority made by the act. With regard to fair market value, DOD's guidance to the services noted that military departments are no longer required to obtain fair market value exclusively through cash

¹⁹Pub. L. No. 109-163, § 2823 (2006).

payments or rate credits. The military departments now have the flexibility to seek consideration in a manner other than a payment of the fair market value when the economic analysis demonstrates it is in the best interest of the government. The guidance also stated that the military departments may not dispose of the government's property without receiving an appropriate return, but the amount and nature of that return may be determined and represented in a number of ways, depending on the negotiated deal.

The change in legislative authority and the additional guidance issued by DOD address our concern with receipt of fair market value for system conveyances. Our review of 10 economic analyses for projects awarded after our May 2005 report showed that the fair market value paid by the contractor and the amount recovered were the same. Thus, according to these analyses, the receipt of the fair market value for the conveyances in these cases did not result in any increased costs to the government.

Conclusions

DOD has made many changes to improve the management and oversight of the utility privatization program since our previous report. If fully implemented, the changes should result in more reliable economic analyses supporting proposed privatization projects, improved budgetary consideration of increased utility costs from privatization, enhanced oversight of privatization contracts, and reduced instances where contractors recover more than the amounts they paid as the fair market value for system conveyances. However, a number of program concerns remain because DOD's changes to address some issues noted in our previous report have not been effectively implemented, some changes were not sufficient to totally eliminate the concerns, and DOD did not make changes to address some concerns. Specifically, implementation of DOD's changes to improve the reliability of the economic analyses, such as requiring independent reviews and noting the importance of postconveyance reviews to compare actual contract costs with estimates from the analyses, could be improved. The reliability of the analyses could continue to be questionable until DOD requires independent reviewers to report to decision makers on the thoroughness of the economic analyses and any significant anomalies between the ownership options, estimated costs, inventories, and assumptions and also issues guidance requiring the services to perform the postconveyance reviews as noted in its March 2006 report to Congress. An additional concern is the services' estimated shortfall in the funds needed to pay contract costs associated with the remaining number of utility systems that might be privatized by the end of their programs. Unless DOD addresses the potential funding shortfall in

view of all DOD and service funding and priority needs, questions will remain over the availability of the additional funds needed to complete the program. Also, although DOD's changes designed to improve utility privatization contract administration and oversight are key steps in the right direction, it may take some time to fully implement improvements as new privatization contracts are awarded and oversight of older contracts is assessed. Until DOD ensures that the contracts awarded prior to the program changes have adequate resources and contractor performance surveillance plans, the adequacy of contract oversight will remain a concern. Further, because contractors own installation utility systems after privatization, they may have an advantage when negotiating contract changes and renewals. Unless DOD places additional emphasis on monitoring contract cost growth as utility privatization contracts undergo periodic price adjustments and other changes are negotiated, concern will continue that containing utility privatization contract cost growth may become a challenge.

Because DOD did not change guidance to require that project economic analyses show the actual costs of continued government ownership if the system is not privatized, or take any other steps to change the perception that the utility privatization program results in reduced costs to the government, DOD continues to provide an unrealistic sense of savings to a program that generally increases government utility costs in order to pay contractors for enhanced utility services and capital improvements. Until DOD requires that each economic analysis includes information on the system's current costs and the actual expected costs if the system is not privatized, decision makers will have incomplete information on the financial effect of privatization decisions. In addition, unless the Secretary of Defense issues detailed guidance explaining how the services should incorporate margins of error in the economic analyses, as required by the National Defense Authorization Act for Fiscal Year 2006, there is little assurance that the full benefit from this requirement will be achieved.

Recommendations for Executive Action

We recommend that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to take the following seven actions:

- require independent reviewers to report to decision makers on the thoroughness of each economic analysis and any significant anomalies in the assumptions used and estimated costs for each ownership option;
- issue guidance requiring the services to perform the postconveyance reviews as noted in DOD's March 2006 report to Congress;

-
- address the utility privatization program potential funding shortfall in view of all DOD and service funding and priority needs;
 - ensure that utility privatization contracts awarded prior to the November 2005 supplemental guidance have adequate resources and contractor performance surveillance plans;
 - place additional emphasis on monitoring contract cost growth as utility privatization contracts undergo periodic price adjustments and other changes are negotiated;
 - require, in addition to the “should cost” estimate, that each project economic analysis include the system’s current annual costs and the actual expected annual costs if the system is not privatized; and
 - issue detailed guidance explaining how the services should incorporate margins of error in the economic analyses.

Agency Comments and Our Evaluation

In comments on a draft of this report, the Deputy Under Secretary of Defense (Installations and Environment) generally agreed with six of our seven recommendations and outlined a plan of action to address each recommendation. The Deputy Under Secretary noted that the utility privatization systems evaluated in our report were approved prior to DOD’s November 2005 program guidance and that the guidance will be fully implemented prior to awarding additional contracts. We recognize that issues identified in this report pertain to contracts awarded before supplemental program guidance was issued in November 2005. Nevertheless, we believe the issues identified in this report highlight areas that merit increased attention as the program continues—and this is reflected in the department’s response to each recommendation.

The Deputy Under Secretary indicated disagreement with our recommendation to require, in addition to the “should cost” estimate, that each project economic analysis include the system’s current annual costs and the actual expected annual costs if the system is not privatized, and also stated that full implementation of DOD’s November 2005 guidance will provide further reassurance that every conveyance will reduce the long-term costs of the department compared to the costs of continued ownership. However, as noted in our May 2005 report and again in this report, we believe that in the short term it is clear that the utility privatization program increases annual costs to the government where contractors make system improvements and recoup their costs from the department through their service contracts. DOD’s sole use of “should costs” as a basis for comparing its long-term costs with those contained in contractor proposals provides a less clear picture of savings to the government since, as our reports have shown, the government’s “should

costs” do not provide a realistic portrayal of the planned government expenditures. Accordingly, we believe our recommendation continues to have merit.

DOD’s comments and our detailed response to specific statements in those comments are presented in appendix II.

We are sending copies of this report to other interested congressional committees; the Secretaries of Defense, the Army, the Navy, and the Air Force; and the Director, Office of Management and Budget. We will also make copies available to others upon request. In addition, the report will be available at no charge on GAO’s Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please call me at (202) 512-5581 or e-mail at holmanb@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. The GAO staff members who made key contributions to this report are listed in appendix III.



Barry W. Holman, Director
Defense Capabilities and Management

List of Congressional Committees

The Honorable John Warner
Chairman
The Honorable Carl Levin
Ranking Minority Member
Committee on Armed Services
United States Senate

The Honorable Ted Stevens
Chairman
The Honorable Daniel K. Inouye
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
United States Senate

The Honorable Duncan L. Hunter
Chairman
The Honorable Ike Skelton
Ranking Minority Member
Committee on Armed Services
House of Representatives

The Honorable C. W. Bill Young
Chairman
The Honorable John P. Murtha
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
House of Representatives

Appendix I: Scope and Methodology

To update the status of the Department of Defense's (DOD) utility privatization program, we summarized program implementation status and costs and compared the status to DOD's past and current goals and milestones. We discussed with DOD and service officials issues affecting implementation of the program, such as the services' suspension of the program between October 2005 and March 2006, and inquired about the effects of implementation delays on program completion plans. Using data from the services' quarterly program status reports to DOD, we summarized the program implementation status by service and compared the status to program status reported in our prior report. We confirmed the quarterly reports' status data on five privatization projects at the four installations we visited but did not otherwise test the reliability of the data. We also reviewed and summarized the services' estimates of the additional number of systems that might be privatized by the completion of their programs and the funds needed to pay the costs associated with these anticipated projects.

To assess the effect of DOD's changes on the program management and oversight concerns noted in our May 2005 report, we documented the changes made by interviewing DOD and service officials and reviewing pertinent policies, guidance, memorandums, and reports, discussed with DOD and service officials the intended objective for each of the changes, and compared the changes with the concerns identified in our prior report. To assess the effect of DOD's changes on the reliability of the economic analyses supporting privatization decisions, we reviewed the economic analyses supporting 10 privatization projects that were awarded after our May 2005 report and that had been subjected to the services' new independent review processes. The analyses were judgmentally selected to obtain examples from both the Army and the Air Force. For each analysis, we evaluated the basis for the estimates and assumptions used and assessed consistency and compliance with DOD guidance. We did not otherwise attempt to independently determine estimates of long-term costs for the projects. We shared the results of our analyses with service officials and incorporated their comments as appropriate. To assess the effect of DOD's changes on consideration of increased costs from utility privatization, we summarized the services' estimates of the additional funds that would be needed to pay costs associated with the remaining number of utility systems that might be privatized and inquired about DOD's plans for dealing with a potential program funding shortfall. To assess the effect of DOD's changes on the administration and oversight of utility privatization projects, we visited four installations with five utility privatization projects awarded prior to our May 2005 report: Fort Eustis, Virginia; the Army's Military Ocean Terminal Sunny Point, North Carolina;

Bolling Air Force Base, Maryland; and Dobbins Air Reserve Base, Georgia. These installations were judgmentally selected because they represented a cross section of typical utility privatization projects, as corroborated with service officials. At each installation, we discussed resources available for contract oversight and plans for contractor performance monitoring. Also, to assess the effect of DOD's changes on controlling cost growth in utility privatization contracts, we reviewed cost changes in the five utility privatization contracts at the installations we visited, discussed the reasons for the changes with local officials, and compared the actual contract costs with estimates from the projects' economic analyses. We also reviewed cost changes in the Fort Rucker natural gas privatization contract because, according to the services, it was the only contract awarded under the legislative authority specifically provided for utility privatization that had completed a periodic price adjustment. To assess the effect of DOD's changes on cost avoidance estimates from privatization, we reviewed the estimates DOD reported to Congress to determine whether the estimates reflected the actual changes expected in the government's utility costs.

We conducted our review from March through July 2006 in accordance with generally accepted government auditing standards.

Appendix II: Comments from the Department of Defense

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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OFFICE OF THE UNDER SECRETARY OF DEFENSE
3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

AUG 21 2006

Mr. Barry Holman
Director, Defense Capabilities and Management
Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Holman:

This is the Department of Defense (DoD) response to the GAO draft report, GAO-06-914, 'DEFENSE INFRASTRUCTURE: Actions Taken to Improve the Management of Utility Privatization, but Some Concerns Remain,' dated July 17, 2006 (GAO Code 350812). I have enclosed a detailed response and plan of action for each recommendation.

As noted in your report, no Department utility systems have been privatized since the issuance of new guidance in November 2005. As such, the systems evaluated within the report were not subject to that guidance. The guidance will be fully implemented prior to the Components awarding any further contracts providing further reassurance that every conveyance will reduce the long-term costs of the Department compared to the costs of continued ownership.

I appreciate the opportunity to comment on the draft report.

Philip W. Grone
Deputy Under Secretary of Defense
(Installations and Environment)

Enclosure:
As stated



GAO DRAFT REPORT - DATED July 17, 2006
GAO CODE 350812/GAO-06-914

"DEFENSE INFRASTRUCTURE: Actions Taken to Improve the Management of Utility
Privatization, but Some Concerns Remain"

DEPARTMENT OF DEFENSE COMMENTS
TO THE RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to require independent reviewers to report to decisionmakers on the thoroughness of each economic analysis and any significant anomalies in the assumptions used and estimated costs for each ownership option.

DOD RESPONSE: Concur with this recommendation. As stated in the report, guidance issued by the Department on 2 November 2005 requires an independent review for all analyses supporting a proposed conveyance. While there are clearly some areas for concern in the independent reviews that were studied, the report also states that these reviews were conducted prior to the Department issuing guidance requiring them. Additionally, these reviews were the first ones conducted and were learning experiences for all involved. Since these reviews, lessons learned have been shared through the Utilities Privatization Working Group to improve the quality of later reviews.

GAO noted specific concerns identified with three of the reviews, but does not make a compelling case that the issues would have changed the proposed outcomes. The estimated cost of recapitalizing a utility system is a judgment call on the part of the estimator. There are a number of factors, including acceptance of risk, which affect the decision. In the case where a contractor proposes a lower amount of up front capital improvement than the government estimate, it is not legitimate for the government to drop the government estimate to match that input. Beyond the concern that this may constitute bid leveling, the contractor may be willing to accept a higher risk of costly emergency repairs to decrease the initial capital improvement costs. Regardless of this difference in philosophy, the contractor would still be required to provide the specified level of service, which is the basis for the comparison.

Plan of Action:

1. Continue to require independent reviews as per current guidance.
2. Through the Utilities Privatization Working Group, emphasize the scope of the reviews and continue to share lessons learned to improve the quality of future reviews.

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to issue guidance requiring the Services to perform the post conveyance reviews as noted in DoD's March 2006 report to Congress.

See comment 1.

See comment 2.

DOD RESPONSE: Concur with this recommendation. As stated in the March 2006 report to Congress, the Department recognizes the value of post conveyance reviews. The report expresses concern over the limited number and scope of the reviews that have been conducted. While the Department agrees that the scope of some of the reviews may be less than adequate, it is important to note that conducting these reviews at a time before the contractor has reached steady state operations is not conducive to reliable and realistic results.

Plan of Action:

1. Issue guidance requiring Service officials to perform post conveyance reviews in a manner and time frame consistent with the March 2006 report to Congress.

RECOMMENDATION 3: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to address the utility privatization program potential funding shortfall in view of all DoD and Service funding and priority needs.

See comment 3.

DOD RESPONSE: Partially concur with this recommendation. The guidance issued 2 November 2005 directs Components to consider and plan for all costs associated with utility privatization before and after conveyance. GAO reports that without identifying additional resources for utility privatization costs, funding for these contracts must come from other base operating support funds. In reality, it has been the utility sustainment funds that have been used in the past for other base support operations that has led to the need and desire to privatize. Components must continue to prioritize competing interests within the constraints provided by budgets and guidance.

Plan of Action:

1. Reiterate guidance through the Utilities Privatization Working Group
2. Monitor progress and respond to program reviews and waiver requests.

RECOMMENDATION 4: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to ensure that utility privatization contracts awarded prior to the November 2005 supplemental guidance have adequate resources and contractor performance surveillance plans.

See comment 4.

DOD RESPONSE: Concur with this recommendation. The GAO report states that written performance evaluation plans as required by Federal Acquisition Regulations were not in place at two installations. Additionally, the report points to concerns that adequate personnel resources have not always been identified. It is the responsibility of the requiring activity and the contracting officer to ensure that both of these items are adequately addressed prior to award. In those cases where that was not done prior to award, it is imperative that the problem be corrected. There is sometimes a difference of opinion in the level of detailed oversight that is necessary and in the adequacy of the workforce to handle the workload in a particular office. These issues should be resolved under the purview of the Service and not at the DoD level.

The Defense Energy Service Center, in cooperation with Defense Acquisition University, recently provided a new online course for Utilities Privatization Contract Administration. This module will be used in a continuing education environment to help ensure adequate training for personnel involved with privatized utilities contracts.

Plan of Action:

1. Reiterate through the Utilities Privatization Working Group that Federal Acquisition Regulations require a written performance evaluation plan and these plans are valuable and essential components of government oversight.
2. Advertise availability of the new Utilities Privatization Contract Administration module through Defense Acquisition University.

RECOMMENDATION 5: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to place additional emphasis on monitoring contract cost growth as utility privatization contracts undergo periodic price adjustments and other changes are negotiated.

DOD RESPONSE: Partially concur with this recommendation. The GAO report identifies cost growth in several contracts, some of which appear to be excessive at first look, but the report does not classify the growth as warranted or unwarranted. Cost growth may occur in utility service contracts due to many factors, including but not limited to, increased labor costs, increased energy costs, and the addition of infrastructure that needs to be covered by the contract. Much of the cost growth discussed in the report occurred in the first year of a contract due to inventory adjustments that were made after award. GAO only looked at the contract cost and did not review the impact to the government estimate. In most cases, while there is cost growth, it would have affected both estimates and as such, the savings delta remains valid. The Component's necessity to prioritize budget constraints is an inherent driver toward emphasizing and controlling unwarranted cost growth. As such, the Department does not consider that there is anything to gain by issuing guidance on this topic.

Plan of Action:

1. Continue to emphasize the requirement to implement procedures to control cost growth in privatized utility contracts.

RECOMMENDATION 6: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to require, in addition to the "should cost" estimate, that each project economic analysis include the system's current annual costs and the actual expected annual costs if the system is not privatized.

DOD RESPONSE: The Department can include the current annual costs in the economic analysis but cannot provide the expected annual cost if the system is not privatized.

The current annual cost, alone, would be of limited use because it could only be compared to the "should cost," which is what we should be spending, as opposed to what we

See comment 5.

are or will be spending to maintain the system. At most, only a handful of systems currently being considered for privatization would have reasonably projected recapitalization projects that could be included to formulate the future annual costs if not privatized. Without inclusion of such recapitalization costs, the projected annual costs would be essentially the same as current annual costs. The projection, therefore, would be of no real value except in those very few cases with pending projects, and then only if the project was essentially a complete recapitalization of the entire system, in order to be comparable to the cost of privatization.

Plan of Action:

1. Considering the intent to provide reliable utility services support, continue to use the appropriate industry standard in determining the long-term costs of the United States for utility services provided by the utility system concerned.

RECOMMENDATION 7: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to issue detailed guidance explaining how the Services should incorporate margins of error in the economic analyses.

DOD RESPONSE: Concur with this recommendation. Although the March 2006 guidance directs Components to include an explanation as to how margin of error considerations were addressed, there is no clear guidance on how margin of error should be addressed.

Plan of Action:

1. The Department will work with the Components to identify the best method for considering margin of error and will issue guidance directing that method be used in future analyses.

The following is our detailed response to the Department of Defense's (DOD) comments provided on August 21, 2006.

GAO's Response to the Department of Defense's Comments

Our responses to DOD's comments are numbered below to correspond with the department's various points.

1. As noted in this report, we identified concerns with the independent review performed on each of the 10 economic analyses we reviewed. We did not attempt in this report to prove that the questionable items we identified with each analysis would have changed the proposed outcomes but noted that improvements are needed in the thoroughness of the independent reviews that will be performed on future projects. Until DOD requires independent reviewers to report to decision makers on the thoroughness of the economic analyses and any significant anomalies, we continue to believe the reliability of the analyses could be questioned. As outlined in our May 2005 report and this report, to ensure a valid comparison of costs we continue to believe that the government's "should cost" estimate should be closely based on performing the same work that the contractor would perform.
2. Our report does not suggest that postconveyance reviews should be conducted prematurely as indicated by DOD in its comments. The fact is that the utility privatization contracts under 10 U.S.C. 2688 authority began to be awarded in 1999, about 7 years ago, and postconveyance reviews do not appear to have been performed on many ongoing utility privatization contracts since that time. Although DOD noted in its March 2006 report the importance of postconveyance reviews as an additional measure to help ensure reliable economic analyses, it has not issued guidance to require the services to perform such reviews.
3. Our report clearly shows that Air Force officials, not GAO, stated that without additional resources, funding for utility privatization contracts must come from other base operating support funds, which would result in diverting critical resources from remaining facilities and infrastructure.

Furthermore, DOD's comment that utility sustainment funds have been used for other base support operations in the past only reinforces the need to address the utility privatization program potential funding shortfall. We have completed a number of reviews in which we have identified examples where the shifting of operation and maintenance funds from one account to other accounts to fund must-pay bills and

other priorities contributes to management problems and funding shortfalls. For example, in February 2003, we reported that the services withheld facilities sustainment funding to pay must-pay bills, such as civilian pay, emergent needs, and other nonsustainment programs, throughout the year and transferred other funds back into facilities sustainment at fiscal year's end.¹ Still, the amounts of funds spent on facilities sustainment were not sufficient to reverse the trend in deterioration. In June 2005, we reported that hundreds of millions of dollars originally designated for facilities sustainment and base operations support had been redesignated by the services to pay for the Global War on Terrorism.² While installations received additional funds at the end of the fiscal year to help offset shortfalls endured during the year, the timing made it difficult for the installations to maintain facilities and provide base support services efficiently and effectively. Similarly, unless the potential funding shortfall in the utility privatization program is addressed, funding will likely have to be redesignated to fund the utility privatization program rather than be used for its intended purpose.

4. Our report raises concerns about the adequacy of the services' oversight of several privatization contracts that were awarded prior to DOD's November 2005 supplemental guidance. Given that the Office of the Deputy Under Secretary of Defense (Installations and Environment) has overall policy and management oversight responsibilities for the utility privatization program, we continue to believe that this office is the appropriate level for providing direction and assurance that utility privatization contracts awarded prior to the supplemental guidance have adequate resources and contractor performance surveillance plans, as we recommend.
5. Our report highlights the importance of monitoring cost growth because contractors have ownership of the utility systems after privatization and, therefore, may have an advantage when negotiating contract changes and renewals. In addition, controlling the potential growth in the cost of ongoing utilities privatization contracts is important to the services in their planning for the adequate funding of the program. We did not review the effect of contract cost growth on

¹GAO, *Defense Infrastructure: Changes in Funding Priorities and Strategic Planning Needed to Improve the Condition of Military Facilities*, GAO-03-274 (Washington, D.C.: Feb. 19, 2003).

²GAO, *Defense Infrastructure: Issues Need to Be Addressed in Managing and Funding Base Operations and Facilities Support*, GAO-05-556 (Washington, D.C.: June 15, 2005).

the government estimate because the government estimate is not a relevant factor in controlling costs once a system has been privatized. Although a comparison of actual costs of a privatization project with the estimates included in the project's economic analysis is a useful tool to help improve the reliability of analyses of future privatization projects, it is unlikely that such comparisons would assist in controlling cost growth.

Furthermore, DOD's comment refers to a "savings delta." As noted in our May 2005 report and again in this report, in the short term it is clear that the utility privatization program increases annual costs to the department where contractors make system improvements and recoup their costs through the service contracts.

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

Barry W. Holman, (202) 512-5581 or (holmanb@gao.gov)

Acknowledgments

In addition to the person named above, Susan C. Ditto, Harry A. Knobler, Katherine Lenane, Mark A. Little, Gary W. Phillips, Sharon L. Reid, and John C. Wren also made major contributions to this report.

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