
June 16, 2004



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Analysis of the Defense Finance and Accounting Service Military Retired and Annuitant Pay Sourcing Options (D-2004-088)

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Acronyms

CGA	Continuing Government Activity
CNA	Center for Naval Analyses
DFAS	Defense Finance and Accounting Service
IG DoD	Inspector General of the Department of Defense
OMB	Office of Management and Budget
OPM	Office of Personnel Management



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
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June 16, 2004

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Report on Analysis of the Defense Finance and Accounting Service Military
Retired and Annuitant Pay Sourcing Options (Report No. D-2004-088)

We are providing this report for your information and use. We performed the audit in response to a congressional request. We considered management comments on a draft of this report in preparing the final report.

Comments on the draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the staff. Questions should be directed to Ms. Kimberley A. Caprio at (703) 604-9202 (DSN 664-9202) or Ms. Anella J. Oliva at (703) 604-9323 (DSN 664-9323). See Appendix C for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

David K. Steensma
David K. Steensma
Assistant Inspector General
for Contract Management

Office of the Inspector General of the Department of Defense

Report No. D-2004-088
(Project No. D2004CB-0066)

June 16, 2004

Analysis of the Defense Finance and Accounting Service Military Retired and Annuitant Pay Sourcing Options

Executive Summary

Who Should Read This Report and Why? Defense officials responsible for the management of military retired and annuitant pay functions should read this report. The report addresses the analysis of sourcing options for the Defense Finance and Accounting Service military retired and annuitant pay functions.

Background. We performed this audit in response to a request from Congressman Dennis J. Kucinich. The Inspector General of the Department of Defense (IG DoD) issued Audit Report No. D-2003-056, "Public/Private Competition for the Defense Finance and Accounting Service (DFAS) Military Retired and Annuitant Pay Functions," on March 21, 2003, that recommended that the Director, DFAS, determine a specific course of action for the military retired and annuitant pay functions contract, to include a determination of why a recompetition should not be held. The director concurred and stated that all available options would be evaluated to decide a future course of action that would be cost-effective and would provide the best service possible for retired military and annuitant pay customers.

DFAS tasked the Center for Naval Analyses (CNA) on June 9, 2003, to provide an analysis of options DFAS could pursue for the military retired and annuitant pay functions. In September 2003 CNA issued its report and concluded that the "preponderance of evidence," including an estimated \$42 million cost savings, favored retaining the existing contract as long as costs continue to be reasonable and performance satisfactory. CNA analyzed four options: retain the existing contract, return the pay functions to in-house performance without another public/private competition, conduct a new public/private competition, and conduct a private/private competition. DFAS awarded the contract to the current contractor in September 2001, and the performance period was a 4-month transition-in period, 10 1-year options, and a 6-month transition-out period. Therefore, CNA used the actual contract cost of the first performance year and revised contract costs for the second and third performance years when analyzing the estimated costs of each of the four options.

After reviewing the CNA report, Congressman Dennis J. Kucinich requested that the IG DoD review the \$42 million cost savings estimate associated with retaining the existing contract until the end of its 10-year performance period, the impact of this cost savings on other options, explain the difference between the summary performance data and the random sample performance data used by CNA to evaluate contractor performance, and evaluate the appropriateness of CNA's presentation of the data.

Results. We disagree that the \$42 million CNA estimated was a fair representation of the cost savings of Option 1, retain the existing contract, compared with Option 2, return to in-house performance, because of the methodology used.

- CNA applied a partial cost reduction to Option 2 and a full cost reduction to Option 1 for the systems work that did not materialize as anticipated in the solicitation,
- CNA did not include a reduction of contract administration costs to Option 2.

Given that the performance of the contractor could not be evaluated on all contractual performance requirements, we also disagree with the CNA report that the overall performance of the contractor could be evaluated. Our audit results on the Option 1 and Option 2 are shown on the following table.

<u>September 2003 CNA Study*</u>			<u>IG DoD Audit Results</u>
<u>Description</u>	<u>Advantage</u>	<u>Disadvantage</u>	
Option 1: Retain the existing contract until the end of the 10-year performance period. Estimated cost: \$286.2 million.	\$42 million less expensive than the MEO [Option 2] and should provide a continuity of operations and continued satisfactory customer service.	Does not return the functions to in-house performance.	Estimated cost: \$286.53 million to \$291.96 million. Difference due to contract administration. The “Advantage” should show \$11.2 million to \$41.5 million less expensive than the MEO [Option 2].
Option 2: Return to in-house performance without a new public/private competition. Estimated cost: \$328.0 million.	Corrects the error made and return the functions to in-house performance.	Would discourage private sector participation in future DFAS competitions. Requires a deviation from OMB and waivers from OPM to rehire employees who left Government service.	Estimated cost: \$303.14 million to \$328.07 million. Difference due to the reduction of systems work.
* We did not review Option 3, conduct a new public/private competition, or Option 4, conduct a private/private competition, because the \$42 million cost savings CNA estimated did not affect Option 3 and Option 4. We also did not review the application of the Service Contract Act; or the out-of-pocket costs to the taxpayer because our scope was limited to the specific matters outlined in Congressman Kucinich’s request.			

Presentation of Contractor Performance Data. CNA did not use equivalent scales when graphically presenting similar performance data. To illustrate the percentage of new accounts established within 30 days, CNA used a line graph with a scale of 93 to 100 to show prior Government performance and a bar graph with a scale of 0 to 100 to show contractor performance. Contractor performance should be shown on graphs of similar type and scale to those used to show prior Government performance.

Contractor Performance Data. DFAS could only evaluate the contractor on 4 of the 10 contractual performance requirements; therefore, because not all contract performance data were available, we were unable to come to a conclusion on the performance of the contractor.

Customer Satisfaction Surveys. CNA used data that DFAS provided to show that customers were as satisfied with contractor performance as they were with Government performance. However, the data that DFAS provided were not based on documented statistically representative sample designs, and therefore, should not be used to compare performance.

Management Action. During the course of our audit, DFAS took management actions to address the methodology for the selection of samples for the customer satisfaction surveys. Specifically, DFAS was developing procedures to ensure that sample selections for future customer surveys for the military retired and annuitant pay functions are statistically representative of the customer base.

Management Comments. The Acting Director, DFAS, concurred with the recommendations to use the most current contractor performance data and relevant economic cost data to make the decision to retain the existing contract at each option year and issue standard operating procedures to ensure that the samples selected for future military retiree and annuitant customer satisfaction surveys are based on documented statistically representative sample designs. Therefore, no further comments are required. See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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Background

Office of Management and Budget Circular No. A-76 Guidance. The Office of Management and Budget (OMB) Circular No. A-76, “Performance of Commercial Activities,” August 4, 1983 (Revised), and OMB Circular No. A-76 Revised Supplemental Handbook, March 1996 (Revised), established Federal policy regarding the performance of recurring commercial activities. The guidance sets forth the principles and procedures for implementing OMB Circular No. A-76, including the instructions for calculating the financial advantage to the Government of acquiring a service through in-house, contract, or inter-service support agreement resources. This guidance was in effect for the public/private competition of the Defense Finance and Accounting Service (DFAS) military retired and annuitant pay functions, which was announced in December 1997. On May 29, 2003, OMB issued OMB Circular No. A-76, “Performance of Commercial Activities,” that supercedes the previous versions. Any new public/private competition will be subject to the May 29, 2003, version of OMB Circular No. A-76.

Public/Private Competition for the Military Retired and Annuitant Pay Functions. On September 11, 2000, DFAS issued a solicitation requesting proposals for performance of the military retired and annuitant pay functions for a 10-year period. One contractor, Affiliated Computer Services, Government Services, Inc., submitted a proposal to the solicitation. DFAS awarded the contract to Affiliated Computer Services, Government Services, Inc., (the contractor) in September 2001. The adjusted total cost of contract performance was \$364.7 million.¹ The contract was awarded to the contractor based on a savings of \$1.9 million. The performance period of the contract was a 4-month transition-in period, 10 1-year options, and a 6-month transition-out period.

Identification of In-house Cost Estimate Error in IG DoD Report. On March 21, 2003, the Inspector General of the Department of Defense (IG DoD) issued Audit Report No. D-2003-056, “Public/Private Competition for the Defense Finance and Accounting Service Military Retired and Annuitant Pay Functions.” The report identified an error in the in-house cost estimate for the military retired and annuitant pay functions. If the error had been identified prior to the award, the in-house cost estimate from the Government would have been reduced by an estimated \$31.8 million.

IG DoD Recommendation and DFAS Response. One of the recommendations in the IG DoD report was for the Director, DFAS, to determine a specific course of action for the military retired and annuitant pay functions contract, to include a determination of why a recompetition should not be held. The Director concurred and on April 22, 2003, stated that he “will consider and evaluate all available options, and will conduct an independent analysis of the options that will consider legal, business, and operational factors.” In May 2003, DFAS requested that the

¹ The adjusted total cost of contract performance is the amount compared to the total cost of agency performance to identify the low cost provider in a public/private competition. The adjusted total cost of contract performance includes the contract price, contract administration, one-time conversion costs, federal income tax adjustment, and the conversion differential.

Office of the Deputy Under Secretary of Defense (Installations and Environment) assist them in obtaining a contractor to conduct the independent analysis.

Center for Naval Analyses Tasking. On June 9, 2003, the Office of the Deputy Under Secretary of Defense (Installations and Environment) tasked the Center for Naval Analyses (CNA) to evaluate the options DFAS could pursue for the military retired and annuitant pay functions. The CNA Corporation operates CNA, a federally funded research and development center. According to their Web site, CNA has provided “full-service” research and analysis since 1942 that has helped the Navy and Marine Corps become more effective and efficient. CNA performed work in the areas of national defense, transportation, education, health care, domestic safety, and the environment. CNA has worked in the area of public/private competition for several years, including identifying ways to run the public/private competitions more efficiently and suggesting incentives to increase cooperation with the public/private competition process.

CNA Report. CNA issued its report, “Analysis of DFAS Military Retired and Annuitant Pay Sourcing Options,” September 2003, in response to the DFAS tasking. CNA analyzed four different options available to DFAS.

- Option 1, retain the existing contract with Affiliated Computer Services, Government Services, Inc., until the end of its 10-year performance period.
- Option 2, terminate the existing contract and return the retired and annuitant pay functions to in-house performance by the most efficient organization (MEO)² without another public/private competition.
- Option 3, conduct a new public/private competition.
- Option 4, conduct a private/private competition.

The contractor was in the second performance year when CNA conducted the study, therefore, CNA used the actual contract cost of the first performance year and revised contract costs for the second and third performance years when analyzing the estimated costs of each of the four options. CNA concluded that, while no option was ideal, the “preponderance of evidence,” including an estimated \$42 million cost savings, favored retaining the existing contract as long as costs continue to be reasonable and performance satisfactory.

Congressional Request. On November 20, 2003, after reviewing the report issued by CNA, Congressman Dennis J. Kucinich requested that the IG DoD evaluate two aspects of the analysis.

- Review the \$42 million cost savings estimate associated with retaining the existing contract until the end of its 10-year performance period.

² The MEO is the staffing plan the Government developed to represent the most efficient and cost-effective organization to perform the functions competed in a public/private competition.

-
- Explain the difference between the summary performance data and the random sample performance data used by CNA to evaluate contractor performance and evaluate the appropriateness of CNA's presentation of the data.

Objective

Our overall audit objective was to review the analysis of the DFAS options for the military retired and annuitant pay functions conducted by CNA. Specifically, we reviewed the \$42 million cost savings associated with the contractor continuing performance and reviewed the basis and analysis of contractor performance data. See Appendix A for a discussion of the scope and methodology. See Appendix B for the congressional request.

Analysis of DFAS Sourcing Options

We disagree with the methodology CNA used to estimate the \$42 million cost savings of Option 1, retain the existing contract, compared with Option 2, return to in-house performance. For the reduction in systems work, CNA applied a partial cost reduction to Option 2 and a full cost reduction to Option 1. Further, CNA did not include a reduction of contract administration costs to Option 2. As a result, we believe that showing the estimated cost savings as a range of \$11.2 million to \$41.5 million is a fairer presentation.

We also disagree that the overall performance of the contractor could be evaluated. DFAS could only evaluate the contractor on 4 of the 10 contractual performance requirements and customer satisfaction data that DFAS provided were not based on documented statistically representative sample designs. Given that all contractual performance requirements can not be evaluated and the customer satisfaction data should not have been used to compare performance, we were unable to come to a conclusion on the performance of the contractor.

Options Provided to DFAS

CNA identified four available options in their report to DFAS for the military retired and annuitant pay functions. For each option, CNA stated they evaluated the following factors:

- cost of performance,
- continued quality of service to customers,
- impact on the affected workforce,
- consistency with A-76 policy and federal procurement laws and regulations, and
- impact on future cost competitions and competitive sourcing.

CNA stated that each option had many significant benefits, but each option also had at least one major disadvantage. In addition to the analyses of the four options available to DFAS, CNA conducted an analysis of the application of the Service Contract Act³ and out-of-pocket costs to the taxpayer. We did not review Option 3, conduct a new public/private competition; Option 4, conduct a private/private competition; the application of the Service Contract Act; or the out-of-pocket costs to the taxpayer because our scope was limited to the specific

³ The Service Contract Act was established to ensure that Government contractors fairly compensate their service workers. In order to provide a level playing field between public and private offers, the in-house cost estimate does not include inflation for personnel costs that are subject to an economic price adjustment beyond the end of the first performance period.

matters outlined in Congressman Kucinich’s request. The CNA review and the IG DoD audit results of Option 1 and Option 2 are shown in Table 1.

Table 1. Summary of CNA’s Review of Option 1 and Option 2 and IG DoD Audit Results			
	September 2003 CNA Study*		IG DoD Audit Results
<u>Description</u>	<u>Advantage</u>	<u>Disadvantage</u>	
Option 1: Retain the existing contract until the end of the 10-year performance period. Estimated cost: \$286.2 million.	\$42 million less expensive than the MEO [Option 2] and should provide a continuity of operations and continued satisfactory customer service.	Does not return the functions to in-house performance.	Estimated cost: \$286.53 million to \$291.96 million. Difference due to contract administration. The “Advantage” should show \$11.2 million to \$41.5 million less expensive than the MEO [Option 2].
Option 2: Return to in-house performance without a new public/private competition. Estimated cost: \$328.0 million.	Corrects the error made and return the functions to in-house performance.	Would discourage private sector participation in future DFAS competitions. Requires a deviation from OMB and waivers from OPM to rehire employees who left Government service.	Estimated cost: \$303.14 million to \$328.07 million. Difference due to the reduction of systems work.

* We did not review Option 3, conduct a new public/private competition, or Option 4, conduct a private/private competition, because the \$42 million cost savings CNA estimated did not affect Option 3 and Option 4. We also did not review the application of the Service Contract Act; or the out-of-pocket costs to the taxpayer because our scope was limited to the specific matters outlined in Congressman Kucinich’s request.

DFAS Decision to Continue Contractor Performance

Prior to the CNA study, DFAS conducted its own analysis of the available military retired and annuitant pay options. DFAS concluded they should continue with the existing contract because it was a low-risk option, provided continued service delivery, and provided time to evaluate available options and make a fully informed decision for the future of the military retired and annuitant pay functions. DFAS officials stated that, in August 2002, they provided a briefing of their analysis to the Under Secretary of Defense (Comptroller)/Chief Financial Officer and subsequently implemented that option. In response to IG DoD Report No. D-2003-056, the Director, DFAS, stated that he would conduct an independent analysis of the options, including all legal, business, and operational factors, and engaged CNA in June 2003 to conduct the analysis.

CNA conducted their analysis between June 2003 and September 2003 and determined that no option was ideal and that none of the options available to DFAS could really reverse the error identified by the IG DoD. CNA recommended, based on a “preponderance of evidence,” that DFAS retain the existing contract as long as costs continued to be reasonable and performance was satisfactory. CNA stated that the way the contractor proposal and the MEO offer were structured, the existing contract becomes less expensive than the MEO each year into the 10-year performance period. DFAS decided to retain the existing contract and will evaluate it each year to ensure it continues to provide best value and acceptable performance.

Methodology for Estimating Cost Savings

We disagree with the CNA methodology for estimating the cost savings associated with retaining the existing contract. CNA applied only a partial reduction in systems work to the Government’s offer and did not include contract administration costs when estimating the cost savings of Option 1, retain the existing contract, compared with Option 2, return to in-house performance. We believe showing the estimated cost savings associated with retaining the existing contract as a range is a fairer presentation.

Cost Savings of Option 1 Compared With Option 2. CNA estimated that Option 1, retain the existing contract, was \$42 million less expensive than Option 2, return to in-house performance. However, when we wholly reduced systems work and included contract administration costs, we estimated the cost of Option 1 ranged from \$11.2 million to \$41.5 million less than the cost of Option 2.

Systems Work Requirements. DFAS estimated in the solicitation that the service provider would be required to perform 120,000 hours of Government-directed automated information system changes (systems work) each year. The contractor proposal included time and materials provisions for the estimated systems work. By comparison, the MEO included the systems work in two different portions of the in-house cost estimate. Specifically, systems work was divided between the MEO Systems Functional Branch and the Technical Services Organization⁴. The cost of the systems work performed by the Technical Services Organization was included on the in-house cost estimate as additional costs. The systems work performed by the MEO Systems Functional Branch was allocated to 43 personnel positions and the cost of those positions was included on the in-house cost estimate as fixed personnel costs.

During the contractor’s first year of performance, which was completed in January 2003, the extent of systems work did not materialize as estimated in the solicitation and the contractor incurred only 23.8 percent of its budget for systems work related time and materials. CNA stated that DFAS officials realized the

⁴ The Technical Services Organization is a DFAS organization that has a service level agreement with DFAS-Cleveland and charges an hourly rate for its services.

systems work would probably continue to be only 23.8 percent of the 120,000 estimated hours, thus negating 76.2 percent of the original requirement.

Adjustment to Contractor Costs for Systems Work. CNA revised the cost of the contractor proposal to reflect the 76.2-percent reduction in systems work. CNA reduced the time and materials portion of the contractor proposal by 76.2 percent for each of the remaining performance years of the 10-year performance period. For those 7 performance years, the revised cost of the contractor proposal was \$190.5 million, a reduction of 18.31 percent of the original contractor proposal. Although we agree with this cost calculation, we don't agree with the methodology CNA used to adjust the MEO costs for the reduction in systems work.

Adjustment to MEO Costs for Systems Work. The MEO divided costs for the systems work between the MEO Systems Functional Branch and the Technical Services Organization. However, CNA applied the 76.2 percent reduction only to the systems work performed by the Technical Services Organization. This reduced the MEO offer to \$222.9 million for the remaining performance years, a reduction of 6.15 percent of the original MEO offer. CNA stated that they did not reduce the cost of the MEO Systems Functional Branch because the MEO Systems Functional Branch was a fixed cost and the MEO technical performance plan described additional duties for the 43 positions assigned the systems work. The additional duties included maintaining and updating the Continuity of Operations Plan, preparing required documentation for other Federal agencies, providing field and production support, and overseeing the security of the retired and annuitant system. Based on this, CNA assumed that the 43 positions would remain with the MEO even though the systems work requirement was reduced, and only applied the 76.2-percent reduction to the systems work performed by the Technical Services Organization. We believe the MEO offer should be reduced by 76.2 percent of the systems work performed by both the Technical Services Organization and MEO Systems Functional Branch, which would reduce the MEO offer to an estimated \$198 million for the remaining 7 performance years, a reduction of 16.65 percent of the original MEO offer.⁵

IG DoD Opinion on Adjustments for Systems Work. Both the contractor proposal and the MEO offer incorporated the 120,000 hours of systems work identified in the solicitation; therefore, we believe the 76.2-percent reduction in systems work should be applied to the full amount of systems work. CNA stated that they chose to reduce only the Technical Services Organization because it did not change the MEO's original management approach for the functions. However, the amount of systems work to be performed in the remaining performance years is unknown, consequently to compare the contractor proposal and the MEO offer fairly, we believe the reduction in systems work should be applied to all portions of the in-house cost estimate. CNA addressed this possibility in its report, but chose not to use it as the basis for estimating the cost savings because they believed it violated the integrity of the MEO's original management approach. We believe that CNA should have reported the potential

⁵ The MEO offer would be understated by the cost of the additional duties performed by the Systems Functional Branch, which we were unable to estimate.

costs savings due to the reduction of systems work as a range. As shown in Table 2, both adjustments favor the contractor and the cost difference between the adjusted contractor proposal and the adjusted MEO offers ranged from \$7.49 million to \$32.42 million.

Table 2. Comparison of Contractor Proposal with MEO Offer Adjusted for the Reduction in Systems Work

<u>Contract Year</u>	<u>Adjusted Contractor Proposal (millions)</u>	<u>CNA Adjusted MEO Offer (millions)</u>	<u>Difference (millions)</u>	<u>IG DoD Adjusted MEO Offer (millions)</u>	<u>Difference (millions)</u>
4	\$27.69	\$30.74	\$(3.05)	\$27.56	\$0.13
5	27.61	31.09	(3.48)	27.79	(0.18)
6	27.52	31.43	(3.91)	28.00	(0.48)
7	27.10	31.81	(4.71)	28.26	(1.16)
8	26.67	32.20	(5.53)	28.52	(1.85)
9	26.85	32.61	(5.76)	28.79	(1.94)
10	27.05	33.03	(5.98)	29.06	(2.01)
Total	\$190.49	\$222.91	\$(32.42)	\$197.98	\$(7.49)

Comparison of Additional Cost Considerations for Option 1 and Option 2. CNA stated that DFAS would incur additional costs if the military retired and annuitant pay functions returned to in-house performance without competition and added those additional costs to the savings identified in Option 1, retain the existing contract. We agree that DFAS would incur additional costs, however, CNA did not account for all costs that would be affected by a change in service provider. CNA determined that the additional costs DFAS would incur were transition costs, new equipment costs, and loss of federal income taxes. However, CNA did not include a cost reduction for contract administration work that would not be performed if the functions were returned to in-house performance.

Cost Adjustments. CNA adjusted the cost of returning to in-house performance by adding transition costs, such as human resources support, training, overhead, and personnel costs to the MEO offer. In addition, CNA added the estimated cost of equipment to replace an older DFAS system with a newer integrated voice response system already in place by the contractor. CNA also added to the MEO cost an estimated loss of \$1 million federal income taxes that the U.S. Treasury would no longer receive if the functions returned to in-house performance. CNA calculated the total additional costs to be \$9.34 million. Using OMB Circular No. A-76 guidance, we calculated the estimated loss of federal income tax to be \$1.52 million, for a total of \$9.86 million in additional costs. Based on a discussion with a DFAS competitive sourcing official, we believe CNA should have also included the costs of information technology and facilities as transition costs for a total of \$10.97 million in cost adjustments.

Contract Administration Costs. CNA did not include the cost of contract administration when identifying the savings associated with a change in service provider. OMB Circular No. A-76 defines the cost of contract administration as the costs incurred in administering a contract, which include reviewing compliance with the terms of the contract, processing payments, negotiating change orders, and monitoring the closeout of contract operations. CNA stated that they did not include the costs of contract administration because the Government would incur administration costs regardless of who performs the function (contractor or MEO). However, OMB Circular No. A-76 specifically states that contract administration does not include costs that would be common to both contract and Government performance, such as quality assurance surveillance, inspection, or other administrative requirements to ensure acceptable performance. Therefore, contract administration costs are specific to contractor performance and would not be incurred if the MEO were performing the military retired and annuitant pay functions.

OMB Circular No. A-76 provides specific guidance on determining the cost of contract administration, stating that these costs “represents the estimated additional cost to administer a contract over and above the cost to administer the same work performed by in-house employees.” Using OMB Circular No. A-76 guidance, we determined the costs of contract administration for the remaining 7 performance years to be \$7.26 million.

Subsequently CNA stated that they did not include the cost of contract administration because DFAS estimated that the time spent on contract administration was less than one staff year; therefore CNA considered these costs to be minimal and have a negligible impact on savings rates. The Director of the DFAS Contract Services Directorate stated that approximately two staff years were allocated for contract administration of the military retired and annuitant pay functions contract. The annual cost of the two positions was approximately \$230,000, or \$1.84 million over the remaining 7 years. Taking into account the reduction of systems work and both actual costs of contract administration and the costs of contract administration per the OMB Circular No. A-76, the cost savings associated with retaining the existing contract ranged from \$11.2 million to \$41.5 million, as shown in Table 3.

	Adjusted CNA Estimate (millions)	IG DoD Estimate (millions)
Adjusted MEO Offer	\$222.91	\$197.98
Adjusted Contractor Proposal	<u>190.49</u>	<u>190.49</u>
Subtotal	\$32.42	\$7.49
Additional Costs		
Plus: Cost Adjustments	10.97	10.97
Less: Contract Administration	<u>(1.84)</u>	<u>(7.26)</u>
Cost Savings	\$41.55	\$11.20

Performance Data

In Congressman Kucinich's request, he also asked that the IG DoD review the CNA evaluation of contractor performance data. Specifically, he asked that we explain the difference between the random sample performance data and the summary performance data as well as evaluate the appropriateness of CNA's presentation of the data.

CNA evaluated contractor performance based upon three types of performance data:

- contractor performance with Government performance during the same time period in the prior year,
- random sample and summary performance data with contract requirements, and
- annual customer satisfaction surveys.

CNA concluded that the contractor was performing satisfactorily, however given that the performance of the contractor could not be evaluated on all contractual performance requirements, we disagree that overall contractor performance could be evaluated. Because not all contract performance data were available and customer satisfaction data that DFAS provided were not based on documented statistically representative sample designs and should not be used to compare performance, we were unable to come to a conclusion on the performance of the contractor.

Contract Requirements. The contract specified that the contractor be evaluated on 10 performance requirements. However, DFAS could only evaluate the contractor on 4 of the 10 performance requirements. The four contractual performance requirements were provide accurate pay and entitlement information to retirees and annuitants, establish new accounts, maintain existing accounts and process changes, and provide customer service. Of those four, the contractor was consistently meeting one of the performance requirements. A fifth performance requirement, which DFAS considered critical, but could not effectively evaluate according to the contractual performance requirements, was the requirement to pay retirees and annuitants in a timely manner. DFAS officials stated the contractor had consistently provided the information DFAS needed to pay retirees and annuitants in a timely manner. DFAS revised the contract performance requirement summary on April 9, 2004, and according to DFAS, it better reflects customer requirements and provides a more comprehensive and complete review of the work for which the contractor is responsible. However, until DFAS can fully evaluate the performance of the contractor on the new contractual performance requirements, we disagree that an overall conclusion on contractor performance data can be made.

Comparison of Pre- and Post-Competition Performance. Using summary performance data, CNA compared performance of the contractor to the Government during the same time period in the prior year as a measure of contractor performance. CNA compared pre- and post-competition performance in three areas: establish new accounts, maintain existing accounts and process changes, and provide customer service and concluded that the contractor was performing at a level comparable to, or slightly better than, Government performance.

Difference Between Random Sample and Summary Performance Data. CNA evaluated contractor performance from February 2002 through April 2003 by comparing random sample data with summary performance data for the three contractual performance requirements and concluded that the contractor was performing satisfactorily. However, a comparison using data obtained by differing methodologies is not a valid comparison. In this case, the random sample data were drawn from the DFAS Continuing Government Activity (CGA)⁶ that performs monthly evaluations of contractor performance. By comparison, the summary performance data used were raw monthly transaction data. Details maintained in each set of data were not consistent. For example, for the contractual performance requirements, “establish new accounts” and “maintain existing accounts and process changes,” the random sample data evaluated timeliness and accuracy, while the summary performance data only evaluated timeliness. For the third contractual performance requirement, “provide customer service,” the random sample data measured the percentage of calls that were answered within 20 seconds, whereas the summary performance data measured the percentage of calls answered. We believe that both accuracy and timeliness are important elements of contractor performance. Table 4 shows the difference in each of the three contractual performance requirements using random sample and summary performance data.

	Random Sample Data (out of 15 months)	Summary Performance Data (out of 15 months)
Establish New Accounts		
FY 2002 Requirement: 98.2%	6 months	5 months
FY 2003 Requirement: 98.3%	1 month	4 months
Maintain Existing Accounts and Process Changes		
FY 2002 Requirement: 99.2%	0 months	8 months
FY 2003 Requirement: 99.3%	0 months	4 months
Provide Customer Service		
Requirement: 80%	0 months	12 months

⁶ The DFAS CGA was established to oversee the quality of work provided by the contractor. The DFAS CGA coordinates with the contracting officer and is the Government point of authority for any deviations, corrective actions, complaints, or other issues relating to the contractor.

Presentation of Data. Congressman Kucinich also questioned CNA’s presentation of contractor performance data. CNA did not use equivalent scales when presenting similar data on graphs. For the contractual performance requirement “establish new accounts,” CNA compared contractor summary performance data with DFAS summary performance data during the same time period of different years. To show this comparison in their report, CNA used a line graph and a scale from 93 to 100. Using this scale, small percentage point differences between contractor performance and DFAS performance were very noticeable. For example, summary performance data showed the contractor established 99.1 percent of new accounts within 30 days in September 2002, and DFAS established 96.9 percent of new accounts within 30 days in September 2001. This 2.2-percentage point difference appears to be large, as shown in Figure 1.

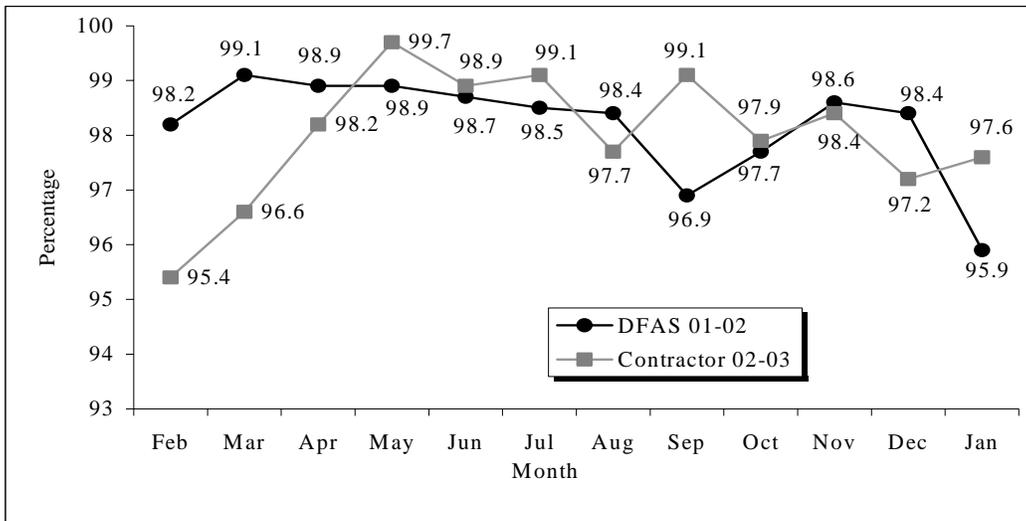


Figure 1. Performance Requirement, Establish New Accounts, as a Line Graph with a Scale of 93 to 100, as Presented in the CNA Report

However, when CNA showed contractor performance by comparing random sample data and summary performance data with the contract requirements, CNA used a bar graph and a scale of 0 to 100. On this scale, the small percentage point differences between the data were not very noticeable. For example, in November 2002, the contractor was required to establish 98.3 percent of all new accounts within 30 days. The random sample data shows the contractor only established 94.2 percent of the new accounts whereas the summary performance data shows the contractor established 98.4 percent of the new accounts. The 4.2-percentage point difference appears negligible, as shown in Figure 2.

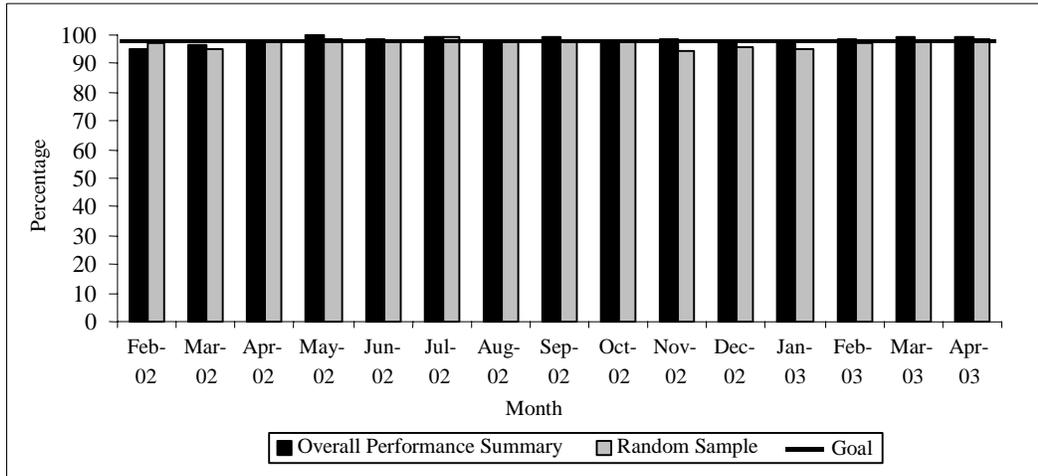


Figure 2. Performance Requirement, Establish New Accounts, as a Bar Graph with a Scale of 0 to 100, as Presented in the CNA Report

A more comparable presentation of showing contractor performance when comparing random sample data and summary performance data with the contract requirements would have been for CNA to use a line graph and a scale of 93 to 100, equivalent to how CNA compared DFAS performance to contractor performance, as shown in Figure 3.

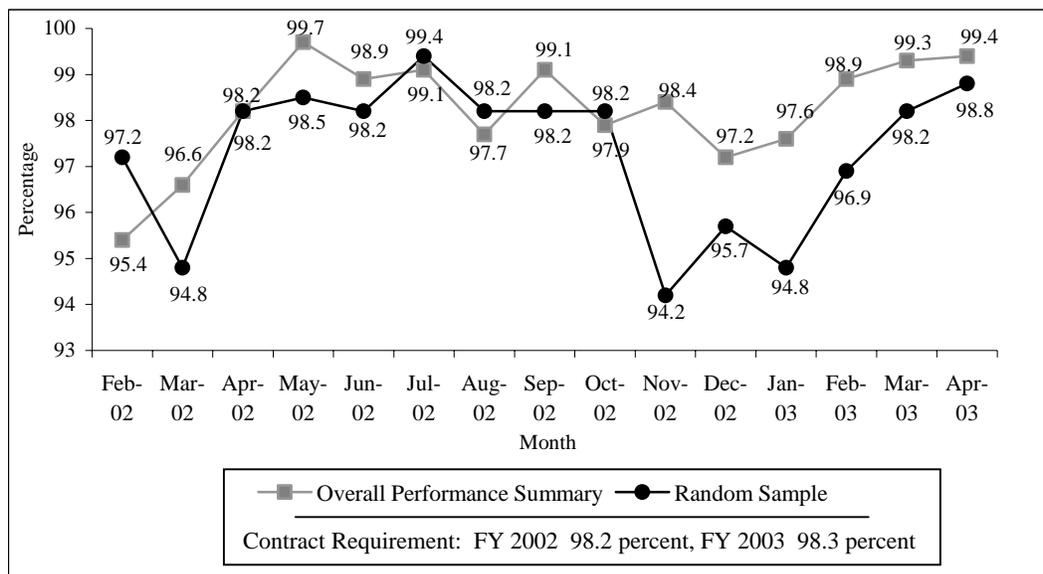


Figure 3. Performance Requirement, Establish New Accounts, as a Line Graph with a Scale of 93 to 100

Customer Service Satisfaction Surveys. CNA cited in its report the annual customer satisfaction survey, conducted by the Office of Personnel Management (OPM), as another measure of satisfactory contractor performance. CNA reviewed the customer satisfaction survey results and concluded that customers were “as satisfied or more satisfied” with contractor performance as they were with prior Government performance. However, the data that DFAS provided were not based on documented statistically representative sample designs, and therefore, should not be used to compare performance.

Agreement with the Office of Personnel Management. In 2001, DFAS wanted to obtain an independent evaluation of the satisfaction of all its customers. DFAS entered into an agreement with OPM to conduct surveys for 13 of its business functions, including the military retired and annuitant pay functions to gauge and compare customer satisfaction. The agreement stated that DFAS would provide OPM customer name and address information for each of the pay functions. OPM independently surveyed the customers DFAS selected, analyzed the survey results, and projected the results to the entire universe of the military retired and annuitant pay customers. OPM provided the survey results to DFAS, which DFAS provided to CNA for use in its analysis.

Military Retiree and Annuitant Customer Satisfaction Survey Sample Selection. DFAS did not ensure that the customers selected for the 2001 and 2002 military retiree and annuitant customer satisfaction surveys were based on documented statistically representative sample designs. DFAS CGA officials were unable to explain how the customers were selected for the 2001 military retiree and annuitant surveys. For the 2002 retiree customer sample, DFAS CGA officials stated that the contractor manually selected the customers. For the 2002 annuitant customer sample, DFAS CGA officials stated the contractor used software to evaluate every 25th record and selected those records that met certain criteria. However, DFAS CGA officials were unable to provide sufficient information to determine whether the sample design was sound and appropriately implemented. OPM was unaware that the methodology of the DFAS sample selection was not based on documented statistically representative sample designs, and therefore, used the results and prepared its reports as if the surveys were statistically representative of the entire customer base.

A statistically representative sample should be designed and selected in order for OPM to project the survey results from the sample to the entire customer base of military retired and annuitant pay customers. DFAS did not have standard operating procedures to ensure the statistical selection of a random sample. Consequently, the results of the samples should not be used to make inferences about the entire customer base or to make meaningful comparisons of the survey results from year to year.

Overall Evaluation of Contractor Performance. CNA concluded that contractor performance was satisfactory based on its review of contractor performance with Government performance, random sample and summary performance data with contract requirements, and annual customer satisfaction surveys. In the three areas that CNA compared contractor performance with Government performance, we agree with the conclusion that the contractor was performing at a level comparable to Government performance, and therefore,

would be considered satisfactory. However, we disagree that overall contractor performance could be evaluated because the contractor could not be evaluated on all contractual performance requirements and because the annual customer satisfaction surveys were not based on documented statistically representative sample designs and should not be used to compare performance. Therefore, we do not believe it was clear whether contract performance was satisfactory.

Management Action

During the course of our audit, DFAS took management actions to address the methodology for the selection of customer satisfaction survey samples. Specifically, DFAS was developing procedures to ensure that the samples selected for future military retiree and annuitant customer satisfaction surveys are based on documented statistically representative sample designs.

Conclusion

DFAS Decision. In August 2002, DFAS analyzed possible sourcing options, and decided to retain the contract because it was a low-risk option, provided continued service delivery, and provided time to evaluate available options and make a fully informed decision for the future of the military retired and annuitant pay functions. In September 2003, CNA provided their study to DFAS. The Director, DFAS, stated in an October 20, 2003, letter to Congressman Kucinich,

The CNA recently completed their analysis and concluded that continuing the contract with [the contractor] is the best overall business decision. DFAS will be retaining the contract and will evaluate it each year to ensure it continues to provide best value and acceptable performance.

We disagree with the methodology CNA used to estimate the \$42 million cost savings of Option 1, retain the existing contract, compared with Option 2, return to in-house performance. We believe the cost savings of Option 1 were an estimated range of \$11.2 million to \$41.5 million. Given that the performance of the contractor could not be evaluated on all contractual performance requirements, we also disagree that the overall performance could be evaluated, and were unable to come to a conclusion on contractor performance. Because the Director, DFAS, stated he would reconsider the decision to retain the existing contract at the end of each option year, he should consider contractor performance using the revised performance requirement summary and relevant economic cost data, to determine whether retaining the existing contract continues to provide the best value.

Management Comments on the Finding and Audit Response

Management Comments. The Acting Director, DFAS cited that the primary concern of DFAS was to ensure uninterrupted service to the 2.4 million retired members and annuitants, and that the use of a contractor has been and continues to be the best economic solution. She further stated that CNA considered “out-of-pocket” costs, such as the planned annual federal pay raises over the remaining life of the contract, that were not fully accounted for in the prior A-76 cost comparison. Such costs were not reviewed by the IG DoD. Additionally, she stated that the contract has cost \$13.1 million less than what had been anticipated in the public/private cost comparison over the first two years.

Audit Response. We did not review “out-of-pocket” costs because our scope was limited to the specific matters outlined in Congressman Kucinich’s request. In addition, OMB Circular No. A-76 requires that annual federal pay raises not be included for personnel positions subject to economic price adjustments beyond the first performance period. This is done to provide a level playing field between public and private offers. When CNA considered “out-of-pocket” costs, CNA concluded that “the MEO is likely to cost about \$22 million more than [the contractor] during the remaining 8 years,” which falls within our estimated cost savings of \$11.5 million to \$41.5 million.

We do not disagree that the contract has cost less than what was anticipated in the public/private cost comparison over the first two years; however, the reason was because the amount of systems work did not materialize as estimated in the solicitation. We subsequently confirmed with DFAS that the contract has cost \$11.3 million, instead of \$13.1 million, less than what was anticipated.

Recommendations and Management Comments

We recommend that the Director, Defense Finance and Accounting Service:

- 1. Use the most current contractor performance data and relevant economic cost data to make the decision to retain the existing contract at the end of each option year.**

Management Comments. The Acting Director, Defense Finance and Accounting Service concurred and stated that actions would be completed by November 1, 2004.

- 2. Issue standard operating procedures to ensure that the samples selected for future military retiree and annuitant customer satisfaction surveys are based on documented statistically representative sample designs.**

Management Comments. The Acting Director, Defense Finance and Accounting Service concurred and stated that the action would be completed by July 1, 2004.

Appendix A. Scope and Methodology

We reviewed the CNA analysis of two of the sourcing options available to DFAS for the military retired and annuitant pay functions. We met with DFAS and CNA officials to discuss the analysis. We reviewed OMB Circular No. A-76 to identify guidance on public/private competitions. We reviewed portions of the in-house cost estimate, the MEO technical performance plan, and the solicitation to identify the requirement for systems work. We reviewed the contractor proposal and a certified public accountant report to identify costs of systems work incurred in the first performance period. We analyzed cost comparison documents and CNA data to determine the estimated costs of Option 1, to retain the existing contract and Option 2, to return to in-house performance. We reviewed DFAS computations of estimated recompitation costs to identify transition costs. We followed OMB Circular No. A-76 to calculate costs defined in the guidance, such as federal income tax loss, contract administration costs, and the conversion differential. We used DFAS and CNA computations for costs not included in the OMB Circular No. A-76, such as transition costs, recompitation costs, and capital costs. We reviewed contractor performance documents that included summary performance data for DFAS from February 2001 through January 2002 and for the contractor from February 2002 through January 2003. We reviewed random sample performance data and deficiency reports from February 2002 through January 2003 to validate data reported by CNA, to differentiate between random sample and summary performance data, and to create uniform graphic illustrations of the data. We reviewed OPM customer satisfaction survey documents for 2001 and 2002. We met with DFAS CGA officials to discuss the sample selection methodology for the customer satisfaction surveys and to discuss the contract negotiations for the revised performance requirements summary.

We performed this audit from December 2003 through April 2004 according to generally accepted government auditing standards.

Limitations to Scope. We did not review the management control program because the audit scope was limited to the specific matters outlined in Congressman Kucinich's request.

Use of Computer-Processed Data. We relied on computer-processed cost comparison data calculated by the DoD-approved COMPARE software program. This Air Force-developed program was released in November 1994 and was the software generally accepted for performing OMB Circular A-76 cost comparison studies by all the Military Departments and Federal agencies. On February 29, 2000, DoD interim guidance mandated use of COMPARE^{*} for all DoD A-76 cost comparisons. Audits of the program by the Army Audit Agency concluded program cost comparison computations adequately documented costs in accordance with the OMB Circular A-76 Revised Supplemental Handbook

* Subsequently, a contractor hired by the Air Force Manpower Innovation Agency, Randolph Air Force Base, Texas, developed win.COMPARE², a Windows-based personal computer application that replaced COMPARE in 2001.

guidance. Nothing came to our attention in this review that caused us to doubt the reliability of the computer-processed data.

Use of Technical Assistance. Personnel in the Quantitative Methods Division, Office of the Deputy Inspector General for Auditing of the Department of Defense assisted in the analysis of the OPM customer satisfaction surveys.

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in DoD. This report provides coverage of the Defense Infrastructure and Defense Contract Management high-risk areas.

Prior Coverage

During the last 5 years, the General Accounting Office and the Inspector General of the Department of Defense have issued numerous reports discussing the OMB Circular A-76 process and public/private competitions, and the Inspector General of the Department of Defense has issued one report specifically relating to the DFAS military retired and annuitant pay functions. Unrestricted General Accounting Office reports can be accessed at <http://www.gao.gov>. Unrestricted Inspector General of the Department of Defense reports can be accessed at <http://www.dodig.osd.mil/audit/reports>.

IG DoD

IG DoD Report No. D-2003-056, "Public/Private Competition for the Defense Finance and Accounting Service Military Retired and Annuitant Pay Functions," March 21, 2003

Appendix B. Congressional Request

DENNIS J. KUCINICH
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(202) 225-5871

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Congress of the United States
House of Representatives
November 20, 2003

Committees:
Government Reform
Education
and the
Workforce

www.house.gov/kucinich

Mr. Joseph E. Schmitz
Inspector General
Office Of the Inspector General
Department Of Defense
The Pentagon
Washington, D.C. 20301

Dear Mr. Schmitz:

I am writing to request that your office examine two aspects of the report by the Center for Naval Analysis, entitled "Analysis of DFAS Military Retired and Annuitant Pay Sourcing Options," September 2003. As you know, this report was prepared at DFAS' request to evaluate options DFAS could pursue following determination by DoDIG that the military and retired annuitant pay functions were erroneously awarded to a private contractor in a flawed A-76 competition.

First, C.N.A. estimated a \$42 million cost savings associated with the contractor's continuing performance for the remaining years of the current contract, relative to the MEO. This estimate was the basis for C.N.A. to conclude that retaining the current contract was superior to the three other options under consideration (return to MEO without competition, public/private competition, private/private competition), Figure 1, page 4. Please evaluate this \$42 million cost savings estimate, as well as the appropriateness of C.N.A.'s presentation of the impact of this cost savings on the other options.

Second, C.N.A. concluded that the contractor was performing the military and retired annuitant pay functions satisfactorily. C.N.A. based this conclusion primarily on summary performance data provided by DFAS. C.N.A. also concluded that in the future, the contractor would perform satisfactorily. Yet, for certain critical areas, the contract establishes random sampling as the tool for evaluating contractor performance, and that would include those areas for which C.N.A. relied instead upon summary performance data. Figures 20 and 21 (pp. 49 and 51) reveal considerable disparity between the summary performance data and random sample performance data. Please explain the difference between the summary performance data and the random sample performance data and evaluate the appropriateness of C.N.A.'s presentation of the data and its conclusions about contractor performance and future performance.

Please do not hesitate to contact me or my staff (Jaron Bourke) to discuss this request.

Sincerely,

Dennis J. Kucinich
Member of Congress

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Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Deputy Under Secretary of Defense (Installations and Environment)
Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Combatant Command

Inspector General, U.S. Joint Forces Command

Other Defense Organization

Director, Defense Finance and Accounting Service

Non-Defense Federal Organization

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform
House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform
House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

Honorable Dennis J. Kucinich, U.S. House of Representatives

Defense Finance and Accounting Service Comments

Final Report
Reference



DEFENSE FINANCE AND ACCOUNTING SERVICE

1931 JEFFERSON DAVIS HIGHWAY
ARLINGTON, VA 22240-5291

MAY 24 2004



MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Comments on Draft of Project No. D2004CB-0066 (Analysis of the Defense Finance and Accounting Service Military Retired and Annuitant Pay Sourcing Options)

This memorandum provides our recommended improvements to the subject report. Our primary concern is to ensure that the best business decisions are made to ensure continued uninterrupted service to the 2.4 million retired members and annuitants. Our focus has been and will continue to be on the best estimate of anticipated costs. Though not reviewed by the Inspector General of the Department of Defense (IG DoD), the Center for Naval Analyses (CNA) referred to this in their report as expected "out-of-pocket" expenses. It considered costs such as the planned annual federal pay raises over the remaining life of the contract that were not fully accounted for in the prior A-76 cost comparison. Using that business case oriented approach, we believe it is important to note that without reducing any systems work requirements, CNA stated in their report that the contract is clearly less expensive than the Most Efficient Organization (MEO) over the remaining 8 annual performance periods. Further, over the first 2 years, the contract has cost \$13.1 million less than what had been anticipated in the A-76 cost comparison. It has been and continues to be the best economic solution for the American taxpayer.

The following specific changes are requested in the report:

DFAS recommends that the following information be added to the "Results" section in the Executive Summary: "The IG DoD independent calculations show a potential range of savings of \$11.2 million to \$41.5 million. While the specific amount of estimated savings is open to differing analytical interpretations, the IG DoD does agree that retaining the contract is less costly and a better alternative than reinstating the MEO."

DFAS recommends that the "Contractor Performance Data" section in the Executive Summary be modified to state that DFAS evaluated 4 of 10 (rather than 3 of 10) contractual performance requirements. The fourth requirement is to provide accurate pay and entitlement information to retirees and annuitants as recently discussed by DFAS and IG DoD personnel.

DFAS concurs with Recommendation 1 and intends to complete the action by November 1, 2004.

DFAS concurs with Recommendation 2 and intends to complete the action by July 1, 2004.

In relation to the "Management Actions" section in the Executive Summary, CNA has informed us that they stand by the analysis, conclusions and recommendations in their report, and will not be changing them.

Revised

Revised

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CNA did agree to correct some minor mathematical and editorial errors that were raised informally by the IG DoD staff. DFAS recommends that the first and second sentences of this paragraph be rewritten to reflect CNA's intent.

Thank you for the opportunity to comment on the subject draft report. Please refer any questions to Jim Nagy at (703) 607-5189.


Jan D. Eakle
Brig Gen, USAF
Acting Director

Team Members

The Office of the Deputy Inspector General for Auditing of the Department of Defense, Contract Management prepared this report. Personnel of the Office of the Inspector General of the Department of Defense who contributed to the report are listed below.

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