The Regents of the University of California

COMMITTEE ON OVERSIGHT OF THE DEPARTMENT OF ENERGY LABORATORIES
January 18, 2001

The Committee on Oversight of the Department of Energy Laboratories met on the above date at UCSF–Laurel Heights, San Francisco.

Members present: Regents Atkinson, Davies, S. Johnson, Khachigian, Miura, and Preuss

In attendance: Regents Bagley, Connerly, Fong, Hopkinson, O. Johnson, Kohn, Kozberg, Lansing, Lee, and Marcus, Regents-designate T. Davis, Morrison, and Seymour, Faculty Representatives Cowan and Viswanathan, Secretary Trivette, General Counsel Holst, Provost King, Senior Vice Presidents Darling and Mullinix, Vice President Hershman, Chancellors Dynes, Greenwood, Tomlinson-Keasey, Vanderhoef, and Yang, Laboratory Directors Browne, Shank, and Tarter, and Recording Secretary Bryan

The meeting convened at 2:25 p.m. with Committee Vice Chair Miura presiding.

1. **READING OF NOTICE OF MEETING**

For the record, it was confirmed that notice had been given in compliance with the Bylaws and Standing Orders for a Special Meeting of the Committee on Oversight of the Department of Energy Laboratories to be held concurrently with the regularly scheduled meeting of the Committee for the purpose of voting on modifications to the contracts for operation of the Lawrence Livermore National Laboratory and the Los Alamos National Laboratory.

2. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of November 15, 2000 were approved.

3. **ANNUAL REPORT OF THE PRESIDENT’S COUNCIL ON THE DEPARTMENT OF ENERGY LABORATORIES**

President Atkinson noted that, as the annual report was mailed to all Regents in advance of the meeting, no additional remarks would be offered.

[For speakers’ comments, refer to the minutes of the January 18 meeting of the Committee of the Whole.]

4. **REPORT ON THE LOS ALAMOS NATIONAL LABORATORY**

Committee Vice Chair Miura indicated that, rather then present an oral report, Director Browne's written report would be mailed to all Regents.

5. **APPROVAL OF MODIFICATIONS TO CONTRACTS FOR OPERATION OF THE LOS ALAMOS NATIONAL LABORATORY AND THE LAWRENCE LIVERMORE NATIONAL LABORATORY**

The President recommended that, the Department of Energy having notified the University of its decision unilaterally to extend the subject contracts to September 30, 2005, pursuant to the current contracts, he be authorized to approve and the Officers of The Regents be authorized to execute a modification of the contracts for the management of the Los Alamos National Laboratory, W-7405-ENG-36, and the Lawrence Livermore National Laboratory, W-7405-ENG-48, said contracts providing that The Regents is responsible for modifications thereof, except for funding modifications and modifications of Appendices, which may be executed by the President.

It was recalled that on November 15, 2000, The Regents instructed the President to enter into negotiations with the Department of Energy (DOE) to extend the current contracts for the continued operations of the Lawrence Livermore National Laboratory (LLNL) and the Los Alamos National Laboratory (LANL).

The DOE contracts for the LANL and the LLNL were executed on September 18, 1997, pursuant to authorization from The Regents, and were effective October 1, 1997 through September 30, 2002. They contain an option for DOE unilaterally to extend UC performance under those contracts for up to five years, or until September 30, 2007.

On September 17, 2000, DOE Secretary Richardson directed the National Nuclear Security Administration to restructure the Department's contracts with the University of California to address security and facility operations issues that have arisen at LANL and LLNL in the past two years. Subsequently, the University proposed a number of measures to strengthen oversight and operations at LANL and LLNL: the creation of a new Vice President for Laboratory Management and the engagement of industrial expertise by the University to assist the laboratories in improving specified operations. DOE accepted the University's proposal for improvements and gave notice on October 16, 2000 of its intent to extend the contracts to September 30, 2005. Preliminary to such an extension, DOE requested that the University's proposal for improvement initiatives be incorporated into the LANL and LLNL contracts as a contract appendix and that such contract modifications be accomplished by November 15, 2000. The President, pursuant to interim authority under Standing Order 100.4(ee), completed a modification to the contracts to incorporate the improvement initiatives.

On December 4, 2000, the University and DOE commenced negotiations on a set of issues necessary to be resolved for contract performance beyond September 30, 2002.

These issues related to University compensation for contract performance under an extended contract – specifically, performance management fee, direct-funded University oversight costs, and the DOE's share of systemwide indirect expenses. In addition, the parties commenced a review of a number of final rules affecting DOE policies and practices with regard to management and operating contracts that have been published since the University and DOE entered into the current contracts in 1997. The most recent rule was published in the Federal Register on December 22, 2000.

Summary of Essential University Requirements Contained in the Proposed Contracts

As reflected in the current contracts, The Regents has endorsed the following principles that continue to be featured in the management contracts:

- *Preservation of the principle of "partnership."* This has been a basic element of the laboratory management contracts for the duration of the contractual relationship between the University and the federal government. This principle remains intact and is reflected in the performance-based management process and in DOE's respect for those requirements placed upon the University as a State agency, including defense of employees, personal information privacy protections, management of the UC Retirement Plan, and public information policies.

- *Preservation of the no gain/no loss philosophy of management of the laboratories.* As an instrumentality of the State of California, the University of California historically has not entered into an agreement for the management of the laboratories which obligated or anticipated that any substantial University funds would be expended for laboratory management purposes. The proposed contracts are consistent with this philosophy by virtue of their provisions for a program performance fee, a limitation of liability provision, additions to the contingency reserve, and the continued ability of the University to terminate the contract. There are two new contract provisions that permit the government to reduce otherwise earned fee: (1) reduction of fee for specified environmental, health, safety, and security problems and (2) failure of the University to meet specified objectives with regard to integrated management and engaging industrial expertise to assist the laboratories in improving specified operations. As described below, in both instances there are agreements regarding these reductions that continue to observe the no gain/no loss principles of the University.

- *Preservation of the academic atmosphere at the laboratories.* This continues to be a cornerstone of the contracts and has become a routine provision in DOE contracts with educational institutions. Key to this atmosphere is the continued linkage between the University's comprehensive personnel policies and procedures and personnel policies applicable to laboratory employees. The contracts continue to contain a number of other provisions that reflect the academic nature of the University, including protections for speech and publication; University ownership of intellectual property and the application of the University's royalty policies; access by foreign scientists, graduates, and post-doctoral students to laboratory facilities; and campus research and supporting efforts to the laboratories.

- *Continued support from DOE for complementary and beneficial activities and collaborative research between the campuses and the laboratories.* The University is ensured of continued support for these activities through contract compensation paid to the University under the contracts.

- *Enhanced University involvement in the work of the laboratories and strengthened University management oversight capabilities for the laboratories.* The contracts create new structures within the Office of the President to achieve a higher level of integration between the laboratories and UC management as well as strengthened support and oversight. The proposed contracts provide earmarked funds for these activities.

Noteworthy Changes in the Proposed Laboratory Management Contracts

Uniform Contract Format and Standard Clauses

As a consequence of the review of DOE procurement rules adopted since 1997, the contract is being reorganized to conform to the federal Uniform Contract Format. Except as otherwise noted, this reorganization and updating of standard clauses does not represent significant change in the operational understandings currently in force.

Federally-funded Research and Development Center

The proposed contract includes a new standard provision for federally-funded research and development centers (FFRDCs) such as the LANL and LLNL. The significance of this provision is to acknowledge the special relationship between FFRDCs and the sponsoring agency.

Public Affairs

The proposed contract includes a new standard provision relating to public affairs operations at the laboratories. The clause calls for a level of cooperation and integration between DOE and the laboratories that assures a coordinated approach to communication with the public. The terms of this contract relating to scientific and intellectual freedom contain assurances that nothing in the public affairs clause is intended to prohibit timely and accurate reporting of research results to the public, and DOE acknowledges the independent obligation of the University to communicate to the public.

Contractor's Organization

DOE has adopted a national policy of giving discretion to the government regarding whether a particular contractor employee may be removed from contract work. As the site owner, DOE is extending its control to include access to the facility itself. However, such control is not to be exerted lightly. To deny such access to an employee requires a specific determination by the highest DOE official, the Secretary of Energy. In addition, DOE has agreed in the proposed contract that it will not direct the University to remove an employee under circumstances that would violate State law or regulation applicable to the University and would consider alternative approaches where the underlying concerns can be effectively dealt with without removal.

Conditional Payment of Fee

DOE has adopted a national policy of retaining discretion to reduce a contractor's fee for certain environment, health, and safety problems. In addition, DOE was directed by Congress to establish fee reduction schedules for violations of recently enacted security requirements. The proposed contracts subject the University's fee to reduction under these national policies; however, DOE has provided special written assurances that in implementing these provisions, the no gain/no loss principles of the University and its status as a State entity and an educational institution will be considered in order to ensure that any reduction of fee does not place at risk any assets of the University that are unrelated to the contract operations.

Performance Objectives for New Initiatives

The proposed contracts contain a new appendix that establishes specific performance objectives for the University in federal fiscal years 2001-02 tied to the proposals made by the University to restructure University oversight and to engage industrial expertise to assist the laboratories in improving specified operations. As described below, the Program Performance Fee has two elements: base fee and fee at risk. In the event that the University fails to perform satisfactorily under these performance objectives, the University becomes ineligible to earn certain amounts of fee at risk.

Advance Understandings and Cost Principles

As part of the recent rule making, DOE has eliminated a number of contract provisions relating to cost allowance. DOE now relies on published cost principles, as supplemented by a limited number of special clauses prescribing cost limitations in particular areas, such as litigation and claims. However, the published cost principles can be supplemented by advance understandings of cost. Thus the proposed contracts contain advance understandings on specific items of cost such as the fee, indirect costs, and direct oversight costs, and much of the former contract language relating to allowance of costs has been eliminated. The net effect of these advance understandings, special cost provisions, and published cost principles on cost allowance is modest to negligible.

Indirect Payments

Compensation of the University for managing the laboratories for DOE will continue to be provided, in part, through indirect cost reimbursement. The current indirect payment of $11 million has been calculated consistent with federal requirements for allocating indirect costs of colleges and universities using a modified form of the federal Cost Accounting Standards (CAS). In the past decade, the UC-managed laboratories have become subject to full CAS coverage. Under revised federal rules, indirect payments involving activities subject to full CAS coverage cannot be based upon modified CAS coverage methodologies. Commencing in federal fiscal year 2002, indirect payments must comply with full CAS coverage requirements. The University will commence the development of a new indirect proposal under the revised standard. In federal fiscal year 2002, DOE has guaranteed that the indirect payment will not be less than $8.25 million regardless of the results of revising the accounting methodology. In federal fiscal years 2003-05, the indirect payments will be subject to a lower floor, $5.5 million, but it is anticipated that by that time agreement will have been reached on a new fixed indirect payment. The negotiated floor is intended to encourage the parties toward agreement on a new negotiated rate and is not an estimate of the outcome of the new methodology.

Designated University Oversight Costs

The proposed contract contains a provision for direct funding of the new Laboratory Management division within the Office of the President in addition to indirect payments. The Laboratory Management division will be comprised of the new Vice President for Laboratory Management, the Laboratory Programs office, and the Laboratory Administration Office. Reimbursement is based on actual incurred costs.

Program Performance Fee

The proposed contract retains the existing maximum fee of $14.4 million combined for LANL and LLNL for federal fiscal years 2001-02 that can be earned based on performance. This maximum is increased to $15.8 million in fiscal years 2003-05 once the performance objectives for new initiatives are met. The base fee is increased from $3.8 million combined for LANL and LLNL to $5.8 million for fiscal years 2001-02 and, once the performance objectives for new initiatives are met, to $6.3 million for fiscal years 2003-05. The portion of fee paid for performance is restructured to reflect three major areas – Science and Technology, Administration and Operations, and Laboratory Management – with weighted sub-elements. This structure assigns fees based on the relative significance of the function to the whole of mission accomplishment.

A review of the rating history suggests that resulting fees, in the absence of events that result in reductions under the Conditional Payment of Fee clause, will be comparable to those earned under the previous structure, and in some instances may be higher. The increase in base fee is a recognition of the no gain/no loss principle and the fundamental reasons for which the University receives fees.

Base and at-risk fee funds will be available for risk management costs associated with the University's laboratory management, including additions to the contingency reserve fund. The University applies the fee funds to defray any costs associated with the laboratories that are not otherwise reimbursable by DOE and for funding complementary and beneficial activities and fostering increased collaborative activities between University campuses and the laboratories, as well as supporting University-directed laboratory research.

Indemnity and Risk Management Issues

The University's management of the laboratories during the past half century has never been entirely free of risk. As a consequence of the 1992 contract extension negotiations, additional risk was accepted in exchange for a program performance fee, and in 1997, this fee was made variable in amount, based on performance. Much of this risk was a result of Congressional action during the 1980s. In addition to availability of the annual performance management fee, the University established a contingency reserve fund from fee revenues. Loss experience during the past eight years has been well within the coverage of the fee and contingency reserve.

In the proposed contract the University accepts some additional increment of risk beyond that in the current contract. The most significant of these are new security fines and penalties enacted by Congress in 1999; possible nuclear safety fines and penalties; and potential reduction of fee for adverse environmental, health, safety, and security events. The statute creating the security fines and penalties includes special provisions for nonprofit entities to ensure that fines do not normally exceed the available fee. Similarly, the proposal before Congress to eliminate the statutory exemption from nuclear safety fines and penalties would limit the assessment of such penalties on non-profit organizations to the fee available. With respect to the potential reduction of fee for adverse environmental, health, safety, and security events, DOE has provided certain written assurances regarding its implementation of the fee reduction authority and the special circumstances of the University. The contracts continue to include a financial limit on the amount of risk that the University accepts for other risks which are policy-based, not statutorily mandated. The cap protects the University in the event that management systems do not control these risks. The amount of the cap is well within the total amount of the program performance fee paid to the University under the contract.

The experience of the past eight years suggests that the allowable cost provisions, the amount of the program performance fee, the size of the contingency reserve, the application of caps on certain liabilities, the implementation of performance-based management systems, and the right of the University to terminate the contract prior to contract expiration continue to be sufficient to assure that the University can perform these contracts without placing University assets at significant risk.

Committee Vice Chair Miura emphasized that the recommendation is an extension of the contracts, which is within the purview of the Secretary of Energy. She acknowledged former Senior Vice President Kennedy for representing the University in the negotiations.

Assistant Vice President Van Ness, who led the negotiating team for the University, discussed some details of the contract modification, which he recalled preserves the principals of the partnership with the DOE, the academic atmosphere at the laboratories, support for complementary and beneficial research, and DOE's most recent rules establishing contract terms and conditions. The most noteworthy of these are advanced understandings and cost principles which replace previous provisions relating to cost allowability. A new clause called Conditional Payment of Fee allows the Secretary to reduce the University's fee according to a schedule for incidence and security or safety. There is also a new provision under which the Secretary has the right to direct removal of a contractor employee from work under the contract. An implementation clause was negotiated which provides the University with 60 days' notice for this action. Further, any implementation of this clause by the DOE provides that any DOE direction must not violate applicable State law and regulation. The modification also incorporates an appendix which sets forth key milestones and objectives related to management improvement initiatives identified by the University. Under this appendix, the University and the laboratories must receive passing grades in each of the first two years of the contract in order to be eligible to earn performance fees above an established base fee. Finally, the fee structure and related terms and conditions under the modification maintain protection of University and State of California assets while employing effective incentives for improved performance.

General Counsel Holst offered an assessment of the risk and liability provisions. He recalled that, beginning in 1992, the most recent contract renewals have resulted in significant changes in the University's liability exposure and the provisions intended to reduce or eliminate that exposure. The analysis of potential University liability under the contracts became much more complicated in 1992 than was the case under previous renewals. The provisions developed through the negotiations following DOE's extension of the current contract continue that pattern. Beginning in 1992, it was no longer realistic to talk about "no loss" other than as an objective. Under the pre-1992 contracts, "no loss" had been essentially assured. With the changes in 1992 and the actual liability exposure which began to be experienced, the challenge became one of being as certain as possible that the performance fee funds allocated for contingency reserve purposes would be more than adequate to cover the increased University exposure to governmental claims, the expense of defending them, and the possibility of third-party claims as well. The experience since 1992 has demonstrated the sufficiency of the contingency reserve as it has been built up to its current level as well as the necessity for it. The funds in that reserve, and those to be added, appear sufficient to protect the University from the unacceptable possibility of being required to expend general University funds as a result of a contract-related incident or circumstance. The real exposure the University does have requires the continuation of the same kind of ongoing evaluation of the sufficiency of the reserve and the University's risk exposure that has been under way since 1992.

Mr. Holst noted that the overall fee arrangement remains the University's primary tool for managing the unavoidable risks associated with operating the laboratories. While the nomenclature has changed somewhat, the principles remain the same. The total program performance fees available from the operations of the two laboratories consist of a partially at-risk base fee and a fully at-risk fee. The partially at-risk base fee is nominally a fixed amount; however, it is subject to reduction under a new provision. The fully at-risk fee continues to be a variable fee, reflecting a weighted average of the University's performance in several areas. It also becomes subject to unilateral reduction by DOE.

The categories of unreimbursable costs and third-party liabilities that may be incurred in the operation of the laboratories have expanded somewhat less with the proposed contract than the expansions that were encountered at the last contract renewals. The changes in the University's risk posture at this contract extension derive instead from Departmental initiatives that subject the University's earned fees to reduction for certain performance deficiencies.

The primary contract development since the last contract renewal in 1997 is the imposition by DOE of two related, yet independent, procedures for reducing the University's available fee in the event of certain performance deficiencies. Because these procedures create the possibility of fee reduction, they pose the threat that fewer funds will be available in any particular year to cover unreimbursed costs and discretionary, University-directed research and development at the laboratories which are funded from the portion of the fee not required to cover University liabilities. The existing reserve fund would be available to compensate for any such loss and could be increased as deemed necessary to meet this risk. In the worst-case event of substantial and repeated annual deductions in fee, the University continues to have the additional option of terminating the contracts on 18 months' notice to the government.

The first of these two procedures has become a permanent part of DOE contracting and is being incorporated into all DOE contracts as they are awarded or extended. It is termed "conditional payment of fee" and is prescribed in the DOE Acquisition Regulations. The clause proposed for the UC contract is based in part on requirements of recent federal legislation directing the Department to adopt a schedule of fee reductions to provide incentives for the proper safeguarding of classified information. Both the partially at-risk base fee and the fully at-risk fee are subject to reduction under this clause; however, the clause leaves the local contracting officer significant discretion in setting any actual fee reduction. Managers of the DOE offices in Oakland and Albuquerque have issued a letter of intent acknowledging the nonprofit and State entity status of the University and stating further that in setting any fee reductions under this clause it is not their intent to place the University in a net loss position after consideration of other costs borne by the University during the period for which the fee is paid. The legal effect of that letter of intent remains to be determined.

The second of these procedures is a special, one-time initiative that will have a limited duration. It identifies key milestones and objectives for the implementation of management improvements identified by the University and is intended to ensure that the University's performance at Livermore and Los Alamos meets the Department's expectations. Only the fully at-risk portion of the available fee is subject to reduction under this provision, which allows the Department to reduce that fee in the event the University fails to pass certain performance requirements. Those requirements relate primarily to facility safety, safeguards and security, construction project management, skilled personnel recruitment, and effective oversight. That provision will expire after two years. To the extent the fully at-risk fee is not reduced by this new position, it will remain available to be earned in accordance with the existing procedures.

Finally, Mr. Holst pointed out that there has been one development that has reduced, at least for the present, the University's loss exposure potential, and that is the recent U.S. Supreme Court decision in connection with the False Claims Act and the ruling that the University, as a State entity, is not subject to suit by individual claimants under the Act.

Committee Vice Chair Miura asked how the performance fee is assessed and by whom. Mr. Van Ness explained that there is a self-assessment by the laboratory which is reviewed by the Office of the President, and the final rating is established by DOE.

Regent Lansing asked whether the University is technically responsible for security at the laboratories and whether the University is sufficiently protected in the event of an accident. Mr. Van Ness responded that the University is responsible for the implementation of security policy as set by the Department of Energy at the laboratories. General Counsel Holst reiterated that it is the judgment of his Office that the University has been and continues to be sufficiently protected from risk.

[For speakers' comments, refer to the minutes of the January 18 meeting of the Committee of the Whole.]

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

The meeting adjourned at 2:55 p.m.

Attest:

Secretary