Office of the President

TO MEMBERS OF THE COMMITTEE ON OVERSIGHT OF THE DEPARTMENT OF ENERGY LABORATORIES:

ACTION ITEM

For Meeting of September 16, 2015

APPROVAL OF A SUBSTANTIVE MODIFICATION TO THE LOS ALAMOS NATIONAL SECURITY, LLC OPERATING AGREEMENT AND A PERFORMANCE GUARANTEE TO ENABLE THE TRANSITION OF CERTAIN LEGACY ENVIRONMENTAL WORK AT THE LOS ALAMOS NATIONAL LABORATORY FROM THE CURRENT PRIME CONTRACT TO A NEW PRIME CONTRACT WITH THE DEPARTMENT OF ENERGY

EXECUTIVE SUMMARY

The Secretary of Energy has directed the transition of the Los Alamos National Laboratory (LANL) legacy environmental remediation (ER) work from the current prime contract with the Department of Energy (DOE)/National Nuclear Security Administration (NNSA) to a new prime contract with the DOE Office of Environmental Management (DOE/EM). The legacy ER work scope comprises about eight percent ($150 million) of the approximately $2 billion total LANL annual budget. If approved by all Los Alamos National Security LLC, (LANS) members, LANS would perform the new prime contract for DOE/EM for a one- to two-year period pending DOE/EM’s selection of a new contractor for the legacy ER work. Contract risks of the new DOE/EM prime contract are commensurate with the existing DOE/NNSA prime contract, coupled with a more than twofold increase in fee-earning potential. The Secretary of Energy’s initiative to realign the legacy ER work under DOE/EM is a response to the operational and oversight deficiencies that resulted in breach of a LANL waste drum at the DOE Waste Isolation Pilot Plant (WIPP) transuranic waste repository in New Mexico, which resulted in its prolonged shutdown, a reduction in fee for LANS, and the assessment by the State of New Mexico of unprecedented fines. The LANL Director (and President of LANS) has taken decisive and substantial steps to rectify the operational deficiencies, and the Laboratory is now better positioned to execute the legacy ER work under this new DOE/EM prime contract. The fines levied by the State of New Mexico for the WIPP incident have since been resolved without additional financial liability to LANS.

1 Of interest to the Committee on Finance.
RECOMMENDATION

The President of the University recommends that the Committee on Oversight of the Department of Energy (DOE) Laboratories recommend to the Regents that the President be authorized to enter into such written agreements as are necessary to accomplish:

1. A substantive modification to the Los Alamos National Security, LLC (LANS) Operating Agreement that will allow LANS to transition on-going legacy environmental remediation (ER) work at the Los Alamos National Laboratory from the current prime contract to a new prime contract with DOE.

2. The transfer of the University’s existing performance guarantee for the legacy ER scope of work to the new DOE prime contract and any other actions as may be necessary to authorize LANS to execute the new DOE prime contract.

BACKGROUND

Los Alamos National Laboratory (LANL) is a national security research facility operated under the auspices of the Department of Energy (DOE)/National Nuclear Security Administration (NNSA). The University is a member of the limited liability company (LLC) – Los Alamos National Security, LLC (LANS) – that holds the DOE/NNSA prime contract to manage and operate (M&O contract) LANL. This prime contract went into effect in 2005, and currently extends through 2017, unless further extended under the award-term provisions of the contract (based on performance) or otherwise modified by DOE.

In order to realign and improve the oversight within DOE of the LANL legacy environmental remediation (ER) work in response to the breach of a LANL waste drum at the Waste Isolation Pilot Plant (WIPP), the Secretary of Energy directed that oversight for this work would be transitioned from DOE/NNSA to the organization within DOE responsible for ER work throughout the DOE complex, namely the DOE Office of Environmental Management (DOE/EM). Accordingly, DOE requires that the legacy ER work at LANL be de-scoped from the DOE/NNSA prime contract and transitioned to a separately negotiated prime contract, to be administered by DOE/EM.

The term of the new prime contract is for a period of up to two years, consisting of a one-year base period, with two six-month option periods. After such time, the work would be transitioned to a new, follow-on prime contractor, to be selected by DOE/EM through a federal Request for Proposal process. It should be noted that DOE/EM may not exercise an option to extend the DOE/EM contract in the event that the DOE/NNSA (M&O) prime contract either had already expired or is set to expire during the six-month option period. The proposed effective date for the new LANS-DOE/EM prime contract is October 1, 2015. The legacy ER work has about a $150 million annual budget, out of a total LANL annual budget of about $2 billion.

LANS’s execution of the new DOE/EM prime contract is contingent upon the unanimous approval of all LLC members, including the University. Without such approval, LANS likely
would continue to perform the legacy ER work under the DOE/NNSA prime contract, with significant negative impacts on LANS’ working relationship with DOE/NNSA (and derivatively the University’s relationship with the Secretary of Energy and DOE as a whole), LANS’ potential for earning performance fee, and award-term extension of the DOE/NNSA (M&O) contract.

In response to the Secretary’s direction, the LANS Executive Committee approved the formation of a LANS team to enter into negotiations with DOE/EM representatives. The team consisted of key, high-level LANS executives and representatives of the LLC members, including representatives of the UC Office of General Counsel and the UC Office of the National Laboratories. Negotiations were expressly premised on the need for unanimous LLC member approval of any resulting contract. The LANS team initially proposed solutions that would allow DOE/EM to direct the legacy ER work under either the current prime contract with DOE/NNSA, or a newly executed prime contract with DOE/EM identical to the current prime contract. After deliberations, DOE leadership rejected these proposals as inconsistent with legal constraints on NNSA and with DOE’s desire to transition to a contract with a more rigorous and prescriptive change control process than the current prime contract with DOE/NNSA. Negotiations concluded in early August, at which time the LANS team presented the proposed contract for member approval.

**Summary of the New Prime Contract**

A summary of the new prime contract’s operational parameters, terms and conditions, and risks are set forth in the sections below.

**LANL Operations under the New Prime Contract**

LANL’s day-to-day performance of the legacy ER work will continue without significant change under the new prime contract. LANL will continue to provide contract services for that scope of work, with the same employees, and under current pay structures and benefit programs. LANL will use its current business and program systems (e.g., payroll, contracting, accounting, human resources policies, etc.) without modification. DOE will continue to fund the work, and LANL will continue to draw down funds for the work through the existing Letter of Credit authorized by the U.S. Treasury. Execution of the work will continue under the direction of the Laboratory Director and his staff, subject to the governance functions of the LANS Board of Governors. The new prime contract would require some modest changes from current operational practice, including new interfaces with DOE/EM, administration of a more disciplined and robust contract management and change control process, and increased legacy ER work oversight and direction from federal employees.

**Prime Contract Terms and Conditions**

The LANS negotiating team was successful in getting most of the contract terms and conditions of the existing DOE/NNSA prime contract included in the new DOE/EM prime contract. The contract remains a cost-reimbursement type contract, with a fixed and performance fee, that is
based on federal procurement regulations. Overall, the contract largely mirrors the terms and conditions in the current DOE/NNSA prime M&O contract, which will allow the two contracts to be consistently managed. Two key differences in the new DOE/EM prime contract versus the existing DOE/NNSA contract are the highly formalized provisions for changing contract cost, scope, and schedule, and an increase in both fixed and performance fee.

Risk Assessment

Key risk elements for the DOE/EM contract are contract performance and reputational risk, environmental compliance-related risks, third-party litigation risks, and the risk-balancing function of fee that can be earned by LANS under the contract. Although the risks of each of these individual elements may be slightly changed, the overall contract risks associated with the new DOE/EM contract on balance are commensurate with the existing DOE/NNSA contract.

There is a slight increase in contract performance and reputational risk arising from the need to administer a new contract, engage with a new DOE/EM customer, manage direction from two DOE organizations, and implement a more rigorous contract change control system. Measures that will be employed to mitigate these risks include: (1) deploying contract expertise and resources from the LLC members; (2) establishing (pursuant to contract requirements) a Steering Committee charged with addressing priorities and resolving conflicts between DOE/NNSA and DOE/EM; and (3) developing and implementing a transition plan to accomplish the necessary administrative and organizational adjustments needed for execution of the new DOE/EM prime contract.

The WIPP incident – that resulted in LANS earning in fiscal year 2014 only a small fraction of the fee historically earned under the DOE/NNSA prime contract – revealed a number of operational and programmatic deficiencies. The Laboratory Director has taken decisive steps to rectify these deficiencies, including instituting new leadership at LANL for its environmental programs, implementing a comprehensive corrective action plan to bring LANL’s waste management procedures and operations into compliance with its hazardous waste permit and associated requirements, and improving processes and methodologies for waste characterization, internal communication, and change-control. Accordingly, LANL is much better positioned to complete the work under the DOE/EM prime contract, and an independent review by LLC member representatives found that LANL is ready for project execution, with recommendations for additional improvements that LANL will be implementing. It should be noted that the scope of work under the DOE/EM prime contract does not include any additional shipments of waste to WIPP, and the fines levied by the State of New Mexico for the WIPP incident have been resolved, without additional financial liability to LANS.

The risks associated with potential environmental-related liabilities are decreased under the DOE/EM contract. This risk reduction is primarily a function of the total segregation of the performance evaluations of the two prime contracts. If DOE sought to reduce the fee paid to LANS for environmental violations related to the legacy ER work, such fee reduction would be limited to the smaller fee base (~$10 million) available under the DOE/EM prime contract. The much larger fee available under the DOE/NNSA prime M&O contract would be insulated from
any such fee reduction associated with legacy ER work performed under the DOE/EM contract. Accordingly, it would be unlikely for LANS to experience again the type of fee reduction that accompanied the WIPP event in fiscal year 2014, when DOE/NNSA reduced the earned fee by about $36 million.

With respect to third-party litigation liabilities, the employment litigation risk (some costs of which may not be reimbursable under federal procurement policy) is slightly higher due to the transition of the legacy ER work scope to the follow-on contractor and associated staffing and morale issues. This risk will be partially offset by LANL’s plans for establishing clear lines of communication with employees about the transition and the relatively higher fee available under the DOE/EM contract for the legacy ER scope of work.

Significantly, the risks associated with the DOE/EM prime contract and the associated legacy ER work will be realized only for up to a two-year period, at which time the contract expires according to its terms, after which a new contractor would be responsible for the scope of work.

The LANS team negotiated a more favorable fee structure than is now available under the current DOE/NNSA contract. Under the existing contract, LANS earns a fixed fee equal to about 0.9 percent of the operating budget and can earn a performance fee equal up to about 2.1 percent of that budget. In contrast, under the DOE/EM contract for the legacy ER scope of work, LANS earns one percent in base fee and up to six percent in performance fee. Accordingly, LANS stands to earn higher revenue from performance of the legacy ER work under the new DOE/EM prime contract than if the work were to continue under the existing DOE/NNSA prime contract. The additional revenue is expected to help to further offset the contract and financial risks associated with the new DOE/EM prime contract and provides an increased level of financial protection to LANS (and derivatively to the University) compared with the existing DOE/NNSA contract.

On balance, the risks associated with the new contract are generally level with the risks under the current DOE/NNSA contract, and there will be additional available fee to offset such risks.

Performance Guarantee

The DOE requires performance guarantees from each of the LLC members, including the University, to ensure that DOE has recourse to a viable entity in the event the LLC can no longer fulfill its contractual obligations. The University already executed such a guarantee in support of the current DOE/NNSA prime M&O contracts with LANS (under which LANS has historically performed the legacy ER work) and Lawrence Livermore National Security, LLC. Accordingly, the execution of a new guarantee does not, of itself, increase the University’s risk; it only ensures continuity of that existing guarantee to the limited scope of work that is being transferred to the new prime contract.
Financial Implications for the University

The financial implications for the University remain fundamentally unchanged under the two prime contracts, except that the University stands to earn slightly more revenue from performance fee. The LLC structure will continue to provide “corporate shield” protection for the University with respect to any third-party (non-DOE) claims against LANS, including environmental fines/penalties. Any DOE claims against the University pursuant to the performance guarantee are not expected to exceed LANS fee revenue, consistent with historical experience, and as additional protection, the University has set aside a total of about $16 million in contingency funds that will be available for University liabilities.

Regents’ Approval Required

In order for LANS to be able to enter into the new DOE/EM prime contract, it is necessary to execute a substantive change to the LANS Operating Agreement to clarify that a purpose of the LLC is to perform legacy ER work in accordance with a prime contract with DOE/EM. Amendments to the LANS Operating Agreement require member approval. Pursuant to Standing Order 100.4(dd)(2), Regents’ approval is required for the President to execute said member approval of substantive modifications to the LANS Operating Agreement. Similarly, in order for LANS to execute the new DOE/EM prime contract, the LLC Members, including the University, must execute a new performance guarantee. Pursuant to Standing Order 100.4(dd)(9), Regents’ approval is required for the President to execute said performance guarantee, under which the University would assume liability for conduct of persons other than University officers, agents, employees, students, invitees, and guests.

Next Steps

Following approval of the Regents, the President would approve, on behalf of the University, the amendments to the LLC Operating Agreement and the performance guarantee that is an integral part of the new DOE/EM prime contract. Review and approvals by the other LANS Members are required and are underway. Approvals of the LLC Operating Agreement amendments and performance guarantee from all members would be required prior to LANS’ execution of the DOE/EM prime contract, which is targeted to become effective October 1 of this year.

Key to Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>DOE</td>
<td>Department of Energy</td>
</tr>
<tr>
<td>EM</td>
<td>Office of Environmental Management</td>
</tr>
<tr>
<td>ER</td>
<td>Environmental Remediation</td>
</tr>
<tr>
<td>LANL</td>
<td>Los Alamos National Laboratory</td>
</tr>
<tr>
<td>LANS</td>
<td>Los Alamos National Security, LLC</td>
</tr>
<tr>
<td>LLC</td>
<td>Limited Liability Company</td>
</tr>
<tr>
<td>M&amp;O</td>
<td>Management and Operation</td>
</tr>
<tr>
<td>NNSA</td>
<td>National Nuclear Security Administration</td>
</tr>
<tr>
<td>WIPP</td>
<td>Waste Isolation Pilot Plant</td>
</tr>
</tbody>
</table>